

Can Modern Economies Function Under Deflation?

Examining the relationship between monetary regimes, debt dynamics and long-term economic stability.

Author: Paolo Torreborre

Autumn 2025



Introduction

THE INFLATION TARGETING CONSENSUS

“We also continue to view a longer-run inflation rate of 2 percent as most consistent with our dual-mandate goals.”

— Jerome Powell, Chairman of the Federal Reserve (2023)

“An inflation rate of 2% is low enough for the economy to fully reap the benefits of price stability (...) while providing a margin against deflation.”

— European Central Bank Policy Brief (2024)

Whether it's the Fed, the ECB, or any other central bank, it has always been instilled that these institutions share two primary goals: promoting economic growth and maintaining low, stable inflation. Over the last thirty years, through trial and error, a 2% became the target inflation rate for most advanced economies, first set by Don Brash at the RBNZ in 1989. Despite Economics being a social science, although that is contested, the idea that economies should aim for, and can only thrive under, a 2% inflation rate is almost treated as a scientific law in university-level economics courses. In spite of this, almost all economists agree that rising productivity and innovation tend to exert downward pressure on prices. This begs the question: if productivity naturally makes goods cheaper, why do we fear falling prices so much?

According to the OECD (2023), inflation is a sustained rise in the general price level of goods and services in an economy over a period of time, usually measured by the Consumer Price Index (CPI). From this, we can derive the definition of deflation as a sustained fall in the general price level of goods and services in an economy over a period of time, also measured by CPI. Whenever deflation is suggested as a potential remedy for economies, it is immediately dismissed amid warnings of debt-deflation, delayed spending, or the ineffectiveness of conventional monetary policy. Conversely, it's striking that, despite widespread public discontent, high inflation and its consequences, such as uncertainty, wage-price spirals, and the erosion of savings, are often accepted as a natural by-product of modern economies: harmful, yet inevitable.

Whilst high or sudden deflation is damaging, a regime of mild, stable deflation, particularly when driven by productivity, might promote long-term stability and preserve purchasing power more effectively than perpetual inflation. This essay explores the alternative of operating under low and stable deflation, analysing the consequences and policy challenges it would pose in a fiat-currency world, whilst also comparing them with those of our current inflation-prone system.

How Deflation Shaped Modern Economic Thinking

Economists tend to separate deflation into “good deflation” or “bad deflation”, depending on their causes and how economies respond to them. Good deflation is determined by the supply side of the economy and is characterised by productivity growth, increased competition, and efficiency (Bordo and Filardo, 2005). Goods and services become cheaper because technological innovation leads to more efficient production and resource allocation, or because an increase in producers and trade leads to currency appreciation, making imports cheaper (Atkeson and Kehoe, 2004). Bad deflation, on the other hand, is determined by the demand side and is characterised by falling aggregate demand. Goods and services become cheaper because spending declines, businesses accumulate excess inventory, and are therefore forced to lower prices. For deflation to occur, supply must outpace demand, but the underlying reason for that imbalance determines whether it is good or bad deflation.

Historically, there are many instances of good deflation. Towards the end of the 19th century (1870 - 1896), both the US and the UK experienced annual deflation between 1-2% (Friedman and Schwartz, 1963). This was mainly due to the monetary system at the time, the gold standard. Every dollar or pound of conventional money was backed by a reserve of gold of equivalent value, and because there is a finite amount of gold, the money supply was naturally constrained. During this period, huge technological advances stimulated efficiency and productivity. The economy naturally grew because there was not enough gold to support the expanding money supply, supply outpaced demand, and prices fell, creating “good deflation.” A more recent and impressive example is Switzerland's steady deflation over

the 2010s, despite operating under a fiat currency system (IMF, 2016). After the Global Financial Crisis, investors rushed to the Swiss franc, which was seen as a “safe-haven” currency. The currency appreciated, making imports cheaper, and produced low and stable deflation of around 0.5% per year, while the economy maintained GDP growth of 1–2% and an unemployment rate of roughly 3%.

