

## 9. The fairytale of the deflation ghost

These days we are all being taught that declining prices is a really bad thing. Economists and popular press want to make us believe that declining prices destroys an economy. The most often heard argument against deflation, as also very often included in school textbooks, goes as follows:

‘As soon as there is deflation, people will delay their consumption. The reason is that consumers expect prices to fall even further. They prefer to wait for even lower prices, thinking they can buy more or more cheaply in the future. This is the beginning of the end. Companies face declining sales and profits, have to lower salaries and investments, which results in lower consumption, even lower prices, etc. The economy is at risk of disappearing into a black hole.’

Why is this a fairytale and not reality?

1. In a world without a growth in the money supply, lower prices are the only way for people to consume more in the future. Obviously, we have to take into account aspects related to quality improvement. If prices stay the same, but the quality of products have improved, one could say people are consuming more. Generally speaking, prices will have the tendency to come down instead of going up, due to entrepreneurs and producers investing in the production structure to meet with the increasing demands by society. People in society signalled they would like to consume more or better in the future, by adjusting their time preferences, by making more savings available and with that, by lowering the interest rates in the market. By making the production process more efficient, by effectively adapting new technologies or by training the workforce, producers are able to produce more (or better). This will be reflected in lower prices of the goods involved. This will allow the people in society to consume more with the same amount of money (same salaries, etc.). Their purchasing power has gone up. They can now start realising their goals of consuming more and harvest the proceeds of all investments made. The whole purpose of society’s investments and efforts were to be able consume more in the future. When that moment has arrived, surely people will buy, at lower prices.

2. The ECB is managing the overall or average price level, they are not concerned about individual prices. If prices on average have gone down, why would people expect prices to go down even further and especially the prices of stuff they want to buy? At what ‘average price decrease’ does the ECB believe the postponing of consumption to start? Is this at a -5%, -1%, or already at 0% price change, year on year? In my view it would be important to know, before implementing price stability policies at all. These question however have never been dealt with, people’s behaviour has not been observed or studied. In practice, in my opinion people do not look at the inflation numbers as published by the ECB. People are concerned with improving their situation and on their individual purchasing power.

3. If prices on average decline, the purchasing power of consumers has increased and people can purchase more goods. In real terms, people will feel like they own more money. The more units of real money we own, the lower the marginal utility of the latest unit that has been added to our bank account. If the marginal utility goes down, we are more keen to get rid of this money. In ranking all our alternatives, other alternatives will become more attractive than our money, of which we have obtained more in real terms. This means that we will be inclined to spend more money on alternative

ends. If we spend more, consumption will rise. So, when prices go down, we will consume more, not less.

4. It is quite possible that the price of a certain good is expected to go down a lot, say 10%. In that case, it may be rational for consumers to postpone consumption. However, even if a consumer would think to know that the price of a good will go down by 10% in a year, would this person indeed decide not to buy now, and NOT consume for say an entire year, in order to be able to buy 10% more in 1 years' time? Would a consumer say, I am not buying this Smartphone for EUR 600,- , because I know the price will be EUR 540, - or even lower next year? Would the use value of EUR60,- in 1 years' time be higher than the use value of using a Smartphone for an entire year? I think all consumers experienced such price declines over the years (televisions in the past, smartphones in the 202s, etc.), however this did not stop people buying those goods.

5. Another aspect concerns the supply side, being producers and entrepreneurs. If people have reasons to believe that prices in general will go down even further, the producers of those goods will also know about this expected price decline. In that case the producer will have less incentives in producing additional products anymore. The profit a producer expects to earn is the difference between the future expected proceeds, that depends on future prices, and the current investment price. If future prices are expected to go down even further, the investment opportunity will be less attractive. In other words, prices or expected prices going down too much, will result in less supply, which will counter the declining trend.

In other words, there is no way of knowing what the impact of the supply and demand forces will be in the unknown future. That is why the market process is so beneficial for society. The whole idea behind the market process is that prices will eventually be shaped according to the preferences of society, which in the future is by definition unknown.

#### *Inflation is good for debtors*

Another reason mentioned often against deflation is that this makes it more difficult for debtors to repay their debt. This is very true. But why should this concern central banks as the ECB? If two parties agree on a lending agreement why should the borrower of money or issuer of a loan be protected?

In the last decade, governments and central banks aimed to 'stimulate the economy', by reducing rates and increasing the money supply. This resulted in increased debt levels to levels which seem unsustainable in 2025. It will become more and more a challenge for governments who issued enormous amounts of debt to repay their debt. These increased debt levels are often used as argument to further stimulate the economy and to create inflation as this may make it easier for governments to repay their debts over time

Maintaining this vicious circle is good for debtors like governments of various (a lot of) countries worldwide. However, for ordinary people it is not. Monetary policies have negative side effects, as seen in the previous article. Price inflation as a result of monetary policies erodes the purchasing power. Inflation erodes society's profit.

Instead of intervening in society, economist and central banks should consider the opposite and to accept that price deflation is not a bad thing at all.