

Why Has This Recession Not Produced a Price Deflation?

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A striking difference between the Great Depression of the 1930s and the current world recession is that unlike then there has been no absolute price-fall this time, which is significant because such a price deflation makes recovery difficult.

There are two reasons why this is so. First, a price deflation raises the real interest rate above the nominal interest rate, i.e. the rate in money terms. If the latter is 2 percent and prices are falling at 3 percent, then the real interest rate is 5 percent. Since recovery from a recession requires a revival of investment, which depends on the real interest rate, price deflation makes things harder. Even if the nominal interest rate is pushed down to zero through monetary policy, if prices continue falling at 3 percent, then the real interest rate remains at 3 percent, which may be too high for a recovery.

Secondly, price deflation also worsens the balance sheets of firms: the real value of debt increases relative to assets. Firms try to correct this worsening of balance sheets, by refraining from adding to their assets, and paying off loans instead, from accretions to their “own funds”, which entails a further contracting of investment. They also try improving balance sheets by selling some assets to pay off debt; but several firms doing so simultaneously has the effect of further lowering prices, i.e. further worsening the deflation, and hence making their balance sheets even worse. [American economist Irving Fisher had explained Great Depressions through this spiral of “debt-deflation”.](#)

The Great Depression of the 1930s had ended only with the Second World War, which had stimulated aggregate demand not only through boosting government military expenditure, but also through wiping off the debt-balloon of the 1930s

via the war-time inflation, and thereby automatically improving firms' balance sheets.

Why the current recession is not marked by a price deflation is discussed in the [April issue of the IMF's World Economic Outlook](#). The IMF's explanation is that the actual inflation rate gets tethered to the expected inflation rate, especially when the latter is low and is exogenously fixed, which, it claims, is the situation now. Central Banks these days pursue "inflation targeting"; not only are these targets very low, but people also believe that they will be realized because Central Banks are autonomous of governments and hence carry credibility. All this keeps the actual inflation rates low; and the IMF concludes that Central Banks should be made autonomous of governments wherever (as in India) they are not.

The IMF study however, like much of "mainstream" economics, analyzes advanced capitalist economies entirely without reference to the rest of the world, especially the developing world. In fact, the absence of price deflation today is mainly because of the behaviour of prices of primary commodities, of which developing countries are significant producers.

The prices of final goods and services produced in the advanced countries consist broadly of three components: the raw material cost, the wage cost, and the surplus-margin. If, for simplicity, we think of these countries as one integrated entity, pursuing one vertically integrated activity, then their final price can decline in absolute terms only if one or more of these components declines per unit of output.

The 1930s Depression had seen substantial *absolute* declines in primary commodity prices, so that even though final goods prices in these countries had also declined, the terms of trade had fallen for primary producers. This had pushed peasants into debt, causing acute agrarian distress in countries like India and boosting peasant support for the anti-colonial struggle. Governments headed by Chhotu Ram in Punjab and Fazlul Haque in Bengal had taken major steps to alleviate peasant distress.

Today, though agrarian distress is pervasive and intense (causing mass suicides), there is no absolute fall in primary commodity prices. On the contrary, this distress, caused by withdrawal of State support to the peasantry, has constrained foodgrain output and availability. [Food price inflation is significant](#); and the [terms of trade](#) between manufacturing and primary commodities are moving *in favour of the latter* (though how much of the benefit of this movement is coming to peasant producers as distinct from the marketing MNCs is a separate matter).

The price of the most important primary commodity, oil, is controlled by a cartel, the OPEC, the like of which did not exist in the 1930s. And though the oil price can fluctuate sharply because of speculation, there is no secular decline in it caused by the recession. Several other primary commodity prices are linked to oil. For instance, since jute is a substitute for polythene, a petro-product, the world jute price gets linked to that of oil; likewise the world coir price, linked to jute, also gets tethered to the oil price; and now, with the development of bio-fuels, even the world grain prices get linked to that of oil. In this situation therefore the recession does not have any significant deflationary effect upon primary commodity prices; the raw material cost component per unit of advanced country output does not decline in absolute terms. And even if the second component of price, namely the wage cost per unit of output, falls, as long as this is not sudden and substantial, the final price does not fall, since oligopolistic firms collude to prevent it by jacking up their surplus margins (the third component of price) correspondingly.

There is reason to expect a reduction in this wage-cost component, since globalization has broken down the segmentation of the world economy that existed earlier. Throughout the nineteenth and twentieth centuries, labour from the “South” was not allowed to move freely to the “North”, a phenomenon that still persists; and capital from the “North”, though freely allowed to move to the “South”, did not actually do so, except to enclaves like plantations, and mining. As a result, “Northern” wage rates were not restrained by the large reserve army of labour that existed in the “South”, in countries like China, India and Indonesia,

where it had been created by the process of “deindustrialization” unleashed by colonialism earlier.

There was therefore an effective segmentation of the world economy where the “Southern” wages remained tied to some subsistence level because of the existence of huge labour reserves, while the “Northern” wages could move up with increases in labour productivity, notwithstanding the existence of some local reserve army of labour which was rather small.

Contemporary globalization has broken this segmentation. Capital from the “North” is now willing to locate production in the “South” to take advantage of cheap wages for meeting the global market, which means that the “Northern” wages are no longer immune to the restraining influence of the labour reserves of the “South”. Indeed much of the export success of economies like China is attributable to the fact that US multinationals have located plants there for exporting to the rest of the world, including the U.S. itself.

Under these circumstances, while wages do not necessarily get equalized between the “North” and the “South”, the gap between the wage rates in the two regions certainly does not increase. And increases in labour productivity, no matter where they occur, have little effect on the real wage rates anywhere, because third world labour reserves remain unexhausted. This means that in the advanced countries *wage costs* per unit of output could be declining for this reason, in addition to possible effects of the recession itself. But this *per se* does not mean a decline in the final price, since oligopoly pricing prevents it.

A revival of world aggregate demand is unlikely to cause any supply-side strains *for the advanced economies*. They have unutilized capacity, unemployment (whose decline, as already discussed, will not raise real wages), substantial food stocks, and access to oil (and bio-fuels) at prices that need not increase with such revival (barring transient speculative pressures).

It will however cause supply-side strains in developing economies, which either do not have adequate food stocks, or are unwilling (as in India) to use them for

keeping down prices, for fear that a larger food subsidy bill would increase the fiscal deficit. A revival of world demand therefore will, *other things remaining the same*, aggravate inflation in these economies; and to prevent such aggravation, *they will adopt austerity measures that curtail the real purchasing power of the people.*

“Inflation targeting” by Central Banks in these economies will be used precisely for curtailing purchasing power with the people, which means squeezing them in ways that are an alternative to inflation. Today, unlike in the 1930s, when primary commodity stocks relative to output were plentiful, getting out of a World Depression would not *ipso facto* benefit all.

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