Outcomes Of Short-Term And Long-Term Deflation

Deflation is defined as price decreasing in general, it happens when price falling leads to price indexes like the Consumer Price Index sustained declines. Based on the article, deflation is more serious than inflation because it affects consumer confidence on making buying decision, and unemployment rate on negative effect. By studying further research, debt becomes unaffordable and recession shows up will be the ending of deflationary spiral.

Within long-term deflation, consumer tends to save the money instead of expensing. One of the reasons is that, the value of money keeps increasing when the amount of active money declining, which makes the consumer less likely to spend their money. One is people will think more before they purchase when one dollar is worth two or more value than before. The other reason is that, consumer expected to buy products on the lowest price where is hard to predict. Therefore, consumer is inclined to wait the price changes. However, less product is sold may cause factory has less revenue when the amount of product they need to produce is less. Therefore, the price is decreasing while the wage keeps in constant, the gap between revenue and cost is becoming smaller and smaller until zero profit and the company bankrupts. In order to avoid losing money, company has to reduce cost of producing, which downsizing is one of the examples. As mentions, long-term deflation causes people buy less and that makes less product has been produced, so that the company need to lay off their employee in order to reduce the cost and get revenue.

One of the instances is Japanese deflation in 1980s. Japanese government decided to quantitative easing in order to subsidized export industry after Japanese yen appreciation. People started to buy house and stock, and expected the value keep rising. However, there was no real industry that can support the high asset price, deflation happened. Therefore, the rate of interest decreased and was excess circulating funds, it causes investors decreasing appetite for speculation and the price for house and stock fell. A large decreased of consumption and caused impact on buyer confidence. Lots of employees lost their job and Japan’s economy suffered economic setbacks.

At the beginning of deflation, company may decide to loan to invest and develop new technology because the interest rate decreases at first. Based on Fisher’s study about debt-deflation theory, he thinks the relation between over-debt and deflation is significantly. When there is negative shock in money supply, it will occur debt-deflation dynamics and default. It happens when there is invest opportunity and company decides to loan which causes over-debt. Company needs to sell the products in low price in order to pay the debt which affects currency declined. Then the revenue keeps falling and causing bankruptcies when price declining. Company becomes lost and losing confidence which lead to another negative circulation of deflation. The economic depression will become worse instead of improving if there is no solution to make the price level back to deflation happened. Therefore, the center bank should increase the money supply by open market operation and lower the discount rate.

On the other hand, short-term deflation has some advantage for people, for example, the price of some basic supplies and raw materials is decreasing, it causes lower cost of living. Food, clothes and houses become affordable when the price goes down along with the deflation. What is more, deflation and price of oil are influence on each other. The cost of producing and transporting is decreasing in deflation, it causes the reduction of crude oil price. Crude oil is the basic raw material in industrial, agriculture and transportation. Therefore, crude oil occupied a large section in the market. However, the total price level may go down when the crude oil price falls. Besides, lower crude oil price benefits people, buy paying less money on gas and heat. Meanwhile, the money that they save can use to pay their debt or purchase goods.

Moreover, oil price is influenced by the changes, a study from César, Miguel and Andrés explains that “the short-time effect of oil on consumer prices is important, as it accounts for 25% of the variance of changes in inflation so, a spiral of deflation/economic contraction could finally happen if a long period of anemic inflation/deflation affects the consumer expectations and, through them, the economic activity.”

By applying macroeconomic knowledge, aggregate demand and aggregate supply can be used to explain the effects of deflation, and there are different changes in both short-term and long-term. The economic is suffering a positive supply shock when deflation just happened in the first period. It causes aggregate supply curve shift to the right and price level decreases while output increase in the short run. Then, there is undersupply happen in the amount of output. In order to solve this problem, the aggregate demand curve may continue shifting left when the shock is gone, until it back to original level. However, in the long-run deflation, the demand will contract, which causes aggregate demand curve shift to the left and the amount of output may shift back to the original amount in equilibrium while the price level keeps decreasing. What is more, there is deflationary spiral when the price level keeps declining in the very long run.

Conclusion

When deflation occurs at the first time, it has some benefit to the consumer on reducing cost of living on food, raw material and oil price. However, there is huge damage when long-term deflation happens, the economic activity mood is in the funk. Long-term deflation will cause some problems, such as deferred consumption, reduce buyer and company confidence, increase in debt stress, which means the cost of borrowing rises when money value increase, and rise in unemployment, all these problems may damage the economic growth at last.