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U.S. ECONOMY MAY STILL FACE LONG-TERM DEFLATIONARY RISKS, ACCORDING TO NEW LEVY ECONOMICS INSTITUTE STUDY

Combination of Record Levels of Private Debt and the Potential for a Drop in Asset Prices, Especially in Real Estate, Poses a Serious Threat to the U.S. Economy

ANNANDALE-ON-HUDSON, N.Y. — Despite recent signs of strength, the U.S. economy still remains fragile and potentially vulnerable to deflationary pressures over the long-term, according to a new study from The Levy Economics Institute of Bard College. With record levels of debt amassed by households and firms, state fiscal crises, and weak demand from abroad, the most likely trigger for deflation would be the fall off in demand created by a sharp drop in asset prices, particularly in the soaring real estate market, the study finds.

"The real danger comes from the possibility of a deflation of asset prices. Given the rising leverage ratios that have become increasingly accepted by financial markets, the margins of safety have been reduced considerably over the past two decades. What this means is that fairly small negative movements of the value of real estate (and other) assets can reduce their value below the debt issued in their purchase," write Levy Institute President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray in their public policy brief, *Understanding Deflation: Treating the Disease, Not the Symptoms*. "The effects of a real estate market crash would be more widespread across American households than were the effects of the stock market tumble after 2000."

In their study, Papadimitriou and Wray argue that, even amid recent signs of renewed growth, dangerous imbalances and deflationary elements remain embedded in the U.S. economy. Among the reasons the economy remains vulnerable, the authors cite the worst

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fiscal crisis faced by state governments since the Great Depression, the ongoing impact of falling asset prices on pension plans, record levels of private debt, and competition by low-cost producers overseas. To guard against the potential shock of a pullback in asset prices and to address the underlying structural problems in the economy, the study urges the federal government to consider broader-based tax cuts than those enacted by President Bush, aid to struggling state governments, and new spending programs to bolster domestic demand. Specifically, the authors suggest the arguement for a cut, perhaps a temporary one, in payroll taxes for both employers and employees, emergency federal support to state governments to limit their budget cuts, and significant federal support for public infrastructure investment.

"These measures will reduce unemployment, increase growth, and relieve deflationary pressures," the authors contend, stressing the limitations of the Bush tax cuts to boost domestic demand. "Capital gains tax cuts, cuts of taxes on dividends, or even across-the-board income tax cuts are not the best way to do this, for the simple reason that these will not put much money into the hands of most Americans."

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Public Policy Brief No. 74, *Understanding Deflation: Treating the Disease, Not the Symptoms*

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