

Deflation

In economics, deflation is a decrease in the general price level of goods and services. Deflation occurs when the inflation rate falls below 0% (a negative inflation rate). Inflation reduces the value of currency over time, but deflation increases it. This allows more goods and services to be bought than before with the same amount of currency. Deflation is distinct from disinflation, a slow-down in the inflation rate, i.e. when inflation declines to a lower rate but is still positive.

Deflation usually happens when supply is high (when excess production occurs), when demand is low (when consumption decreases), or when the money supply decreases (sometimes in response to a contraction created from careless investment or a credit crunch) or because of a net capital outflow from the economy. It can also occur due to too much competition and too little market concentration.

In modern credit-based economies, deflation may be caused by the central bank initiating higher interest rates (i.e., to 'control' inflation), thereby possibly popping an asset bubble. In a credit-based economy, a slow-down or fall in lending leads to less money in circulation, with a further sharp fall in money supply as confidence reduces and velocity weakens, with a consequent sharp fall-off in demand for employment or goods. The fall in demand causes a fall in prices as a supply glut develops.

This becomes a deflationary spiral when prices fall below the costs of financing production, or repaying debt levels incurred at the prior price level. Businesses, unable to make enough profit no matter how low they set prices, are then liquidated. Banks get assets which have fallen dramatically in value since their mortgage loan was made, and if they sell those assets, they further glut supply, which only exacerbates the situation. To slow or halt the deflationary spiral, banks will often withhold collecting on non-performing loans (as in Japan, and most recently America and Spain).