

Deflation

Deflation is a fall in the price level. It is a negative inflation rate.

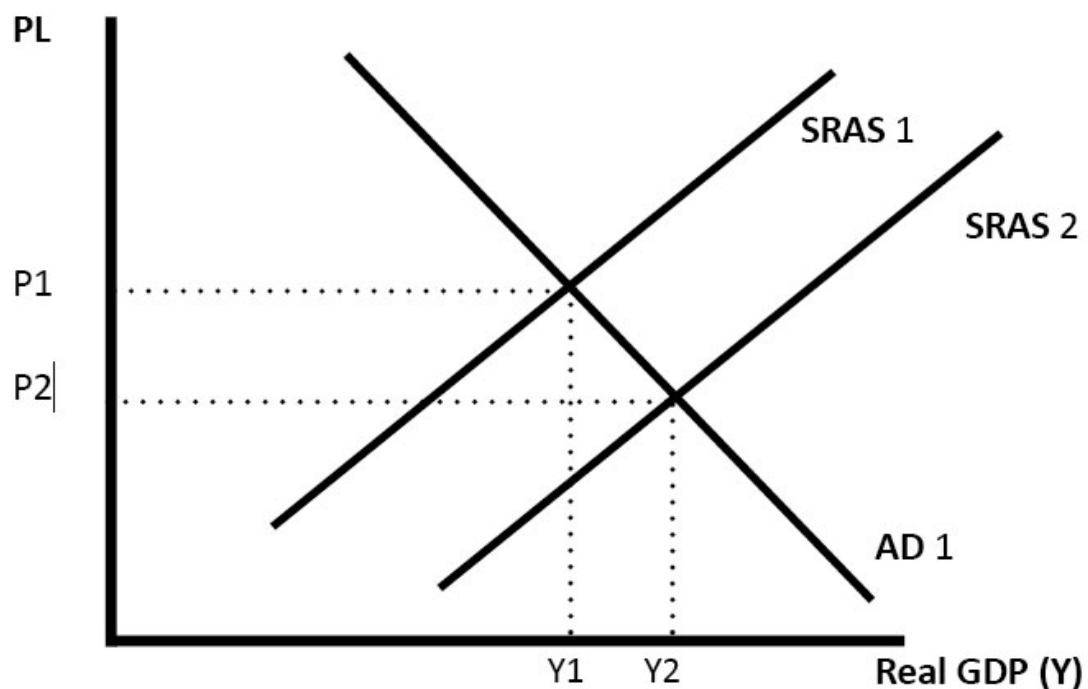
Causes of deflation

There could be different causes of deflation.

- 1) **Falling aggregate demand.** If there is a sharp fall in AD, falling output and a rise in unemployment, then this can lead to lower prices and lower wages.

Deflation caused by falling AD tends to be harmful to the economy.

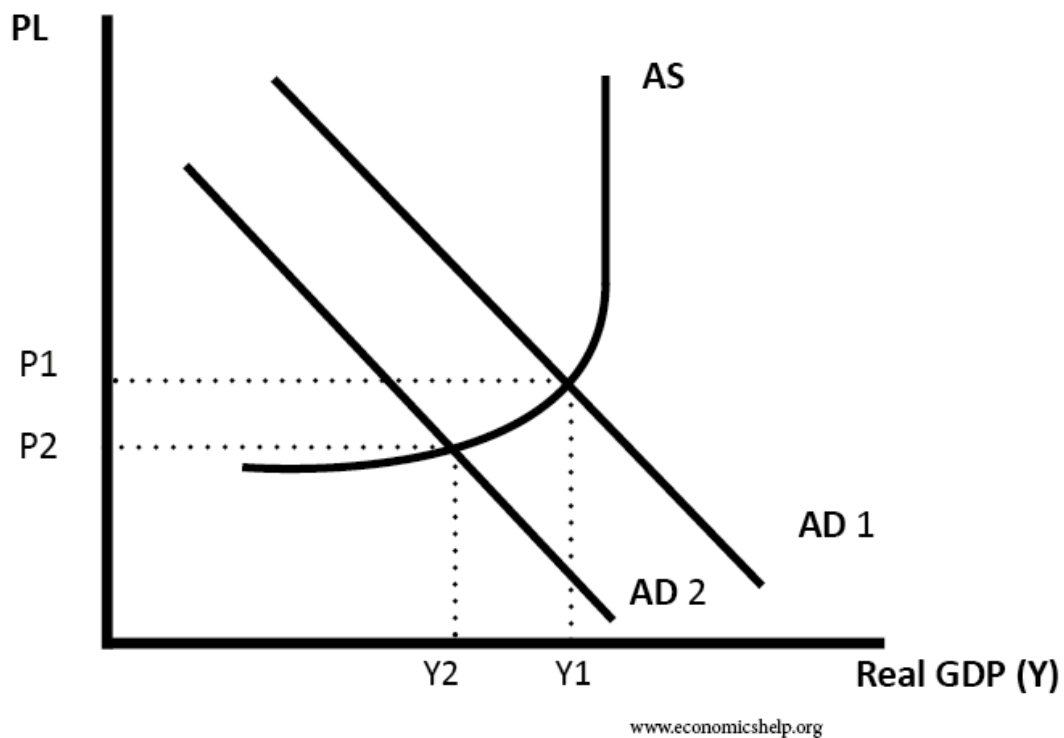
- 2) **Rising productivity.** If deflation is caused by a fall in costs and rising productivity, then deflation may be beneficial the economy. This kind of deflation can also cause rising real GDP.



- This shows deflation caused by SRAS shifting to the right, but it also enables higher real GDP.
- Another potential benefit of deflation is that your economy may become more internationally competitive, and it could lead to rising exports. It depends whether other countries are also experiencing deflation.

Problems of deflation

If prices fall, this can also cause problems for the economy.



- **Less spending.** Falling prices may deter people from buying goods (they wait for them to be cheaper later); this leads to lower aggregate demand.
- **Higher real debt burden.** If prices and wages are falling, then deflation causes the real value of debt to increase. Debt repayments will become a bigger percentage of income. This gives consumers less disposable income and can cause lower AD.
- **Monetary policy becomes ineffective.** Interest rates cannot fall below 0%. If we have deflation, real interest rates effectively increase. Deflation can become difficult for Central Banks to solve because they can't use conventional monetary policy of cutting interest rates.
- **Government debt as a % of GDP likely to rise.** Deflation can make it more difficult for the government to reduce debt to GDP ratios. Because with deflation they will see falling tax revenues, but the amount of debt they have to pay back stays the same.
- **Real-wage unemployment.** If prices fall, but wages stay the same 'sticky wages', it will cause real-wage unemployment. Workers often resist nominal wage cuts because no one likes to see their wages actually cut.
- **Deflationary spirals.** Once prices start falling, it can cause a deflationary spiral. With falling prices, people cut back on spending causing further deflation. It can be difficult for governments to overcome deflation.