

DEFLATION AND ECONOMIC GROWTH

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Joseph T. Salerno (2003) argues economic growth has occurred in periods of deflation. The Austrian School's broad understanding of deflation is underscored by the four definitions offered by Salerno (growth deflation, cash-building deflation, bank credit deflation, and confiscatory deflation). Keynesians, by contrast, define the phenomenon more narrowly, equating it with a negative Consumer Price Index (CPI) and economic contraction. The purpose of this note is to argue that economic expansions have occurred in periods of negative CPI,¹ and to challenge Keynesians to improve upon their narrow definition of deflation.

Samuelson (1998), Krugman (1998), and DeLong (1999) are examples of economists working in the Keynesian tradition who equate periods of deflation with economic contraction.

Samuelson (1998, p. 337) writes, "A deflation occurs when prices decline (which means that the rate of inflation is negative)." He writes (pp. 406-07),

The opposite of inflation is deflation, which occurs when the general level of prices is falling. Deflations have been rare in the late twentieth century. In the United States, the last time consumer prices actually fell from one year to the next was 1955. Sustained deflation, in which prices fall steadily over a period of several years, are associated with depressions, such as occurred in the 1930s or the 1890s.

The classic explanation of a liquidity trap is by Keynes (1936), cited by Krugman (1998). Krugman (p. 141) defines a "liquidity trap" as "a situation in which conventional monetary policies have become impotent, because nominal interest rates are at or near zero: injecting monetary base into the

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¹A pioneering work on deflation and economic growth in the late nineteenth century is Shields (1977). A recent example is Bordo, Lane, and Redish (2004) who conclude deflation in the period "was primarily good."

economy has no effect, because base and bonds are viewed by the private sector as perfect substitutes.” Krugman equates a liquidity trap and “the unemployment and output slump” that occurs under such circumstances as the U.S. in the 1930s or Japan in the 1990s as “what happens when an economy is trying to have deflation—a deflationary tendency that monetary expansion is powerless to prevent.”

DeLong (1999, p. 240) writes, “Thus there seems to be reason to be afraid of deflation. But there is no reason—at least not yet—to be very afraid.” He concludes (p. 241) deflation should never be tolerated: “(T)he conclusion is obvious: good monetary policy should aim for a rate of change in the price level consistently on the high side of zero.”

If deflation is truly synonymous with contraction, as Keynesians maintain, one would not find periods of negative CPI in expansions. Yet this has occurred at least six times since the Civil War (1879, 1895, 1922, 1928, 1939, and 1955). According to the National Bureau of Economic Research’s business cycle chronology, which dates to 1854, expansions occurred in the U.S. all six years.²

The Bureau of Labor Statistics (2004) published estimates that show CPI was negative for 11 years in the late nineteenth century, including 1879 and 1895. The NBER chronology shows the economy was in expansion for nine months in 1879 and 11 months in 1895 despite a negative CPI both years.

Federal Reserve Bank of Minneapolis data show CPI was negative for 13 years in the twentieth century, including 1922, 1928, 1939, and 1955. The NBER chronology shows the economy was in expansion for 12 months in each of these years.

Thornton (2003) defines *apoplithorismophobia* as “fear of deflation.” These examples of expansions in periods of negative CPI suggest some laboring in the Keynesian vineyard suffer from this malady. Unless they are willing to argue the NBER chronology is invalid they should concede deflation is not synonymous with contraction, and differentiate between *good* and *bad* deflation.³ *Good deflation* occurs when prices and interest rates decline, consumers receive more purchasing power from most assets, output expands and productivity expands due to technological innovations. *Bad deflation* occurs when prices and interest rates fall yet many consumers receive less purchasing power from most assets, output contracts and productivity declines as a result of central bank policies.

Salerno (2003) illustrates the broader Austrian School understanding of deflation. One topic for further inquiry is whether the incidence of deflation

²For an Austrian critique of the NBER approach see Rothbard (1988).

³Keynes did not differentiate between good and bad deflation but his understanding of the subject was deeper than today’s Keynesians. Keynes (1977, pp. 356–60), in a paper on the Genoa Conference and the stabilization of European exchanges considered four arguments for deflation. He concluded the first was “difficult to weigh,” found “sympathy is easier than agreement” with the second, accepted the third as “important in such a country as Germany,” and rejected the fourth as “delusion.”

early in economic expansions is linked to the ongoing elimination of malinvestments. The NBER chronology shows all six periods of negative CPI and economic growth occurred *early* in expansions. Contractions ended in March 1879, June 1897, July 1921, November 1927, June 1938, and May 1954. In each instance CPI was negative and growth occurred in the following years, early in ensuing expansions.

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