"Good Deflation:" A Critical Look at the Bogeyman of Western Economics

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To the disappointment of fortune-seekers and policymakers alike, economics is no rigorous science. It is a field riddled with theories and models that feature a high tolerance of "sometimes," "maybe," or even "probably not." Economists, therefore, hold onto their few absolutes quite dearly, and certain prescripts are repeated like mantras. Perhaps the most precious among them is this: deflation is bad. The words are so strongly associated that such a sentence is practically a truism. An aversion to any financial doctrine that could lead to deflation has guided Western financial policy for nearly 100 years since the Great Depression. It is troubling, then, that so many counterpoints exist to this philosophy so foundational to Western macroeconomics. While a wariness towards deflation is well earned, the degree to which it is shunned verges onto the dogmatic. Theoretical models and real-life examples— significantly, the entire nation of Switzerland— demonstrate that "good deflation" certainly can exist in the modern Western economy.

To continue, several key terms ought to be defined. Broadly, deflation is when the price of goods and services declines. More narrowly, the term is generally used to refer to monetary deflation, which is caused by a decrease in the supply of money itself or an increase in the demand for money such that it outstrips the current money supply, resulting in the same effect ("Deflation"). Deflation is seen to be particularly dangerous to borrowers, as they become "bound to pay their debts in money that is worth more than the money they borrowed" ("Deflation"). Historically, another fear of economists was money hoarding: if the value of a consumer's dollar will be greater tomorrow, why would they spend today? On a national scale, this could create a drop in aggregate demand, which is another way to say the total demand for everything for sale in a given economy (Kenton). This low demand would surely translate to low employment because producers need to scale down if consumers are not buying. This assumption of a necessary link between employment levels and deflation is called the Phillips curve. The noted economist and Nobel Prize winner Milton Friedman would question its validity in the 1960s. He would later be vindicated by a decade of "stagflation," a period of high inflation and unemployment spanning the 1970s (Caldwell). The Phillips curve is no longer seen as a viable predictor of long-term economic behaviour and instead is only seen in the short term. After such a debunk, why are central banks still so reticent to pursue deflation?

This trepidation was not formed in a vacuum. The longest recession in modern history, the Great Depression, ran from 1929 to 1941. Nearly a century on, there is still, amazingly, some debate surrounding the specific causes and how weighty their individual impacts were, but many unambiguous precursors have been identified (Segal). The preceding decade, often called the Roaring Twenties, was prosperous, if not somewhat modest, in terms of economic growth (Romer and Pells). This slow-and-steady approach to developing the GDP was not reflected in the stock market, which was enjoying a period of unrestrained excess and speculation. Between 1921 and 1929, stock prices would more than quadruple, reaching "levels that could not be justified by reasonable anticipations of future earnings" (Romer and Pells). It is difficult to pinpoint what broke the spell, but when a few trivial circumstances resulted in a slight decline in prices, investors lost confidence *en masse* in a panic-selling event known today as "Black Thursday," October 24, 1929.

Meanwhile, the Federal Reserve, the central bank of the United States of America, had allowed the money supply to grow by about 62% throughout the 1920s. This inflation, combined with low-interest rates, had, in many ways, contributed to the excess of the market. In an attempted course reversal that historians have widely regarded as a mistake, the Fed responded to the crisis by cutting the money supply of the US Dollar by nearly a third (Segal). With such enormous deflation, no one could be convinced to borrow or invest, even with exceptionally low-interest rates to entice them— that short-term hoarding phenomenon that would one day be described as the Phillips curve and assumed to be a foundational aspect of deflation. While spending did eventually pick back up, ultimately, by 1933, one in five American banks that had existed in 1930 would fail. (Romer and Pells).

