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Andrew Cassel | As deflation fears grow, a look at how it would affect us

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This week's economic news is grimmer than last week's. Yesterday's report that consumer confidence plunged in October to its lowest point since 1993 added more weight to fears that the nation's wobbly recovery might take a lot longer than hoped, or even run out of gas altogether.

We probably shouldn't panic. Any transition period between recession and growth is going to produce mixed reports; the lights don't all flash green at once. But flagging consumer confidence, along with drops in the leading economic indicators and a shaky Christmas-season sales outlook, makes it harder to argue that the recovery is on track.

Indeed, the latest numbers have fueled worries that something much more ominous might be developing. In the last few days, a number of respected economists have argued that deflation - a phenomenon not experienced in this country since the 1930s - might be making a comeback.

What is deflation, and what would living in a deflationary economy be like? It might be hard to imagine, particularly if you came of age in the '70s, when the opposite problem - inflation - dominated our worries.

In simplest terms, deflation means a time of generally falling prices. As with inflation, the critical term is "generally" - you can't call it deflation just because shoes or computers are on sale. The decreases must be very widespread, and last longer than the month after Christmas.

Real deflation also wouldn't feel like an after-Christmas sale. As in the 1930s, the prevalent mood would be pessimism, even fear. People would be inclined not to buy much of anything - either because they felt sure they could get it cheaper later on or because they were too worried about the future to spend more than absolutely necessary.

You can see how this might feed on itself. Less spending means lower sales and profits, forcing companies to lay off workers or go out of business, which makes more people afraid to spend, and so on.

There would be other unpleasant side effects as well. As incomes and profits shrink, it becomes harder to repay debts. (By contrast, inflation favors debtors, letting them pay back with cheaper dollars.) Rising defaults would put banks and other financial institutions at risk.

Needless to say, this wouldn't be good for investment assets such as stocks or real estate. Falling values would add to the general sense of fear and uncertainty, fueling what would amount to a shrinkage of the entire economic pie.

Is such a scenario likely? Some say it's already occurring, and the consumer-confidence plunge this month is evidence in their favor.

At a conference in New York this week, officials of the economic forecasting firm Global Insight (formerly DRI-WEFA) said the risk of worldwide deflation has grown enough to warrant "bold action" by the Federal Reserve and its counterparts around the world.

Global Insight chief economist Nariman Behravesh said the Fed should cut its key short-term interest rate to 1 percent - a 0.75-percentage-point drop from the current level.

Congress and the Bush administration should pitch in with additional spending and tax cuts totaling $50 billion, he said. Officials in Europe, Japan and elsewhere should adopt similar moves - the goal being to jump-start the global economy before the deflation cycle takes hold.

Not everyone feels the situation is quite so dire. At the same New York conference, Morgan Stanley economist Richard Berner said he saw "no hint of deflation" in the current economic picture, noting that prices for some imported goods have actually been rising recently.

Anyone looking at recent changes in the price of health care or college tuition might be similarly skeptical that deflation has arrived.

Nevertheless, concern about deflation is clearly spreading, and the next question is whether it has seeped under the doors of Alan Greenspan's office at the Fed. If the answer is yes, look for interest rates to fall again when Greenspan and his colleagues meet again next week.