

## **The Possible Return of Deflation in a Changing Global Order**

Today, inflation remains one of the most prominent concerns in economic policy debates, while deflation is widely acknowledged as a warning sign of crisis, typically associated with the collapse of demand, financial instability, and rising unemployment. This perception is reflected in most of the modern macroeconomic thinking, and has developed due to historical experiences such as the Great Depression, where falling prices were mainly due to severe economic contraction (Bernanke, 2002). However, this association has not always been the case. Historically, periods of declining prices were also accompanied by strong productivity growth and rising accumulated wealth. Today, this older dynamic is being reconsidered. The potential of AI-driven productivity gains, together with the gradual fragmentation of a dollar-centric global monetary system, raises the possibility that deflation may re-emerge in certain cases not as a signal of recession or a collapse, but as a consequence of efficiency and cost reduction. Whether such a shift leads to prosperity or instability will depend less on deflation itself, and more on the structure of the underlying economic and monetary system. Understanding this shift requires reevaluation of the era when falling prices were associated with growth, rather than gloom.

### **From Gold Standard to Collapse**

Throughout the nineteenth century, especially during the Industrial Revolution, the economic structure was quite different from the modern economic and monetary environment. As production methods improved and economies expanded, productivity had increased at an unprecedented pace, which often pushed prices down. This happened in a period when the gold standard was being used, where the money supply was more limited. For that reason, falling prices were not perceived as a problem. Instead, they were often a result of better production and higher efficiency. This meant that economic growth and declining prices could happen at the same time. What we might call “good deflation” today was mostly driven by these supply-side improvements rather than weak demand (Bordo, Lane and Redish, 2004; Cutsinger, 2025). In this sense, the nineteenth century exhibits a historical precedent for productivity driven and supply-side affected deflation.

This aspect, often associated with Friedrich Hayek and other economists from the Austrian School, suggests that falling prices can be a natural consequence of economic progress and real accumulation of wealth. However, this view has changed dramatically in the early twentieth century. The Great Depression was a major turning point for that. During and after this period, falling prices were no longer due to increased supply but were mainly connected to collapsing demand, rising unemployment, and financial instability. As John Maynard Keynes argued, “the outstanding faults of the economic society in which we live are its failure to provide for full employment,” (Keynes, 1936, p. 372) which became strongly associated with deflationary periods.

Over time, this changed how deflation was perceived. It was no longer evaluated as something that could come with growth, but rather as the most prominent sign of economic problems. It became associated not with productivity, but with collapse. This change in thinking was later reinforced by the structure of the postwar monetary system. The fiat money monetary system increased the economy’s tendency to higher inflation and led to experiencing deflation less and harder. The difference between “good” and “bad” deflation still matters today, as economists continue to debate how it should be interpreted.

## **The Dollar-Centric Monetary Order**

In the postwar period, and especially after the breakdown of the Bretton Woods system, the global economy altered significantly. With the shift toward a full fiat money system, the money supply became far more flexible. Central banks no longer had constraints in the same way as under the gold standard, and over time, they gradually took a more active role in managing economic and credit cycles. This was mainly due to preventing deflation, as falling prices were associated with recession.

At the same time, the dominance of the U.S. dollar as the world's reserve currency mainly determined global liquidity conditions. Capital flows, interest rates, and monetary policy decisions in the United States had begun to influence the global economy as a whole. This led to a system that was more tolerant of inflation and more resistant to deflation.

A clear example of this can be seen in the early 2000s. The rapid expansion of China's manufacturing capacity significantly increased global supply and pushed production costs lower. If this had occurred under the gold standard, it might have resulted in "good deflation" alongside rising global wealth. However, it took place during a period of ongoing monetary expansion in many economies, so its effect was reflected more in relatively low inflation rather than deflation, especially until the 2008 crisis. This shows that price dynamics are shaped not by monetary factors solely, but also by changes in global production structures (Autor, Dorn and Hanson, 2016).

## **The Possible Return of Deflation in a Changing World**

Global trade and monetary dominance have long depended on geopolitical stability and secure trade routes, from the Roman and the Mongol Empires, to modern U.S. naval power. In the modern era, the United States has taken this role, with the dollar and maritime influence supporting a relatively stable system (Kindleberger, 1986).

However, history shows that such dominance cannot last forever. The decline of sterling accelerated after the 1956 Suez Crisis, when Britain's geopolitical and financial limits became clearer to both its allies and creditors (Eichengreen, 2008). While it is not directly comparable, today's tensions in the Strait of Hormuz could signal underlying vulnerabilities and lead to similar consequences.

Such deep structural changes rarely happen suddenly. Those developments can lead to a shift to a more fragmented system, where regional monetary dynamics become more important and price trends diverge across economies. While fragmentation is often associated with higher costs, some regions may offset this through productivity gains, particularly as AI adoption accelerates.

Similarly, debt levels shape how economies respond to deflation. In highly indebted economies, falling prices increase real burden of the debt and therefore countries with higher debts tend to refrain more. In contrast, economies with lower debt levels may be more able to tolerate deflation, especially when it is driven by productivity rather than weak demand.

Historically, technological progress has often reduced prices by lowering costs and expanding supply (Oerth and Birks, 2023). Even though some recent work on AI suggests that higher output may not fully translate into higher ultimate productivity (Catalini, Hui and Wu, 2026), if these technologies lead to productivity growth which coincides with the increasing

fragmentation, it could create conditions in which deflation reappears in some regions not as a sign of weakness, but as a result of falling costs and increased efficiency.

### Conclusion

Deflation should not be seen as inherently harmful, but understood within a changing global economic and political landscape. As the dominance of a single monetary centre becomes less certain, governments and institutions may face very different trade-offs in how they respond to falling prices. In a more fragmented system, some economies may resist deflation due to debt pressures, while others may be better positioned to accommodate it. With technological change accelerating, the key issue is not simply whether prices fall, but how economic power, policy choices, and global structures shape those outcomes.

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