Dealing with Deflation
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by
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Malaysia's Consumer Price Index (CPI) inflation rate has been trending lower for the first half of this year. The inflation rate has lowered from 1.7 per cent (year-on-year) in January 2003 to only 0.8 per cent in June, and 1.0 per cent in July 2003. In 2002, the inflation rate was at a subdued rate of 1.8 per cent, following another sedated 1.4 per cent in 2001. The inflation rate has been coming down since 1998 when it peaked at 5.3 per cent during the height of the crisis. The plunging ringgit during the Asian crisis had made imported goods more expensive and that led to the rise in inflation in 1998. So, despite the deep recession in 1998, the steep deprecation in the currency led to higher inflation, contrary to the normally subscribed negative relationship between recession and inflation. Since then on, inflation rate has mellowed along with the bouncy Malaysian economy, and now inflation is hovering around 1.0 per cent or so. With Malaysia's inflation rate already so close to zero, it is not unlikely that we may see a transitory incident of falling prices. What's more, several Asian countries experienced deflation last year, including Hong Kong (-3.0%), Taiwan (-0.2%), and Singapore (-0.4%).

If one were to look at some other broad measures of prices, Malaysia may have experienced deflation in 2001. The GDP deflator, which is a broader measure of prices than the CPI, fell by 2.5 per cent in 2001, while producer prices dropped 5.0 per cent in the same year. However, following normal conventions, the fall in CPI inflation for several months remains the standard definition for deflation. Looking at the components of the CPI, the three major sub-groups that made up 75 per cent of the total weightage, showed very mild changes. Prices for the food subgroup rose by only 1.5 per cent (year-on-year) in July, gross rent, fuel and power showed a 1.0 per cent uptick, and transport and communication reported a similar 1.0 per cent increase. Price controls and adjustable price mechanism have curbed food prices from rising unreasonably, not to mention the availability of cheaper import substitutes. The impact of higher telephone charges that was imposed in March 2002 has faded away after affecting inflation for a year or so.

The term sometimes used to describe a downtrend in the inflation rate is called "disinflation". There is still a rise in general consumer prices but the degree of the rise has been decreasing over time. The present inflation rate is close to zero which means that prices are almost stagnant. The term "disinflation" has to be differentiated from "deflation", which is a situation where prices are actually falling. A country that has disinflation faces the risk of an outright deflation. Japan has suffered from deflation for the past six years, which is a symptom of chronic banking and corporate crises that have retarded economic growth as well. The prolonged weak economy and falling prices have bent Japanese households to delay purchases with the expectations that prices would go lower. Malaysia does not have a deflation problem yet, but the inflation rate is so close to zero that deflation appears to be almost at our doorstep.

It is neither accurate nor appropriate to say that all deflations are bad. Arguably, there are broadly three types of deflation. In some sense, deflation can be "good" if the reduction in prices is the result of increased productivity due to better technology or improved production processes. The increasingly stiff global competition has also pressured prices downwards. The resulting cost reduction will be passed on to consumers, while some firms would profit from higher sales volume. This kind of price reduction is welcomed by consumers and is readily observable in prices of electrical and some other household goods. Purchasing power of households will rise, but on the flip side, real interest rates burden on loans will increase. It is also sensibly argued that imports of cheaper goods from countries like China have contributed to lower inflation rates worldwide. Taking advantage of cheap labour cost and the undervalued yuan, China has become a global manufacturing powerhouse. China was ranked sixth in the world in total merchandise export value in 2001, and it can only get better in the rankings. So far, about 8 per cent of Malaysia's imports come from China.

There are also discussions on the "not-so-bad" deflation. This kind of modest and transitory deflation usually appears when demand is weak and the economy is going through a temporary slowdown or a mild recession. This could either be due to waning domestic demand or a short-term disruption in the global economic cycle. This kind of "not-so-bad" deflation can be overcome once demand conditions are restored as the economy reverts to its true potential level. It is believed that some Asian countries currently face this type of temporary and surmountable deflation.