Naturally, it would be wrong to discuss historical examples of deflation without mentioning possibly the worst economic event of all time — the Great Depression. The Great Depression is perhaps the best example to highlight the pitfalls of deflation and is arguably one of the key reasons why modern economies operate within an inflation-averse framework. Following the 1920s credit boom and speculative surge in the U.S. stock market, the 1929 crash wiped out enormous household wealth and shattered business confidence. As firms and households rushed to repay their debts, spending collapsed, banks failed, and industrial production fell by nearly half (Bernanke, 1983). Since the U.S. operated under the gold standard, monetary expansion was restricted, preventing the Federal Reserve from injecting liquidity or lowering rates aggressively. The inability to expand the money supply meant that falling prices and output reinforced each other, creating the deflationary spiral that Irving Fisher later formalised through his “debt-deflation theory” (1933), explaining how falling prices increase the real burden of debt and trigger self-reinforcing downturns. This concept will be further explored throughout this essay.

The U.S. ultimately abandoned the gold standard in 1933, allowing the Federal Reserve to reflate the economy. After World War II, a modified version of this system was introduced under the Bretton Woods Agreement (1944). Currencies were pegged to the U.S. dollar, which itself was convertible into gold i.e a halfway house between the classical gold standard and today’s fiat money. This event, however, clearly traumatised an entire generation who sought to avoid deflation at all costs. It is perhaps no surprise that U.S. President Richard Nixon, under whose administration the Bretton Woods era ended and the world transitioned to a fiat currency system, was only sixteen when the Great Depression began, and would later pursue policies designed to prevent deflation from ever occurring.

Contemporary Dynamics of Inflation and Deflation

Many economists see inflation as useful because it creates a buffer against potential deflation and, in theory, prevents nominal interest rates from hitting the Zero Lower Bound (ZLB) (Bernanke, 2002). The ZLB occurs when inflation is near zero or negative, causing real interest rates to rise even if nominal or policy rates are already very low. Since interest rates generally cannot fall below zero, as people would simply hold cash rather than pay banks to store cash, central banks lose their ability to stimulate the economy through conventional rate cuts during downturns. Hence, the need for a 2% target helps ensure that monetary policy remains effective. Inflation can also provide benefits such as wage flexibility and debt management, as moderate inflation erodes the real value of public and private debt. However, it simultaneously diminishes savings, reduces purchasing power, and distorts asset prices, creating distributional and financial stability challenges (IMF, 2013).

Having already explored the potential upsides of deflation, it is important to address one of its main criticisms: the ineffectiveness of conventional monetary policy when nominal interest rates hit the ZLB. When this so-called liquidity trap occurs (Keynes, 1936; Krugman, 1998), policymakers are forced to turn to unconventional monetary policy, a strategy employed twice in the last two decades. Both instances followed major crises: the Global Financial Crisis (2008) and the COVID-19 pandemic (2020). In both cases, central banks implemented Quantitative Easing (QE) to stimulate growth by lowering long-term interest rates and supporting credit conditions. QE is the process by which a central bank purchases large quantities of bonds, usually government securities such as gilts, from financial institutions, thereby injecting liquidity into the economy and encouraging lending and investment (IMF, 2013).

Massive episodes of QE took place in 2009 and again in 2020, marking some of the most significant expansions of central bank balance sheets in modern history. Following the 2008 Global Financial Crisis, the Federal Reserve’s balance sheet rose from roughly \$900 billion in 2007 to over \$4.5 trillion by 2015, while the Bank of England’s increased from £200 billion in 2009 to around £895 billion by 2021 (Federal Reserve, 2022; Bank of England, 2022). In response to the COVID-19 pandemic, both institutions launched additional QE rounds, and by 2022, the Fed’s assets exceeded \$8.9 trillion, while the BoE’s balance sheet reached the equivalent of around 40% of UK GDP (FRED, 2023; Bank of England, 2022). These interventions successfully lowered long-term yields, stabilised credit markets, and supported post-crisis recovery, demonstrating that even when traditional monetary policy becomes ineffective near the ZLB, unconventional tools like QE can still provide powerful stimulus (Bank of England, 2022).

