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Japanese Deflation Loses Something in the Translation

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> "Indeed, there is an especially pernicious, albeit remote, scenario in which inflation turns negative against a backdrop of weak aggregate demand, engendering a corrosive deflationary spiral."
>
> —Alan Greenspan, testimony before Congress, July 15, 2003

In recent months, market analysts have been reacting to comments by Federal Reserve officials, such as Chairman Greenspan's testimony before Congress quoted above, concerning the possibility of Japanese-style deflation in the United States. As the Chairman emphasized, such a possibility is remote. Why "remote"? The type of deflation under discussion here involves a long, steady price level decline, not just a temporary one- or two-month blip of deflation. But such a long price level decline would normally be supported by sustained, slow rates of monetary expansion. Japan has experienced slow rates of money growth in the past five years, but the United States has not.

The chart shows M2 growth for the United States and Japan, measured on the right axis, along with the consumer price index (CPI) inflation rate for each country, measured on the left axis. Growth is calculated as a year-over-year rate, recording the percent change in the measures from the previous year. It is evident from the chart that the relatively high rate of money growth in the United States has been associated with a positive rate of inflation, while the relatively low rate of money growth in Japan has been associated with deflation. This pattern is especially clear over the past three years, during which Japan has experienced a consistent deflation of about 1 percent per year. Money growth has been significantly faster over this horizon in the United States than in Japan, consistent with the faster rate of CPI inflation in the United States.

Assuming that Federal Reserve officials are intent on maintaining the pace of monetary expansion around the level of the past five years, the chart suggests deflation in the United States is unlikely. Possibly, a negative shock to the U.S. economy could cause a temporary decline in the price level. But most analysts would agree that, to obtain a Japanese-style deflation in the United States, the pace of monetary expansion would have to slow significantly from its present pace and remain slow for some time. Based on this thinking, the chances of deflation occurring in the United States appear to be "remote" indeed.

Of course, other factors may have influenced inflation in Japan. First and foremost, real performance has been poor, with real GDP growth near zero or negative in four of the past five years (in 2000, the economy expanded). Other problems include a large portfolio of bad loans held by commercial banks and, perhaps critically, the unanticipated nature of the onset of deflation in Japan. Still, slow or stagnant monetary expansion is a prerequisite to ongoing deflation. Recent statements, such as the quotation above, suggest U.S. monetary authorities are watching and remain ready to act decisively should deflation become more than a remote possibility. ■

A Tale of Two Countries, 1998-2003