



## Deflating Expectations About Falling Prices

Be careful what you wish for—especially if it's lower prices for the things you buy. Spread across the entire economy, that spells deflation.

The D word is suddenly popping up across the economic landscape. Some armchair economists think deflation is a logical extension of falling inflation. Well-publicized rollbacks on gasoline and car prices spur the feeling that prices are declining across the board. Feeding the hype is speculation that Japan is exporting its deflation to the United States. When Japan cuts prices on cars, competitors here feel they must follow suit to preserve their market share.

Naturally, the prospect of saving money appeals to American consumers, especially after decades of inflation. But the person who wishes that all prices would fall isn't thinking very far ahead.

Producers can't absorb price cuts forever. Many of their costs—wages, insurance and rent—are fixed. When all the "fat" is cut, layoffs begin, triggering a downward spiral. Laid-off workers begin pinching pennies. Demand drops, further depressing prices. More people are laid off, and the cycle is repeated. As profits shrink, stocks tank. Your and my 401(k) suffer, while other assets—land and housing—lose value. Eventually, desperate firms start cutting wages, too. In such a scenario, even those with money don't spend it because they think tomor-

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row's bargains will outshine today's. This same mindset greatly extended the Great Depression of the 1930s.

Should we be worried now?

No. Despite a few red flags waving, we are not experiencing true deflation. Just because your jeans and your SUV cost less today than a year ago doesn't mean prices in general are falling. Is the bill at your favorite restaurant lower? Has your child's college slashed tuition—or even kept it the same? True deflation occurs when prices are falling in most segments of the economy, not in just two or three. And the overall decline must be lasting, not momentary. Sure, inflation indexes have shown some tiny monthly declines since last fall, mainly because of the Sept. 11 tragedy. But the inflation rate for all of last year still neared 2 percent.

Contrast this situation with that of Japan, which has been suffering more than any other country from textbook deflation. Prices have declined across the board, even in the once lofty real estate market. The value of the Nikkei equity price index has dropped from almost 40,000 in late 1989 to around 11,000 today. The losses in U.S. indexes don't compare.

Japan's problems are blamed, in large part, on its central bank, which has failed to boost liquidity. The Fed once had the same problem—70 years ago. Most economic historians say that the Fed's refusal to make money readily available during the Depression worsened and lengthened the hard times. But the Fed long ago learned its lesson. It has ensured liquidity during every major crisis of the past generation, including after Sept. 11.

Some critics say, however, that the Fed has no ammunition left to stimulate the economy, given that its target for the federal funds rate is already below the rate of inflation. But the target is still well above zero. And our economy has started to respond. Before long, people will again be talking about the risk of rising prices.

# President's Message

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*William Poole*