Economic Viewpoint

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Must we Dread Deflation's Dangers?

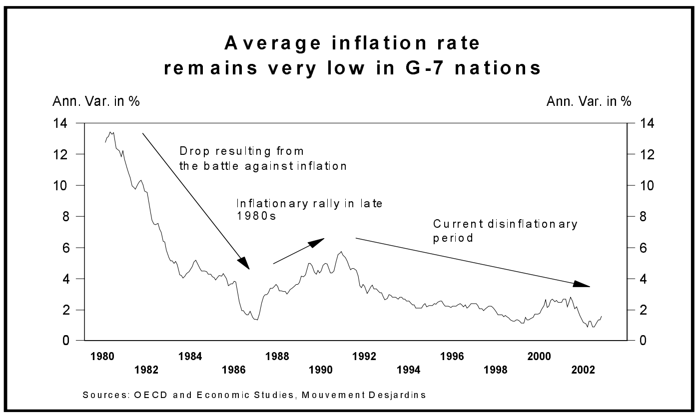
This rare economic occurrence must be feared like the scourge

Alarmed by the excessive accumulation of production capacities, an extremely high level of both household and business indebtedness, and sluggish economic growth in several major industrialized countries, many observers are beginning to believe that the scourge of deflation has returned.

For most people, the very notion of deflation remains theoretical as very few of us have lived through the dreadful experience that is a *deflationary period*. With the exception of Japan that has been grappling with deflation since 1995, the last truly deflationary period dates back to the 1930s, or the Great Depression.

What is this scourge?

"Deflation" occurs when prices in general are on a downward spiral. It is the direct opposite of inflation. It must not be confused with disinflation which is a diminishing pace in the increase of prices – or inflation – , as we have traversed since the early 1980s.



Generally, an extended deflationary period causes global demand and production to spiral downward and usually degenerates into a harsh recession which can often lead to an economic depression.

One of the initial effects of deflation is shrinking consumer spending since, in a context of falling prices, consumers will want to wait for further drops before making purchases.

This drop is followed by a downturn in business revenues and profits, which will eventually curb salary hikes and job creation, and might lead to massive layoffs. Fixed nominal salaries which, in a context of falling prices, push real wages up, also causing a downturn in jobs. Once consumer spending has begun to wane, the vicious circle sets in because the drop in household spending generates a further drop in business revenues.

Deflation also has a substantial impact on the track record of economic agents (households, businesses and governments) since it boosts their actual debt level and reduces the real value of their assets. This leads to supplementary credit risks and, in general, a surge in non-performing loans that can also spark bankruptcies.

Finally, a drop in price levels can very often prevent key lending rates, in real terms, to be negative as the central banks would have it in such a situation, in the hopes of stimulating the economy as much as possible. The impact of deflation goes to show to what extent this occurrence, albeit very rare, must be dreaded like the scourge.

Why do deflationary periods occur?

There are two major chains of events that spark deflation. First, a dismal event, usually economic, must take place. It can be in the realm of national wealth, with the drop of stocks and real estate asset prices, or of a structural nature, such as an overly rigid labour market. It can also be caused by geopolitical change such as Germany's reunification in the 1990s.

Second, the negative shock must be linked to a currency exchange rate policy that is out of touch with the country's context, or a monetary policy slow to react (which amplifies the downturn in economic activity and, in turn, price indices) or structural problems that prevent the economy from adjusting to these phenomena post shock.

Periods of deflation therefore appear on the heels of unfortunate events, when there is a real overvaluation of the national currency, a slow reaction or a reaction out of sync with monetary policy and structural firmness. In sum, deflation is the outcome of strategic errors in economic policies. Furthermore, it is true that the spectre of deflation

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has become more plausible lately due to the globalization of industrial production and the weakening of banks' situations in many countries.

The context of late and the context ahead

An analysis of the present-day period indicates without a doubt, that we are going through a disinflationary period that has not, however, yet reached the deflation stage. Of course, in certain sectors such as natural resources and consumer goods, and for certain countries, we have been seeing prices fall of late but, overall, global price indices are still on the rise.

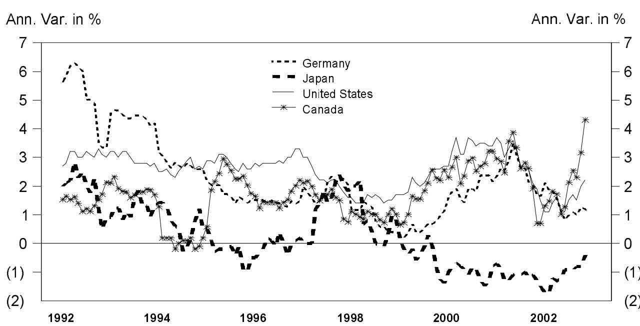
Basically, this can be explained by a sharp rise in prices in the services sector, the sector most quickly expanding in major industrialized economies. Services are not as vulnerable to international competition as is the goods market. This can be observed with the recent admittance of China into the World Trade Organization and the competition among nations of the former Soviet empire as well as new emerging countries, particularly in Asia. These countries have fanned the downward pressures on the prices of manufactured goods, mainly for less sophisticated products.

Current Deflation Factors

X: means this variable has a potentially deflationary impact	*Japan*	*Germany*	*United States*
Weakening of internal economy	XXX	XX	X
Corporate overinvestment	XXX	X	XXX
Swelling of financial bubble	XXX	X	XXX
Growing debt level of private sector	XXX	XXX	XXX
Strong competitive pressures on prices	XXX	XX	XX
Weakening of banking system	XXX	X	
Rigid nature of monetary policy	XXX	XX	
Unwavering fiscal policy	XXX	XX	
Far-reaching structural problems	XXX	XX	
Social and political paralysis	XXX	XX	
Shrinking and ageing population	XXX	XX	

Sources: The Economist and Economic Studies, Mouvement Desjardins

A rise in the level of consumer price indices has been noted recently



Sources: Datastream and Economic Studies, Mouvement Desjardins

Even if the current downturn in global economic growth has had the effect of significantly curbing inflation, the risks of generalized deflation are still quite slim, especially if the monetary authorities of the major countries concerned remain vigilant and keep expansionary monetary policies in place. Therefore, deflation must not be confused with the slower rise in prices that is an outcome of the competitive operation of the goods and labour markets, as was the case in 2001.

In Canada, that risk is almost improbable; the inflation rate has already picked up with the solid performance of our economy. In the United States, it is slightly more probable, but the risk remains quite slim. Sustained by increases in the price of services, particularly in the medical and insurance realms, the growth of the Consumer Price Index has, after having slowed somewhat during the recession, recently topped the 2% mark.

Indeed, to have a deflationary climate south of the border, the economy would have to experience further setbacks and stock market prices would have to continue to fall and extend to the real estate sector. For the time being, the US central bank might lower its key lending rates still, and the US government could boost its spending and cut income tax, in addition to following a policy of a weaker dollar.

As it now stands, Germany might be the only major country, after Japan, to flirt with deflation. As in Japan, serious structural problems, inefficient economic policies and the aging of the population are factors that could lead to deflationary conditions in Germany. In addition, since the monetary and exchange policies are chosen for the entire euro-zone, the interest and exchange rates in real terms in Germany have been overly high for some time; this is why there is marked disinflation and a potential for deflation. Luckily, however, the current trend in German price indices suggests a certain stability in prices rather than deflation.

In conclusion, Japan's experience aptly shows that once the scourge of deflation has taken root, it is very difficult to oust. That is why, faced with deflationary dangers, government authorities must act quickly and firmly and not slowly and falling short.