The Economic Fallout of Losing Control

We have established that both inflation and deflation can be beneficial when low and stable, and that various forms of monetary policy, both conventional and unconventional, can be employed during periods of high inflation or deflation as a remedy. It is important to note that, despite what policymakers might claim, neither low and stable inflation nor deflation can ever be guaranteed. Economic shocks, geopolitical crises, and behavioural expectations all play a role in destabilising price levels. This section explores which of the two extremes, runaway deflation or high inflation, poses the greater threat to economic stability.

Seen as the most damaging consequence of high deflation, debt-deflation has the capacity to cripple most developed economies today. As seen earlier, while inflation erodes the real value of debt, deflation has the opposite effect. When prices fall sharply, the real value of existing debt increases, leading to defaults, bankruptcies, and a downward spiral in spending, output, and prices (Fisher, 1933). Economies experiencing deflation rarely enter this spiral spontaneously; there is usually an initial shock, such as a financial crisis or credit bubble collapse, as was the case in 1929 with the Wall Street Crash. Since debts are fixed in nominal terms, repayment becomes harder as prices and incomes fall, forcing households and firms to deleverage by selling assets, which in turn drives asset prices down further. As collateral values fall, banks are forced to pull back lending, shrinking the money supply and intensifying deflation. This vicious cycle, first observed by Fisher, is described as the debt-deflation spiral (Bernanke, 1983).

Debt-deflation is particularly damaging because it amplifies recessions, turning a normal downturn into a depression as falling prices increase real debt burdens and trigger widespread defaults. Rising real interest rates further discourage borrowing and spending, while asset-price collapses erode wealth and collateral values, tightening credit conditions. At the same time, monetary policy becomes ineffective near the ZLB, and expectations of further price declines undermine confidence and delay spending, trapping the economy in a self-reinforcing cycle of contraction. Economists are especially fearful of debt-deflation in today's high-leveraged, fiat-money economies, as debt levels are astronomically higher than those in 1930 (Eggertsson and Krugman, 2012).

While Debt-deflation can clearly paralyse an economy, its inflationary counterpart, hyperinflation, can be equally destructive. Hyperinflation can also be triggered by economic shocks, but it often hinges on unanchored inflation expectations (Cagan, 1956). Normally, inflation expectations are “anchored” around a target such as 2%, which helps stabilise wage and price-setting behaviour. However, when the public begins to expect ever-rising prices, workers demand higher wages to preserve purchasing power, and firms pre-emptively raise prices, creating a wage–price spiral that fuels itself (Blanchard, 2016). Because wages are typically “sticky”, they adjust slowly relative to prices. Workers are always chasing inflation, which can sustain prolonged, high inflation or escalate into hyperinflation.

There are multiple examples of this throughout history. The Weimar Republic (Germany, 1921–1923) experienced one of the most extreme hyperinflations ever recorded: prices doubled every 3.7 days, and the exchange rate collapsed from 4.2 marks per U.S. dollar in 1914 to 4.2 trillion by 1923 (Bresciani-Turroni, 1937; Ferguson, 1995). The government printed vast quantities of money to pay war reparations and domestic debts, ultimately rendering the currency worthless and wiping out savings. Similarly, Zimbabwe's hyperinflation in the 2000s peaked at 79.6 billion percent per month in November 2008, as money printing was used to finance government spending amid a collapsing economy (IMF, 2009). Across Latin America during the 1980s, countries such as Argentina, Brazil, and Peru faced chronic high inflation, often exceeding 100% annually, as fiscal deficits and weak policy credibility eroded public confidence (Dornbusch and Fischer, 1993).

