International Chamber of Commerce
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Deflation: a business perspective

Prepared by the Corporate Economists Advisory Group

Introduction

Early in 2003, ICC's Corporate Economists Advisory Group discussed the risk of deflation in some of the world's major economies, and possible consequences for business. The fear was that historically low levels of inflation and faltering economic growth could lead to deflation - a persistent decline in the general level of prices - which in turn could trigger economic depression, with widespread company and bank failures, a collapse in world trade, mass unemployment and years of shrinking economic activity.

While the risk of deflation is now remote in most countries - given the increasingly unambiguous signs of global economic recovery - its potential costs are very high and would directly affect companies. This issues paper was developed to help companies better understand the phenomenon of deflation, and to give them practical guidance on possible measures to take if and when the threat of deflation turns into reality on a future occasion.

What is deflation?

Deflation is defined as a sustained fall in an aggregate measure of prices (such as the consumer price index). By this definition, changes in prices in one economic sector or falling prices over short periods (e.g., one or two quarters) do not qualify as deflation.

Dec lining prices can be driven by an increase in supply due to technological innovation and rapid productivity gains. These supply-induced shocks are usually not problematic and can even be accompanied by robust growth, as experienced by China.

A fall in prices led by a drop in demand - due to a severe economic cycle, tight economic policies or a demand-side shock - or by persistent excess capacity can be much more harmful, and is more likely to lead to persistent deflation. Japan has in recent years been experiencing such a general fall in the level of prices, with great economic and social pain.

What causes deflation?

Prices may fall in response to a shock to confidence such as the bursting of an asset bubble (equities, housing) or a shock to commodities (such as a fall in oil prices). If the fall is thought to be one-off, it is unlikely to lead to a deflationary process. Generally, short periods of falling prices do not break underlying inflationary expectations. However, if expectations are changed, deflation could follow.

Persistent excess capacity is another source of falling prices. Sectors subject to excess capacity include telecommunications, airlines, steel, banking (including investment banking), cars and other durable goods. However, it is necessary to distinguish between falling prices of some goods and services from a fall in the general level of prices. Changes in sectors and relative prices take place all the time. In some sectors, such as investment banking, excess capacity is taken out quickly. In other sectors (cars, airlines, steel), excess capacity can persist for a long time, putting downward pressure on prices.

More generally, inflation will tend to fall in countries where output grows at less than potential, creating an "output gap". There is a considerable degree of judgement in estimating an output gap, but both the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) have estimated significant output gaps in Europe, North America and Japan.

What happens in deflation?

The danger with deflation is the development of a vicious circle. As prices fall, consumers postpone buying, particularly durable goods, in the expectation that they will be cheaper in the future. Producers respond to the drop in sales by cutting costs, labour costs in particular. This sets off a further fall in demand. The central bank cuts its interest rate to stimulate activity but it cannot set levels beyond zero. As a result, the real interest rate rises, discouraging investment and contributing to the fall in demand. There is a redistribution of income from debtors to creditors, which further reduces demand as creditors are more likely to save than debtors. Where debts cannot be serviced, creditors (e.g., banks) suffer.

How to escape deflation?

The way to escape deflation is by raising the level of demand and encouraging the removal of excess capacity. This can be done by fiscal stimulus (cutting taxes, increasing public spending), monetary easing (cutting interest rates, devaluation) or by unconventional central bank operations (buying government bonds and other assets to increase their price). As the Japanese experience has shown, no course is easy, especially when deflation coincides with the need to restructure large parts of the corporate and banking system, and when the social safety net is inadequate and the budget deficit is already high.

What are the implications for business?

A low and stable inflation rate is widely recognized as being beneficial to business and the economy as a whole. But there should always be enough policy scope to prevent a negative spiral of deflation. In deflation, companies are the first to suffer, as falling prices squeeze profit margins. Companies in turn act as driving belts of deflationary pressures, by setting in motion the downward spiral of in activity, employment, profits and prices. For example, in Japan, after three years of persistent deflation, over 80% of companies believed that deflation has had a negative impact on Japanese business .

When faced with deflationary pressures, companies meet a number of difficulties:
- Falling prices result in slower growth in nominal sales.
- The real value of debt contracted rises in nominal terms. Companies with large corporate debts may face bankruptcies and sometimes cause bank failures.
- Similarly, the real cost of pensions and wages becomes an increasing burden for companies unless they can cut in nominal terms.
- As more debtors default, banks reduce lending and companies find it harder to obtain new financing.

There are a few measures that companies can take to minimize the negative impact of deflation on their bottom line:
- As companies cannot raise prices in a deflationary context, they have to cut operating costs. This

means restructuring - cutting wages, and jobs if wages are rigid downwards.
- They can also squeeze their suppliers by negotiating lower commodity prices, lower real estate prices and costs of bought-in services.
- They are led to minimize debt and avoid multi-year agreements, such as wage settlements.
- More pro-actively, measures to combat deflation include increasing value added to products and services, and developing new products.

A difficulty for companies is to understand the cause of falling prices and to react accordingly. If the fall in prices is demand-driven or results from excess capacity, companies may then need to implement the above measures to keep their business profitable.

The problem is that while these measures can help businesses ease the pain, they may also end up reinforcing the downward spiral of deflation, thereby putting off prospects of sustainable economic recovery. At a macro level, rising unemployment would result in lower demand, increasing the downward pressure on prices.

However, if falling prices are caused by productivity gains or increased competition, they may just be the sign of an "adjustment to a new equilibrium" , which could eventually result in stronger output growth and benefit companies.

Conclusion

It is important not to overestimate the chances of falling into a 1930s-style depression. Short periods of falling prices do not necessarily lead to recession. Changes in relative prices (some rising, some falling) reflect the natural operation of markets. They often result from positive economic developments such as productiv ity improvements and increased competition, allowing more efficient resource allocation. While this can be painful for companies which take out spare capacity, the economy as a whole benefits. Even in Japan, where prices have been falling for a considerable time, the economy has stagnated rather than fallen into a deflationary spiral, though the economy still faces considerable risks as it struggles to purge its huge load of bad debts.

The recent signs of rapid economic growth in the US and recovery in Europe and Japan suggest that the risk of deflation has receded - at least for the time being . But governments and central banks must continue to be alert to the danger over the medium term and retain sufficient policy flexibility to encourage economic recovery, as it is always easier to prevent deflation than to cure it.

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