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Low inflation and deflation risks

Technical box extracted from:

Inflation Report no.3, August 2014 [1]

Considering that the projection of the Inflation Report no. 2, 2014 placed the average annual CPI inflation in the lower band of the variation, there has appeared the necessity to mention the risks of low inflation and deflation. The experience of Japan in the early 90s shows that deflationAn economic phenomenon that is the opposite of inflation, characterized by the decrease in the average general price level of goods and services. may have serious consequences on the domestic economy as high inflation, being difficult to be countered in vulnerable and too weak economies to cope with high debt. As the loans are fixed in nominal terms, decreasing wages and prices increase the burden of paying them.

Even when it does not reach critical levels, a too low inflation has “costly” side effects. In such situations, cash becomes more attractive to investors as a measure of value. Such a circumstance favors economies to fall into a liquidity trap and makes the Central Bank’s mission to reduce the real interest rate more difficult. The liquidity trap is associated with the reduction of the nominal interest rate close to zero (zero lower bound), the central banks remaining without leeway and losing the ability to reduce the monetary policy rate to stimulate demand in times of economic downturn or recession. There are two underlying causes triggering a liquidity trap: erroneous expectations on the low level of interest rate, considered to be normal, and lack of confidence in the financial sector, which may lead to a crisis in the lending sector. In both cases, there is a shortage of liquidity in the market, causing the rupture of the relationship between the base rate and the cost of credit.

Conventionally, the expansion of the money supply will cause inflation, because a greater money supply is available for the same amount of goods. However, during a liquidity trap, the increase of money supply is fully absorbed by the excessive demand for liquidity. Investors accumulate the money supply to the detriment of their spending, because the opportunity cost of holding liquidity (income from uncharged interestThe difference between the obtained earnings and the ones that would have been recorded in the absence of additional charges and fees, as well as the time lost.) is zero when the nominal interest rate is zero. If the increase of demand for money is proportional to the increase in the money supply, inflation will remain stable. However, if the demand for money increases in a higher proportion than the increase in the money supply, the prices decrease. In extreme situations, if the money supply is increased by purchasing a large amount of financial assets, investors will transfer their holdings of interest-bearing assets from the portfolio into liquidities in order to cover long-term debts.

In general, wages are rigid, especially when these have to be reduced. If inflation is very close to its target, employers may increase nominal wages, but a possible diminution is more difficult. Employers are under pressure to maintain the same level of wages, while prices and, consequently, the income are declining. This situation disadvantages the expansion and additional employment, which is desirable in a slow economy with high unemployment.

Perhaps, the biggest risk of low inflation is slipping into deflation. Initially, if the nominal interest rate is placed at a low level, a situation which occurs when the current and future inflation projection values are low, central banks have no sufficient maneuver to reduce additionally the interest rate. But, in case of deflation and future deflationary expectations, even a nominal interest rate of zero percent may result into a positive real interest rate, which is higher than the level required for stimulating the economy in recession or deflation. Nominal interest rates cannot be reduced below zero, as potential lenders will tend to hold cash rather than borrow at negative rates of interest. This is called the zero lower bound.

The generalized decrease in prices over a long period of time can significantly reduce the profit marginIt is the ratio between gross profit and net sales. The profit margin is an indicator of a company's ability to turn into profit a monetary unit earned from sales, after the cost of sold goods was covered. of economic agents, which determines an investment risk and acts in detriment to stimulating producers; subsequently, causing a decrease in investments. Lastly, deflation affects budget revenues and leaving the deflationary spiral can only be achieved through a series of sustainable monetary and fiscal policies. Thus, if the deflation avoidance maneuvers do not give successful results, the economy enters a deflationary spiral: the decrease of prices results in decreased production, which in turn leads to lower wages and higher unemployment, leading further to lower prices.

See also

Tags
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