TESTING TIMES FOR TREASURERS

THERE MAY BE MUCH TALK ABOUT DEFLATION, BUT **JEREMY PEAT** OF THE ROYAL BANK OF SCOTLAND BELIEVES IT'S DISINFLATION THAT WE SHOULD ALL BE WORRYING ABOUT.

Mentions in the media of potential perils associated with rising inflation have become scarce. A word search of the broadsheets would, I suspect, show up more references to 'deflation' than 'inflation'. But is this really a risk for this economy and our key trading partners in the US and the core of the eurozone? In sum, my answer is that deflation is probably not a major and imminent risk – with the odd exception – but that the phenomenon of disinflation is likely to be with us for many a moon.

DEFLATION STEMS FROM THE DEMAND SIDE… Deflation is a demand-side phenomenon. It occurs when there is a sustained period in which the general price level is falling across the economy, and where both consumers and producers expect a sustained continuation of falling prices. Because these groups believe prices will fall further, they delay decisions to both consume and to invest, looking for better deals later on. The more that such delays take place, the more that aggregate consumption and investment fall back, the more that demand deficiency is consequentially experienced and the greater the tendency for a continuing trend of price falls across the economy.

Another reason for delayed investment by firms in the pernicious world of deflation is that there are unlikely to be signs that demand is set for an early recovery. Furthermore, in a world where the general price level is falling, the real value of existing debt will be increasing, thereby causing further disadvantage to households and companies and reducing their willingness and ability to spend. (In periods of rising prices, on the other hand, inflation reduces over time the real value of a given nominal level of debt.)

Although net creditors find that the (paper) value of their assets is increasing, rising real debt burdens and contracting economic activity will lead to insolvencies and inevitable worsening of bank balance sheets. In the 1930s, this type of scenario led to bank runs and bank failures.

…WHILE DISINFLATION COMES FROM THE SUPPLY SIDE. Disinflation is a state of the economic world in which some prices of goods and/or services are declining, and may possibly decline for extended periods, but as a result of supply-side shocks, rather than aggregate demand deficiency.

In the UK economy at present, there are a variety of examples of falling prices, but for specific sectors or products. Along with others in the global economy, we have, in recent years, been the subject of significant supply-side shocks. These have included technological change (in the information, communications and technology sector); regulation issues (in motor vehicles and utilities); and the emergence of major new low cost sources (for example, China) of goods across a range of sectors, with prospects ahead of new low-cost entrants on the tradable services front.

DEFLATION IS RARE. Falling prices in a deflationary environment are a symptom of an exceptionally deep economic downturn – in other words, extremely deficient demand – with output, consumption, investment and employment all in decline, and with no immediate prospect of improvement. As shown in *Figure 1*, deflation is, thankfully, rare.

Deflation is not the same as recession. In the past 100 years, the UK has experienced four bouts of recession (the 1920s-early 1930s; the early 1970s; the early 1980s; and the early 1990s). But deflation occurred in only the first of those periods. More recently, counter-cyclical policies – raising spending, reducing taxes and cutting interest rates when demand is exceptionally weak, and vice versa when demand is unsustainably strong – have been deployed to dampen down the economic cycle.

Descent into deflation requires exceptional economic circumstances, adverse shocks and sizeable economic policy errors by governments and central banks. Or, as in the 1920s and 1930s, a less sophisticated understanding of the role governments can play in smoothing economic cycles.

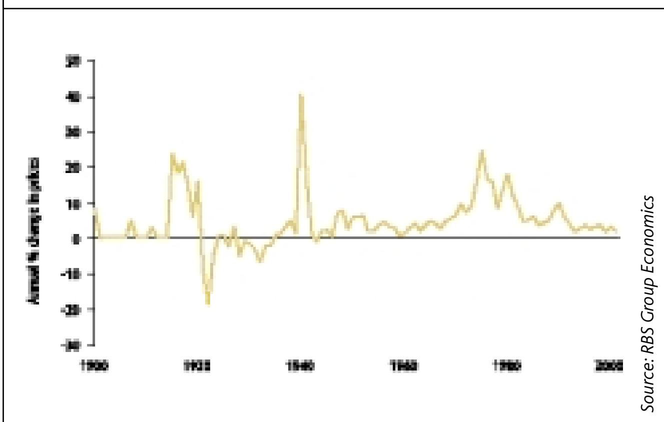
SOLVING INFLATION IS NOT EASY. Once this nasty state of affairs materialises, however, policy solutions are scarce commodities. Loosening monetary policy can work, if used in time. But even cutting rates to zero can, as Japan has discovered, fail to work when too little and/or too late. Other monetary policy interventions would likewise be problematic, as would attempting to devalue out of deflation – especially if other countries are also in a similar economic position and a set of competitive devaluations is set in train.

