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Is Deflation Coming?

Judging from the spate of newspaper articles and commentary on the subject, many analysts are becoming increasingly concerned about the possibility of sustained deflation, which was last prevalent during the Great Depression, when it was viewed as a source of economic turmoil.

Those who fear deflation argue that U.S. monetary policy has been unduly tight at the wrong time—when financial asset prices are at unsustainably high levels and when worldwide excess capacity has severely constrained firms' ability to maintain or raise prices. The recent plummet of gold prices, many believe, can be viewed as one piece of supporting evidence for these assertions. Those who raise the specter of deflation in the United States, though, would be wise to consider a few additional facts.

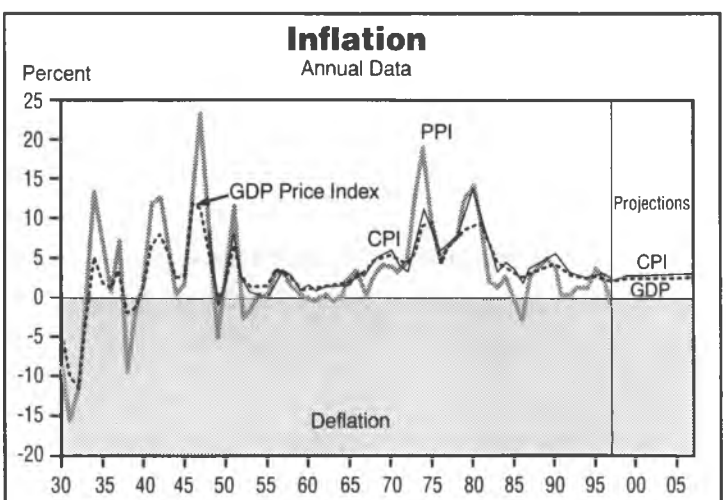
To begin with, *disinflation*, which has been seen in the United States for the past few years, is not the same as *deflation*. The latter is an ongoing decrease in the aggregate price level—the opposite of inflation. The former occurs when the price index rises at a slower rate—for example, 2 percent inflation versus 3 percent inflation. Second, changes in relative prices can sometimes give the impression that all prices are declining. For example, the PPI declined over each of the first seven months of 1997, due partly to lower food and energy prices. However, the PPI is not a good measure of the aggregate price level. Rather, it is a subset of it. Moreover, as the chart shows, the PPI fluctuates quite a bit in response to these transitory influences—especially relative to broader price indexes.

Many people instead regard the consumer price index (CPI) as a good proxy for the aggregate price level because of its widespread use for cost-of-living adjustments. The broadest measure of the price level is the GDP chain-type price index, which is an output price index that encompasses goods and services not captured in the CPI, such as investment goods. No matter which index one chooses to follow, however, deflation does not actually occur unless the price index declines.

Most forecasters do not expect this to occur. For example, current projections from the Congressional Budget Office expect some upward drift in the CPI and GDP price indexes over a longer-term horizon. Private-sector forecasters, as reflected by the Blue Chip consensus, are largely in agreement with this outlook. In fact, even those projecting the least inflation foresee prices increasing by an average of about 2 percent or slightly higher over the next 10 years. Thus, while both the CPI and the GDP price index have been on a disinflation track recently, and possibly expected to continue to do so, they are still far from the negative territory of deflation.

So why the recent hubbub over the possibility of deflation? Perhaps analysts are concerned that the Fed's commitment to price stability will result in brief periods of deflation. Indeed, such periods are not out of the question in a low-inflation environment, but they are not necessarily cause for alarm. In any case, the likelihood of such an event, as best forecasters can judge, is not high.

—Kevin L. Kliesen



NOTE: The values for 1997 are annualized rates of change for the first three quarters of 1997. The values for 1998 to 2007 are CBO forecasts in "The Economic and Budget Outlook: An Update," September 1997.