Hyperinflation devastates economies because it destroys the value of money, erodes savings, and collapses real incomes, forcing citizens to barter, dollarise, or rely on foreign currencies. Prices become meaningless, planning becomes impossible, and living standards deteriorate sharply. Beyond economics, hyperinflation undermines social cohesion and political legitimacy, as seen in both Weimar Germany and Zimbabwe, where extreme price instability contributed to political radicalisation and social unrest.

Which Framework Delivers Greater Stability?

Having explored both deflation, inflation and their respective pitfalls, it becomes clear that deflation driven by productivity can raise real wages, strengthen purchasing power stability, benefit savers, and discipline credit creation and speculative bubbles (Bordo and Filardo, 2005). By encouraging efficiency and deterring excessive borrowing, mild deflation acts as a natural check on financial exuberance, fostering more sustainable long-term growth. However, in practice, low and stable deflation would be difficult to sustain in today's fiat-money system, which depends on continuous money-supply growth and debt expansion. Such economies cannot tolerate prolonged price declines, since governments rely on mild inflation to service public debt and maintain fiscal flexibility (Eichengreen, 1996; Mishkin, 2007).

When comparing the extremes of debt-deflation and hyperinflation, both are devastating, but debt-deflation tends to be more sensitive to external shocks, whereas hyperinflation can spiral more autonomously once expectations become unanchored. Moreover, debt-deflation has occurred under both commodity-backed and fiat-currency regimes, meaning it is not inherently a symptom of operating under low and stable deflation. Modern monetary policy tools, such as Quantitative Tightening (QT), also lack the stimulative potency of QE, since reducing central-bank balance sheets contracts liquidity rather than boosting it. This asymmetry highlights how monetary policy is structurally biased toward expansion, reinforcing the preference for mild inflation over deflation (IMF, 2013).

Inflation can also be viewed as a "hidden tax," disproportionately affecting lower-income groups while benefiting asset holders and the wealthy elite (Piketty, 2014). Because it erodes the real value of savings, inflation advantages those whose wealth is concentrated in appreciating assets such as real estate, equities, and financial instruments. Meanwhile, households with little or no exposure to such assets experience a decline in purchasing power, as wages typically fail to keep pace with rising prices. Over time, this dynamic widens wealth inequality, transferring value from wage earners and savers to those who already possess capital.

Conversely, mild and stable deflation could theoretically have the opposite effect. Falling prices would increase the real value of savings and wages, strengthening the financial position of lower-income households that rely more on cash and fixed incomes. However, because deflation raises the real burden of debt, it would disadvantage borrowers and highly leveraged institutions, making it politically and financially difficult to sustain in modern, debt-driven economies. While lower-income households with debt would still face challenges, they would at least no longer operate in a system that is built to repress them from achieving financial stability and independence.

Ultimately, the persistent 2% inflation target reflects not just economic reasoning but institutional self-interest and narrative reinforcement within academia, central banks, and the media (Mishkin, 2007; Stiglitz, 2018). The modern fiat framework rewards credit expansion, asset accumulation, and short-term fiscal convenience, ensuring that inflation remains the "path of least resistance." As such, while productivity-driven deflation could, in theory, enhance long-term prosperity and purchasing power, our current system is structurally and politically incapable of embracing it.

Conclusion

In conclusion, while both inflation and deflation carry risks, a regime of mild, productivity-driven deflation could, in theory, offer greater long-term stability, strengthen purchasing power, and restore a more equitable distribution of wealth. Unlike inflation, which silently erodes value and encourages debt dependence, deflation rewards efficiency, savings, and genuine productivity growth. Yet, in practice, such a system remains incompatible with the modern fiat-money framework, which relies on continual credit expansion and mild inflation to sustain debt-laden economies. The challenge, therefore, is not proving that deflation can be beneficial, but recognising that the current economic architecture is too dependent on inflationary mechanisms to allow it. Until that structure changes, the pursuit of permanent price stability will remain constrained by a system designed to inflate.