The new buzz word is deflation. Few things in economics are scarier that the prospect of deflation – a widespread, sustained decline in prices. Deflation is usually associated with the Great Depression of the 1930s and Japan's more recent slump. Six years ago I wrote a paper along with some of my former colleagues at the US Federal Reserve that examined Japan's experience to shed light on how countries might prevent deflation. Alas, I think it's time to dust off that study.

Financial markets are pricing in deflation in the United States. Given the rapid deterioration in economic activity in Europe, deflation is also a real possibility on this side of the Atlantic. Many forecasters are projecting falling consumer prices next year in this country. Energy prices and interest rates are dropping, sterling is plummeting, and businesses have begun to slash prices to clear unsold stock.

The main problem with deflation is that it makes it much more difficult for the central bank to reactivate the economy. With an economic depression looming, the Fed would like to cut interest rates so that real (that is, adjusted for inflation) interest rates are zero (or even below). But it can only lower policy interest rates to zero from one per cent at present. Even if policy interest rates are zero, real interest rates will be positive if consumer prices are falling. This depresses spending more, which causes more deflation, and so on. The risk is that the US economy may get caught in a deflation trap.

The lesson from Japan's experience is that when inflation and interest rates have fallen close to zero, and the risk of deflation is high, massive monetary and fiscal stimulus is needed. The new US government is going to throw everything they can at the economy. Time will tell whether it'll be enough.