

Deflation

Deflation is just the opposite of inflation. It is essentially a matter of falling prices. Deflation, according to Prof. Paul Einsig "is a state of disequilibrium in which a contraction of purchasing power tends to cause, or is the effect of, a declining of the price level." Deflation is that state of falling prices when the output of work by productive agents increases relatively to money income. Deflation arises when the total expenditure of the community is not equal to the value of output at existing prices. Consequently, the value of money goes up, and prices fall. In short, deflation is a condition of falling prices, accompanied by the decreasing level of employment, output and income.

Effects of Deflation

Though the effects of deflation are just the opposite to those of inflation, deflation also poses its own menacing threat to economic stability in a system. Effects of Production. Deflation adversely affects the level of production, investment activity, employment, and income level in an economy. During deflation, when prices are falling rapidly but the cost of production does not fall correspondingly, producers incur heavy losses and curtail employment and output. This causes aggregate income to fall and aggregate demand to decrease, with prices falling further and so on. Business pessimism emerges and gradually is commonly described as "poverty in the midst of plenty" because economic activity, income, output, and employment diminish miserably and ample resources remain unutilised or underemployed. Much of the poverty during deflation due to deficiency of demand. Lack of effective demand causes poverty in the midst of plenty.

Effects on Distribution

Deflation has also an adverse effect on the distribution of wealth and income in the community. The share of profit earners in total income declines while that of wage earners increase. Thus, deflation, favours the consumer class and not to producer class. During deflation, creditors tend to gain at the expense of debtors. Investors in fixed-interest bearing securities, rentiers etc., and fixed-income earners gain by the rising value of money. In general, all fixed-income earners gain and all flexible-income earners loss in times of deflation. During deflation there will be a stimulus for savings but as the general income level is low, the ability to save will get reduced. Deflation benefits the middle class at the expense of the richer classes. But its dampening effect on production is bad from the society's point of view, as it reduces the level of employment. Increasing unemployment leads to further social discontent. In this sense, deflation is worse than inflation.

Control of Deflation

Broadly speaking, deflation can be checked by making attempts to raise the level of aggregate effective demand. Effective demand can be uplifted partly by inducing the people to spend more on consumption and partly by stimulating investment expenditure in the economy. Marginal propensity to consume in an economy can be raised by a redistribution of income from the rich to the poor classes. Thus, anti-deflationary measures involve a progressively high income-tax and other forms of direct taxation and a subsidies programme to poor people. Similarly, measures should be taken to induce investment. In this context, a lowering of the rate of interest by increasing money supply, provision of adequate tax relief to corporation's programme of public investment to provide social overhead capital, and public projects which do not compete with private enterprise and rendering all facilities to raise marginal efficiency of capital in the private sector, are very essential. As an antideflationary measure, a programme of public investment should be financed by borrowing rather than taxation. Deficit financing may also be helpful in this context. There should be proper planning and public works policy and the programme should be properly implemented. In short, deflation also should be attacked by various other weapons. A monetary or fiscal policy alone cannot be very effective. There should be a well-knit co-ordination of monetary and fiscal policies with other measures to combat deflation.

Inflation vs Deflation

Both inflation and deflation are socially bad, but inflation may be considered to be the lesser of the two evils. **Inflation is unjust in its Effects on the Following Counts:**

- i. Inflation redistributes income in favour of the rich and profiteer~' class at the cost of the poor masses - the wage earners and consumers.
- ii. Through its redistributive effects, inflation increases the inequality of income in the community by widening the gulf between higher income groups and lower income groups. The rich become richer and the poor become poorer during inflation.
- iii. Inflation is regressive in effect in the sense that it hits hard those who are already weak and cannot protect themselves. It is specially the middle class which suffers most due to inflation.
- iv. Inflation is unjust because it affects different people and classes in society in different ways and to different degrees. If inflation were to affect everyone in society in exactly the same manner and to the same degree, it would not alter economic and social relationships in the community. But inflation takes away wealth from some people and transfers it to others arbitrarily without taking into consideration the sound maxim of social equity.
- v. Inflation is also unjust because it breaks public morale. From the point of view of social ethics, inflation is always demoralising; it introduces the spirit of gambling. It promotes speculation, hoarding and diverts business skill and efficiency from productive purposes to speculative purposes.
- vi. Inflation erodes real savings by deterioration of the value of money.
- vii. Inflation -creates money illusion and generates artificial prosperity which is not permanent.

On the Other Hand, Deflation is Inexpedient and, Therefore, Not Advisable. It is Considered Inexpedient for The Following Reasons:

- i. Deflation means falling prices in general which adversely affect the marginal efficiency of capital. Consequently, investments volume tends to contract causing unemployment to increase.
- ii. Deflation paves the way for depression. In a depression phase, economic activity contracts, scale of production is curtailed, output shrinks, no new investment is forthcoming; on the contrary investment is curtailed.
- iii. By reducing aggregate income, it also pauperizes every group in society. It inflicts on society the harsh punishment of mass unemployment. Volume of employment falls, money income of the community diminishes and, therefore, even though people's purchasing power is increased due to falling prices, they are unable to buy goods. Thus, aggregate demand falls, profit falls, and producers suffer heavy losses and curtail investment and output further, leading to a further decline in employment and income.

