Richard C.K. Burdekin and Pierre L. Siklos, eds., _Deflation: Current and Historical Perspectives_. Cambridge: Cambridge University Press, 2004. xxii + 359 pp. $75.00 (cloth), ISBN: 0-521-83799-5.

With oil prices accelerating rapidly over the past year, housing prices "frothing" in coastal areas, and the Federal Reserve raising the federal funds rate eleven times since the end of the most recent recession, the timing of a new book addressing the topic of deflation seems somewhat inopportune. Nevertheless, it is worth remembering that, as little as two years ago, American policy makers were seriously pondering the possibility of deflation. Improvements in labor productivity and the expanding use of global supply chains to manage input costs were holding the lid on the overall price level, and short-term interest rates were approaching the zero bound in the wake of the 2001 recession and the collapse in spending on information technologies. Such circumstances warranted the consideration of the small-probability event of sustained deflation, given Alan Greenspan's risk-management approach to central banking. Deflation and related issues such as asset price booms and busts, liquidity traps, and the operation of monetary policy in extremely low interest-rate environments consequently received renewed attention from domestic policymakers and economists. Moreover, policy debates over the effects of deflation and the appropriate response to it had been taking place for some time in other parts of the world. In particular, Japan was bearing witness to the first recorded deflation in an industrialized country since the Great Depression. These issues and policy debates form the backdrop for the edited volume by Richard Burdekin and Pierre Siklos, which offers a critical evaluation of historical episodes of deflation and some long-run perspective on more recent events.

The edited conference volume consists of twelve chapters that examine deflation by drawing on theory, history, and empirical evidence. The book features interesting contributions by many eminent financial and economic historians. This alone would make it appealing to specialists working in macroeconomic history, but it ought to attract a broader readership, including macroeconomists, central bankers, and policymakers, since the editors were careful to include papers that employ more recent data and theory. Indeed, one of the strengths of the volume is that the contributors employed a variety of methodological perspectives to analyze monetary phenomena and compare present issues with past episodes of deflation.

After an introductory chapter that provides a useful summary by the editors, the book is divided into four sections. The first part of the book, entitled "Fears of Deflation and the Role of Monetary Policy," begins with an essay by Hugh Rockoff. He suggests that the U.S. bank failures of the 1930s exhibit characteristics that are similar to twin crises (banking and exchange rate crises) that have occurred more recently in national economies. Rural regions in the U.S. experienced "capital flight" because depositors feared that declining export prices and demand would undermine the ability of borrowers to repay; this eventually prompted runs on some banks and led authorities to impose restrictions on withdrawals (bank holidays). Rockoff contributes to the growing literature on regional differences in bank performance during the Great Depression by focusing on "silent runs" – the withdrawal of deposits from rural areas and their movement to Eastern financial centers – a process that was driven in part by declining prices and deflation. The interregional evidence is consistent with his argument, although individual bank data showing that losses of deposits had important consequences for the survival of banks would further strengthen his argument.

In the second chapter of this section, Forrest Capie and Geoffrey Wood take a longer-run perspective and examine whether debt-deflation had damaging effects on the British economy between 1870 and the 1930s. J.M. Keynes' views on debt deflation suggested that expected real rates are important for generating real effects, whereas Fisher emphasized that rising realized rates produced dilatory effects on existing debtors. The authors use simple time-series analysis to produce price-expectation series and then construct real interest rates that take into account either expected inflation or actual inflation, according to the respective ideas of Keynes and Fisher. They use these series as well as bond spreads to assess the effects of debt deflation, and find little statistical evidence that debt deflation in Britain created adverse effects for the real economy (or for financial stability); the authors rightly point out, however, that Britain's experience with deflation was much milder than that which occurred in the U.S., so it is difficult to rule out the debt-deflation hypothesis in general. Klas Fregert and Lars Jonung close out the first section of the book by examining two cases of interwar deflation in Sweden, 1921-23 and 1931-33. They use the relatively short interval of time between these two episodes to assess how policymaking and macroeconomic outcomes in the first episode were influenced by the inflationary period of World War I, and how this deflationary episode (and the persistent and high unemployment that emerged in the 1920s) in turn influenced beliefs and behavior ten years later. Fregert and Jonung employ qualitative evidence to argue that the large deflation in the early 1920s greatly influenced the thinking of economists, policymakers, and wage setters in the latter episode. Heterogeneous expectations across these groups limited the deflation of 1931-33 as wage contracts were shortened and, in some cases, abandoned.

The second section of the book, entitled "Deflation and Asset Prices," provides new contributions to the growing literature examining the relationship between monetary policy and asset prices. The first, by Michael Bordo and Olivier Jeanne, develops a model to assess whether monetary policymakers should respond to an asset price "boom" – a term which, according to the authors, differs from a "bubble" in that it is not necessary for policymakers to determine if asset prices reflect fundamentals in order to act. If monetary policies decide not to lean against the wind, they run the risk of a boom being followed by a bust, and a collateral-induced credit crunch dampening the real economy. On the other hand, pursuing restrictive monetary policy implies immediate costs in terms of lower output and inflation. Although the model is very stylized, they find that a proactive monetary policy is optimal when the risk of a bust is large and the monetary authorities can let the air out at a low cost; moreover, they argue that such a policy rule will not look like a Taylor rule in that it will depend on the risks in the balance sheets of the private sector. They then present some preliminary empirical evidence that the boom-bust cycles of their model appear to be much more frequent in real property prices than in stock prices and more common in small countries than in large. (The obvious exceptions to this are Japan's experience in the 1990s and the U.S. during the Great Depression.)

