Living in Deflationary Times? Hold Your Breath

Business World

By Holman W. Jenkins Jr.

She may put on a brave face for the kids around the Christmas tree, but the more historically illuminated Wall Streeter is wracked with care lest the 1930s are repeating themselves, this time with a sinkhole on the other side of the world. Something is coming down the chimney, and it might be deflation.

In his exhaustive 1992 book "Golden Fetters," whose title sounds like an indictment of the gold standard, economist Barry Eichengreen traces the global depression, as have others, to an improperly tight Federal Reserve policy, which other nations were forced to emulate to maintain their own fixed currency rates.

His argument does not convict the gold standard so much as the rise of mass, interest-group politics, with which the gold standard proved incompatible. International moneymen no longer believed countries would keep faith with the international economy against the domestic rabble, and so the stabilizing capital flows that made the gold standard such a charm no longer took place.

The same democratic politics, in the wake of war, made it hard for countries to coordinate their policies and reflate together while maintaining their exchange rates. Instead they let their currencies float and reflated separately. By then the damage was done: bank and business failures, unemployment, in some countries a radicalization of the middle class.

We are notoriously inept at judging how much money is afloat from the price level. Often we confuse inflation with the changes in the relative prices of things, even labor, which has the Fed on edge right now. Wages may well rise when supplies are tight, without it meaning the monetary engine is running out of control.

There is also the impossible problem of accounting for shifting baskets of consumption, and for changes in quality. A car costs more than it did, but it isn't the same car. By the reckoning of the Boston Consulting Group, time between repairs was rising 5% a year in the early 1990s.

Category killers like Home Depot (a revisitation of the chain stores that were a controversy during the 1920s) have taken high-quality, cheap merchandise to places that had neither. Much less of what we consume is even tangible now. A TV hasn't changed much, but it delivers 120 channels instead of six or seven.

Properly accounted for, the real cost of living may have been subtly falling for a decade. As for companies, their prices may be sticky but their processes have become more efficient, keeping them profitable. Owners and bosses are forgiven the big rewards downsizing brings them as long as new opportunities catch the displacees. In a deflationary world, the real value of future profit dollars is higher, so the market should be willing to pay more in current dollars; stocks should command higher multiples.

To be true, this wouldn't have to be understood in detail by the average mutual fund investor. He just has to believe he's not losing anything now by holding on to his money—i.e., inflation isn't eating it up. And that, all things considered, the future will be worth living, and saving, for.

In the 1920s, Europe was borrowing heavily from the U.S. to pay its war debts and war reparations, and when the U.S. went into deflation, the loans were no longer forthcoming.

Japan and the West have been pouring money into Asia, but today the international capital markets are more open and decentralized, and the Asians are great savers. If they show themselves willing to liquidate bad projects and shut or recapitalize insolvent lenders, the money will rush back in. Already money is picking up bargains among the wrecks in Thailand. Failure is a better deregulator than an IMF agreement. Indeed, the best way to prolong the crisis is to keep everyone in suspense about how and when the losses will be allocated.

All financial crises are political crises at heart, and get drawn out because the politics turn nastier and nastier. Japan seems rudderless. Korea frightens a lot of people. China has 100 million displaced peasants on the hoof, many of them working on construction sites in Shanghai and other boomtowns. If those sites go quiet, and if the authorities try to shoo the unemployed back to the countryside, anything could happen.

History advises that heroic measures are religiously to be avoided at such moments.

Boris Yeltsin could die, and that would give the markets something to think about. Neither China's nor Russia's economy matters much now, but China's figures in the future profits of many big multinationals. A more gnawing concern is that a slackening of U.S. resolve could allow the world to become safe again for war.

No one can be sure the next sour note won't be the one that finally snuffs out the residual confidence holding up the markets. History advises that heroic measures are religiously to be avoided at such moments. It may be too late to call off the IMF. But Europe might do well to reconsider an overreaching, geopolitical project that is uncalled for except by a belated desire to prevent the last war.

The gold standard was a spontaneous order, to which countries came of their own volition, for their own benefit. Great Britain's role as superintendent has been played down by recent researchers, who believe it was precisely the distributed, nonhegemonic nature of the system that allowed it to work so well. Looking to Europe's plans for monetary integration on very different lines, some of us get a queasy feeling.

Its promoters are steeped in the trauma of the World War II, and not all their conclusions are wrong. The fundamental fact of our age is not the global marketplace, but, as it has always been, the rise of welfare, interest-group societies. Their fractiousness is their strength, and the only force capable of displacing that fractiousness with a dangerous harmony is nationalism. Yet the Eurocrats may end up reviving this wolf rather than euthanizing it by trying to force Europe into their mold.

Local politics continues to call the tune in history. In the works of recent historians you can find a conviction that, without the paranoid, grandiose personality of Stalin, there might not have been a Cold War. In his latest book, John Lukacs reminds us how different our century would have been if not for the peculiar attributes of Adolf Hitler, whose strange influence over the most educated, literate people in Europe led them to disaster.

Personality can matter disproportionately in history, never more so than in an age dominated by mass politics and mass communications. Confidence came back quickly under Hitler, as Germany's falling suicide and rising birth rates after 1933 vividly show. Left alone, bad economic times are self-correcting. But the demagogic careers that bad times may launch can take on a logic of their own.