

How to Escape Deflation

By Mizuno Kazuo

Deflation as a Result of Market Integration

Japan's consumer prices have fallen for five consecutive years since fiscal 1999. Deflation hit one year earlier in China, where consumer prices fell in both 1998 and 1999. China emerged from deflation thereafter, but then experienced a relapse in 2002, and consumer prices are now only rising at an annual rate of less than 1%. Hong Kong and Taiwan have been experiencing deflation since 1999 and 2001, respectively.

Consumer prices in Germany (not including energy, food, tobacco or alcohol) were up by 0.9% in September 2003, growing slower than before. Prices are also rising at a rate of less than 1% in Austria, the Czech Republic and Poland, all of which are part of the greater German economic sphere. In the United States, as well, consumer prices (not including energy or food) were up only 1.2% as of September. Considering the tendency of consumer price indexes to be on the high side, it would appear that both the United States and Germany are experiencing zero inflation.

Falling prices (or disinflation) are not a phenomenon peculiar to Japan. Prices have been falling throughout the world since the latter half of the 1990s. This deflationary period coincides with a round of globalization that has brought a "process of market integration involving not only goods and capital, but also employment and services." The Balassa-Samuelson hypothesis distinguishes between tangible goods, which it refers to as tradables (manufacturing sector goods prices) and intangible goods, which it refers to as non-tradables (service sector prices), and upon this basis explains why prices are higher in developed nations, where services account for a larger proportion of economic output. But this hypothesis no longer holds true now that information technology (IT)

has ushered in cross-border provision of services. (Fig. 1)

As the markets of developed and developing countries undergo integration within a single capitalist economic system, the y intercept in the rising trend line in Fig. 1 will not start rising until full employment is achieved in labor-abundant countries like China and India. As long as it is possible for the service industry to absorb the labor freed up by the offshore migration of manufacturing, aggregate income will not be lost overseas, but once it becomes possible to outsource services to overseas providers (as in the case of call centers and, more recently, corporate analysts, chip designers and aeronautical engineers), downward price pressure will come to bear on service prices, of which the cost of labor accounts for more than half. Under such circumstances, because service sector employment does not rise, aggregate labor incomes do not rise. Falling service prices push the trend line in Fig. 1 into a moderate decline, because the gradient of the trend line depends on the gap between goods prices and service prices. This process causes price levels in developed countries to fall. (Fig. 1, AA' - BB')

Deflation Is Not a Monetary Phenomenon

The fact that deflation is not peculiar to Japan becomes quite clear when the rates of increase for money supply and consumer prices in various countries are plotted out on a distribution curve. Up through the mid-1990s, growth in money supply accounted for about three-quarters of the impetus behind the rate of increase in inflation rates (Fig. 2, trend line AA'), but since 1995, rising money supply has not explained inflation rate fluctuations (Fig. 2, trend line BB'), because inflation and deflation are not monetary phenomena. For deflation to be a monetary phenomenon, the

velocity of circulation of money ($v = \text{nominal GDP}/\text{money supply}$) would have to be constant in Irving Fisher's equation, but in actual fact, the velocity of circulation of money in the United States and Japan veered upward in the latter half of the 1990s, and the same thing has happened in the European Union (EU) since 2000. Globalization has put the lie to the quantity theory of money.

Because of globalization, investments in a particular country no longer necessarily lead to accumulation in that same country; money now flows freely across international borders (the complete mobility of international capital is confirmed by the Feldstein-Horioka test). In addition, the level of full employment (i.e. potential for growth) in a particular country is no longer limited by its capital (K) and labor (L). Using statistics for a single country to assign values to money supply (M) on the left side of the Fisher equation ($Mv = pY$), and to real GDP (Y) on the right side of the same equation, will lead to skewed results. Either: (1) the rate of money supply increase has been insufficient, and further easing of monetary policy is thus called for; or (2) it was considered that a four-year period was enough for the velocity of circulation of money to return to stability, but it will now take some time. In either case, one can only conclude that things will get worse before they get better, and that we will just have to tough it out in the meantime.

Given the impact of globalization, we should abandon the outdated concept of separate equations for individual countries, and think in terms of a single equation for the whole world. The accumulation of savings that used to take place separately in separate countries will now take place within a single global pool. Because China and India are emerging as the "world's factory" and the "world's office," respectively, it

is now necessary to think of “Y,” which expresses movements of goods and services, as a globally integrated quantity. No matter what sort of monetary stimulus policies are adopted by Japan and the United States, these will not cause a globally integrated “Y” to reach full employment.

If we adjust the Fisher equation to account for globalization, and change the formula to read $Mv = pT$ (replacing the Y with T, which accounts for transaction amounts), rather than increasing Y (goods and services activities), which falls well short of a sharply increased full employment level, extra money would flow into money and capital markets. Thus, if we include money and capital transactions (T) when calculating money velocity, we will find that the velocity has not been low at all; on the contrary,

it is higher than ever before. This statement is borne out by soaring house prices in the United States and Europe, and the huge transaction volumes on the Japanese stock markets. This analysis does not support the call for an eased monetary policy.

