

# Deflation: causes and effects



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## **Introduction:**

In economy, inflation decreases the actual value of money, whereas deflation escalates the actual value of money; as in deflation there is continual decrease in the price of goods and services which gives more value to the money. Inflation is usually understood as a condition of considerable and fast common increase in the level of prices, that results a decline in the value of money over time. Deflation is the opposite of inflation; it is basically an issue of price falling. Deflation as Prof. Paul Einzig stated, “ 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”. (Mehra, 2002).

## **Definition:**

Deflation is the contradictory of inflation which means that the prices or value of goods reduces. Deflation is when there is a constant decline in the level of consumer prices of goods, or a constant escalation in the acquiring power of money because of the decrease in available credit and money; which means the power of money holders will remain in their hand due to the decrease in prices. In addition, Deflation could be caused by direct reduction in expenses and payments. Also it can occur if there is a reduction from government spending rate, investment spending or individual spending. The process of deflation often leads to a lower demand in the market and economy.

## **Historical Experience with Deflation**

Here is some of the most famous historical periods of deflation knowledgeable by a mixture of nations around the world. So let's, in short,

obtain a plan of the economic disorder that deflation wreaked on these countries during a variety of periods. (Anonymous, 2010)

### **1- Post panic of 1837 Deflation in the US**

Subsequent the Panic of 1837, which was caused by all banks' firmness on compliant expenses in any silver or gold currency alone, and there was a five-year long era of economic depression in the US throughout which the money provide in the US economy had decreased by approximately 30%! (Anonymous, 2010)

### **2- The Enormous Deflation in the US**

It occurred 20 years long age, straddling from 1870-1890, in the US while there was a radical refuse in the costs of labor , goods, raw materials, and services all through US. And this was an uncommon example of a state in fact gaining from deflation as owing to the low price of resources and work, the just beginning to industrialize US economy of those times was improved clever to quickly flood itself with industries and put factories and manufacture units at a lesser rate. Throughout this time, the well recognized manufacturing nations such as Great Britain suffered inexpensively owed to a fall in prices and demand. And this is all happened because this deflationary time is credited to the return to gold normal position Civil War. (Anonymous, 2010)

### **3- The Great Depression of the 1930s**

The Great Depression is, possibly, the most infamous between all historical periods of deflation! It in progress with the disastrous US supply market collides on 29th October, 1929. Actually this fact is as well recognized as the

Wall Street Crash. The Great Depression was natural out of various reasons such as huge failures in monetary structures such as stock markets and banks, reduction of cash supply by the US Federal Reserve, choice to go back to the Gold Standard by Great Britain previous to World War 1. The ripples of this depression were felt universal, with nearly all countries experiencing its start at dissimilar period throughout the 1930s, till the early 1940s. (Anonymous, 2010)

#### **4- The Asian Financial Crisis of 1997**

It all happening after the Thai Baht warped, as a result of the Thai government's choice to drift the state money by cutting down its hanger to the USD. This choice was spurred by crash to hold the Baht swap over speed following extended periods of financial extensions, the majority of which was complete towards actual land. Thailand was already beneath a superbly high overseas money owing, method sooner than the Baht crashed, and was officially considering bankruptcy in the eyes at that time. The money runs into only additional petroleum to the previously powerful fire of economic fall down! Preliminary from Thailand, the Asian Financial Crisis increase its threatening hold winning a large fraction of Asia, counting Indonesia, South Korea, Laos, Malaysia, Hong Kong and Philippines, these were the countries that conventional a main financial gust owing to this monetary crisis. Additional Asian countries like China, India, Singapore, Taiwan, Vietnam and Brunei as well felt the ripples, while on a great deal lesser level.

(Anonymous, 2010)

## **5- The Japanese Deflation of the 1990s**

initial in the early on fraction of the 1990s, the deflation in Japan, which motionless continues, was a consequence of a mixture of assorted economic and demographic dissonances. The leader in the middle of them was benefit cost deflation, venture in bankrupt companies, additional room of non-performing loans by banks. As well, owing to the huge occurrence of banks concerned in non-performing loans, citizens in Japan favor investing their funds in coffers Bonds quite than in bank financial records, additional approaching these banks towards bankruptcy. One more main anxiety is Japan's unenthusiastically irregular demographics. An important element of the Japanese population consists of persons over the age of 60. This element of the population is headed towards a refuse and a senior death rate, which considerably exceeds the birth rate in Japan, creation such demographics a main matter, as far as payment to the economy is worried. (Anonymous, 2010)