Loosening fiscal policy will be another option, either by cutting personal taxation to encourage consumers' expenditure or by financing public sector job creation and infrastructure/public works programmes. Unfortunately, if tax cuts or works programmes are seen as temporary while confidence is low, then extra incomes tend to be used to repair household balance sheets, paying down debt or restoring savings. Households may see this as their priority, rather than fuelling increases in consumption and hence stimulating the level of demand in the real economy.

Economists refer to the problem here as 'pushing on a string'. In these circumstances, policy interventions do not work through the economy in the manner desired. Designing and then implementing an exit strategy from deflation is immensely difficult to achieve.

USE POLICY MEASURES IN ADVANCE. It is invariably better to avoid deflation than to face the search for a cure. In the present downswing, we have seen governments across the world taking policy steps that can be seen as pre-emptive measures to reduce deflation risks. We have seen earlier, and larger than expected, interest rate cuts in the US and the UK, partially reflecting perceived deflation risks. We have seen the Reserve Board of New Zealand – famed as the first central bank in the world ever to have an inflation target – raising that target, a clear indication of a view that deflation risks worried the institution more than upside inflation risks.

FIGURE 1
DEFLATION IS RARE.



Source: RBS Group Economics

We have seen fiscal package after fiscal package in the US, sufficient to merit some censure from the venerable Alan Greenspan at the US Federal Reserve. Looking forward we are likely to see acceptance of the growing deficit in the UK, in part given a priority to ease deflation risks. Policy-makers are making strenuous efforts to keep ahead of the game.

DEALING WITH THE PROBLEM. In the UK, I see the deflation risk as limited. Certainly, manufactured goods prices have been falling for the past six years, while retail goods prices fell by 1.5% last year, and in nine of the past 12 months. But retail goods prices have fallen fastest in sub-sectors whose share in consumer spending has increased in the past six years. That does not smack of any problem over aggregate demand. Domestic demand growth has been deliberately stimulated through monetary and policy loosening, and as a result has grown more rapidly than whole-economy output in each of the past six years as a result of strong consumer demand – the first time that this has happened since the 1870s.

As for any evidence of economy-wide deflation, underlying RPIX inflation is currently at its highest level for nearly five years – having been below the 2.5% target for nearly all the previous three years. This compares with current inflation rates of 2.4% in the US and 1.1% in Germany.

Overall service price inflation reached 4.8% in 2002, its highest level for nine years, with the prices of leisure services rising at an annual rate of over 9%. Furthermore, inflation expectations (for both consumers and producers) are stable at about 2.5% and are showing no signs of falling.

Given this environment, and given continuing policy credibility, outright deflation is unlikely to occur in the UK. Were stronger signs of generalised downward demand and price pressures to emerge, then the Bank of England has ample scope to stimulate the economy, with UK interest rates well above levels in either the US or eurozone. The UK government, unhampered by the Stability and Growth Pact, has scope to stimulate the economy with fiscal policy. This should be without undue risk, given past policy prudence. The UK's current debt-to-GDP ratio, at just over 30%, is the lowest of all the major industrialised economies, and compares starkly with Japan's 150% ratio and levels well above 100% in Italy, Greece and Belgium.

COULD OTHERS BE AT RISK? The main features of deflation, as articulated above, include:

- a lack of demand in the economy;
- a sustained period in which the general price level is falling;
- prices expected to continue to fall, reducing current demand even further;
- serious monetary and fiscal policy errors;
- nominal interest rates zero, or lack of independent scope to cut rates;
- increasing debt burdens, falling activity, investment and employment;
- bank runs and bank failures;
- structural rigidities;
- banking sector fragility; and
- political paralysis.

This does not to me sound like the UK or the US. However, we are likely to face continuing pricing pressures as competition – domestically and internationally – intensifies and technological change accelerates. In some sectors, prices could fall sharply and for extended periods. In other words, disinflation will be rife. This phenomenon may pose less critical macro policy responses, but across the corporate sector a combination of transformational change and productivity improvement will mean no shortage of challenge ahead.

For others, with less scope for, or willingness to carry through, policy response, deflation risks may be greater – especially if the present phase of sub-trend global growth were to continue for longer than anticipated. Obviously here the finger can be pointed at those economies at the core of the eurozone, Germany in particular, where inflation is already well below the average for the zone.

Germany has no independent scope to cut interest rates. The 'one-best-fits-all' policy of the European Central Bank will tend to result in higher than optimal – for Germany – real interest rates. When coupled with a cautious approach and policy targets with a deflationary bias, the risk is apparent. On the fiscal front the Stability Pact acts as a significant constraint. Structural rigidities abound and a real commitment to policy change is not yet evident. Watch this space.

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