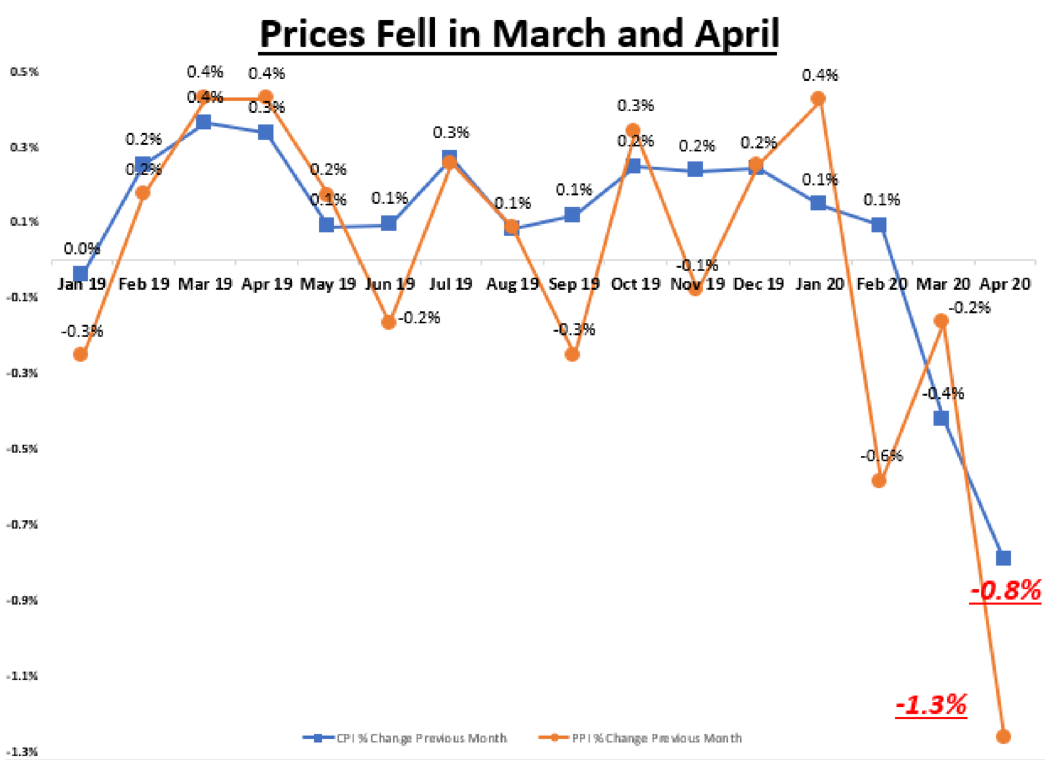
The Potential Risk of Deflation in the U.S. Economy

The Federal Reserve's response to the COVID-19 crisis has caused some to worry about inflation. The Fed has provided trillions of dollars of liquidity for the financial markets. That money, in theory, could flow through to the real economy and cause prices to rise. That could become a problem someday in the future. Right now, the bigger worry is deflation.

Deflation is the reverse of inflation. It is when prices fall. It is devastating for businesses which have fixed costs for things like wages, debt, and other inputs. When the price of their products falls, it makes it harder for them to meet these vital costs.

Data on consumer and producer prices the last few days shows that deflation is occurring. The [Consumer Price Index (CPI)] for April showed consumer prices fell 0.8% in April. In March they fell 0.4%. The Producer Price Index (PPI) fell 1.3% in April—the largest decrease since the series started in 2009—and 0.2% in March. Producer prices are the costs to businesses to produce their products. Troublingly, the fall in PPI was driven largely by the decline in demand for finished products.



This data is not surprising given the enormous global economic disruption we are in the middle of. Consumers aren’t spending, so prices are falling. The downward pressure on prices explains why the Fed will focus on providing as much liquidity as necessary for the time being and will worry about any inflation those funds cause in the future.

Energy prices are a big cause for the drop in both sets of prices. Demand for energy will turn around as the economy unlocks. That will drive prices higher. Demand for all goods will rise too, which will push prices up.

Until there is enough consumer activity unleashed to at least keep prices stable, the concern for policymakers should be counteracting deflation. The time to worry about inflation is in the future.

—Curtis Dubay, Senior Economist, U.S. Chamber of Commerce