## **6- Financial Crisis of 2007-2010**

The current economic recessions that rocked the worldwide economy happening with a refuse in the liquidity that took position in the US banking segment. Extensive joblessness in conditions of radical refuse in staffing and a climax in notices that all companies over the world has witnessed and perceived it all the way through the period from December 2007 till June 2009. Repercussions and ripples of economic despair can at rest be seen and felt at nearby, while on a much lesser level than after it started. (Anonymous, 2010)

Additional countries which have knowledgeable the wickedness of deflation and economic depression in a variety of periods comprise France, United Kingdom, Finland, Belgium, Austria, Australia, Spain, Denmark, Canada, Germany, Italy, New Zealand, Norway, Ireland, Switzerland, Netherlands and Sweden. (Anonymous, 2010)

That was a short impression of the major historical periods of deflation and economic depression. Even though there are convinced industrial differences in comparison with recession vs. depression, the bottom line remains the same – equally cripple the economy! (Anonymous, 2010)

### **Causes of deflation:**

Varied causes contribute in the deflation occurrence in the economy. Firstly, the capitalism distinguished by adequate existence of competition, it is believed that it is one of the aspects that leads for the appearance of deflation. The improvement in the capital stocks will increase the total number of competitors which will lead to increment in the ratio of good supplement. As a result, the prices must decrease to achieve the demand stabilization and this will lead us to the deflation. (Anonymous, 2010)

Secondly, a decrease in the money supply will decrease the demand. Accordingly the prices will go down and this is called the supply surplus. It is an appearance of a deflationary spiral where the prices will be less than the cost of financing product. (Anonymous, 2010)

Thirdly, the existence of deflationary spiral will be a huge obstacle for the commercial sector in the country and it will stop its revenues, in spite of reducing the prices of their completed products. As a sequence, the

commercial sector will be forced to become liquidated. To overcome the deflationary spiral, the non-performing loans should be avoided by banks.

(Anonymous, 2010)

Finally, in the view of economic monetarist, the main reason behind deflation is the decrease money velocity and the amount of supply per person.

(Anonymous, 2010)

In fact to sum up the causes of deflations we can notice that the cutting back in the money supply or the growth in the demand for money also the rise in the supply of goods and the dropping off in the demand for goods are the main reasons of deflation. (Anonymous, 2010)

### **Effects of Deflation:**

In general, deflation is measured harmfully, since it's a challenge on borrowers and holders of illiquid possessions, which gives an advantage for savers and holders of liquid assets and money. Additionally, nowadays deflation is caused by the disintegration in demand. Deflation causes several problems and issues in the economy, as the value of the illiquidity assets decreases such as lands, home, and other types of properties.

There are several effects caused by deflation that affected on several categories of society such as companies and employees and a large number of public: Ø\$Ù,, Ø\$Ø³Ø²Ù...Ø\$Ø¹Ù, Ø±Ø\$Ø;Ø© ØμÙ^Ø²ÙŠØ© Ù,, Ù,, ÙfÙ,, Ù... Ø\$Ø²

### **-Declining nominal prices for goods and services, and company profit may fall**

In the case of deflation companies not only cannot increase, but it must reduce the prices for goods and services. If they hadn't declined their prices, they may go out of business. even if in a deflationary environment, most possible their production costs as well decline, most popular of companies' revenue reduce too, and after a few years they are going to yearly losses.

(Anonymous, 2010)

### **-Unemployment might rise:**

The company profit may decrease so they will need to cut cost; so they need to fire employees, which are not producing or reduce them salary.

(Anonymous., 2010)

### **-Company profits may fall:**

The prices of materials that used to make goods and services are more than the selling price for same goods and services.

- On the other hand, deflation will raises trades and economic action by making basics (food, housing, fuel etc.) which cannot be ignored and delayed, more affordable to challenging customers, thus falling complexity and period of recession.

-Discourages bank savings and decreases investment: Companies will be afraid of the risk to invest in this period because the probability of loss is greater than the probability of profit. Also, most banks will not risk to finance companies because in the case of deflation companies will be delay in the payment of taxes and interest to banks.



-Deflation can be considered as a type of economic danger: where the danger of the return of assets falls to negative, shareholders and consumers will collect and keep money rather than spend it, even in the most secured economic countries. This can produce the hypothetical form, much discuss as to its practical chance, of a liquidity trap. A central bank cannot, usually, charge negative attention for cash, and still charge 0 attentions frequently create less simulative effect than a little higher rate of interest. In a blocked economy, this is as charge 0 attentions also earnings have 0 returns on government securities, or even negative return on short maturities.

(Anonymous, 2010)

In another way, deflation takes place when there is an enhancement in the manufacturing and production effectiveness that is lesser than the general price of goods which causes a loss. The progress in production effectiveness usually occur due to the economic manufacturers of goods and services are induced by the secure thought of increasing profit margins, that results from the production enhancement they perform.

