

Inflation and Deflation

THE ESSENTIALS

Inflation describes a **sustained and generalised increase in the prices of goods and services**, and not only of one or a few products.

Deflation is the opposite of inflation, i.e. a **lasting and widespread drop in prices**. Deflation should not be confused with disinflation, which refers to a decrease in the rate of inflation (i.e. a slowdown in the pace of inflation).

Inflation and deflation have **effects on our daily lives**. In the case of inflation, the same quantity of currency (or the same amount of money) allows you to buy fewer goods and services. In other words, inflation causes the value of money (its **purchasing power**) to decrease.

Excessive inflation has several effects. Firstly, it blurs price benchmarks and can therefore disrupt the purchasing or investment decisions of households and businesses, leading to the **misallocation of resources**. Secondly, it pushes lenders to increase the interest rates they charge. Finally, it has **redistributive effects** between the different economic actors (e.g., individuals, businesses, governments), to the detriment of the purchasing power of people who cannot increase their income accordingly to protect the value of their savings.

In extreme episodes of **hyperinflation**, the negative effects described above are multiplied, and inflation is self-sustaining in an **inflationary spiral** (see the simplified diagram), whilst price and wage increases follow one another at a frantic pace. Inflation then increases exponentially. This was the case in Venezuela, for example, where inflation reached 686.4% in 2021.

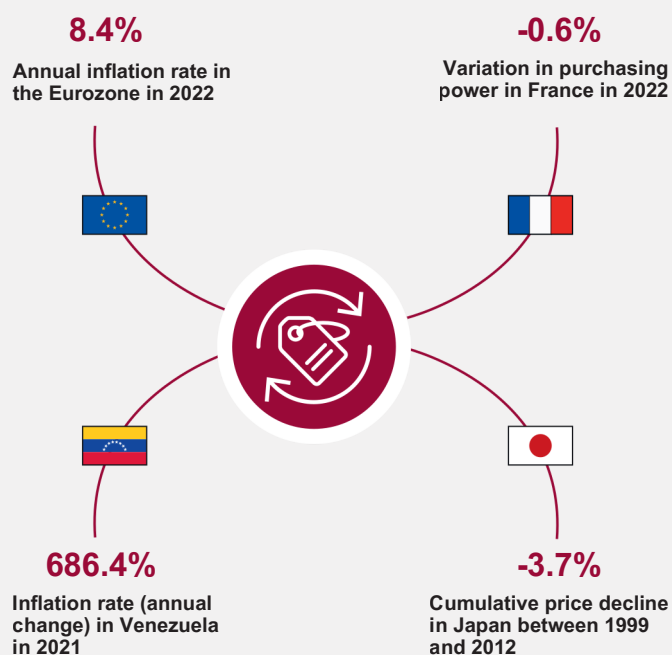
Deflation, on the other hand, leads to a slowdown in economic activity that can be prolonged and significant. Indeed, if prices fall for a long time, households tend to postpone their purchases and companies their investments, because they anticipate further price falls. Companies sell less; they are no longer hiring, or even firing. Unemployment is rising; wages tend to fall. The real value of debts increases, making them more difficult to repay.

Money creation is also hampered because banks are more reluctant to grant credit to economic agents (households, companies, etc.) whose future incomes are uncertain. This is the **deflationary spiral** - a vicious circle from which it is difficult to get out (see the simplified diagram).

In the medium and long terms, it is considered optimum for an economy to have moderate and stable inflation, which avoids the disadvantages of excessive inflation and limits the risk of deflation. In fact, if prices rise but in modest and predictable proportions, it allows, for example, companies to anticipate their future costs, thus investing and creating jobs, which boosts the demand for goods and services and therefore growth.

Price developments must be measured, anticipated and controlled. **Monetary policy**, which is the responsibility of the central banks, has the role of maintaining moderate and stable inflation. In the UK, the mandate to maintain price stability has been given to the Bank of England, with an **inflation target of 2%**.

Examples



Sources: Eurostat, INSEE, FMI and Banque de France (forecasts)

Understanding

Calculation of the Consumer Price Index



Inflation is assessed on the basis of changes in the prices of a **basket of goods and services that are representative of household consumption**. The purchase of real estate, considered as investment and not as consumption, is not taken into account in inflation.

It is the Office for National Statistics (ONS) which calculates the **Consumer Price Index (CPI)**. An additional measure is the CPIH, which is the CPI adjusted for owner occupier housing costs.

To calculate these two indicators, the ONS regularly records the price of hundreds of products throughout the country. These products are grouped into categories (food, housing, clothing, transport, etc.) that are weighted according to their importance, to calculate an average figure in the household budget. The measurement of inflation takes into account changes in quality.

Other indicators can be calculated, such as **core inflation**, which excludes products whose prices strongly fluctuate in the short term, such as fuel or certain food products.

