

Disinflation

BY RENEE HALTOM

Many people know that “inflation” is a rise in the overall price level. Many people also know that “deflation” is a *fall* in the overall price level — that is, the rate of inflation is negative. But fewer people are familiar with the path from inflation to deflation: disinflation, a situation in which the inflation rate is falling. Like a runner who slows down but still propels forward, when there is disinflation, prices may still be rising, just at a slower rate than before.

Disinflation can be good news or bad news. It is a good thing if it comes from increases in productivity and technology, like those that helped keep inflation low in the late 1990s.

More commonly, disinflation is brought about by contractionary Fed policy. In such episodes, disinflation is intentional and welcome. This was especially the case during the most favorable disinflation episode in the Fed’s history: the early 1980s, when inflation (as measured by the year-over-year change in the personal consumption expenditures price index) declined from more than 11 percent in early 1980 to an average of roughly 3.5 percent in 1985. Though high inflation hasn’t been a problem since, the goal of tighter monetary policy is generally to produce modest disinflation to get inflation closer to the central bank’s target.

There is even such a thing as “opportunistic disinflation,” the name that former Fed Governor Laurence Meyer gave the monetary policy strategy of allowing the economy’s inevitable recessions to ratchet down inflation over time. Under this strategy, the central bank would sustain boom periods with low rates but jump the gun slightly on raising rates after recessions to preserve the lower rate of inflation — and the reduced inflation expectations that help keep inflation down. The result would be gradual disinflation, with perhaps some short-term cost in terms of unemployment but long-term gains in reducing the distortions of inflation. Though some have suggested this was the Fed’s strategy during the 1980s disinflation, the Fed is less commonly believed to have been following this strategy in the last 20 years, when inflation has generally been low. At those low inflation rates, opportunistic disinflation could risk reversing a recovery and tipping the economy into deflation — and large declines in the overall price level can be a self-perpetuating trap.

Policymakers tend to get particularly concerned about disinflation when inflation falls below 2 percent, the Fed’s official goal since early 2012. In recent history, there have been two notable episodes of disinflation sparking deflationary fears.

In 2003, when the economy was still limping out of the 2001 recession, core inflation — total inflation minus the volatile categories of food and energy, often a better measure of current inflation for policymaking purposes — fell steadily to 1.3 percent. And more recently, core inflation fell from 2.3 percent in mid-2008 to roughly 1 percent a year later; after climbing back up, it plunged to 1 percent again 18 months later.

In both disinflation episodes, many economists talked seriously about the risk of deflation. In 2002, former Fed Chairman Ben Bernanke, then a governor, made a famous speech outlining how to prevent something like Japan’s decades-long bout with deflation. He said the chances of deflation were quite low but also that deflation is notoriously hard to predict. That’s partly because monetary policy works with a lag and partly because it is not always obvious why inflation has fallen. For example, 2004 research by Richmond Fed economist Andrew Bauer and then-colleagues at the Atlanta Fed showed that the U.S. disinflation of the early 2000s was driven primarily by falling housing and car prices, for reasons unique to those sectors and unrelated to the economy’s overall weakness.

Therefore, Bernanke said, the very best medicine for deflation is to never get into it in the first place. Put differently: Be vigilant in disinflation episodes for threats of deflation. The Fed lowered interest rates in 2003,

with some Fed policymakers urging even larger cuts. When the Great Recession hit in 2007, by contrast, there was little doubt that monetary policy should ease aggressively. After pushing interest rates to near zero in late 2008, the Fed added some unprecedented policies, such as massive asset purchases (often called “quantitative easing,” or QE) to pump the banking system full of reserves and, hopefully, stimulate growth and mitigate any risk of deflation. When the disinflation trend resumed throughout 2010, the Fed initiated a second round of QE starting that November, and a third round began in September 2012.

Today the economy has recovered considerably; unemployment has finally fallen below 6 percent, and QE officially ended in October 2014. But inflation remains below the Fed’s goal of 2 percent. The economy seems to have improved enough that most Fed policymakers have not expressed concern about continued disinflation or outright deflation. Instead, today’s policy debate has centered on how quickly inflation is likely to return to the 2 percent goal — and accordingly, whether it is worth holding rates low for a lot longer, risking a little inflation to boost employment further. **EF**



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