Paul Krugman - New York Times Blog

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Why Don't We Have Deflation?

Whenever you see a piece suggesting that the US economy has entered a "new normal" of slow growth, you're likely to see someone making the argument that if the economy actually had lots of excess capacity, we should be seeing deflation. And the question of why we don't have deflation is a good one. It is, however, a question that people like me have answered repeatedly; unfortunately, it seems that this analysis hasn't been making it to, say, a number of current and former Fed officials.

So here's a restatement of what we think we know. Long-time readers will find this familiar, but as a number of commenters have wisely pointed out, there are a lot of people reading this blog now who weren't reading it a year or two ago. (We're adding Twitter followers at around 20,000 a month, which is some indication of the number of newbies).

OK, first things first: back when the crisis started, I did expect to see deflation, Japanese style, if it went on for an extended period. I was wrong — and I did what you're supposed to do (but far too people actually do) when they're wrong, which is to look for an explanation of your error that is consistent with the available evidence.

One immediate thing to look at was to see whether what was happening to inflation in the United States was consistent with historical experience of deep slumps that we know involved the economy operating well below capacity for an extended period. And it turned out that the Japanese deflation (which has never been very fast in any case) is pretty much unique. The IMF looked at Protracted Large Output Gaps — PLOGs — and found that in general inflation gets squeezed toward, but not below, zero:

And our own history actually points in the same direction: the 1930s were marked by sharp deflation in the early years, but considerable inflation as the economy partially recovered, even though unemployment remained very high.

So inflation seems "sticky". But why? One immediate thought was that we might be looking at the effects of downward nominal wage rigidity: employers are very reluctant to engage in actual wage cuts. Way back in 1996 Akerlof, Dickens and Perry suggested that this would make inflation stubborn at low rates, breaking the usual link between high unemployment and disinflation.

Still, how can you tell if sticky inflation reflects sticky wages, as opposed to being the result of an economy that really doesn't have very much slack? The answer is that sticky wages should leave a "signature" in the wage data: a large number of workers whose wages neither rise nor fall, and a rising number of such workers as the economy slumps. Sure enough, researchers at the San Francisco Fed found exactly that:

Actually, once you start looking for it, downward nominal rigidity is everywhere. For example, Catherine Rampell had a great piece pointing out that starting salaries at elite law firms have been frozen at precisely $160,000 for years:

The bottom line is that we have a lot of evidence suggesting that the failure of deflation to materialize reflects wage rigidity, not absence of economic slack. And it is therefore frustrating to see supposedly well-informed people talk about this issue as if none of that work had been done.