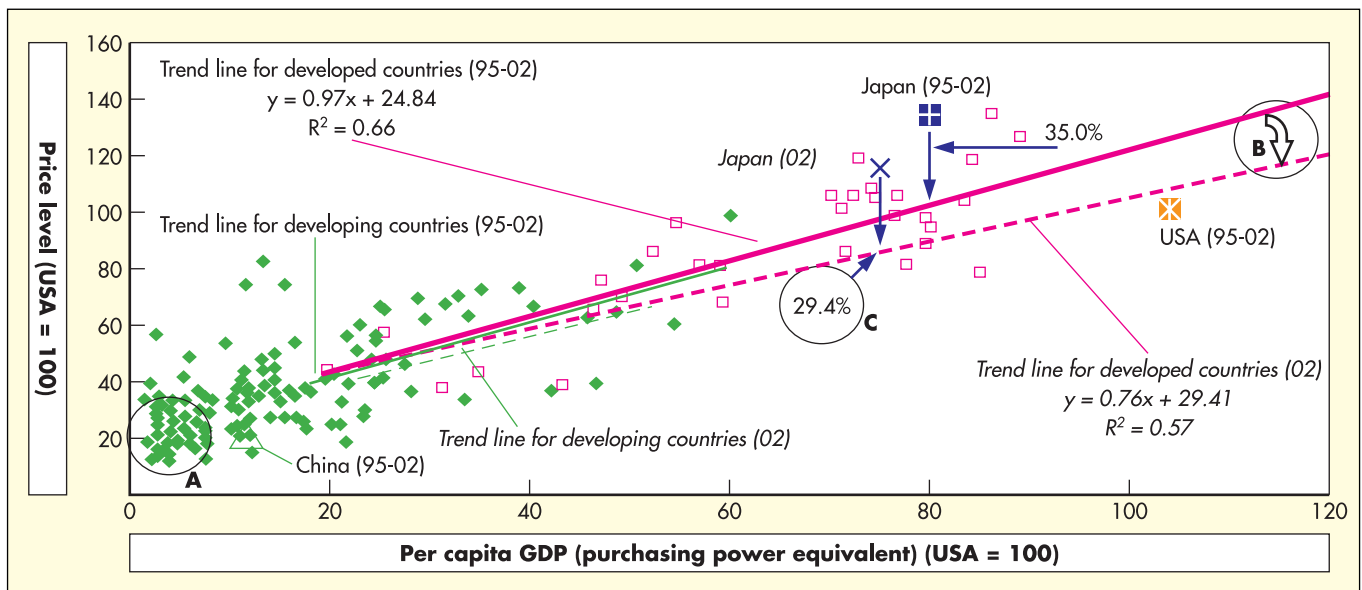
The intersection between the rising curve for aggregate supply and the falling curve for aggregate demand represents the point of equilibrium for prices and production volume. As a result of global integration of the goods and services activities of different countries, the level part of the aggregate supply curve will inevitably become longer, and will only begin to rise when the relatively large production volume Y is reached. Moreover, technological advances spurred by the IT revolution will also pull the aggregate supply curve

downward, which means that consumer prices in the United States will not climb even when real economic growth is at 6-7%. With the level part of the aggregate supply curve drawn out long and shifting downward, what we can actually expect to see is a combination of fast growth and falling prices.

The Outdated 20th-Century Idea of “Escaping Deflation”

When deflation is looked at in this light, an easy monetary policy and inflation targeting are the worst possible policy options. Increasing the amplitude of asset price fluctuations beyond that required by the fundamentals only makes for needlessly large swings in the real economy. Unduly high asset prices inevitably lead to a bubble collapse. At a

Figure 1 Relationship between per capita GDP and price levels



- Notes:
1. Price level figures were obtained by taking purchasing power parity (as calculated by the International Monetary Fund [IMF]) and dividing by the exchange rate.
 2. For both price levels and per capita GDP, the baseline of 100 is based on U.S. figures.
 3. The term “developed countries” refers to 35 nations with a total population of 1.18 billion, including the 29 countries classified by the IMF as “advanced economies” and the 30 member countries of the Organization for Economic Cooperation and Development (OECD). The term “developing countries” refers to 131 countries (total population: 4.91 billion) that are classified by the IMF as “developing and transition countries” and which are not members of the OECD. (Population figures are for 2002.)

Source: IMF, *The World Economic Outlook Database* September 2003

time when globalization has forced companies to implement inventory control and maintain overseas inventories, thereby enabling the real economy to avoid severe recession, it would be most unfortunate if the authorities adopted policies based on their experience in an earlier inflationary period. Avoiding sudden severe jolts to asset prices, including foreign exchange rates, thus becomes a prerequisite condition for structural reform.