Friedman was no stranger to the effects of the Great Depression. Born in 1912, he was an adolescent during Black Thursday. However, unlike many of his contemporaries, he made it through this period without developing a fear of deflation. Across the course of his career as an economic researcher and educator, he published several financial theories which have all at times been referred to as "the Friedman Rule," but most frequently, the phrase is used to describe what Friedman refers to as the optimum quantity of money (Mihailov 2). To Friedman, the optimum amount of money in an economy is attained by sustained deflation at such a rate so as to guarantee that nominal interest rates are equal to zero. A nominal interest rate is the sum of the real interest rate and the projected rate of inflation (Nickolas). If inflation is negative— another way to describe deflation— and it sums to zero when added to real interest rates, then real interest rates must be positive. The Friedman Rule, in short, guarantees positive real interest rates (Mihailov 2). The real interest rate is what an investor actually achieves after all inflation is accounted for. Even if the investor's bank account number has gone up, they have lost money after inflation is accounted for if real interest rates are negative (Nickolas). Thus, we can see that, in theory, deflation can be a powerful tool against inflation while simultaneously protecting investors and alleviating fears of money hoarding. This seems to run counter to the long-standing assumption that history proves otherwise.

Andrew Atkeson and Patrick J. Kehoe, researchers from the Federal Reserve Bank of Minneapolis, directly address this discrepancy in their paper "Deflation and Depression: Is There an Empirical Link?" published in *The American Economic Review*. Atkeson and Kehoe open their paper by referencing the Friedman rule and noting that policymakers seem "extremely reluctant" to implement deflation-inducing monetary policies and that "[t]his reluctance seems to stem from the experience of the Great Depression, in which deflation and depression appear to have been tightly linked" (Atkeson and Kehoe 99). However, after examining inflation and output growth data for seventeen countries and for more than 100 years, only one episode linking deflation and depression unambiguously could be identified: the Great Depression itself (Atkeson and Kehoe 99). They go as far as saying that the fear of deflation is "greatly overblown" (Atkeson and Kehoe 99). In their concluding remarks, after reiterating that their research shows virtually no link between deflation and depression, they amend their findings with the caveat that their study made no attempts to control for anything like currencies used or whether a given country's central bank predicted a depression, but even so, "without such controls, the data show no obvious relationship. The bar has thus been raised for those who claim that deflation and depression are closely linked" (Atkeson and Kehoe 102).

These ideas are not confined to pure theory. The Swiss franc is seen as a "haven" currency against the comparably less stable euro and US dollar in times of financial uncertainty (Jolly). 2011, with a trading scene still reeling from the effects of the Great Recession (a financial crisis that spanned 2007 through 2009), could be considered such a time (Duignan). The Swiss National Bank, which has been described as "probably the best run central bank in the Western world," was afraid of the deflation that would result from the overvaluation of the franc as demand soared from international investors seeking its stability (Schmieding qtd. in Jolly). A demand for francs that exceeds their supply is definitionally deflation, and these fears were, in a way, well-founded. It is true that Switzerland entered into deflation for an unprecedented five consecutive years ("Historical inflation rates for Switzerland"). What they did not enter into was a depression. Instead, Switzerland enjoyed increased productivity, a trading surplus, and growth in consumer spending (Blackstone). Unemployment during this period was "rock-bottom" (Blackstone). By 2017, shortly after this period ended, the Swiss economy would enjoy its eighth consecutive year as the world's most competitive (Financial Times). "When citizens tolerate deflation, the central bank can too," writes the team at the Financial Times, a British daily economics newspaper, "[and] Switzerland may be the first advanced country to live happily with stagnant prices" (Financial Times).

The Great Depression has cast its century-long shadow over the discourse of deflation. Perhaps economics journalist Mattew C. Klein said it best when he quipped, "Economists agree: deflation is either good, or bad, or irrelevant" (Klein). However, the theoretical models and the global economy are in consensus- it is not deflation itself but the context surrounding it that is implicated in creating an economic depression. While our Depression-era fears may, for now, keep Friedman-style monetary policy from entering real-world practice, we can at least look to countries experiencing deflation and observe how a disaster is consistently averted. As Canadian inflation rates, at last, begin to cool, these lessons are as prudent as they have ever been.

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