

DEFLATION



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DEFLATION

Breaking News: India Inflation Rate reported at 0.27% for the week ending March 14, 2009!

- This has been the lowest since 1977.
- Are we getting into negative space ?
- Will it happen next time?
- Are we heading for deflation or is it disinflation?
- What are these terms and how do they affect us?



Understanding Deflation
– By Prof. *Simply Simple*



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- ❑ Let us first understand deflation and in this bargain we will understand disinflation.
- ❑ In economics, deflation is a sustained decrease in the general price level of goods and services.

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Also...

- ❑ Deflation occurs when the annual inflation rate falls below zero percent, resulting in an increase in the real value of money — a negative inflation rate.
- ❑ Inflation reduces the real value of money over time, conversely, deflation increases the real value of money.



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Now let's understand disinflation...

- ❑ Deflation refers to a sustained reduction in the level of prices below zero percent based on year-on-year inflation.
- ❑ Disinflation, on the other hand, denotes a slow-down in the inflation rate (i.e. when the inflation decreases, but still remains positive).



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But what are the effects of deflation on the economy?

- Deflation is caused by a fall in the aggregate level of demand.**
- This means that there is a fall in the going price for goods.**
- Because the price of goods is falling, consumers have an incentive to delay purchases and consumption until prices fall further, which in turn reduces economic activity even further.**



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Lack of demand leads to an increase in the idle capacity bringing down the rate of investments leading to unemployment and lower disposable income and hence a further fall in demand and increase in loan defaults.

This is known as the Deflationary Spiral.



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So what can one do about it?

- ❑ **An answer to falling aggregate demand is:**
 - **Stimulus, either from the central bank, by expanding the money supply**
 - **Suitable monetary policies such as lowering of interest rates so that the consumers are encouraged to borrow and spend of goods and services**



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While a fall in prices may sound like good news to most, economists see this as an ominous sign of a collapse in demand in the economy.



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How does one counteract against deflation?

- Until the 1930s, it was commonly believed by economists that deflation would cure itself.**
- As prices decreased, demand would naturally increase and the economic system would correct itself without outside intervention.**
- This view was challenged in the 1930s during the Great Depression by the economist Keynes who argued that the economic system was not self-correcting with respect to deflation.**



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What did Keynes say?

- ❑ According to him, governments and central banks had to take active measures to boost demand through tax cuts or increases in govt. spending.
- ❑ Today, to counter deflation, the Reserve Bank of India (RBI) can use monetary policy to increase the money supply and deliberately induce price rise.
- ❑ Rising prices provide an essential lubricant for any sustained recovery because businesses increase profits and this takes some of the depressive pressures off them.



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What about India? Are we heading towards deflation?

- Not really. There is no cause for alarm.**
- What we are witnessing is more of disinflation.
Prices are not actually falling yet.**
- Also this is not expected to sustain itself which is a key
requirement for deflation.**



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And remember in India when we refer to deflation we are talking about WPI – Wholesale Price Index and not CPI – Consumer price index which is used as a reference in most economies
Remember the CPI is still at 10%!



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Again one needs to bear in mind that our GDP growth engine is still humming along at nearly 6.5%.

For deflation to set in, the GDP growth rate needs to substantially fall as is seen in many western countries.



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Our government still has tools in its armory to counter a deflationary situation.

With the help of monetary policy, fiscal stimuli, investment in infrastructure projects etc, we are well poised to ward of any immediate threat of deflation.



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To Sum Up

- ❑ **What:** Deflation is a sustained decrease in the general price level of goods and services.
- ❑ **How:** Deflation occurs when the annual inflation rate falls below zero percent and prices continue to fall on a sustained basis
- ❑ **Why:** Deflation is caused by a shift in the supply and demand curve for goods and interest, particularly a fall in the aggregate level of demand.
- ❑ **So:** As of now the Indian economy remains fairly robust to ward off deflationary forces.



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Hope you have now understood
the concept of Deflation



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