Abstract

After an absence of almost half a century, the spectre of deflation is once again haunting the corridors of central banks and finance ministries in the industrial world. While preventing or combating deflation poses some unique difficulties not present in preventing or combating inflation, deflation can be prevented and, if it has taken hold, can be overcome, using conventional instruments of monetary and fiscal policy. These include changes in the short nominal interest rate (when the zero bound constraint is not binding), the intentional depreciation of the external value of the currency, open market purchases of government securities and monetary financing of government deficits caused by expansionary tax cuts, increases in transfers or higher public spending on goods and services. Base money-financed tax cuts or transfer payments – the mundane version of Friedman's helicopter drop of money – will (almost) always boost aggregate demand, but require coordination of monetary and fiscal policy.

Unconventional monetary and fiscal measures are also available. These include open market purchases of private and foreign securities, negative nominal interest rates (through a carry tax on currency) and temporary tax measures aimed at shifting private consumption from the future to the present, by tilting the intertemporal terms of trade. An example is Feldstein's proposal for a cut in VAT today coupled to the credible commitment of a VAT increase in the future.

Deflation results from a combination of bad luck and poor economic management, including the failure to coordinate monetary and fiscal policy. Sustained unwanted deflation is evidence of policy failure. Both the knowledge and the tools exist to prevent unwanted deflation.