IN DEFENSE OF DEFLATION

PHILIPP BAGUS
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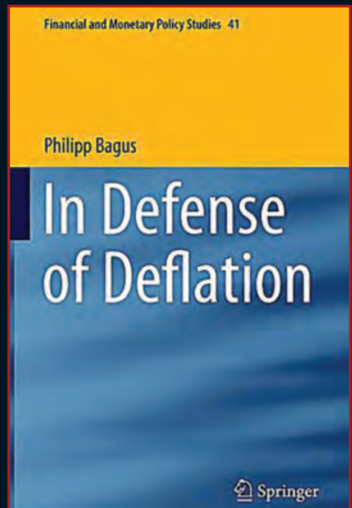
The world often seems to be scared of deflation. For example, at the beginning of the 21st century, after the dotcom crash, there was widespread fear of deflation in the US. The response to this fear was several years of loose monetary policy which, arguably, contributed significantly to the financial crash of 2008.

In much of the commentary in the UK in recent years, we have at least come to accept so-called "good" deflation. The fall in the price level (or, strictly speaking, the fall of inflation to below target) in recent times has been caused by the fall in commodity prices and so is an adjustment to supply-side conditions that only brings benefits in terms of lower prices for consumers and lower costs for businesses.

But, Philipp Bagus' book, *In Defense of Deflation*, deals mainly with what is widely believed to be "bad" deflation. This would involve a continuing fall in the price level caused by monetary deflation. The book is excellent and timely.

Bagus begins by noting that there was very little concern about deflation amongst economists before the 20th century despite the fact that happened relatively frequently. In the current era, we are fearing something that we have not experienced whereas, in the past, the reality did not seem worth writing about.

After this discussion of the historical context, there is an excellent section on the



functions of money balances which is accessible to any student of economics (though I disagree with the author on the apparent "legal privileges" of fractional reserve banking). Indeed, this section could be applied to help our understanding of fluctuations in the value of digital monies such as Bitcoin.

The book moves on to knock down the theoretical arguments against deflation. Bagus also shows how the losers when prices fall unexpectedly are powerful interest groups (generally firms for which the value of debt rises in real terms) who are able to lobby against deflation.

Perhaps in knocking down the arguments against deflation the pudding is over-egged. The impression is sometimes given that monetary disturbances are part of life that entrepreneurs and other households can deal with.

If that is so with deflation, then it is also the case when it comes to inflation. But the same author would argue that inflation distorts investment decisions and is highly damaging.

The book finishes with excellent case studies. It examines the US between 1865 and 1896. In fact, this was a "growth deflation" whereby economic growth in the context of stable monetary policy allowed prices to fall – in many ways another type of "good" deflation. The German deflation of the 1930s is also discussed. This is interesting in that it followed a bout of inflation.

Bagus argues that the problems arising during the deflation were largely inevitable after the distortions caused by earlier inflation and, in fact, deflation speeded up adjustment, which would have been faster still had labour markets been more flexible.

This is an excellent book. A student e-edition is available now for just €25. Bagus has put together a highly effective defence of deflation in most circumstances.

A second edition (or perhaps a different book by the same author) would benefit from a discussion of, for example, present-day Japan and also the euro zone. In the euro zone, if deflation is not accepted in some countries at some times, there will be a very strong bias towards inflation because the ECB will loosen monetary policy to avoid deflation anytime, anywhere. A sequel would also benefit from more explanation of the economic reforms that would reduce the costs of deflation•

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A MONETARY HISTORY OF THE UNITED STATES 1867-1960

MILTON FRIEDMAN AND ANNA JACOBSON SCHWARTZ
PRINCETON UNIVERSITY PRESS 1963

It can be easily claimed that Friedman and Schwartz's *A Monetary History of the United States* is one of the two books that most influenced economic policies in the twentieth century, the other being Keynes' *General Theory* (1936).

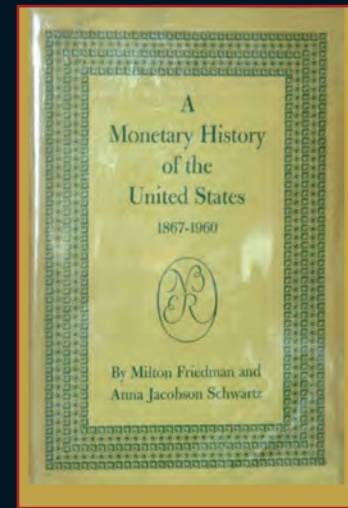
During the 20 years or so that preceded the publication of the *General Theory*, the Great War, the Russian Revolution and the Great Depression not only caused the destruction of the prevailing liberal order, but also destroyed many of its underpinning beliefs.

Keynesianism became the accepted wisdom guiding fiscal and monetary policy of the post-war financial order, with plenty of wiggle room for inflationary policies in a world where the money in your pocket was many degrees apart from the gold notionally anchoring the US Dollar that anchored the international monetary system established in Bretton Woods in 1944.

When *A Monetary History of the United States* was released, it made public a wealth of data showing the relationship between the stock of money and other economic phenomena clarifying many theoretical questions.

Milton Friedman's treatment of the demand for money and the Great Depression is a good example of the different policy conclusions elicited from the economic data.

At the time *Studies in the Quantity Theory of Money* was published (Friedman,



1956), influenced by Keynes, the demand for money was considered to be very elastic in response to changes in the interest rate, and the propensity for consumption was considered rigid.

From that came the idea that "the Great Depression was the result of a collapse in investment, amplified by the multiplier, and monetary policy had been powerless to offset it". But that changed with Friedman and Schwartz's research. As pointed out by David Laidler in a 1994 essay:

Friedman's theory of the Consumption Function (1957) would soon challenge the idea of a stable marginal propensity to consume out of current income, and hence of a stable multiplier, and in 1956 he was suggesting that it was the demand for money function which was the stable relationship in the economy.

This had drastic implications. Leading economists came to regard the business cycle as a largely monetary phenomena and the quantity of money as having more explanatory power than autonomous expenditure variables.

Eventually, a new synthesis was developed and it is safe to say that today the differences between monetarists and Keynesians are more political than methodological; and the authoritative data presented in *A Monetary History of the United States* was key for that development to happen.

Another important aspect of Friedman and Schwartz's research is the evidence they brought to light of the inflationary expansion of money and credit in the US as part of American war financing.

In the words of Friedman and Schwartz, "The Federal Reserve became to all intents and purposes the bond-selling window of the Treasury, using its monetary powers almost exclusively to that end.

Although no 'greenbacks' were printed, the same result was achieved by more indirect methods using Federal Reserve notes and Federal Reserve deposits" (216).

During World War I, the Fed also expanded the money supply and the cost came in the form of post-war inflation of roughly the same magnitude as the variation in the money supply.

There are many lessons to learn from Friedman and Schwartz's account of monetary history.

Chief among these is the role of central banking in war finance. Their research continues to influence current economic understanding and policy in many different ways•

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