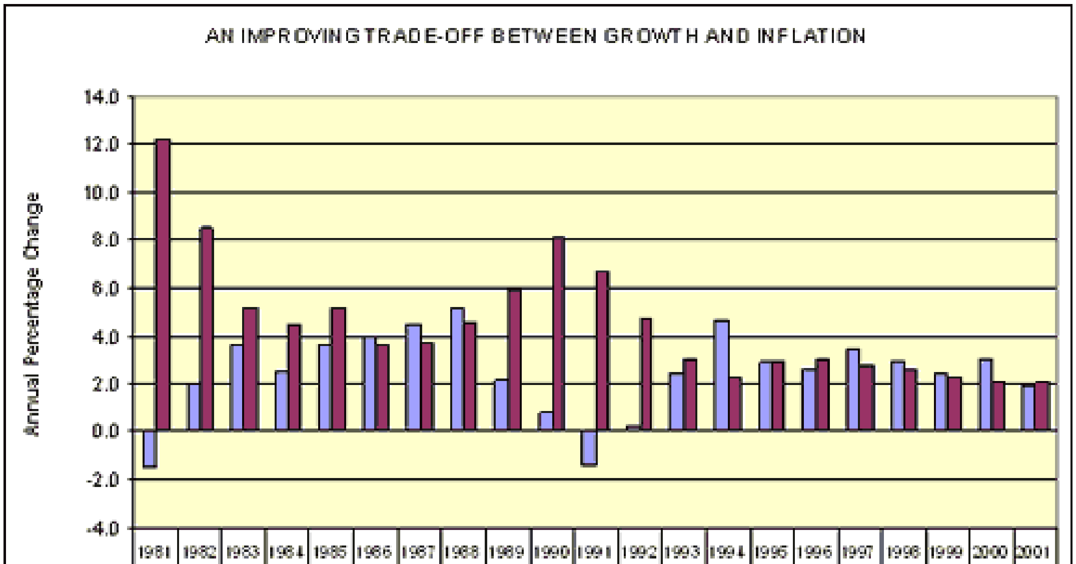
Which is Worse; Inflation or Deflation?

In discussion of healthy economies, one of the main considerations is the rate of inflation, or perhaps deflation. Inflation is most common and is defined by an increase in average prices throughout the economy. Consequently the value of money decreases because people can buy less now with the same amount as money as before. In absolute contrast to this, deflation means that there is a *fall* in prices and so the value of money is raised simultaneously. Another term falling into the issue of inflation or deflation is disinflation. This is simply a fall in the rate of inflation. Typically, as regards to macroeconomic policy, the government aim for a low and stable inflation rate.

Benefits can be enjoyed from the *low* and *stable* rate of inflation that governments target. Low inflation can urge economic growth. For example, firms are encouraged to invest and expand by their business due to their confidence in the steadily rising prices. If firms are spending they are goi ng to produce more and the economy's output will increase. Furthermore, firms are able to raise prices and profits before they pay out higher wages. With reference to the public, people earn more and so pay more income tax to the government, again benefiti ng the economy. Finally, from the perspective of a borrower, inflation is good because at the time of borrowing, the money will be worth more than it is when it is paid back - however the rate of interest may cancel out this benefit.

In the graph below the link between growth in GDP and the rate of inflation is apparent. If inflation is increasing too much per year (generally higher than 6%) there will be little growth or even a decline in GDP.



	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
GDP	-1.5	2.0	3.6	2.5	3.6	3.9	4.5	5.2	2.2	0.8	-1.4	0.2	2.5	4.7	2.9	2.6	3.4	2.9	2.4	3.1	1.9
Inflation	12.2	8.5	5.2	4.5	5.2	3.6	3.7	4.6	5.9	8.1	6.7	4.7	3	2.3	2.9	3	2.8	2.6	2.3	2.1	2.1

Of course, there are severely negative aspects of inflation. Many of the public are on fixed incomes, meaning their wages aren't affected by inflation so, following high prices they can afford less than before. Consequently there may be disputes if workers are unable to secure wage increases to restore their standard of living. Also those who are loaning money will lose out because when it is repaid the money will have less "purchasing power" (it will be able to buy less). One significant disadvantage of inflation concerns the balance of payments. For example, if Britain's prices go up and prices over seas remain cheaper, more goods will be imported rather than bought internally and also less goods will be exported. Britain will lose international competitiveness. Moreover an unstable rate of inflation can cause doubt in business planning and discourage capital investment. High inflation can cause a break down in the "price mechanism". Prices signify to producers how they should allocate resources so following rising prices there will be larger supply but lower demand (because of the higher price). Yet another harmful effect inflation can have is that of unemployment. Professor A.W. Phillips found a trade off between inflation and unemployment. He concluded that either inflation must be accepted or unemployment must be. Both can't be lowered both simultaneously.

Equally, there are both beneficial and harmful sides to deflation. From the point of view of lenders or "savers" deflation is good because when they receive their repayment the money will be worth more than more before the deflation as prices will be lower giving the same amount of money more "purchasing power". Perhaps if prices are lower than people will be encouraged to spend their money more freely. This happened in Japan as a result of the deflation.

On the other hand, in consideration of the negative aspect of deflation, consumers may postpone their consumption if they expect prices to fall. Coupled with this is the increased demand for money (notes and coins), because people want to save as much money as possible. Also from the standpoint of a borrower (inclusive of government, businesses and consumers) deflation is very disadvantageous because when they repay their debt the value of the money will be higher than previously due to the now lower prices. This will discourage loans and subsequently spending and consumption. Another disruptive element of deflation is that it means businesses are taking less revenue and so need to cut their costs as efficiently as possible – perhaps leading to increased unemployment due to redundancies.

The conclusion of which is worse (inflation or deflation) depends on the viewpoint from where the question is being answered. From the point of view of a saver/creditor inflation is undoubtedly worse. The money they are loaning out will have less value when it is paid back after prices have risen. In stark contrast it will be deflation that borrowers/debtors consider worse. Any money that they have loaned will be more valuable when repaid if deflation occurs.