

The Economics of Deflation

A2 Economics

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What is Deflation?

- Deflation is a sustained fall in the general price level
- A sustained period of negative inflation
- The internal value of money rises
- Not to be confused with disinflation - when the rate of increase of the price level is falling
- Deflation is not new for the UK – but since the Second World War (WWII), annual inflation has averaged around 7%, and on an annual basis prices have not fallen in a single year

Price deflation for audio visual & clothing

RPI inflation now negative for 1st time since the 1960s

What does deflation mean for you?

What is deflation? A historical lesson

Wage cuts and the dangers of deflation

Evidence of deflation in [China](#)

Charles Bean on deflation

- “At its simplest, deflation is a sustained period over which the general price level is falling. But just as there are many different strains of influenza, some of them lethal, and some of them producing just temporary discomfort, so it is with deflation.
- And just as a bad cold may generate 'flu-like symptoms, so economies may exhibit some of the symptoms of deflation without necessarily suffering from the virus.”
- *Charles Bean, Bank of England Chief Economist*

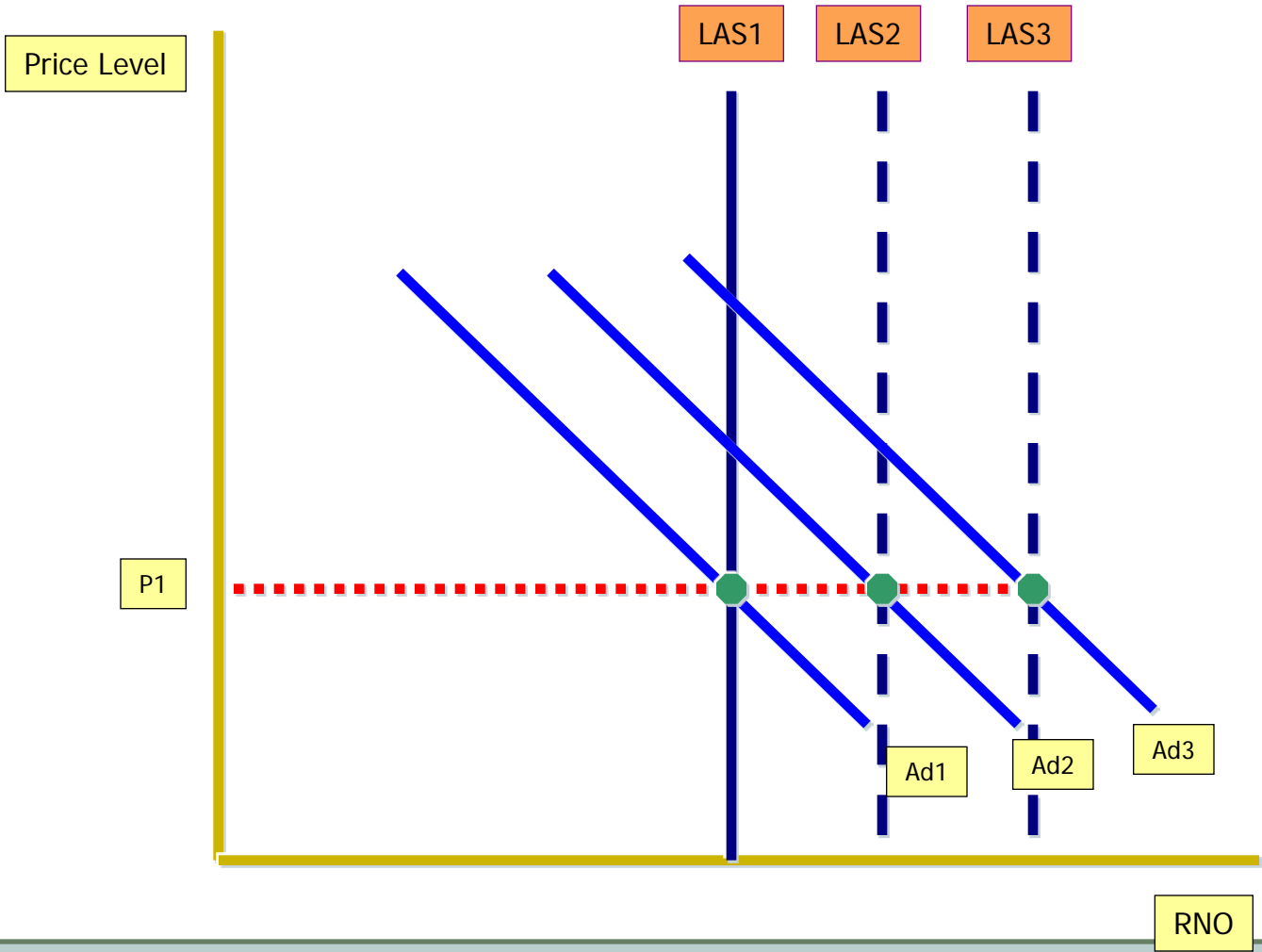
Possible Causes of Deflation

- A Large (adverse) Fall in AD
 - Exogenous shocks to the economy
 - A global recession leading to a fall in exports and investment
 - A rise in the exchange rate (leading to lower exports and cheaper imports)
 - Declines in domestic and international asset prices
 - Deliberate attempts by macroeconomic policy to reduce AD through tightening of fiscal and/or monetary policy

