No need to worrry about deflation -- yet, economist says

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A University of Illinois economist says consumers and investors concerned about the specter of deflation looming over an already bleak economic landscape should relax - for the time being, at least.

Although the consumer price index is near zero, J. Fred Giertz says we're unlikely to see a prolonged deflationary period like the slump Japan experienced during its "lost decade" of the 1990s.

"We're close to zero right now, but we're not below zero," said Giertz, an Institute of Government and Public Affairs economist who compiles a monthly barometer on the Illinois economy. "It's part of a bigger picture of where the economy is going, and I think the economy is stalled out in a very slow recovery."

Giertz says deflation "isn't necessarily the worst thing in the world," but it would undoubtedly create more problems for an already battered economy.

"Generally, we like very little inflation - we can live with 1 to 3 percent inflation per year," he said. "But when it's at zero or below zero, that's a little more problematic. Consumers react by waiting on purchasing big-ticket items - homes, automobiles and appliances - because they think prices are going to fall. So they may defer consumption, which makes the overall economy even worse."

Although the Federal Reserve has the means to tame inflation, Giertz says its tools to fight deflation are much more limited.

"The Fed has a lot of ability to deal with inflation - they have less ability to deal with the situation we're in right now," he said. "When the consumer price index gets close to zero, the Fed's options become limited."

One thing the Fed can do is to buy Treasury bonds, Giertz says.

"They're doing that right now, and by doing so, they're trying inject more capital into the money supply. But the low interest rate environment that we're in right now makes monetary policy that much more difficult."

Even though interest rates on a 30-year mortgage are at all-time low, Giertz says home sales are down because homeowners could be having difficulty qualifying for loans because their creditworthiness is deteriorating, or because their income has taken a hit.

"Interest rates are very low, but you need to be creditworthy in order to capitalize on these record-low rates," he said. "Everything has an upside and a downside, so there are no easy answers. It's good news, bad news."

With homes sales flat lining, Giertz doesn't foresee another incentive program for home sales this spring - at least, not unless things get really bad.

"At some point you want the market to take off on its own, and not depend on subsidies," he said. "Eight thousand dollars per house is pretty expensive way to keep the housing market moving. The recovery has been very painful, and it's taking a very long time to turn around, but that's the place we're in right now."

Despite the prolonged slump, Giertz is bearish on the prospects of a second stimulus, citing both the efficacy and the lack of popularity of the first.

"That's a question I don't think anyone knows the answer to," he said. "You could line up Nobel Prize winners on both sides of that argument, so there's obviously no consensus. One argument against a second stimulus is that the first stimulus didn't work too well - it was supposed to keep the unemployment rate at eight percent, so that it wouldn't go up to 9 percent. But now the rate is at 10 percent, so the predictions were way off base."

For anxious consumers and investors, the only thing left to do is wait.

"My opinion is that we've probably done enough, and now we just need to be patient," Giertz said. "One possibility is it's just a temporary dip and we'll start a more vigorous recovery. The other is it may be long-term slow growth."

The worst-case scenario, according to Giertz, is that it turns into a double-dip recession, though he doesn't foresee that as being very likely.

"If we have a double-dip recession, that's when we might get into the possibility of deflation," he said. "It's certainly possible that we could go into a prolonged recession, but I don't think that will be the case. I think we'll probably start to grow again, but not as fast as we would like. I also think it's going to be a long time until we get back to low unemployment rates."

What's happened in the economy from 2008 to the present has been "out of the range of experience" for most economists, Giertz said.

"No one really thought it was a Great Depression until 1931 or '32," he said. "Everyone thought it was just another bad recession and we'll bounce back. Over the last three decades, we've had this period of great moderation where, rather than having a recession every five or six years, we've had one every 10 years, so they've been pretty infrequent and quite mild. The unemployment rate didn't go up that much then, and output continued to keep pace. But this time, I think there was some hubris; we got a little overconfident that we had our economic problems mastered.

"It turns out that bad, unexpected things can still happen."

Provided by University of Illinois at Urbana-Champaign

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