The spectre of deflation[1]

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Currency goes up … and so does debt

The huge fall in energy and other commodity prices towards the end of 2014 has driven the overall rate of inflation in prices of all commodities down. It increasingly looks likely that this is not just a temporary phenomenon caused by a competitive battle to gain market share in the sale of oil and other energy products. Low inflation - and deflation - is here to stay.

In December, the euro zone fell into deflation for the first time in more than five years. Japan is nearly back there, while US and UK annual inflation rates are well under central bank targets of 2% a year.

Good news or bad?

Is this good news? Will low price inflation or even falling prices mean more money in the pockets and bank accounts of working class households in the major economies, allowing them to spend more and so boost demand for goods and services in the economy? Or do deflating prices mean a squeeze on the profits of capitalist combines, reducing their ability and willingness to invest in more technology and jobs?

The answer is both. But the question at debate is, which factor will dominate? If it is the former, then low and falling prices could support an acceleration in the economic recovery that has been so sadly lacking since the end of the great recession in 2009. Combined with faster growth in gross domestic product and employment in the US, this suggests a more optimistic scenario for capitalism in 2015. Lower gasoline prices means that American and other households can spend more money on other goods and so boost demand.

This is the argument of the optimists among the mainstream. This argument was recently well presented by Gavyn Davies, former chief economist of Goldman Sachs and now a columnist for the *Financial Times*. As he put it,

> After several years in which inadequate demand has seriously constrained activity in the global economy, causing repeated downgrades to growth forecasts, 2015 should see an improvement. Lower oil prices and a more demand-friendly fiscal/monetary policy mix should result in faster growth in aggregate demand …. This will be a year in which excess capacity in the global economy will start to be absorbed.[1]

Davies pins this forecast on the apparent pick-up in demand and employment in the US. With ‘potential’ long-term growth in the US fixed at about 1.7%, Davies expects the US economy to grow some way above that in 2015. He recognises that the euro zone and Japan are struggling to avoid a new recession, but hopes the European Central Bank (ECB) will introduce quantitative easing, although “It is very doubtful whether this will be enough to restore inflation expectations fully to the ECB’s target, considering that headline inflation will dip to zero, as oil price effects feed

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through the system."Nevertheless, real GDP growth should improve in 2015. As for the emerging economies, China may be slowing down, but will still manage 6%-7% a year, so that overall global growth would reach 3%, up from 2014.

When we consider the evidence from economic data from the end of 2014 and into 2015, it is not encouraging for Davies's assessment. Take Germany, the only powerhouse of growth in the euro zone. Factory orders there fell 2.4% in November, much more than expected. Germany factory output was also much weaker than economists had forecast in November, falling by 0.1% from the previous month. It is now falling by 0.5% year on year.

UK industrial production and construction output also unexpectedly contracted in November, falling 2% month on month - a bad miss from expectations for a rebound after October's shrinkage. Construction output is up 3.6% this year, well short of hopes for a 6.7% reading. That is a sign that the driver of UK growth in 2014 - the property boom - is coming to an end. French industrial production also fell last November by 0.3% after a monthly fall of 0.8% in October.

The US economy is now regarded as the main global growth driver for 2015. But will US growth be enough to stimulate the rest of the world? The latest figures of factory goods orders were not promising. In November, they fell 0.7%, so that the year-on year figure was down 1% compared to a rise of 2.1% in October. In contrast, US employment has been picking up. In 2014, the number of jobs rose more than in any year since 1999. The unemployment rate ended the year at 5.6%, the lowest since the great recession.

But, when compared to those of working age, the share of Americans with jobs or actively seeking employment fell back to a three-decade low of 62.7% in December. And the level of long-term unemployed remains well above that before the great recession. Most important, average hourly earnings rose only 2.3% in 2014. So more jobs have not produced higher real incomes from work. Indeed, in November, hourly earnings for private-sector employees fell by five cents to $24.57 - marking the largest monthly decrease since at least 2006. What seems to be happening is that those getting jobs are doing so in low-paid sectors like retailing and in part-time holiday work. These 'entry-level' workers get paid less. This story is repeated in the UK and Japan.