## **Examples of Deflation:**

### **Deflation in UAE:**

Mario's Maratheftis, the head of research at standard chartered bank in Dubai mentioned that there is a possibility that UAE might face deflation especially with the job losses that UAE is facing nowadays. Moreover, the falling in the oil price, constructing market and the rate of tourism decrease make it all easier to face such an economic crises in the future. The oil price decreased from 147 to 100 because of the recession fears. (Anynomous, 2010)

The interest in UAE has increased, the banks also faced the issue of the loans and mortgages as the customers are unable to pay back the debt they hold for them. This will lead to the deflation in the UAE and it will also affect the market badly. Banks can decrease the interest rate to compensate with their losses, because the higher interest rates will be a challenge for customers to take loans and to pay it back. So by providing less interest rate this will decrease the chance of deflation occurrence and it will be available for consumers and construction markets. (Anonymous, 2010)

In UAE when the person lose his job there is a big chance to lose also the visa, because the terms of UAE to have a visa the person should be under a contract and if he lose it he should find another job within 30 days, but this is alone a challenge and the country will lose the working hands which is unemployment and it is an effect of deflation. (Anonymous, 2010)

As Dubai being one the world best attraction places for tourism, the tourism has decreased and affected the GDP from 17. 22% to 5. 10%. As a result, this has affected mostly the economic market in Dubai. (Anonymous, 2010)

Moreover, the business travels industry still suffering from the global economy and it has some fears of facing other recession. As the business travels are the most benefit for them, which was decreased by the recession that happened. (Anonymous, 2010)

As what Carol Madison, the UAE manager at Visit Britain said “ that the business travelers didn’t come back as what they were before.” (Anonymous, 2010)

## **Counter acting Deflation:**

As it's already clear that deflation is a negative inflating rate, and it is a decrease in the price level of goods and services which means an increase in the real value of money possessed; in other words, a person can buy more goods in the same amount of money. And such economic case benefits only demanders where suppliers stand watching their loss. However, there is always a way to counteract deflation. Firstly, governments have the ability of lowering taxes. This is the best way to encourage citizens to put their money into economy. For example, when people and business in both perspectives get less tax, they will have more money to spend on buying goods and stuff, and that is where they'll put their money, in government's pockets. However, taxes are not implemented in our United Arab Emirates society and therefore, such a solution has no effect. Secondly, governments can reduce regulations on businesses. This solution has a great effect on encouraging new businesses to start which will generate money for the benefit of the country by the end. For example, when less regulation are there, new business entrants will be able to start their own local businesses, and then people will deal with them because they are cheaper than foreign businesses and that will put the money in the government's pockets rather than going to the foreign countries. Thirdly, making insolvency laws less favorable to creditors will prevent irresponsible lending in country. For example, when the central bank gives an order to the banks in the country not to lend loans to employees who have less salaries than 2000 DHs, this will stop banks from giving irresponsible loans to people; this will result in protecting money from being badly invested and thrown away. Fourthly, Governments have to stop their greed for money. For example, the raise in petrol price was known due

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to the raise in demand; however, it was due to the greed of governments. Such greed will cause a high profit in the beginning and an increase in the inflation rate, but every action has its reaction, and a fast raise in inflation rate will cause a severe drop in deflation which causes a depression, and that was seen in the case of great depression 1929- 1940. Fifthly, businesses should have new ways and tactics to pull customers attention to their products. That can be achieved by improving marketing strategies. So either than increasing the cost of products because there is less demand on them, businesses can pull higher demand on an average price given by the business. Sixthly, governments can increase the wages of employees, so their salaries can afford the inflation rate without the need of a reaction which can cause a deflation. Seventhly, governments should start encouraging local agriculture and industries, for this is a good way of getting the money from people without having to pay it back as an import expense. In this case, economy will be able to produce its own goods without the needs of outside depts. Finally, governments should encourage people to start consuming from local restaurants and for local restaurants to provide better goods and services rather than consuming from international chains which will only benefit their countries. For example, our government should encourage the starting of restaurants like “ Al yahar” and burger cafeterias rather than “ Americana fast food chain”; as a result: the money will go to the pockets of the government. The prevention of deflation is not a hard thing to accomplish; it is just a step to be taken only if suppliers and governments lose their greed in money.

**Conclusion:**

In short, Deflation is one of the basic problems that may enclose an actual and deep influence on the economic scheme and arrangement. It is caused due to several reasons such as: a drop in the supply of money, increase in the supply of goods, less demand of goods, and the increased the demand of money. Each economy should be aware of the consequences of deflation, and be prepared to such economic disruptions to resolve it easily and effectively.