IDEAS ON LIBERTY
MARCH 2003

The History of "Deflation"

Lately a new word has made an appearance in economic commentary and journalism. Or, rather, it is now being used in its original, correct meaning. That word is "deflation." Used correctly, it means a general decline in prices, or a steady increase in the value, or purchasing power, of a given unit of money.

For most of the last 50 years the term "deflation" has been misused to mean nothing more than a decline in the rate of price increase ("inflation"), rather than an actual decline in prices. This reflected the reality that since the end of the Great Depression, most economies were in a condition of secular, that is general, long-term, inflation. The rate of price increases might accelerate or diminish, but it never stopped, much less went into reverse. With time, inflation came to be seen as the normal state of affairs. Some critics argued that this was the product of mistaken policy, but even they only looked forward to price stability. They did not expect, much less advocate, price decline.

This has now changed. The economic columns are now full of alarmed comment about our entering a period of secular deflation, something most of them see as a dark prospect. The reason for this shift in perception can be summed up in one word: Japan. Since the bursting of its real-estate and share bubble in the early 1990s, Japan has had years of stable and, more recently, declining prices. The Japanese Consumer Price Index has shown a decline for each of the last three years. Last September Reuters reported that this deflation was, if anything, accelerating. The fear now gripping U.S. and European commentators and policymakers is that this phenomenon may spread from Japan to the rest of the world. Last June the Federal Reserve published a paper titled "Preventing Deflation: Lessons from Japan's Experience in the 1990s." Its title reflects the two shared assumptions of most current argument: that secular deflation is something to avoid and that this can be achieved through the correct policy.

However this commentary reveals a lack of historical perspective. Using evidence such as price records for grain, real estate, and building materials, historians have been able to construct a historical account spanning hundreds of years. It puts our current alarms into a much bigger picture.

The central lesson of all this information is that secular deflation is not unusual. Periods of general price stability tending to deflation are as common and long lasting as periods of inflation. Typically, in periods of deflation the decline of prices is less dramatic than the rise in prices found in periods of inflation, although the prices of some particular products may decline sharply. A period of general inflation may be marked by episodes of deflation and vice versa, but these are short-lived and often local.

The work of economic historians such as James Thorold Rogers (1823–1890) and

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Wilhelm Abel (1904–1985) is ably summarized by David Hackett Fisher in his 1996 work, *The Great Wave: Price Revolutions and the Rhythm of History*. We can identify several major periods of generally rising prices ("price revolutions," in Fisher's terminology) and also long periods of secular deflation. There are relatively short episodes of price stability between the longer periods of secular inflation and deflation, but on closer examination these turn out to be times of sharp fluctuations in key prices.

Starting in the high Middle Ages we can trace periods of secular inflation in roughly 1180 to 1330, 1490 to about 1670, 1770 to about 1850, and 1895 to 1995. The corresponding periods of secular deflation were 1330 to 1490, 1670 to 1770, and 1850 to 1900. There were also episodes of deflation during the early years of the seventeenth and twentieth centuries.

The question is whether we are now entering a period of secular deflation. The evidence increasingly suggests so, with Japan leading the way. The data also imply that ultimately public policy has little or no influence over this.

Why do these long-term movements in prices happen? Here the evidence is suggestive but no more, and we have to say that ultimately this phenomenon is mysterious, given the present state of historical knowledge. A frequent explanation is demographic, relating periods of rising prices to population growth, and periods of stable or declining prices to population decline. This works for some periods but not others. In particular, the period of deflation after 1850 coincided with a sharp growth in population. Another popular argument is that these phenomena are the consequence of monetary fluctuations caused by both government policy and (before 1900) changes in the supply of money due to increases or stagnation in the available quantity of precious metals. However this works even less well, as Fisher convincingly argues (pp. 241–51).

One suggestive fact is that episodes of deflation occur when the quantity of resources at people's disposal tends to increase. This can be due to a fall in population, but also to a sharp rise in productivity, coupled with an increase in trade. The effect of this is to reduce costs generally and to limit the return to investors and producers as competition for consumers works to keep prices down. One thing we can say is that many features of earlier periods of deflation are now clearly present.

Not a Bad Thing

The other main lesson that the history of prices holds for us today is that deflation is not such a bad thing. As Fisher and other historians have pointed out, there are both winners and losers from deflation, and such periods correlate with other trends, many of which are generally thought to be desirable. In general terms, deflation is good for creditors but bad for debtors. It makes forward planning easier and encourages longer term thinking. Periods of deflation typically see a decline in the returns to capital (including land) and an increase in real incomes for wage earners. They are also characterized by a number of other major social trends, above all, declining rates of criminality and such other indicators of social stress as illegitimacy, family breakdown, and political upheaval. These are all trends that have become apparent in most countries during the last decade.

Almost everyone alive today has lived most of their life in an age of secular inflation. The apparently dull work of historians such as Abel suggests that we may now have to look forward to a long period of gently declining prices, or secular deflation. It also implies that we can do little about it and should, on balance, welcome it. □