Japanese prime minister Shinzo Abe, who has just won another term of office, claimed that his so-called 'Abenomics' would raise wages and employment to revive the economy and defeat deflation or price falls. Yet earnings (adjusted for inflation) dropped 4.3% from a year earlier in November. It is the steepest decline since the 2009 global crisis and marks the 17th month of falls. Inflation has clocked in at a 14-month low. The slowdown in China threatens to push the economy into deflation there too.

Worldwide, the latest economic activity indexes suggest a slowdown, not an acceleration, in growth. I have constructed a composite index of national business activity indexes (PMIs). I find that developed capitalist economies (DE) are still expanding (above 50), but at a much slower rate than last summer, while emerging economies (including China) are not accelerating. So the world economy is in a lower gear than a year ago.

While Gavyn Davies may be optimistic about global economic growth in 2015 because of 'higher demand', Tim Adam, the president of the Institute of International Finance - a group that represents the world's largest banks, pension funds and insurance companies - is much less so:

> The question is, can a wealth effect in a liquidity-juiced US economy provide the engine of growth for the global economy? ... One could have a fairly pessimistic outlook on global growth if you take all these things into consideration.[2]

The International Monetary Fund is also doubtful that lower oil prices will lead to a consumer boom. In its latest economic forecast, Olivier Blanchard, the IMF chief economist, commented that there were

new factors supporting growth: lower oil prices, but also depreciation of euro and yen. But they are more than offset by persistent negative forces, including the lingering legacies of the crisis and lower potential growth in many countries.[3]

It seems much more likely that low inflation and deflation of overall prices is not just the result of an oil glut from extra US fracking production and extra Saudi pumping of reserves, but due more to a general slowdown in global demand.

The Economist agrees. As the magazine explains,

The drop in oil prices is in part due to higher supply, but it is also the product of slowing growth around the world. China's slackened appetite for raw materials has hit emerging-market commodity suppliers particularly hard. And an energy-induced drop in prices, though good for consumer purchasing power, risks reinforcing expectations of lower inflation overall; it is part of the threat's pernicious nature that such expectations easily become self-fulfilling.[4]

While lower prices may benefit average households in reducing their energy bills, so that they can spend more on other things, it puts downward pressure on the profitability of capitalist production. This might inspire the introduction of new technology to lower costs. But there is little sign of that at present in the major capitalist economies. The energy producers are cutting back on investment globally (some 40% of total capital investment), and other sectors are not compensating.

Two sorts of deflation

In a way, there are two sorts of deflation. The first arises from the decline in the value of each unit of production, as investment in technology replaces labour and/or increases its productivity. *Ceteris paribus*, the cost of production will fall and, with it, the price of the commodity. This is a tendency inherent in the capitalist mode of production that is at the essence of Marx's law of the tendency of the rate of profit to fall in capitalist production. It can be counteracted by a number of factors, including monopoly pricing and a credit-fuelled boost to the demand for goods, services and financial assets (quantitative easing, for example). But the downward pressure on profitability through a fall in the price per unit of production is always there.

However, the current deflationary pressures come from the crisis in capitalist production. A capitalist slump takes the form of a sharp reduction in capital values: in other words, a fall in the value of existing capital (both technology and the labour force). As the labour force is turned into a reserve army of labour and weaker firms go bust or are taken over and 'restructured', labour incomes fall and so does demand for goods and services. This 'realisation crisis' (for sales) is expressed in a fall in prices. And it is this that is being exhibited now.

The global economic slowdown has led to a reduction in global demand growth for energy and other commodities (alongside 'overproduction' of oil, etc), as well as in investment demand. Inflation has slowed and in the very depressed parts of the global economy there is outright deflation.

