

# HOW DANGEROUS COULD DEFLATION BE?

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## WHAT IS DEFLATION?

Deflation is a sustained decrease in the general price level.

Normally falling prices for consumers would appear to be a good thing as decreasing prices in individual markets raises consumer surplus which increases consumer welfare. However deflation makes it more difficult for a country to grow its GDP. There are also other reasons economists regard deflation as potentially bad.

## WHAT ARE THE COSTS OF DEFLATION?

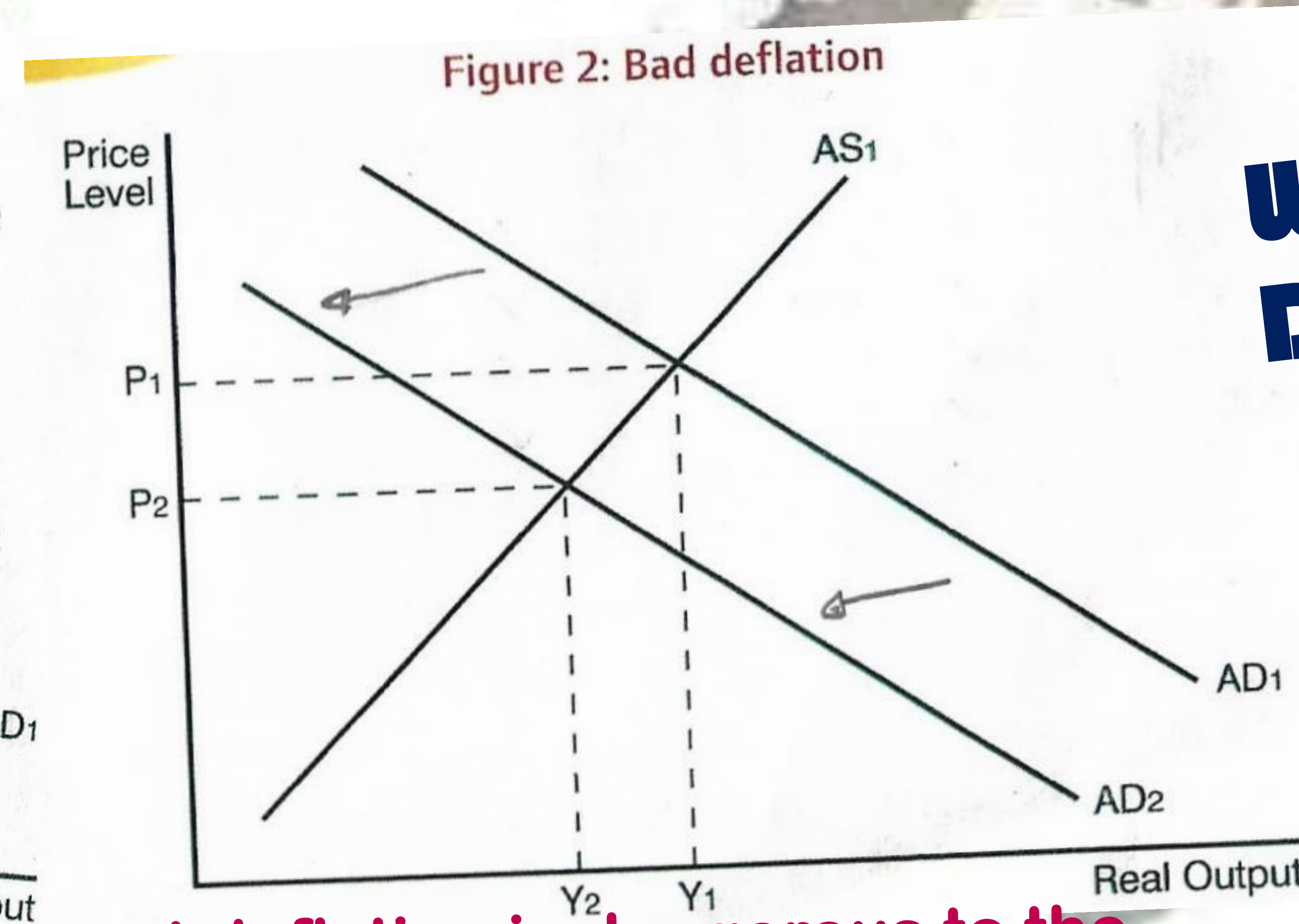
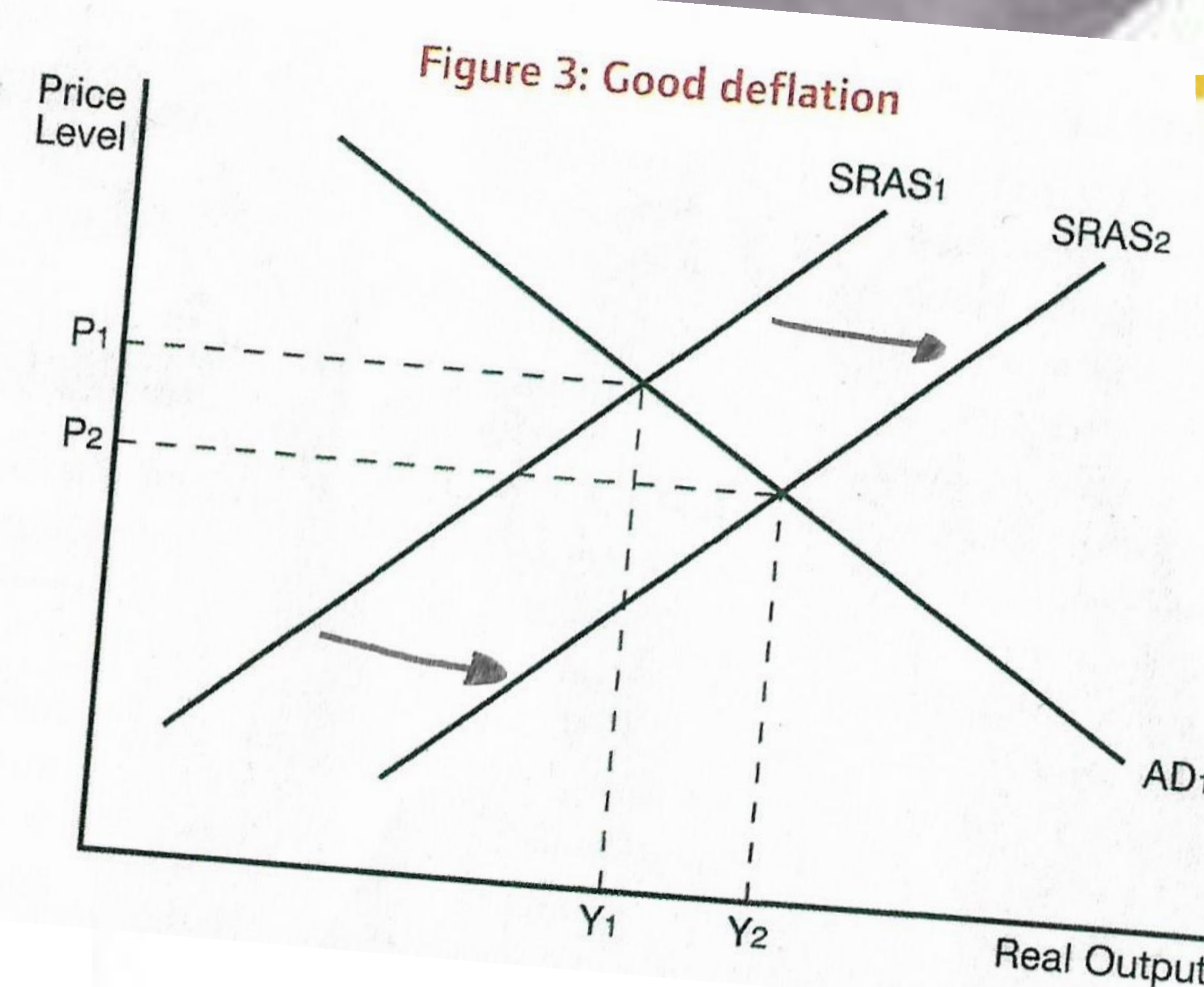
### • Deflationary Spiral

If prices are falling, consumers expect prices to continue falling therefore this discourages them from spending as they delay their purchases which decreases the general price level further.

### • Deflation Raises The Value Of Debt

This discourages borrowing by both consumers and firms so their spending falls causing aggregate demand to fall.

This will deepen a recession if the economy was already in one and will also increase unemployment.



## WHAT ARE THE POLICY RESPONSES TO DEFLATION?

However deflation is not a common phenomenon and if it does occur it may not persist due to the policy responses of central banks around the world.

For example one way of increasing the general price level would be Quantitative Easing. This policy involves increasing the money supply into the economy which will decrease interest rates so the cost of borrowing decreases so consumers and firms are able to borrow from banks which increases their consumption. This increases AD which in turn raises the price level and economic growth.

**AD** – total quantity of goods and services that buyers in an economy want to buy

**AS** – total quantity of goods and services produced in an economy

It is important in deciding whether or not deflation is dangerous to the economy.

Deflation could be caused by a shift of aggregate demand (AD) to the left. This is known as bad (dangerous) deflation which is associated with economic recession because there is a decrease in real output and increase (GDP) in unemployment.

It could also be shown as a shift of aggregate supply (AS). This is known as good deflation as there is an expansion along the AD curve and a rise in real output (GDP).