Deflation and Economic Growth

With the consumer price index inflation rate reaching relatively low levels in 1997, some analysts have begun discussing the possibility of deflation—a sustained decline in the price level—as a realistic prospect for the U.S. economy. Forecasts of a widespread price decline may be premature, since such an event has not occurred in the United States for many years and probably will not happen any time soon. Even if it does occur, however, moderate deflation need not be viewed in the negative light in which it is often portrayed. The U.S. economy has experience with sustained deflation, and that experience suggests that the real economy can flourish against a backdrop of declining prices.

The U.S. experience with sustained deflation stretches over a quarter century in the post-Civil War era, from 1875 to 1900. During this period, the United States became an industrial giant and a world power. While recessions did occur periodically, the real economy performed well, on average. Part of the policy mix that helped produce this outcome was a gold standard, which constrained the growth of the U.S. money supply and led to a long period of declines in the U.S. price level. Thus, the qualitative story is that the last quarter of the 19th century can be characterized by relatively strong growth in real output coupled with deflation.

The chart displays data which corroborate this qualitative story. Centered, three-year moving averages of real output growth rates and inflation rates are pictured, based on estimates of real output and price levels from 1875 to 1900. The moving averages smooth the data and help us to discern longer-run trends. Since this era is one in which national accounts were not kept as they are today, these data are crude estimates, but the estimates reflect the best efforts of economists working in this area. The average rate of change of prices was approximately negative 1 percent—a 1 percent rate of deflation—while the average rate of growth in real output was just over 4 percent. It seems clear that the U.S. economy was able to grow and industrialize rapidly in an environment of consistent price declines.

For many economists, worries about deflation are associated with the experience during the Great Depression, when a sharp deflation was associated with a catastrophic decline in real output. Few would disagree that a large and unexpected deflation could damage economic performance, just as a large and unexpected inflation could. But for smaller, less volatile movements in the price level, the evidence from the late 19th century suggests that we should be careful about assuming that deflation *per se* has serious detrimental effects on the real economy. Instead, the evidence seems to suggest that strong economic performance and mild deflation are wholly compatible.

–James Bullard

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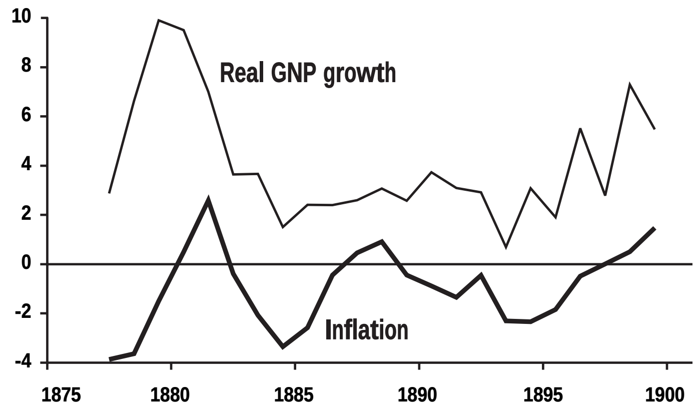
Percent change, 3-year centered moving average



Source: Gordon, Robert J., *Macroeconomics-5th ed.*, Scott, Foresman and Co.