A Sinking Feeling at the Register

By DAVID LEONHARDT

One year ago, a 50-inch Hitachi television cost $1,400 at Circuit City. It costs $1,000 today.

Five years ago, automakers charged $25,500 for the average new vehicle. They charge about $24,500 today.

A decade ago, a round trip on Delta Air Lines between New York and San Francisco cost $388 — and it was part of a sale. Delta now sells the same advance-purchase ticket for $317.

Most stunning is the price path of Burger King's Whopper sandwich, which cost about $1.40 some 20 years ago, when the Dow Jones industrial average hovered around 1,000 and hourly wages were about one-half their current level. This weekend, a Whopper sells for 99 cents.

Deflation, a sustained decline in prices across the economy, remains merely a threat, with overall prices still rising mildly. For some of the nation's largest industries, though, falling prices are a reality. The costs of cars, clothing, electronics, furniture, jewelry, kitchen equipment and toys — indeed, of most manufactured goods — have been dropping for more than a year, causing turmoil for companies and their workers. Although airlines and fast food are among the only industries in the service sector to be suffering through declines, overall service prices are rising more slowly than they were two years ago, according to figures released last week.

"More goods are chasing less money," said Arthur J. Rolnick, research director at the Federal Reserve Bank of Minneapolis, "instead of more money chasing fewer goods."

Worried about falling prices, the Fed lowered its benchmark interest rate again late last year. Officials say deflation remains unlikely but, because it is so hard to stop once it starts, they are taking preventive measures.

The lack of pricing power has been forcing executives to cut costs even as they increase production, and it has helped to make the current economic recovery a jobless one. Almost 200,000 jobs were eliminated across the country in November and December.

The squeeze has also cost some chief executives their jobs, like Jack M. Greenberg of McDonald's, who resigned last month, shortly before the company announced its first quarterly loss since going public 38 years ago. Other companies, including airlines, automotive suppliers and, last week, FAO, the toy retailer, have filed for bankruptcy protection.

The biggest culprit is the 1990's bubble that left many industries with more goods than they could profitably sell and more capacity than they could use. But the surge of imports from low-cost countries like China, the rise in American productivity and the continuing trend toward deregulation and market-
determined prices are all playing roles.

FACED with stagnant revenue, many companies are aggravating their industries' troubles by further reducing prices to grab pieces of a shrinking pie.

The weak economic growth of the last year has caused poultry prices, for example, to drop about 1 percent. Tyson Foods, the world's biggest seller of chicken, has responded by offering more promotions to supermarkets, said John Tyson, the chief executive.

General Motors, the first automaker to offer zero percent financing after Sept. 11, 2001, expanded its incentives last month to match the deals offered by Ford Motor, after G.M. had cut them back in November.

"We go to zero percent, 36 months, then the guys who were griping about incentives go to 60 months," Rick Wagoner, G.M.'s chief executive, said in an interview, referring to competitors. "And guess what? They get big market share, and we don't."

Now "they're going to have to fight toe to toe," Mr. Wagoner said.

Even some products in great demand have become less expensive, as retailers use them to woo customers. Although Chicken Dance Elmo, a doll based on a "Sesame Street" character, is dancing its way off shelves, Wal-Mart and Target still cut its price to $15, from the list price of $20, said Jim Silver, the publisher of The Toy Book, which covers the industry. Other sellers followed quickly, contributing to a 30 percent decline in overall toy prices since 1996.

Across the economy, inflation is running at an annual rate of about 1 percent or 2 percent, depending on the government measure. With the economy still weak, however, economists and policy makers worry that a deflationary trap similar to Japan's is now possible, if unlikely.

"There are some well-founded reasons to presume that deflation is more of a threat to economic growth than is inflation," Alan Greenspan, the Federal Reserve chairman, said recently. But, he added, "the United States is nowhere close to sliding into a pernicious deflation."

So long as an economy's demand for goods remains much below its capacity to produce them, inflation tends to decline, and the continuing job cuts suggest that the American economy is still operating well below capacity. If low inflation turns into deflation, unemployment can spike, debts can become unmanageable and, in the most extreme cases, consumers may hold onto their money, waiting for prices to fall further.

The Fed, by lowering interest rates and making dollars effectively less valuable, can typically cause inflation to rise — unless banks, consumers and businesses hoard their cash. Even if Fed officials cut their benchmark rate to zero, they can still print more money to keep prices stable or rising at a slow clip, they say. "We can always prevent deflation," Mr. Rolnick said. "There are enough people in central banks around the world who think it's a bad thing that they just aren't going to let it happen."

In recent weeks, a few economists have started wondering if 2003 will be the year inflation reasserts itself. Many of the Fed's interest-rate cuts the last two years are still washing over the economy, giving people reasons to spend, while a war with Iraq could bring both a spike in government spending and a climb in oil prices. The dollar has also lost some of its value recently, and import prices will probably
rise as a result.