In addition, when earned income is migrating offshore, public expenditures are the only way to increase the money supply. The result is that Japan's central government borrowings have reached ¥700 trillion. The existence of this debt causes worry about the future at the level of household finances and needlessly depresses consumption. Easy monetary policy and aggressive public spending should be a last resort, used only when there is serious concern about a deflationary spiral. But with consumer prices

currently falling at a rate of less than 1%, policy should gradually be returning to normal.

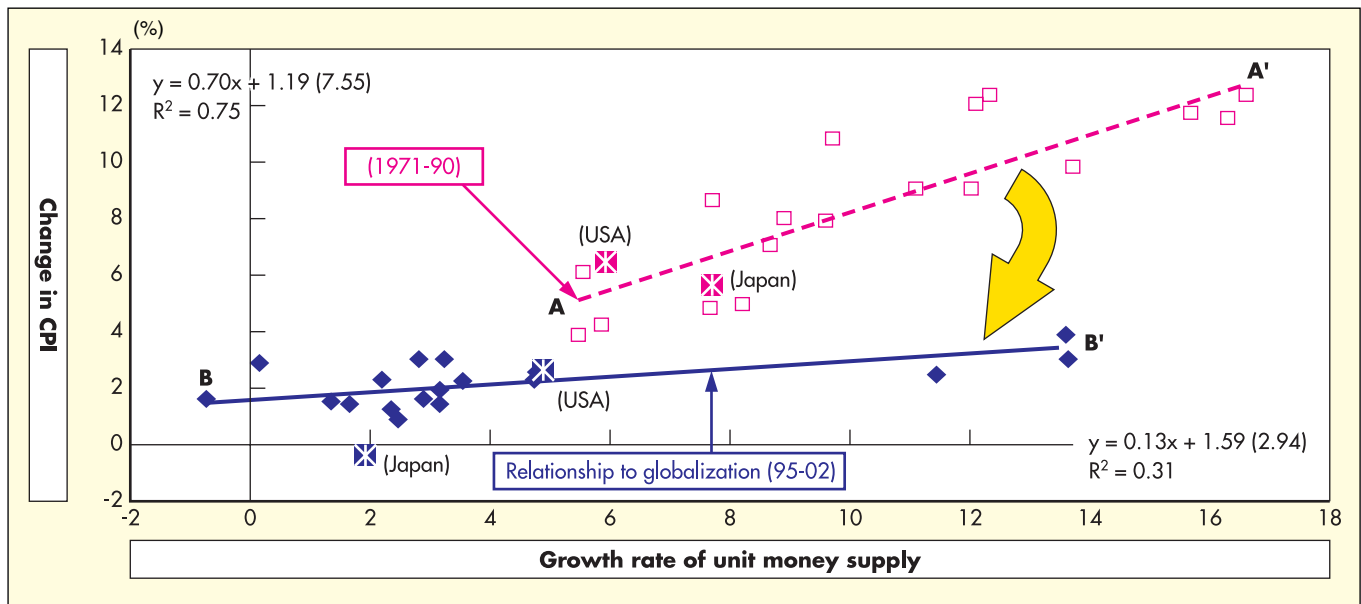
Within the context of globalization, given the fact that the economies of Japan, the United States and Asia are headed toward integration, what the Japanese government can do is work to build a pan-Pacific economic and free trade zone. In a global economy, a floating exchange rate system is inappropriate. U.S. companies, which are best geared to meet the requirements of a global economy, do not maintain inventories within the United States. Barring a severe economic recession that puts negative pressure on personal consumption, the fact is that the U.S. economy has a built-in mechanism that causes its current account deficit to rise in both good times and bad. Within another three or four years, the U.S. current account deficit will reach 10% of the country's GDP, which is where it stood

in Canada early in the 20th century when capital was flowing in at its fastest rate ever thanks to the gold standard that Canada was on at that time.

The threat posed by a global economy to an individual country is the possibility of sudden drops in asset prices, because it would trigger capital flight from that country. That risk is concentrated in the dollar. Twenty-first-century globalization will involve a pan-Pacific free trade zone and integration of the Japanese yen, U.S. dollar and Chinese yuan, because such developments would increase the size of the total economic pie by more than enough to offset the impact of deflation upon prices. **JS**

Mizuno Kazuo is a deputy executive officer and the chief economist at Mitsubishi Securities Co.

Figure 2 Inflation rates and unit money supply



- Notes: 1. Growth rate of unit money supply = Growth rate of money supply – Real GDP growth rate
 2. Money supply is M2 (M1 + quasi-money), except for Japan, where it is M2 + CD (average line)
 3. The graph above is based on figures for 21 OECD members (excluding the Czech Republic, Greece, Hungary, Iceland, Luxembourg, Mexico, Poland, Slovakia and Turkey).

Sources: IMF, *World Economic Outlook*, *International Financial Statistics*