The Economist

The Economist explains
Explaining the world, daily
Sponsored by

The Economist explains

Why deflation is bad

Jan 7th 2015, 23:50 by H.C.

PRICES in the euro zone are falling. Figures released on January 7th showed that consumer prices in the year to December fell by 0.2%, marking the return of deflation for the first time since 2009. Weak demand, driven by austerity, debt and a lack of economic growth is dragging down prices. The falling oil price is making things cheaper, too. One might think falling prices would be something to celebrate. But concerns about deflation traps and downward spirals abound. The European Central Bank may launch a programme of quantitative easing this month to fend off the threat. Why do economists so dread falling prices?

One common explanation is that in anticipation of falling prices, consumers delay purchases, causing them to fall still further. This argument is a simplification; it can be made with equal power in reverse to argue that inflation will inevitably run upwards as consumers bring purchases forward to avoid being stung later. But the argument hints at the right problem: deflation's effect on interest rates. Generally speaking, the interest rate reflects the price of consumption today relative to consumption tomorrow. When interest rates are high, savings are worth more tomorrow, and vice-versa. The return in money terms (the rate advertised by banks) is called the "nominal" interest rate. But inflation also matters. Subtracting expected inflation from the nominal rate produces the real interest rate—the expected return after inflation—which is what people respond to in most models of the economy.

Low inflation or deflation constrains this crucial variable. The nominal interest rate cannot fall below zero, because that would mean reducing savers' bank balances every month, and would prompt them to withdraw their deposits from banks and stash cash under the bed. Together with inflation, this puts a floor on the real interest rate too. If inflation is low and real rates can't fall far enough to boost demand and perk up prices, demand will weaken still further. This is the dreaded deflation trap. There are other problems, too. Lower-than-expected inflation increases the real burden of debts. Lenders benefit, but because they are more likely to save than borrowers, demand is sapped overall. Deflation also increases rigidity in the labour market. Workers are resistant to wage cuts in cash terms, but inflation lets firms cut real wages by freezing pay in nominal terms. Deflation, by contrast, makes this problem worse.

To avoid the trap, central banks can resort to unconventional policies such as quantitative easing, although there is debate over their fairness and efficacy. In the long run, some economists think inflation targets should be higher. That would give more room for real interest rates to fall when economies are hit by negative shocks. But in a few decades, the problem may disappear: in a cashless economy it is impossible to stash money under the bed. That would allow nominal interest rates to go negative, as everyone's bank balance could simply be reduced simultaneously. But that might be easier said than done.

Dig deeper:
The euro zone slides into deflation (http://www.economist.com/blogs/freeexchange/2015/01/euro-zone-slides-deflation) (Jan 2015)
Politicians and central bankers are not providing the world with the inflation it needs (http://www.economist.com/news/briefing/21627625-politicians-and-central-bankers-are-not-providing-world-inflation-it-needs-some) (Oct 2014)
Fears of deflation may lie behind recent weakness (http://www.economist.com/news/finance-and-economics/21625825-fears-deflation-may-lie-behind-recent-weakness-bears-no-picnic) (Oct 2014)