The causes of inflation

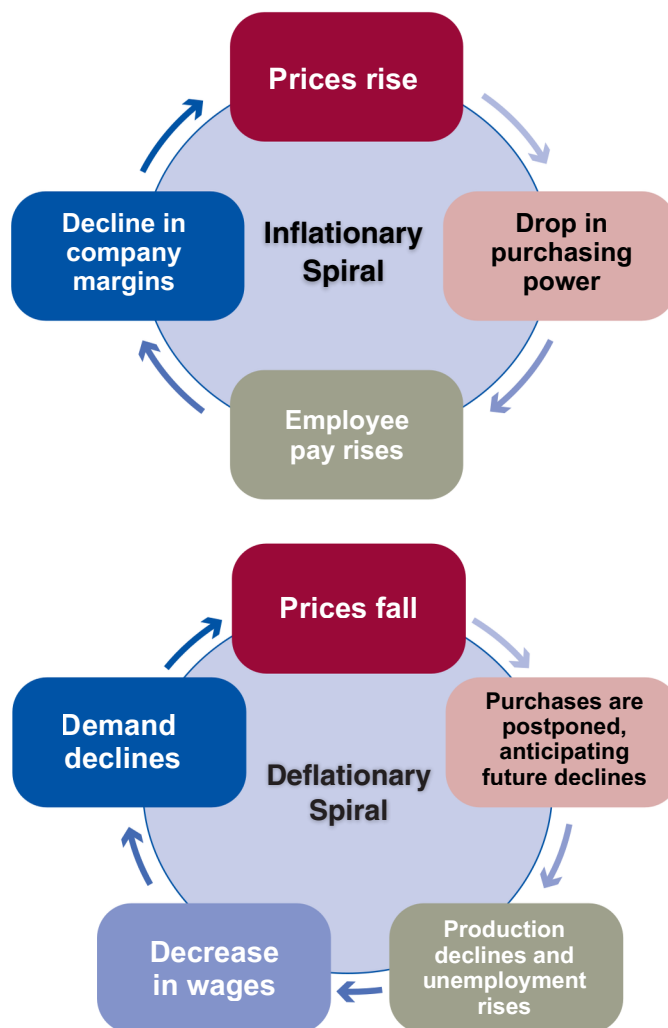
Inflation can come from factors **external** to the economy, such as the rise in prices of imported goods and services (particularly energy or raw materials) due to a geopolitical crisis; the strength of the recovery from a health crisis (demand is strong while international trade is still hampered and supply is more limited) or a less favourable exchange rate (the more a currency depreciates against foreign currencies, the higher the cost of imports). If the imported goods and services are directly consumed by households, their price variation has a direct impact on the inflation rate. If they are consumed by companies (referred to as intermediate consumption), inflation can be affected if they pass the increase in their production costs onto their prices.

Inflation can also come from **internal** factors, such as an increase in wages paid. Companies, in the event of low unemployment or sectoral recruitment difficulties, may be encouraged to increase wages to retain or attract employees.

Companies partly pass on these increases to their prices. Employees, who are also consumers, may in return demand further wage increases to compensate for this price increase. We talk about a **price-wage loop**. Generally speaking, when the economy is above its potential (i.e., when demand is greater than supply), pressures on production factors results in higher inflation.

The **degree of competition** in an economy can also influence inflation: in a highly competitive environment, companies are less free to increase their prices and their level of profit. On the other hand, the **quantity theory of money** indicates that all other things being equal, an increase in the quantity of money in circulation increases the general price level.

Inflationary predictions from companies and households also play an important role. If a company anticipates future price increases, it is in its best interest to increase its prices straight away. In this context, the central bank plays a critical role in ensuring that inflation and inflationary predictions from economic actors remain well in line with the medium-term target.

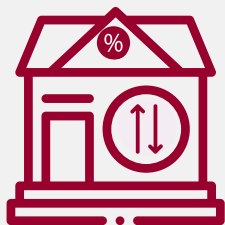


How does inflation affect you?

Inflation has a direct impact on households' **purchasing power**, since the evolution of this power is measured by comparing the evolution of income with that of prices - if incomes increase faster than the general price level, there is an increase in purchasing power. Conversely, if prices rise faster than incomes, there is a drop in purchasing power.

To analyse certain economic variables such as prices, incomes or interest rates, a distinction can be made between their **nominal** level (their gross value) from their **real** level (their inflation-adjusted value).

For example, if inflation is 2% over one year, and a household sees its nominal income increase by 5% over the same period, the evolution of its real income will be 3% (5% - 2%): its purchasing power **increases**.



If its nominal income remains stable, real income will fall by 2% (0% - 2%): its purchasing power **decreases**.

Inflation also has an impact on the **wealth** of market participants.

It **benefits debtors**, by reducing the real level of their debt, and **disadvantages savers**, by making their savings lose value. High inflation also tends to disadvantage the poorest who have fixed incomes and fewer opportunities to protect themselves against rising prices.



Inflation and Deflation - a brief history -

- **Third century AD** The Roman Empire was going through a political and economic crisis: its currency was depreciating and food prices were rising sharply.
- **Sixteenth century** Jean Bodin considers that the rise in prices observed at the time was the result of the huge flows of precious metals from Latin America.
- **1694** Creation of the Bank of England, whose primary objective is to maintain price stability.
- **1750** David Hume introduces the principles of the quantity theory of money.
- **1795** The excessive issuance of assignats (a type of monetary instrument) during the French Revolution leads to inflation and a loss in the value of this paper money.
- **1873-1896** The Great Depression was a period of economic downturn associated with deflation in Europe and the United States.
- **1921-1924** Hyperinflation in Germany. The rate of inflation reached 100% per day in 1923.
- **1929** Stock market crash in the United States. In response, the Fed is raising interest rates, credit is contracting, and activity is slowing down. Deflation is also spreading to Europe.
- **1973 / 1979** Oil shocks stoke inflation and reduce activity: this is stagflation.
- **1999** Following the stock market and real estate crashes at the beginning of the decade, Japan enters deflation.
- **2008** Economic and financial crisis. To counter the risk of deflation, central banks are implementing unconventional monetary policies.
- **2022** Faced with the return of inflation, in the context of the post-Covid-19 recovery and the war in Ukraine, central banks are accelerating the normalisation of their monetary policy.