Why Is Deflation Bad?

Paul Krugman, *Intrenational New York Times*, August 2, 2010

http://krugman.blogs.nytimes.com/2010/08/02/why-is-deflation-bad/

A number of readers have asked me to explain why deflation is a bad thing; and the truth is that while I've alluded to the issue a number of times, I'm not sure if I've ever laid out the whole case. So here goes.

There are actually three different reasons to worry about deflation, two on the demand side and one on the supply side.

So first of all: when people expect falling prices, they become less willing to spend, and in particular less willing to borrow. After all, when prices are falling, just sitting on cash becomes an investment with a positive real yield – Japanese bank deposits are a really good deal compared with those in America — and anyone considering borrowing, even for a productive investment, has to take account of the fact that the loan will have to repaid in dollars that are worth more than the dollars you borrowed. If the economy is doing well, all this can be offset by just keeping interest rates low; but if the economy isn't doing well, even a zero rate may not be low enough to achieve full employment.

And when that happens, the economy may stay depressed because people expect deflation, and deflation may continue because the economy remains depressed. That's the deflationary trap we keep worrying about.

A second effect: even aside from expectations of future deflation, falling prices worsen the position of debtors, by increasing the real burden of their debts. Now, you might think this is a zero-sum affair, since creditors experience a corresponding gain. But as Irving Fisher pointed out long ago (pdf), debtors are likely to be forced to cut their spending when their debt burden rises, while creditors aren't likely to increase their spending by the same amount. So **deflation exerts a depressing effect on spending by raising debt burdens** – which, as Fisher also points out, can lead to another kind of vicious circle, in which depressed spending because of rising real debt leads to further deflation.

Finally, in a deflationary economy, wages as well as prices often have to fall – and it's a fact of life that it's very hard to cut nominal wages — there's downward nominal wage rigidity. What this means is that in general economies don't manage to have falling wages unless they also have mass unemployment, so that workers are desperate enough to accept those wage declines. See Estonia and Latvia, cases of.

Now, alert readers will have noticed that none of these arguments abruptly kicks in when the inflation rate goes from +0.1% to -0.1%. Even with low but positive inflation the zero lower bound may be binding; inflation that comes in lower than borrowers expected leaves them with a worse debt burden than they were counting on, even if the inflation is positive; and since relative wages are shifting around all the time, some nominal wages will have to fall even if the overall rate of inflation is a bit above zero. So the argument that deflation is a bad thing is also an argument saying that some economic problems get worse as inflation falls, and that **too low an inflation rate may actually be economically damaging**. **That's why the fact that inflation, while still positive, is below the Fed's target is bad news**; and it's why respectable people like Olivier Blanchard (pdf) have suggested that a higher target, something like 4 percent inflation, might make sense.

And no, 4 percent inflation wouldn't turn us into Zimbabwe. I remember when we had stable inflation of around 4 percent – and it was morning in America.