"I don't know if we've reached the inflection point," said Peter L. Bernstein, an author and economic consultant, "but my impression is that this phase is coming to an end."

There are still worrisome trends, however, that suggest the 1990's spending binge by consumers and executives has left a bigger hangover than a typical expansion does. In most recent downturns, prices in the service sector continued to rise as fast as they had been, largely because demand for services like education, medical care and haircuts does not drop during recessions. Since late 2000, by contrast, inflation in services has fallen to 1.8 percent annually, from 3 percent — a sign of weak demand, said Stephen Roach, the chief economist at Morgan Stanley and probably the most vocal deflation worrier.

"The good news is that policy is responding," Mr. Roach said. "The bad news is that there's no guarantee it will work."

In many industries, the issue is far more than academic. The battle against runaway inflation in the late 1970's and early 80's was won, but the victory has created its own troubles.

Encouraged by the stability and prosperity of the 90's, American companies spent billions on new factories, equipment and software, vastly increasing their ability to make products. Some service companies helped inflate the bubble, too.

Combined, McDonald's, Burger King and Wendy's opened 6,100 restaurants from 1994 to 2001, expanding by about a third, according to Technomic, a research company in Chicago. Many now compete with one another, as well as with thousands of new outlets of Starbucks, Subway and other chains that have lured customers more successfully than the burger chains.

In response, McDonald's and Burger King have waged price wars, of which the current 99-cent Whopper sale is a part. Wendy's rarely offers discounts, but its president, Thomas J. Mueller, said, "We pride ourselves on not increasing our prices."

Manufacturers also face new competition from overseas because many foreign companies are attracted to the American market, which they consider the world's healthiest. Since 1995, in fact, the United States has accounted for almost two-thirds of global economic growth, Morgan Stanley says.

In the auto industry, Honda and Toyota began making hundreds of thousands of sport utility vehicles every year. Hyundai captured parts of the low end of the vehicle market. Volkswagen increased its sales here.

To keep factories running and high fixed costs covered, American companies fought back by offering incentives and markdowns. Today, those discounts are equal to $3,100 a vehicle, twice the level of two years ago, according to Autodata, a research company. A family making the median income now must use about 20 weeks of pay for a new vehicle, compared with 29 weeks in 1996, according to Comerica Bank.

"The competition has basically turned the industry into an unprofitable one," said David E. Cole, president of the Center for Automotive Research, a consulting firm in Ann Arbor, Mich. "The business model is broken."

The shakeout is beginning. Fiat, the Italian car company, is struggling to stay in business. Ford is
planning to cut billions of dollars in expenses this year.

"It's not a very pretty process," Mr. Cole said. "And it's not over."

But globalization's contribution to price pressure can also come wrapped in an American company's label. Since the double-digit inflation of 25 years ago, Mexico, China and other low-wage countries have greatly increased their manufacturing bases. The strong dollar of recent years — another reflection of the American economy's primacy, even in a slowdown — has made imports even less expensive.

Imports have helped prices fall 12 percent for men's pants since 1999 and 10 percent for women's suits, the Labor Department calculates. Furniture prices are down 4 percent.

Ethan Allen, a chain of 315 furniture stores, made nearly all its products in the United States in the early 1990's; now the portion has fallen to 80 percent. Some of its most expensive products, like a $3,000 bed, are made in factories in China and the Philippines that have become much more efficient in recent years, said M. Farooq Kathwari, Ethan Allen's chief executive.

"That has put a tremendous amount of pressure on prices," said Mr. Kathwari, who announced some price cuts late last year. "In the next year or couple of years, I don't see much chance of increasing prices."

Since 2000, Ethan Allen, based in Danbury, Conn., has also cut its work force about 5 percent, to 10,000, while its sales have risen slightly. It operates 17 factories, compared with 27 a decade ago.

Elsewhere, a slow unwinding of government regulation has laid the groundwork for price declines. The federal government stopped setting airline fares in 1978, for instance, but low-fare airlines have only recently established their presence in almost every region of the country. Their success has kept fares flat since 1990, and it played a crucial role in the bankruptcy filings last year by United Airlines and US Airways.

The rise in productivity in the last decade has also helped bring down inflation. With new technology, new management techniques and an increasingly educated work force, American companies can make more goods than they did in the past while using the same amount of labor. G.M. made a profit in its most recent quarter, despite its discounts, partly by becoming more efficient.

In some previous eras of high productivity, like the late 1800's, deflation and economic growth coexisted as companies and workers split the spoils of their efficiency. The technology sector benefited from a similar virtuous cycle in the 1990's.

Today's wave of price cutting — stemming mainly from economic weakness — continues to bring benefits for consumers, but there is little that is virtuous about it for companies caught in its vise.