Moreover, they suggest that such busts can create banking crises and lead to severe reductions in output.

The second chapter in this section also examines boom-bust cycles in credit markets, but focuses on the linkages between bank lending and asset prices. Using vector autoregressions, Charles Goodhart and Boris Hofmann argue that movements in property prices during the period 1985-2001 had significant effects on bank lending in a sample of twelve developed countries. Their impulse response functions, however, show that bank lending appears to be insensitive to changes in interest rates. On the other hand, asset prices seem to respond negatively to interest-rate movements. The authors provocatively conclude that there is limited scope for effectively using monetary policy as an instrument to provide financial stability in periods when there are asset-price swings, in part because the effects of interest rates on asset prices and bank lending are highly nonlinear. One challenge to their interpretation of the evidence is that monetary policy is treated in isolation from changes in bank regulation that also took place during this period. Regulatory changes likely also influenced bank lending decisions. One prominent example of this was the adoption of BIS capital-asset requirements in 1988 by Japanese banks, which strengthened the relationship between bank lending and equity prices. Banks could count 45 percent of latent capital as part of tier-II capital requirements; this ensured that increases in equity prices increased bank capital, which in turn, encouraged banks to lend more on real estate and supported rising asset prices.

The third part of the book provides additional case studies of deflation. Michael Bordo and Angela Redish point out that "good" deflations are often defined as periods when prices are falling as a result of positive supply shocks (like technological progress); hence, aggregate supply outpaces aggregate demand. "Bad deflations" are periods when prices fall because aggregate demand increases faster than aggregate supply; this can occur when there are money demand shocks. They suggest, however, that this simple classification can be difficult to square with empirical evidence. Examining the United States and Canada during the classical gold standard period, they find some evidence that both negative demand shocks and positive supply shocks drove prices downward between 1870 and 1896. Output growth was more rapid during the inflationary period of 1896-1913 than the preceding period of deflation, but their time series evidence suggests that there was no causal relationship: price changes were not driving the determination of output.

Michele Fratianni and Franco Spinelli look at Italian deflation and exchange-rate policy during the interwar period, and Michael Hutchinson analyzes Japan in the 1990s. These two chapters make use of a comparative historical approach. Fratianni and Spinelli compare and contrast the Italian deflation of 1927-33 with the disinflation that took place during the adoption of the EMS (1987-92) to argue that fixed exchange rates became unsustainable as economic fundamentals deteriorated. In particular, the interwar gold-exchange standard imparted a deflationary bias, which eventually led authorities to abandon the fixed exchange rate regime in order to pursue lender of last resort activities (thereby assisting failing banks and preventing banking panics) and stabilize the money supply. Hutchinson provides a nice overview of the most important recent episode of deflation, Japan, and shows how injections of liquidity by the central bank (which eventually reduced nominal rates to zero) have not been very effective at improving the growth in broad money aggregates (at least until the last few years). He examines both the liquidity trap and "credit crunch" views of the Heisei Malaise, and argues that, in spite of some policy mistakes that prolonged the deflation and made it more costly, Japan's deflationary experience has been nowhere near as disastrous as the experience of the U.S. in the 1930s. However, Hutchinson suggests that Japanese policymakers could have made their commitment to zero-interest-rate policy more effective by also adopting an explicit inflation target.

The last section provides three studies that explore the behavior of asset prices during deflations. Lance Davis, Larry Neal, and Eugene White examine how the 1890s deflation affected the core financial markets of the time. Largely narrative in its treatment, this chapter examines how the corresponding financial crisis of that decade prompted different degrees of institutional redesign and regulation in the financial markets of Paris, Berlin, New York, and London. In the next chapter, Martin Bohl and Pierre Siklos study the behavior of German equity prices during the 1910s and 1920s. They argue that this period of German history is particularly useful for analyzing the long-run validity of the present value model of asset price determination because the model can be studied for periods of deflation and hyperinflation. Their empirical results suggest that, while the theory holds for the long run, German share prices exhibited large and persistent deviations in the short run, perhaps the result of noise trading or bubbles. The final chapter by Richard Burdekin and Marc Weidenmier suggests that gold stocks might be a useful hedge against asset price deflation. They find evidence of excess returns on gold stocks after the 1929 and 2000 equity-market declines, but scant evidence of excess returns after the 1987 crash, and interpret these results as indicating that gold stocks only serve a useful hedge if asset price reversals are prolonged.

Even though deflation has lost some of its immediate relevance to policymakers, there is much to be commended in the editors' efforts to design a book that demonstrates the importance of developing a greater empirical and theoretical understanding of deflation. Although one can always quibble with the compromises that occur when assembling such a volume (for example, in this book, despite the fact that many of the chapters discuss the interwar period, there is no single chapter that attempts to examine deflation using a true panel-data approach), this book's chapters certainly have enough thematic overlap that the sum of the articles still ends up being of greater value than the individual parts – something that is often difficult to achieve in conference volumes. In this respect, it is a welcome addition to the literature for those interested in monetary economics or those wanting an enhanced historical perspective on recent policy debates.