The most feared type of deflation or the "bad" type of falling prices is the one brought about by a sharp decline in asset prices which is then followed by a damaging blow to the financial system and the overall economy. If not contained fast, this "bad" deflation will keep spiralling as the banking and corporate sectors become heavily saddled with bad debts, while at the same time altering consumer expectations with regards to prices. Narrowing profit margins due to declining prices will send some firms out of business. This type of persistent deflation is seen happening in Japan, one that many central banks do not want to get embroiled into. Once deflation becomes deeply grounded in the system, it is very difficult, as Japan found out, to recover from the economic malaise. Many attempts to pump prime the economy through massive fiscal spending and ultra low interest rates were of no avail, as the financial intermediation process became less effective. With confidence dented badly, private spending was not responding to such measures.

In the case of a transitory deflation, any kind of expansionary policies to reflate aggregate demand should help arrest deflation. Once the economy is reasonably expanding again and income growth is restored, the problem of falling prices could be overcome. One general prescription for deflation is to increase money supply aggressively so as to get prices rising again. However, this will only work if money supply can be expanded through the banking system. A reasonably healthy banking system is needed to get the money multiplier working effectively. The central bank can also buy more bonds to increase liquidity in the system. Yet another way suggested is to go for devaluation but sometimes there will be unacceptable trade-offs arising from such move. The sliding US dollar is said to be an important factor that can keep a lid on deflation in the US. But in Japan's case, it had to persistently intervene to keep the yen from appreciating too much. Thus, weakening the currency could be a costly affair. In Malaysia, aside from fiscal spending to boost the economy, the government is generous enough to grant bonuses to civil servants when it can afford them.

The disinflation trend in Malaysia, it is generally argued, has risen from the under-performing economy and the resulting excess capacity in the system. The economy is currently operating below potential, as some capital and labour are still under-utilised. In fact, the unemployment rate had edged up slightly in the first quarter (3.8%), while layoffs picked up as up to May. MIER's Business Conditions Survey reported that capacity utilisation averaged at 78 per cent in the second quarter, still below the pre-crisis level of around 85 per cent or more. The slack in the economy is also reflected by sluggish loans growth as firms lack interest in any form of expansion under the current circumstances. When there is surplus capacity, the demand for labour will cool down somewhat and the pick up in employment will lag behind the recovery cycle.

With sentiments still steady and backed by a healthy banking system, expansionary policies have been quite effective in encouraging spending. However, consumers are not ready to splurge. Although private consumption is still growing, we continue to see a lot of bargain hunting. The many sales promotion going on is another indication that retailers are trying hard to woo shoppers who are only spending cautiously. Big-ticket items such as cars and houses are facing some challenging times. Nonetheless, the price war among non-national cars has excited consumers to the extent that bookings for them have surged strongly.

Bank Negara has had an impressive track record in keeping inflation under control, and it should not be too difficult for it to ward off deflationary threats as well. Even though the likelihood of deflation is quite small, the central bank has to remain vigilant. Moreover, there is still some room for a limited monetary manoeuvre. One thing for sure is that private consumption has been holding up quite well, boosted by the accumulated impact of low interest rates and fiscal stimulus. The stock market is showing some cheering moves although it is a bit choppy at times. Credit for consumers are still expanding double digit, while consumer and business sentiments have improved lately. The most recent economic package, which delivers bonuses, EPF cuts and micro credits, is expected to have more impact in the second half of the year. Abroad, the US economy grew by a higher-than-expected 2.4 per cent in the second quarter, suggesting that external demand would be improving. MIER's latest Consumer Sentiments Survey reported that 70 per cent of households expect prices to continue rising, which means that there is little thought of deflation in the minds of Malaysian households, except maybe for some goods imported from China. Or, it could just be that households are having difficulty making a distinction between the low "inflation" and the ever-increasing "cost of living".

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