Most capitalist firms are continuing to try and boost profitability through raising profit margins by holding down wages. A recent staff paper by the Federal Reserve Bank of San Francisco argued that "wage stickiness" had hampered American firms' ability to adjust costs during the great recession.[5] The paper argues that wage rates stayed up "too much", so firms would rather not raise wages now in the recovery. Now, if sales demand and price rises should slow again, there could be a "pent-up" demand to cut more jobs. So the improvement in the US jobs market could grind to a halt.

World inflation has been very low since the great recession - another indicator of the long depression that the world economy has been locked into. What inflation of prices there has been was mainly due to the sharp rise in energy prices since 2009. Non-energy price rises have been minimal. But now, with the sharp fall in energy and other commodity prices (metals, food, etc), deflation is beginning to submerge economies.

Oxford Economics finds that if oil prices were to fall to as low as $40 a barrel, then 41 out of the 45 countries would experience deflation. Some argue that this is good news. This is the line of some mainstream economists. For them, falling prices, particularly in energy and food, will raise consumer purchasing power, and help boost consumer demand and thus economic growth. But for profitability it is bad news. Inflation of corporate producer prices has been a 'counteracting tendency' to the tendency of capital accumulation to experience falling profitability. If prices stop rising, then the downward pressure on profitability from any new technology investment will be greater, as falling prices squeeze profit margins.

Profitability and deflation

Profit margins are currently at record levels in the US. But the tendency for profitability to fall is still there. A recent paper by Barclays Bank on US corporate profitability explained:

> ... higher profit margins are not leading to higher rates of return on capital. Indeed, profit margins have climbed steadily higher for nearly three decades. But return on capital measures, such as return on invested capital (ROIC) and return on equity (ROE), have not.
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> Barclays' economists offer an answer to this conundrum:
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> We believe the answer is less asset turnover, defined as the ratio of revenues to assets. If a company generates fewer revenues per unit of assets, then it must earn higher margins on those sales to maintain the same return on capital.[6]

In other words, higher profit margins have not been enough to compensate for the cost of investing in assets and make them work fast enough to generate more profit. This is what Marx would have called a rising organic composition of capital (the cost of machinery outstripping the cost of employing labour) rising faster than any increase in the rate of exploitation of labour (margins). This is Marx's law of the tendency of the rate of profit to fall - and it continues to operate in the US economy.

Why does the cost of accumulated investment in machinery, plant and technology outstrip the gain of record high profit margins? One of the reasons is that the vast majority of the value of the existing capital stock is in structures - houses, apartments and offices - rather than equipment or 'intellectual property' (software, etc). Advanced technology accounts for only a small fraction of the capital stock, and this fraction has been roughly stable over the last several decades.

Structures continue to comprise the vast majority of the private capital stock in the US - 175% of GDP at current prices. The other components of private capital - equipment, intellectual property and consumer durables - are much smaller, and within them the share of capital related to automation and the information revolution is smaller still. Within equipment, for instance, 'information processing equipment' (computers, communication, medical, etc) is only 8% of GDP, as compared to 27% of GDP for all other equipment. Software is 4% of GDP, versus 11% for other intellectual property. And technology-intensive consumer durables (computers, TVs, phones, etc) stand at 3% of GDP, as opposed to 27% for other durables.

So the productivity-enhancing effect of investment in new technology and the holding down of wages and employment may boost the rate of surplus value and profit margins. But this has not been enough to drive profitability back up to pre-crisis levels, especially when many businesses face higher debt levels and a slow growth economy.

Indeed, the huge cash hoards that the largest companies in the G7 economies built up in recent years by squeezing wages and jobs and not investing are now beginning to decline, as companies buy back their own shares and pay out dividends to their shareholders.

Debt and deflation

In a slump or depression, the second sort of deflation is at work. And it is reinforcing. The mainstream economist of the 1930s depression, Irving Fisher, dubbed it a debt-deflation spiral.[7] If prices fall, debt becomes larger in real terms to pay back. So more companies and households default on their loans, bonds or mortgages. Those defaults reduce incomes and demand in the economy further and the slump deepens. Deflation is worsened.

