Reining in inflation

The spectre of inflation is again haunting the economy. Malaysia's consumer inflation has risen to a six year high of 3.1 per cent in May, up from a benign 1 per cent a year ago. The anxiety is also reflected in the MIER Consumer Sentiment Index (CSI), with about 80 per cent of the households surveyed expecting further rise in future inflation. The rise aside, the level of inflation reading, which is lower than conventional analysis would have predicted, is a subject of debate amongst many economic observers. Incidence like this points to the need for a reliable estimate of inflation, which is central to the conduct of sound monetary policy.

However, Bank Negara sees little need to fret over the inflation risk, reading that the recent spike as transitory. Judging the inflation figures insufficient to justify a hike in interest rates, Bank Negara has kept its policy steady. To put the current policy stance in perspective, the short-term determinants of inflation are analysed. In theory, consumer price inflation can arise due to excess liquidity (excess monetary growth), excessive economic growth (or wage inflation), rising imported inflation and inflationary expectations.

One of the most pressing challenges for Bank Negara has been liquidity management. Maintaining an undervalued currency has invited the inflow of speculative funds betting on a revaluation. Aggressive foreign exchange market intervention to stabilise the exchange rate, resulting in a rapid expansion of the domestic monetary base, could prove counterproductive and subvert market efficiency.

But Malaysia has avoided most of the symptoms of macroeconomic overheating, thanks to Bank Negara, which has successfully maintained control over domestic money stock. The central bank limited the expansionary consequences of capital inflows through Herculean sterilisation efforts. The 10 per cent growth in reserve money against the near 50 per cent upsurge in foreign reserves last year implies that the bulk of the inflow has been successfully sterilised. This has kept the pace of M3 growth consistent with the rate

of economic growth, preventing bubbles in housing prices and equities, and excessive credit expansion.

Another principal factor affecting inflation is the extent of slack in the economy. The output gap is the difference between actual and potential GDP (the maximum level of output consistent with steady inflation). A projected economic growth of 5 per cent or thereabout this year, against an estimated 5.8 per cent potential GDP growth, suggests that some slack still remains in the economy and therefore should not exert any upward inflationary pressure.

Prices of imported goods impact domestic inflation either by directly affecting imported goods in the consumption basket or indirectly influencing production costs of imported inputs. With the US dollar sliding considerably against many major currencies, the ringgit exchange rate has likewise depreciated significantly, making imports from these countries more expansive. In 2004, only 14.5 per cent of Malaysia's imports originated from the US, compared with 24 per cent from ASEAN, 22.9 per cent from major North East Asian countries (excluding Japan), 15.9 per cent from Japan and 12 per cent from the EU. Despite the sharp decline, the observed rate of exchange rate pass through on imported prices has been notoriously low, as suggested by the 2 per cent rise in both the import price index and the producer prices for imported goods last year. Price competition in the retail sector and the reduction of duties on consumer goods could have helped offset somewhat the effects of the depreciation on prices.

A fourth factor affecting inflation is inflationary expectations. Empirically, inflation in Malaysia has been characterised by a high degree of persistence, meaning that inflationary expectations have considerable influence on current as well as future inflationary trend. If the rise in inflation is deem to be permanent, firms and households would build the higher expected inflation into wages and prices. But core price increases, excluding food and energy prices, are more benign than the aggregate rate of price increases, indicating that, higher energy cost aside, inflationary expectations have not had a material effect yet on the price of finished goods. From the above analysis, the rise in

consumer prices is due to rising imported inflation and inflationary expectations, which would be more effectively dwelt with by appreciating the ringgit exchange rate, administrative price controls and vigilance against profiteering.

There are two important things to remember when analysing the current inflation trend. First, there is a need to distinguish whether the increase is due to generalised demand driven (persistent or core inflation) or supply driven (transitory) factors. Second, interest rate policy is not equipped to deal with the damage from oil price increases. If monetary policy cannot directly prevent costs, due to higher oil prices, from escalating, then some inevitable combination of lower output and higher inflation would have to be tolerated.

Indeed, much of the increase in consumer prices are policy induced, through reductions in fuel subsidies, the imposition of higher duties on cigarettes and liquor, the increase in toll charges, and ad hoc foreign labour policy. In other words, the rise in inflation is mainly due to supply-side factors with little signs of any demand-driven pressure.

While persistent inflation, due to demand pressures, is seen as a legitimate policy concern, an upsurge in inflation due to transient distortion, which is the case in Malaysia, is unlikely to influence forward looking policy setting. Therefore, the central bank is right in not overreacting. Further substantiating the current monetary stance, a number of indicators had suggested that the economy is losing momentum. Despite the good showing in 1Q2005 real GDP, poorer corporate profits, higher provisions for property loans by the banks and initial signs of slowing demand for residential property are signs of a slowing economy. Also, softer trade data points to a weaker economy in the coming months, especially the significant drop in intermediate goods purchases. Consistently, the US Institute for Supply Management (ISM) new orders, a leading indicator of Asian exports by 6 months, fell to a 25 month low in May, suggesting that the current sluggishness in Asian exports could persist well into the second half of this year.

The expectation is that, inflationary pressures would gather pace in the coming months. However, given the ineffectiveness of the interest rate policy tool in containing oil-

induced price increases and in view of the transient nature of inflation, Bank Negara would remain hesitant to raise rates, as long as the economic momentum is still on a downward trajectory.

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