Taking a Closer Look at Inflation

Following the hike in fuel prices, interest rates and, more recently, electricity rates, there has been growing concern about the return of the inflation spectre. They crimp consumer confidence, while businesses attempt to balance their books by passing the burden of higher costs to the consumers. The raising of interest rates by Bank Negara Malaysia (BNM) is not surprising as price stability has always been an important government policy objective in Malaysia. In the past thirty over years, double-digit inflation was recorded only in 1973 and 1974. In the decade of the sixties, average inflation rate was less than 1 per cent, while the inflationary periods in the mid-70s and early eighties were the result of the two oil shocks.

Price stability is as important to policymakers as it is to businessmen and investors for purposes of planning, forecasting and decision-making. An unstable price level is always disruptive as it creates uncertainties that impede the accuracy of one's expectations. If prolonged, this uncertainty could lead to economic instability. For instance, in a high-inflation environment, corporations face difficulties in planning and making decisions, since they face the prospect of sudden inflationary shocks. And for those who are unable to cope with rising costs, staff retrenchment seems inevitable. There is also the fear that companies may have to compromise on their profit margins if they were to maintain the existing workforce, without passing on the rising costs through price increases. And to many unsuspecting consumers, the increase may not be reflected in nominal prices, but in real prices, with poorer quality or smaller quantities taking a toll.

Long-term interest rates may rise as investors become less willing to stow away money for years because they fear that the value of their investments will deteriorate. But inflation also erodes the value of fixed income assets as well as the value of interest rates. Thus, for bond investors, the control of inflation is necessarily a concern of macroeconomic policy, even if it is achieved in an environment of low growth and high unemployment; low inflation with low growth and long-term lower earnings is more favourable. Inflation and the consequent high interest rates are a bane to stock market investors because it increases bond yields relative to the yield earnings of stock holdings.

Creeping inflation is always bad news for consumers. For them, high inflation means even unchanged payrolls would eat into their purchasing power, and this does not augur well for private consumption. The slower growth of private investment will also erode input demand and lower capacity utilisation. With a large proportion of consumption and investment goods being imported, higher cost of imports will translate into higher domestic prices.

Theoretically, a stable monetary growth will lead to a low and stable price level. Arguably, the rate of monetary growth should be more or less equal to the real growth rate of the economy. Such criteria is necessary to prevent excess liquidity in the economy which could lead to rising prices. This simple approach, if maintained, will be significantly helpful and useful in creating an economic environment that is more predictable and stable.

During 2003-2005, Malaysia's average deviation of monetary growth from the real GDP growth hovered around 4.1 percentage points. This is in line with the practice in developed countries where their rate of monetary growth is low and is comparable with their real growth rates. For instance, for the 2003-2005 period, the monetary growth for the U.S. economy averaged 4.5 per cent annually which was 1.0 percentage point above its real GDP growth. However, in the U.K. and the Euro Area where annual monetary growth rates during this period were 8.6 and 6.7 per cent, respectively, the corresponding real GDP growth rates were 2.4 per cent and 1.3 per cent.

Discipline, consistency and predictability of monetary growth are, therefore, very important ingredients for the concoction of a stable business and economic environment. While a small and an acceptable divergence of monetary growth from real GDP reflects a highly-disciplined monetary policy and is usually observed in developed countries like the U.S (one percentage point) and the Euro Area (5.4 percentage points), such a policy, in its extreme form, has to follow a clear long-term monetary path. Too much and too frequent adjustments of monetary growth is not necessary, as inflation will, in a normal situation, play its role as an automatic adjustment mechanism equating the supply and demand for money.

Partly affected by movements of speculative funds, Malaysia's monetary growth (M3) for the period of December 2003 to December 2005 was at an average of 10.0 per cent per year. Although this lower money supply growth is becoming normal for our economy, compared to higher growth prior to the 1997/98 economic crisis, it reflects strong discipline on the part of the central bank in the conduct of our monetary policy. With increasing positive signs of economic pick-up, sooner or later, it is likely that the demand for money will rise. And with a real GDP growth of 6 per cent on the cards, there is still room for more monetary growth.

The writer is research fellow with the Malaysian Institute of Economic Research (MIER)