Debt in most mature capitalist economies remains high. As the EU Commission in its latest report put it,

> ... recoveries following deep financial crises are more subdued than recoveries following normal recessions ... recent estimates suggest that it would take about 6½ years (median) or eight years (mean) to return to the pre-crisis income level in the wake of a deep economic and financial crisis ... the recovery from the recession in 2008-09 has been slower than any other recovery in the post-World War II period on both sides of the Atlantic.[8]

So the global financial crash is the biggest factor in making the recovery slower than normal. The crash and the subsequent bailout by governments across the major economies, by incurring more debt, left a heavy burden of debt financing, despite near zero interest rates. As the OECD shows, overall debt levels in the main economies are higher now than they were in 2007. And China too has built up debt that is close to many advanced economies.

The EU Commission makes the point that a possible reason why the US economy has recovered better is that "US corporations have cut debt more than those in the euro area. This has been supported by positive profitability trends, providing companies in the US with the internal funds necessary for adjustment of balance sheets." The Commission argues that "delayed deleveraging in Europe can be expected to weigh on investment activity and thus to explain partly the gap between the contributions to GDP growth in the euro area and in the US."

Financial debt has shrunk as a result of the global financial crash, but it has been replaced by a large rise in government debt used to bail out the banks. Since the financial crisis struck in 2008, the world has become more leveraged; total public and private debt reached 272% of developed-world GDP in 2013, according to a report put out under the aegis of the Geneva Reports on the World Economy.[9]

Debt is high and economies are growing more slowly than before the crisis, so they are not generating the incomes to service the debt as rapidly as they were. Household incomes, company revenues and government tax receipts can rise or fall, but debt payments are often fixed. Low inflation, especially if it is lower than borrowers expected when they took their loan, weakens that process and leaves debt burdens heavier than they would have been. Outright deflation would be even more burdensome.

The problem with low inflation and/or deflation is that the real value of existing debt owed by firms and households rises and, if the Fed goes ahead with its plan to raise interest rates later this year, then the cost of servicing that debt will rise, hitting the ability of companies to invest and households to spend.

Take Greece. Prices have been falling for nearly two years. Indeed, in December, deflation deepened to a 2.5% annual rate. Back in 2012, the EU leaders finally recognised that the huge public-sector debt that the Greeks had incurred in bailing out their banks and in funding the repayment of debt and interest to foreign lenders (mainly German and French banks) was just too great. They agreed with the conservative government in Athens that more funds would be made available, but that private creditors would take a 'haircut' in what was owed them. So French and German creditors swapped their Greek government bonds for new ones worth a little less, but guaranteed by the euro stability funds.

This 'haircut' (along with savage austerity measures) was designed to reduce Greek government debt from 165% to 120% of GDP by the end of this decade. But the problem is that, if the Greek economy does not grow and drops into a deflationary spiral, then, even if the euro value of Greek debt is reduced, the euro value of Greek GDP will fall even more, so that the debt burden rises, not falls. And that is what is happening. In 2012, after the restructuring, the public-sector debt ratio stood at 165%. Three years later, it now stands at just under 175%. No wonder the first issue on the agenda of negotiations between an impending Syriza government and the euro leaders is precisely the debt.

The IMF reckons that this debt ratio can fall by 40 percentage points by 2019 - *if* austerity continues, as agreed by the conservative government, real GDP grows by over 3% a year and inflation returns at a rate of over 1% a year. Instead the Greek economy is deflating. The debt ratio is likely to rise even more.

The long depression

It is now seven years since the great recession started across the major economies. As IMF director general Christine Lagarde puts it, global growth is "still too low, too brittle and too lopsided". There was a risk, she added, of the euro zone and Japan getting stuck "in a world of low growth and low inflation for a prolonged period".[10]

The World Bank has cut its forecast for global real GDP growth - yet again.[11] The bank forecast the world economy will grow 3.0% this year and 3.3% in 2016 - down from its earlier forecast of 3.4% and 3.5% respectively. Indeed, this lower forecast relies on the US growing faster than the 2.5% rate in 2014 or 3.2% in 2015. But it made the point that supposedly stronger US economic growth this year would be unable to compensate for slowing growth and deflation elsewhere: in the euro zone, Japan and the major emerging economies of Russia, Brazil, China, South Africa and Turkey (only India might grow faster this year). World trade growth continues to fall well behind trend before the great recession. The so-called emerging economies are running well below their full potential, according to the World Bank.

