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Suddenly We're Talking About 'Deflation.' Here's What That Means for You

Could the Federal Reserve's interest rate hikes have gone too far to slow inflation?

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For well over two years now, inflation has been relentless. Almost everywhere we go, the prices we're charged just seem to get higher and higher, even if not at the same shocking pace as before.

So is it even possible that we might soon experience the opposite — a sustained decline in prices known as deflation? The head of Walmart, the nation's largest retailer, seems to think so.

"In the U.S., we may be managing through a period of deflation in the months to come," Walmart Chief Executive Officer Doug McMillon said on a conference call with stock analysts Thursday. "And while that would put more unit pressure on us, we welcome it because it's better for our customers."

But how could we suddenly go from inflation to deflation? And if it does happen, would it be as great as it sounds? Here's what you and your family need to know as the U.S. economy potentially reaches a turning point.

First, a quick recap. Prices of goods and services go up when there isn't enough of them to meet the demand. That's what ignited inflation in 2021: Consumers who were emerging from pandemic lockdowns had more pent-up demand than the shortages and supply bottlenecks could support.

The imbalance got so bad that by early 2022, when the inflation rate was headed toward a four-decade high of over 9%, Federal Reserve officials stepped in. Since people don't spend as much money when it's more expensive to borrow it, the central bank started to raise its benchmark interest rate.

But the key is not to go too far and stifle demand so much that the economy shrinks and prices fall. And the 11 rate hikes the Fed has instituted since March 2022 — which pushed the benchmark to its highest in more than two decades — have done just that, according to Cathie Wood, founder and CEO of ARK Investment Management, an asset management firm.

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"The Fed has overdone it," Wood said on Bloomberg TV earlier this week. "The greater risk here is deflation."

Wood pointed out that commodities prices as well as airfare and car prices are already declining and said the inflation/deflation rate most people refer to — how much the overall Consumer Price Index (CPI) rises or falls over a rolling 12-month period — may very well turn negative, meaning start to drop.

It rose 3.2% in the 12 months through October, decelerating from the 3.7% increase in the 12 months through September and a 40-year high of 9.1% between June 2021 and June 2022.

"I think we are going to see a lot more deflation going forward," Wood said. "I would not be surprised to see CPI inflation negative at some point next year."

Deflation may be a relief for consumers, but it's generally considered bad for an economy, as is evidenced by a Federal Reserve that says 2% inflation is the ideal.

Not only can deflation encourage people to hold off on their purchases, but it can also lead to a spiral that pulls wages down as well. The last time the U.S. had significant deflation was in the 1930s, during the Great Depression, when the unemployment rate reached 25% and wages tumbled 43%.

Walmart has already rolled back prices on many holiday toys and said this week there may be "a period of deflation in the months to come." Brandon Bell/Getty Images

The last time there was any deflation at all was in 2009, after the start of the financial crisis, but that was "short and mild," according to research from the Federal Reserve Bank of St. Louis.

Although anything is possible, deflation next year is "an unlikely scenario," according to Mark Zandi, chief economist of Moody's Analytics.

"Hard to see that happening, unless we are hit by another massive shock, like another pandemic or NATO being dragged into war with Russia," Zandi told The Messenger.

Deflation would mean "businesses and households with debt are unable to pay back that debt as their sales and wages are falling due to the deflation," Zandi said. "As defaults mount, the financial system caves. It's an ugly economy."

Walmart executives told stock analysts the company has already rolled back prices on certain general merchandise including toys like the Barbie Malibu House dollhouse, Melissa & Doug home set and the classic Furby, all things they expect to be popular holiday gifts.

The ubiquitous retailer is happy to lower prices, the executives said, as long as they can make up for it by selling more of the less expensive items. Deflation could hit certain grocery categories next, they said.

"General merchandise had been coming down and came down a little more aggressively in the last few weeks or months than the trend before that, which we think is a really good thing," McMillon said. "But it does start to have an impact on dollars when units don't go up enough to offset the deflationary impact."

Deflation shouldn't be confused with the term disinflation, which means overall prices are still increasing but not as quickly as they were.

Disinflation is what we have right now, and even as Wood warns of deflation, other economists point out CPI has been languishing in the 3% range since June — even ticking up over the summer.

"It's first-order stupid to say that deflation is on the horizon," said Laurence Kotlikoff, a professor of economics at Boston University and a best-selling author of financial advice books. "The problem isn't deflation. The problem is that we may be stuck with an inflation rate in the 3s for too long."