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Deflation: The Basics

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The idea of deflation has gotten more play in the press over the last two weeks than it has over the last ten years -- thanks to unusual negative readings in government price statistics such as personal consumption expenditures, import prices, the Producer Price Index and the Consumer Price Index. That's great news for those of us who have been warning of deflation for years (see “Still Think Deflation's Just a Bugaboo?” November 15, 2001) -- we are delighted to have this important issue go mainstream.

On the other hand, most of the recent media coverage and Wall Street analysis of deflation has been largely misinformation, or even disinformation. This and my next several commentaries are intended to identify and correct the most common errors. Today I'll talk about the basic definition of deflation, and over the next few days I'll discuss the relationship between deflation and the business cycle, and the idea of whether there is such thing as what some commentators are currently calling “good deflation” and “bad deflation.”

But now, let's begin at the beginning. The most important and most persistent error is one of basic definition. So let's clear it up. This is what deflation is: *deflation is the revaluation of the monetary unit of account.* In the US, the monetary unit of account is the dollar. When it is revalued, the nominal value of goods and services measured in dollars goes down.

Deflation is *a monetary process* and falling prices are an eventual result of it. As a monetary process, it is totally a function the **Federal Reserve's** management of monetary policy. It has nothing to do with the business cycle, productivity, taxes, booms and busts or anything else -- except insofar as these things provide the backdrop against which the Fed must find the right monetary policy.

Think of the dollar as being like any other unit of measurement defined by the government, such as the mile or the ounce. If the government were to arbitrarily revalue the mile to consist of 10,560 feet instead of 5,280 feet, then with the stroke of a pen San Francisco Airport would go from being 25 miles from my home to being only 12-1/2 miles from it.

Why is this important? It wouldn't really matter to me if I were walking home from the airport, because SFO and my house haven't really gotten any closer to each other. But it would surely matter if I were taking a cab, and the driver and I had a long-standing deal in which he promised to drive me home for $2 per mile. Instead of collecting $50 for the trip as he always had, now he'd collect only $25. Chances are, under theses circumstances, he'd decide to take the day off whenever he saw me coming out of baggage claim. And that's how arbitrary changes in units of measurement wreak havoc throughout an economy -- the arbitrary losers, like the taxi driver, have to default on the bad deals they find themselves stuck with.

Not seeing it? Well, think of the dollar as something more simple and more concrete than the dollar really is. Imagine that the dollar were embodied as one-dollar certificates, each exchangeable at the **Treasury** for one loaf of bread. One day, the government announces that it will make all the certificates in circulation exchangeable for *two* loaves of bread instead of one. Throughout the economy goods and services that had been measured and contracted for in

dollars -- that used dollars as a unit of account -- would have to be revised as quickly as possible. Of course a loaf of bread at the grocery store would go from $1 to 50 cents instantly -- and anything else that could be quickly and easily repriced would be repriced.

But long-term contracts could not be repriced. Anyone entitled to payments in dollars would get a windfall, and anyone making such payments would be ruined. Dollar debtors would have to give up twice as many loaves of bread to dollar creditors for the same goods and services. Going back to the taxi example above, and assuming that the mile had remained constant, now the driver would be the winner and I would be the loser. He'd now get 100 loaves of bread for his $50 ride instead of only 50 loaves. Chances are, under those circumstances, I'd decide to walk. And then we'd *both* be losers: I'd have sore feet, and he'd have lost a good customer.

Now let's step away from the example, and back into reality. Dollars aren't exchangeable at the Treasury for bread, or gold, or anything else. So the Federal Reserve can't revalue the dollar and trigger a deflation by changing the terms of exchange explicitly. But dollars *do* contain something of concrete value: each dollar is a claim on a little slice of the massive loaf of bread that is the US economy. And the Fed can add *more* value -- more "bread" as it were -- to each dollar *by issuing too few dollars* in relation to the size of the economy on which the dollar is a claim. That makes each dollar a proportionately larger claim on the economy -- each dollar effectively contains more value, more "bread." When that happens, the dollar price of any goods and services that can be repriced will drop, because the dollar itself has become more valuable: the unit of account has been revalued.

If this is difficult to visualize, then consider the *opposite* condition in which the Fed issues too *much* money in relation to the size of the economy and the demand for money as a medium of trade. In that case, the dollar represents too little value, too little "bread." The unit of account has not been *re*valued, but rather *de*valued -- and people will therefore demand more dollars for any goods and services that can be repriced. The price of things, in dollars, goes up. This is, of course, *inflation*. And we've all seen how *that* works. Well, deflation is the same thing, upside-down.

The Fed's job -- at least ideally -- is to preserve the stability of the value of the monetary unit of account. No inflation, no deflation. Unfortunately, maintaining the unit of account is not as easy as maintaining a constant value for a unit of measurement such as the meter. The meter is defined as the distance that light from an iodine stabilized laser travels in a vacuum in 1/299,792,458 of a second. But there is no iodine stabilized laser that can be applied to the dollar, to make sure it represents a stable claim on the output of the economy. And even if there were, a political institution like the Fed may deliberately choose to destabilize the unit of account in one direction or another in an attempt to manipulate the business cycle.

But market participants do have ways to judge the stability of the monetary unit of account, and to prepare themselves for the terrible consequences of inflation or deflation. The best technique is to observe the behavior of those goods that can be most quickly repriced in reaction to a possible change in the value of the unit of account, and goods that are least likely to be influenced by any non-monetary factors. Many observers favor gold as the monetary equivalent of an iodine stabilized laser -- it can be instantaneously repriced in the spot commodities markets and there are relatively few outside influences changing its supply or demand: its supply is fairly fixed, and the industrial demand for it is small. Other commodities can serve, as well -- as can foreign currencies. All of these have been pointing to deflation for years.

Oddly, among the *worst* indicators of changes in the unit of account are the broad price indices such as the PPI and the CPI. These indices are ridiculously complex, and subject to all manner

of measurement error and bias. But even if they were perfect, they include so many goods and services based on long-term contracts that they will always be deeply lagging indicators. They will never serve as a monetary diagnostician -- at best, they can be a monetary coroner.

And that's where we are today. I'm glad the press and the Wall Street economists are *finally* waking up to the reality of deflation because the broad price indices are *finally* beginning to show it. But the pundits act as though the declines in these indices *are themselves* deflation, when in fact they are *the result* of deflation. And the pundits act as though the deflation they see reflected in falling prices is the result of economic slowdown, or a drop in productivity, or the aftermath of the tech-wreck or the September 11 terrorist attacks. It is not, primarily, any of those things. It is the creature of mistaken policy by the Federal Reserve.

Deflation, usefully understood, *is the revaluation of the monetary unit of account.* TM