This clearly shows that though Inflation is Unjust, it is better Than Deflation. Keynes Showed a Preference for Inflation, because it is the lesser of the two Evils. The Following Point Bring out the Fact that Inflation is a Lesser Evil:

- i. Inflation, though it redistributes income and wealth in the community in an unjust manner, does not reduce the national income of the community. Deflation, on the other hand, reduces the national income of the community and pauperizes society as a whole.
- ii. Deflation increase the level of unemployment in the economy, whereas, inflation at least implies that all factors are employed in some way or another. Inflation is a post full-employment phenomenon; deflation is an underemployment phenomenon aggravating the problem of unemployment.
- iii. It is easy to control inflation by a dear money policy coordinated by appropriate fiscal policy but it is difficult to recover from deflation. Once a deflationary tendency starts, it increases business pessimism, the marginal efficiency of capital diminishes, and investment is contracted, and ultimately a severe depression sets in. Monetary policy becomes helpless here, and no amount of increases in money supply can revive the price level and business expectations or marginal efficiency of capital in the economy during depression. On the other hand, an inflationary spiral can be related by controlling credit and money supply.
- iv. Keynes felt that a mild inflation can stimulate economic development. In his opinion poverty in the midst of plenty can be overcome by raising the price level through the injection of more purchasing power by way of deficit financing of public investment programmes. Thus, Keynes prefers inflation to deflation. But, at the same time, recognises the dangers of inflation and suggests that it should not go out of control, since hyperinflation can be extremely bad.

Deflation Affects the Entire Economic Life of a Country. The Different Sections of Society are Affected in the Following Manner:

Producers and Traders:

The producers are adversely affected on three counts: (a) the production costs at a time of deflation do not fall as rapidly as the prices of the finished products, (b) whenever a producer buys raw materials, etc., he has to pay the higher price for them but when the finished product reaches the market the prices of raw materials will have fallen still further and the producer will be compelled to sell his product at a reduced price, and (c) the demand for commodity also goes down at a time of deflation. The traders are also adversely affected by deflation because the prices are high when they make the purchases, but by the time they are able to sell the goods, the prices undergo a further fall. Likewise, deflation also hits the farmers, particularly the small farmers, who do not have any reserves to fall back upon.

Investors:

There are two types of investors in a capitalist economy. Firstly, those investors whose income is fixed. Secondly, those investors whose income is variable. The fixed income investors actually gain by deflation, the reason being that their income is constant, while the prices continue to fall as a result of deflation. On the contrary, the variable income investors are adversely affected by deflation, the reason being that their income goes down consequent upon deflation.

Salaried and Labouring Classes:

These classes are beneficially affected by deflation. The reason is that with the fall in prices, it is not easy to cut down the wages of the workers. Any attempt to reduce the wages is stoutly opposed by the trade unions. Likewise, it is not possible to cut down the salaries of the employees. Hence, both of these classes gain as a result of deflation. Their money income remains constant while the prices of goods and services decline. iv. Consumers. The consumers are beneficially affected by deflation. Due to falling prices, the purchasing power of money rises up, enabling the consumers to buy more goods and services than before. v. Debtors and Creditors. Creditors gain while debtors lose as a result of deflation. The creditors gain because whatever amount they receive in the form

of interest, etc. carries now a higher purchasing power than before. The creditors also gain because at a time of deflation, the demand for consumption loans goes up and the creditors can charge arbitrary rates of interest on them. But the debtors are the losers at a time of deflation. The farmers are the worst hit by deflation because the burden of indebtedness goes up as a result of falling prices. Deflation creates industrial unrest in the country. The economic development suffers a set-back and the economic, social and political life of the country gets upset. Hence, deflation is extremely harmful for the economy of a country. **"Inflation is unjust; deflation is inexpedient. or the two, deflation worse."**—(Keynes).

Explanation: Inflation vs. Deflation

Which is better, inflation or deflation? Both inflation and deflation are harmful for society, but inflation may be considered to be the lesser of the two evils. In the words of Keynes, "Inflation is unjust; deflation is inexpedient. Of the two, deflation is worse."