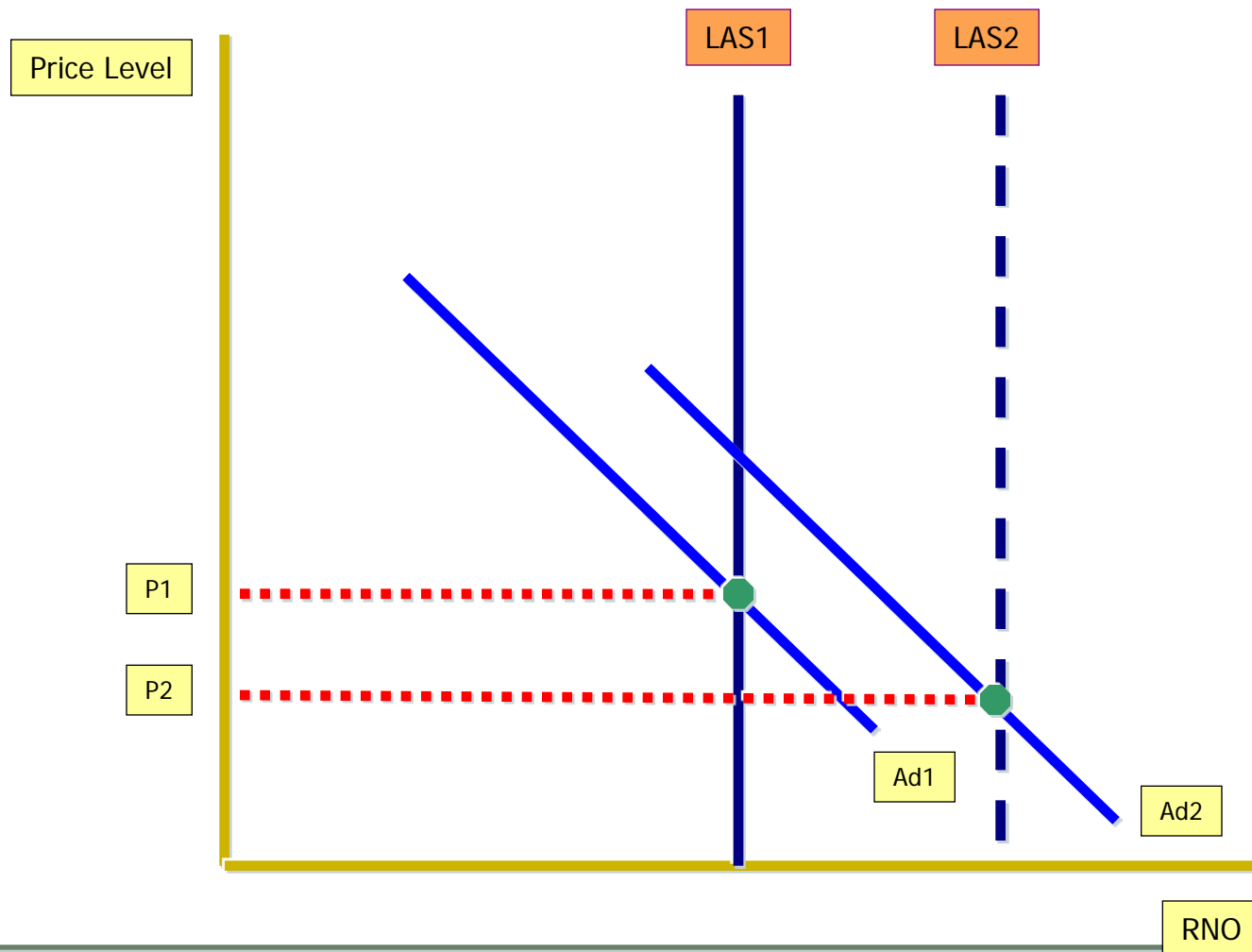
Possible Causes of Deflation

- An Increase in Long Run Aggregate Supply
 - The supply potential of the economy has been boosted by a series of beneficial shocks such as
 - Impact of rapid technological advances
 - Reductions in the international prices of commodities and capital goods
 - Higher productivity which drives down unit cost of production
 - Exploitation of economies of scale leading to lower LRAC
 - Excess supply in some industries due to over-investment in new capital machinery
 - i.e. deflation results from a persistent demand deficit over existing and potential productive capacity.

