



B A C K G R O U N D E R S

# Disinflation and Deflation

The terms disinflation and deflation are sometimes confused.

**Disinflation** is a slowing in the rate of increase in the general price level, as represented by the average price of goods and services in the consumer basket. For instance, between 1981 and 1983, the annual rate of increase in the Canadian total **Consumer Price Index** (CPI) declined from 12.5 per cent to just under 6 per cent. Again, from 1990 to 1992, the rate of inflation slowed from about 5 per cent to 1.5 per cent. This is disinflation.

**Deflation**, on the other hand, refers to a persistent fall in the level of the total CPI, with negative inflation being recorded year after year. The one major episode of sustained deflation in Canada was during the Great Depression of the 1930s, when the overall level of prices fell by more than 20 per cent over a four-year period.

Deflation can be particularly harmful when caused by a protracted sharp contraction in spending (as in the 1930s), which triggers a persistent fall in the general level of prices. This can throw the economy in a deflationary spiral, as incomes fall and the real debt burden of borrowers increases. In such a case, ongoing price declines lead to lower production and wages, which further reduce demand by consumers and businesses, leading to still lower prices, and so on.

By contrast, a temporary decline in the total CPI, attributed to a narrow set of more volatile prices (for example, a sharp drop in gasoline prices) or declines in the relative prices of a specific class of goods (such as personal computers) due to technological advances or productivity gains, does not constitute deflation. To the extent that such one-off price declines leave incomes and the debt burden unchanged, their effects on the economy are not detrimental. In fact, price declines resulting from higher productivity enhance the purchasing power of consumers.

## Monetary policy response to deflation: Keeping inflation on target

Like sustained high and variable inflation, persistent deflation increases uncertainty and has negative consequences for economic growth. Moreover, in an economy where a low positive rate of inflation is being targeted, as in Canada, deflation is harmful because it leads to surprises and casts doubt on the credibility of monetary policy. That is why the Bank of Canada views with equal concern the risk of inflation moving above or below the 2 per cent target and acts symmetrically to avoid both significant inflation and deflation over the medium term.





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Under such an inflation-targeting framework, any risk that deflationary expectations would take hold, if inflation were to fall temporarily into negative territory, is mitigated by the central bank's commitment to act decisively to bring inflation back to target. Thus, small price declines over short periods of time are very unlikely to trigger a deflationary spiral. [See also the [speech by David Dodge, 29 January 2003.](#)]

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