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# Deflation, Reflation, Exasperation

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**Widespread misunderstanding of today's deflation threat may be as dangerous as deflation itself.**

In the late 1990s we were among the very first economists to identify **the Fed's** deflationary monetary errors. But the mainstream economics community and the media disregarded deflation until very recently, when the Fed -- after five years of denial -- belatedly pointed to the potential risk. Deflation is no longer ignored -- but it is deeply misunderstood. And that poses its own new kind of danger -- the risk of acting against a deflationary threat that no longer really exists.

**Paul Krugman**, the ***New York Times'*** leftist economics columnist, provides an important example of that misunderstanding with his column Saturday, "Fear of a Quagmire?" Krugman warns about the potentially calamitous deflationary consequences of a supposed "liquidity trap." In reality, though Krugman refers to his published academic work on the subject, the column exposes with near-perfect clarity the fallacious reasoning behind much of the **neo-Keynesian** claim that the US now risks falling into a deflationary chasm. If Krugman -- who sidelines as a **Princeton** Ph. D. economist and is sometimes mooted as a future **Nobel** candidate -- is presenting the deflation alarmists' best case, the risk is a tiny one indeed.

Actually, Krugman gets off to a fairly promising start. "Ordinarily," he says, "deflation...is easy to fight. All the central bank has to do is print more money, and put it in the hands of banks." True enough. Since deflation -- a sustained rise in the value of the unit of account against the goods and services for which it exchanges -- results from a scarcity of monetary liquidity relative to demand, more central bank money-printing is critical to reflation -- *i.e.*, reversing deflationary pressures.

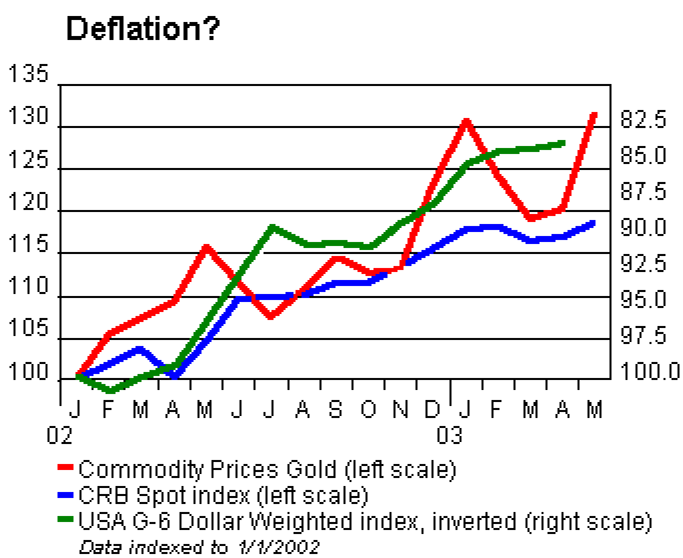
It quickly becomes clear, though, that these classical, time-tested monetary principles are not what Krugman has in mind, as he proceeds to catalog many of the misconceptions currently generating so much confusion and misinformation about deflation risk. For Krugman and the Keynesian "mainstream" of which he is a leading light, the function of central banking is not to stabilize the purchasing power of the currency by balancing supply and demand for dollar liquidity. Rather, it is to manipulate interest rates so as to provide banks with enough cash to support a desired level of lending and so maintain sufficient rates of economic growth.

In this conception, "monetary policy loses its effectiveness" and an economy "is likely to slide into deflation" when it is affected by "such a deep malaise that pushing interest rates all the way to zero" isn't enough to spur growth. "Then you're in a liquidity trap," Krugman says, "additional cash pumped into the economy -- added liquidity -- sits idle, because there's no point in lending money out if you don't receive any reward."

But an economy doesn't "slide into deflation" due to a lack of lending. Quite the contrary, as prices fall, the burden of repaying existing debt rises, squeezing borrowers and putting the asset portfolio of lenders at risk. That leads to growing risk aversion in the financial system, rising risk premia and less credit creation. Lending stagnates along with a falling price level, but the cause and effect relationship is exactly the opposite of Krugman's formulation.

The dreaded "liquidity trap," meanwhile, is akin to an urban legend springing from this conceptual confusion. In practice, central banking in the post-Bretton Woods era has largely -- though with important exceptions -- conformed to the rate-manipulation doctrine. But to recognize that that has been the operational orientation of choice the past three decades in no way implies that the powers of monetary policymaking are necessarily limited to the mechanics of interest-rate targeting. As **Fed Governor Ben Bernanke** observed in a speech last fall, the Fed has an important tool at its disposal -- the monetary printing press -- that would allow it to directly inject essentially unlimited quantities of liquidity into the financial system if need be. **Fed Chairman Alan Greenspan** has reiterated on several occasions that the central bank could easily provide liquidity by jettisoning the rate-targeting regime and focusing its open market purchases on longer-term maturities.

For Krugman, raising the specter of deflation gloom-and-doom is no doubt wrapped up in his liberal, anti-**Bush** political agenda. Perhaps he will next regale us with a disquisition on the dangers of a declining dollar without once pausing to acknowledge the obvious contradiction -- that a dollar falling in value cannot at the same time present a risk of a deflationary rise in real purchasing power. But if Krugman can, in a sense, be excused based on his overt political partisanship, the incognizance of much of the financial media and pundit community -- bemoaning mounting deflation risk while simultaneously declaring that the dollar is doomed -- is not easily explained.




To date, the dollar's fall since early last year has been almost an entirely salutary event, unwinding nearly the entirety of the deflationary policy error previously transmitted by the Fed. Whether measured in terms of foreign exchange, gold or broader commodity indexes, the dollar has reflated to levels not seen since the late 1990s, after deflating by upwards of 30% in the earlier four- to five-year period. The U.S. equity market certainly shows no inkling of the dollar treading on dangerous ground. The period since early April during which the dollar's decline has accelerated has also witnessed one of the more encouraging stock market rallies of the past few years. Indeed, from our perspective, the convincing reversal of the last of the deflationary influences has been a significant factor in the equity rally, offering real hope for its sustainability.

While speculation centers on action the Fed might yet take to subdue any remaining deflation pressures, our analysis is that the central bank effected a marked shift in its operational posture some six months ago to provide the needed dollar liquidity. That can be seen in the expansion of its balance sheet, which has gone from a year-on-year rate of 7-8% to a range around 10.5%, marking the Fed's most generous, sustained stance in a decade. At this point, we would not be sanguine about the consequences of further significant ease, as the Fed would soon risk drifting into a posture of inflationary overshoot. Our reading, however, is that Greenspan is reluctant to sanction further action, and has hinted at the possibility largely to maintain the appearance of consensus within the **FOMC**. TM