Inflation May be Considered to be Unjust on the Following Grounds :

- i. It increases economic inequalities through its redistributive effects. By transferring purchasing power from the poorer to the richer sections, inflation widens the gulf between the richer and the poorer classes.
- ii. Inflation is also regressive in character. By raising the prices of essential goods, it imposes a heavier burden on the poorer sections of the community. Inflation especially hits the middle classes who are the worst sufferers from rising prices and increasing shortages.
- iii. Inflation also results in an invisible taxation of the people. As a result of inflation, the prices of goods and services invariably go up. The consumers are deprived of these goods and services and are not able to consume them to the extent desired. Inflation, thus diverts the goods and services meant for public consumption to the government which is totally unjust and inequitable.
- iv. Inflation gives rise to a sort of artificial prosperity in the country. The price-level goes on rising and after some time it reaches its highest limit. This upsets the working of the economy and the government is compelled to take certain steps which, in their turn, give rise to deflationary tendencies in the economy.
- v. Inflation is also highly demoralizing in character. It gives rise to a spirit of gambling among the people. It promotes speculative activities and diverts the businessmen from productive activities to speculation.

Deflation is Considered Inexpedient on the Following Grounds:

- i. Deflation, by reducing prices and production, results in a marked decline in the national income of the country. The country becomes poorer than before.
- ii. By leading to a fall in production, deflation causes a marked increase in unemployment. The businessmen close down their establishments or cut down the volume of production, giving rise to mass unemployment in society.
- iii. By causing a downward movement in prices and production, deflation causes economic depression in the economy. The economy has to suffer all the evil consequences of depression.
- iv. Deflation is also considered inexpedient because once it starts, it goes on gathering momentum and the crisis becomes deeper and deeper with every passing day.
- v. The social, economic, political and moral consequences of deflation are vicious and as such highly undesirable. It is, thus, clear that though inflation is unjust, it

is better than deflation. That is why, Keynes looked upon inflation as the lesser of the two evils. It does not, however, imply that Keynes preferred inflation to price stability. But if a choice is to be made between inflation and deflation, Keynes would vote for the former, not the latter.

He considers inflation better than deflation on the following grounds:

- i. Inflation, though it redistributes income and wealth in favour of the richer sections, does not result in curtailing the national income of the community. Deflation, on the other hand, has the undesirable effect of reducing the national income of the country
- ii. Deflation also has the result of cutting down the volume of employment in the economy. Inflation, on the other hand, is a full employment phenomenon. Hence, deflation cannot be considered desirable from the social point of view.
- iii. Inflation, howsoever serious, can be controlled to some extent by the application of monetary and fiscal measures. Deflation, on the other hand, is rather difficult to check despite the application of monetary and fiscal measures. Once deflation starts, it gathers momentum till the entire economy is enveloped in a severe depression.
- iv. A moderate inflation may even be good for a depressed economy. A mild dose of monetary expansion can serve to stimulate the economic development of a depressed economy. Mild inflation is, therefore, any day better than deflation from the point of view of economic growth. It is on the above grounds that Keynes wanted to avoid deflation at all costs. But it does not imply that he advocated inflation as a monetary policy. Inflation also has its dangers, particularly when it gets out of control and develops into hyperinflation. In a different section of society.

SYNOPSIS ON DEFLATION :

What is deflation and why is it bad for the economy?

Deflation is a fall in the price of goods and services. Deflation occurs when the inflation rate falls below zero per cent. This is the opposite of inflation. When the inflation rate is negative, the economy is said to be in a deflationary period.

Why does deflation happen?

A fall in spending -- it could be personal spending or a cut in government expenditure -- leads to deflation. The decline in the supply of money and credit thus leads to deflation. So, if money-supply decreases; supply of other goods increases, demand for money rises, and the demand for other goods slips, it is deflation.

What are the consequences of deflation?

Deflation leads to a lower level of demand in the economy. It increases the real value of money. It also increases unemployment.

In a deflationary environment, those sectors with a high proportion of variable costs are likely to benefit from falling input prices, according to Goldman Sachs.

What could happen if India slips in deflation?

India would see deflation or reduction in general price level from next month due to slackening demand, according to financial services firm Goldman Sachs said.

"We expect yearly headline WPI inflation to fall rapidly below 1 per cent in March. And enter a period of deflation beginning in April, which could last till end-2009 due to not only continuing demand destruction but also a sharp step-up in the base," it said in a research report.

"There will be negative inflation for a few weeks in the first quarter of next fiscal, driven largely by higher base effect but we do not expect a pronounced deflationary trend in the economy," Dun and Bradstreet chief operating officer Kaushal Sampat said recently.

Is deflation good for you as prices are falling?

A fall in the prices may sound good for consumers. But it is not actually good. The lack in demand may push companies to further lower prices.

This can lead to a situation where the prices of product fall below the cost of manufacturing a product. This in turn forces the companies to cut production, slash jobs and shut down business till demand picks up. This worsens the situation.

Is deflation here to stay?

Deflation is not likely to last long. The monetary and fiscal stimulus measures of the government is likely to boost demand in the long run. In 2010, however, Goldman Sachs expects inflation to come back due to both a gradual pick-up in demand, and conversely, a low base from 2009.

It further said that the Reserve Bank could slash cash reserve ratio (CRR) for banks by 150 basis points by mid-2009 to provide liquidity into the system.