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TOPIC :- THE CONCEPT OF DEFLATION IN MONETARY ECONOMICS

Deflation is just the opposite of inflation. It is essentially a matter of falling prices. According to Prof. Paul Einzig, "Deflation is a state of disequilibrium in which a contraction of purchasing power leads to cause, or is the effect of, a declining of the price level. Deflation is that state of falling prices when the output of work by productive agents increases relatively to money income. Deflation arises when the total expenditure of the community is not equal to the value of output at existing prices. Consequently the value of money goes up, and prices fall. In short, deflation is a condition of falling prices accompanied by the decreasing level of employment, output and income.

Effects of Deflation:-

The effects of deflation are just the opposite to those of inflation. Following are the effects of deflation on economy:-

(1) Effects on Production:-

Deflation adversely affects the level of production, investment activity, employment and income level in an economy. During deflation, when prices are falling rapidly but the cost of production does not fall correspondingly. Producers incur heavy losses and curtail employment and output. This causes aggregate income to fall and aggregate demand to decrease, with prices falling further and so on. Business Recession emerges and gradually is commonly described as "poverty in the midst of plenty" because economic activity, income, output and employment diminish miserably and ample resources remain unutilised or underemployed. Much of the poverty during deflation is due to deficiency of demand. Lack of effective demand causes poverty in the midst of plenty.

(ii) Effects on Distribution :-

Deflation has also an adverse effect on the distribution of wealth and income in the community. The share of profit-earners in total income declines while that of wage-earners increase. Thus deflation favours the consumer class and not to producer class. During deflation, creditors tend to gain at the expense of debtors. Investors in fixed interest bearing securities, rentiers etc., and fixed-income earners gain by rising value of money. In general all fixed income-earners gain and all flexible income-earners lose in times of deflation. During deflation, there will be a stimulus for savings but as the general income level is low, the ability to save will get reduced.

Deflation benefits the middle class at the expense of the richer classes. But its dampening effects on production is bad from the society's point of view, as it reduces the level of employment. Increasing unemployment leads to further social discontent. In this sense, deflation is worse than inflation.

Control of Deflation :-

Deflation can be checked by making attempts to raise the level of aggregate effective demand. Effective demand can be uplifted partly by inducing the people to spend more on consumption and partly by stimulating investment expenditure in the economy. Marginal propensity to consume in an economy can be raised by a redistribution of income from the rich to the poor classes. Thus anti-deflationary measures involve a progressively high income-tax and other forms of direct taxation and a subsidies programme to poor people. Similarly, measures should be taken to induce investment. In this context, a lowering of the rate of interest by increasing money supply. Provision of adequate tax relief to corporation's programme of public investment to provide social overhead capital, and public projects which do not compete with private enterprise and rendering all facilities to raise marginal efficiency of capital in the private sector, are very essential. As an anti-deflationary measure, a programme of public investment should be financed by borrowing rather than taxation. Deficit financing may also be helpful in this context. There should be proper planning and public works policy and the programme should be properly implemented.

In short, deflation also should be attacked by various other weapons. A monetary or fiscal policy alone cannot be very effective. There should be a well-knit co-ordination of monetary and fiscal policies with other measures to combat deflation.