Now the IMF has joined the World Bank in cutting its forecasts - yet again. Global growth is now projected at 3.5 percent for 2015 and 3.7 percent for 2016, lowering its forecast by 0.3 percentage points for both years.

So this is not a normal 'recovery'; it is not 'a return to normal'. The great recession has morphed into what I call a long depression, with real GDP growth in the major economies well below the historic trend average, led by really weak business investment. The global economy is stuck in 'low gear'. As OECD puts it in its latest report, the world economy "is expected to accelerate gradually if countries implement growth-supportive policies".[12] Note the caveat: *if* the G20 leaders adopt more "growth-supportive" measures. OECD reckons that global real GDP growth was just 3.3% in 2014, but will “accelerate” to 3.7% in 2015 and 3.9% in 2016. But even that will be “modest compared with the pre-crisis period and somewhat below the long-term average”.

This mild acceleration - assuming it is achieved, and that is open to serious doubt - will be led by the US economy, says the OECD. OECD recognises that Europe and Japan will be lucky to grow more than 1% over the same period. The stagnation in Europe, particularly the euro zone, was also confirmed by the latest forecasts from the EU commission. The commission cut its forecasts yet again, saying the euro zone would expand by only 0.8% in 2014, 1.1% in 2015 and by 1.7% in 2016 - the 2016 level it said six months ago would be achieved in 2015. So once again, the commission has cut its more optimistic forecasts: it is always jam tomorrow.

OECD commented in its report that “we have yet to achieve a broad-based, sustained global expansion, as investment, credit and international trade remain hesitant”. And the EU’s economics commissioner, Pierre Moscovici, repeated much the same thing: “There is no single and simple answer. The economic recovery is clearly struggling to gather momentum.”

Higher profits have enabled US corporations to hoard cash, buy back their own shares to boost the market value of the company, and thus executive bonuses and share options, but it has also allowed a relatively faster rise in productive investment, albeit still poor compared with before the great recession. Investment in productive assets per head of population still has not reached the peak levels of 2007 in any of the major advanced capitalist economies, but at least the US has done better.

Total investment relative to GDP in the G7 economies stood at 19.3% in 2013 - a decline of 2.6 percentage points relative to 2007. Business investment (ie, investment in machinery, equipment, transport, structures and intangible assets) has been especially weak. In the second quarter of 2014, G7 private, non-residential investment amounted to 12.4% of GDP, compared to the peak of 13.3% in 2008.

The whole situation reminds me of 1937 during the great depression. Then it appeared to the US authorities that the slump was over and it was time to ‘normalise’ interest rates. On doing so, however, the US economy promptly dropped back into a new recession that was only overcome when the US entered the world war in 1941. The reality was that the profitability of capital and investment had not really recovered and raising the cost of borrowing on still high debt tipped the economy back.

The key indicator is business investment. Where investment goes, so will growth. But investment follows profits. Profits call the tune. And in the US, where the economic recovery has been greatest relatively, corporate profit growth has now virtually ceased. If total corporate profits stop growing from here, investment will soon follow.

The European Central Bank will shortly announce a new round of credit injections or quantitative easing designed to provide the banks and big corporations with virtually free money to invest or spend. So far, QE in Japan, Europe and even the US has failed to convince as a weapon to avoid slow or deflating economies.

The spectre of deflation remains.

Michael Roberts blogs at thenextrecession.wordpress.com. He has also just published a set of essays on the issue of *Inequality in modern economies*.

The print version is available at www.createspace.com/5078983;

and the Kindle version at www.amazon.co.uk/s/?field-keywords=Essays%20on%20inequality%20%28Essays%20on%20modern%20economies%20Book%201%29&node=341677031.

Notes

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