An Increase in Long Run Aggregate Supply



Higher LRAS causing deflation



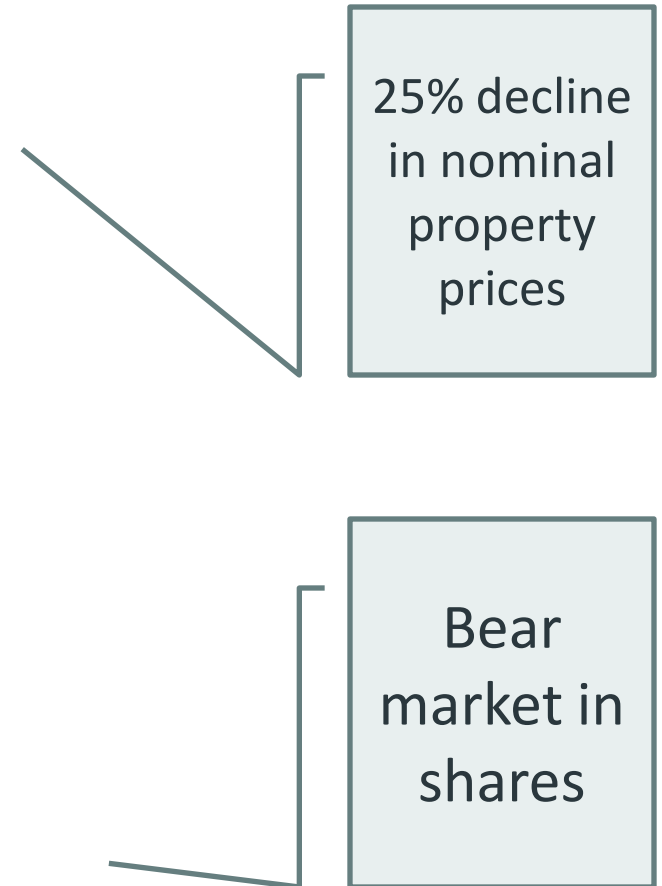
Benign Deflation

- If the falling prices are simply the result of improving technology or increased productivity

Malign Deflation

- Malign deflation occurs when prices fall because of persistent lack of demand
- Deflationary pressures are greatest when the economy is operating with a large negative [output gap](#)
- Whether deflation remains benign or becomes nasty depends, to a large extent, on how people react to it
- [Keynesian emphasis](#) on the dangers of an economy operating with a level of AD insufficient to achieve full-employment of factors of production

Asset price deflation in 2008-09



Can Monetary Policy Avoid Deflation?

- Monetary Policy
 - Cuts in policy rates to stimulate the demand for money
 - [Quantitative easing](#) to unfreeze the supply of credit
- But.....
 - If confidence is low, the impact is small – this is known as the [liquidity trap](#) – very low interest elasticity of demand
 - If asset prices are falling, the demand for cash savings will remain high – consumption may not respond
 - The higher real value of debt encourages saving and higher saving can make a recession worse – the [Paradox of Thrift](#)
 - Monetary policy may become ineffective at times of deflation
 - There is a zero bound for policy interest rates

UK policy rates and inflation

“Once at the zero bound, monetary policy loses its ability to affect the economy in a conventional manner by cutting interest rates counter cyclically in response to a deflationary shock. But other monetary policy tools are available to stimulate the economy as necessary” (BoE analysis)

BoE action can stem deflation

Q&A on Quantitative Easing

Guardian articles on interest rates

Japan's zero interest rate strategy

Japan's battle
with inflation

Japanese prices
in record fall

Japan factory
struggles in
recession

Can Policy Avoid Deflation?

- Fiscal Policy
 - Fiscal expansion through higher government spending and borrowing
 - Lower taxation to boost disposable incomes
 - Tax cuts might be announced as temporary (e.g. VAT cut in the UK from 17.5% to 15%)
- But
- Consequences for national debt / interest payments
- Low confidence reduces impact of fiscal stimulus
- Might stoke up some inflationary pressure if too much stimulus is applied for too long

Avoiding Deflation in the UK

- Bank of England is committed to price stability
- CPI target of 2% with upper & lower band 3% and 1%)
- Inflation target reflects that an economy operating below productive potential and risking a period of deflation can bring economic and social costs
- If there is a risk of an inflation under-shoot, monetary policy can be relaxed (i.e. cuts in short term interest rates)

Consequences of deflation

- **Holding back on spending:** Consumers may opt to postpone demand if they expect prices to fall further in the future
- **Debts increase:**
 - The real value of debt rises when the general price level is falling and a higher real debt mountain can be a drag on confidence
 - Mortgage payers on fixed mortgage interest rates will see the real cost of servicing their debt increase
- **The real cost of borrowing increases:** Real interest rates will rise if nominal rates of interest do not fall in line with prices
- **Lower profit margins:** This can lead to higher unemployment as firms seek to reduce their costs.
- **Confidence and saving:** Falling asset prices such as price deflation in the housing market hit personal sector wealth and confidence – leading to further declines in AD. Higher savings can lead to the paradox of thrift

Web resources on deflation

deflation - why it is much scarier than inflation!



First UK deflation for 50 years



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