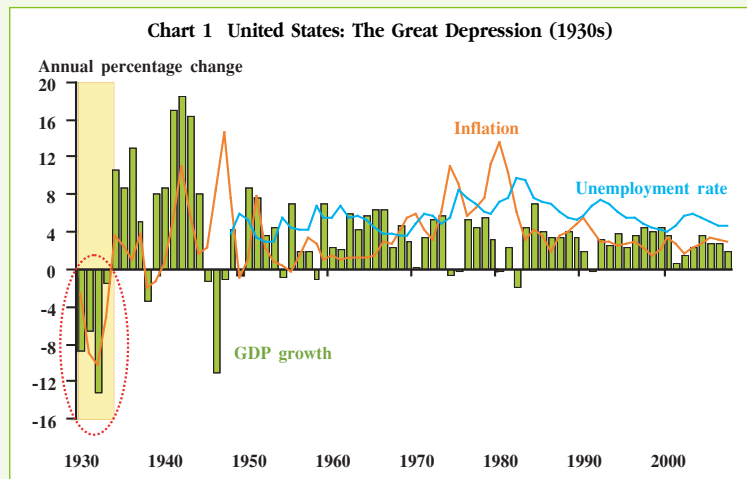


Deflation

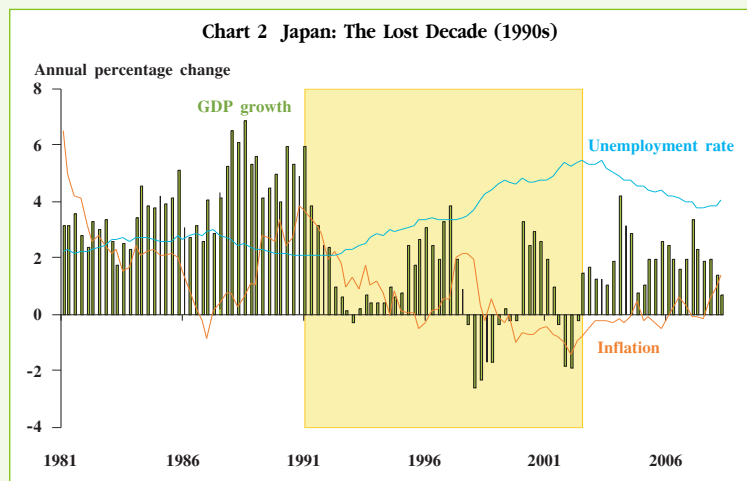
The world economy has slowed down, several economies are in recession and it is more likely that it will take some time before the world economy would recover. Consequently, the prices of commodities, especially oil prices, have declined substantially. This sharp decline has led headline inflation to fall in most economies and to rising concerns about the possibility of deflation.

What is deflation?

In theory, the decrease in the general price level of goods and services, or negative inflation, could occur from both supply factors, such as productivity expansion, and demand factors, such as severe and prolonged economic recession, possibly caused by excessively tight economic policies. Nevertheless, negative inflation would be considered “deflation” when the decline in the general price level is broad-based. The decrease in prices of goods or services in a specific sector of the economy does not constitute deflation. In addition, the rate of price decline must be persistent and result in public expectation that prices will continue to decline in the future. In this situation, consumers and businesses will likely postpone their purchasing and investment decisions. However, there is no consensus on what the duration of negative inflation would be to classify it as “deflation”. In general, a short period of negative inflation would not be called “deflation”. Furthermore, deflation usually results from economic recession and low levels of confidence which cause monetary policy to become less effective as a stabilizing tool^{1/} as the public is not willing to spend even when interest rates are very low.



Source: Bloomberg



Source: Bloomberg

^{1/} Speech on “The euro after four years: Is there a risk of deflation?”, Otmar Issing, 2 December 2002 and Speech on “Deflation: Making sure it doesn’t happen here”, Ben S. Bernanke, 21 November 2002.

The US and Japan had an experience with deflation in the 1930s and 1990s, respectively. In the case of the US, the deflationary period started from the burst of stock price bubbles and the financial crisis, which was to a certain extent a result of tightening monetary policy to curb stock price rises in the prior period. In addition, fiscal policy was not deployed in time to help stimulate the economy. This brought about the Great Depression. As for Japan's case, the problem originated from the sharp decline in property and stock prices, which contributed to considerably high non-performing loans in the banking sector. Moreover, monetary policy easing and expansionary fiscal policy were too slow and not effective in stimulating the real economy. The Asian crisis in 1997 was a crucial factor that further pushed the Japanese economy into a lengthy period of deflation.

In the present days, according to Consensus forecasts, inflation in industrial and Asian economies would decline in the next several quarters. However, demand is not expected to drop to very low levels for such an extensive period that would put the world in deflation-like condition. Factors that would help avoid deflation are the relatively solid economic fundamentals before the current crisis, as reflected by the generally strong financial positions of the corporate sector as well as the aggressive stances of monetary and fiscal policies in boosting the economies. The exception is Japan, which has a greater risk of entering a deflationary period ahead because internal and external demand is expected to contract more severely than that faced by other economies. Moreover, the Japanese economy had also recovered from the dotcom crisis relatively more slowly compared to others and since then it has been heavily reliant on external demand.

Table: World inflation forecasts

Country (Per cent)	2008	2009				2010	
		Q1	Q2	Q3	Q4	Q1	Q2
World inflation	4.8						
US	4.0	1.1	0.1	-1.0	0.9	1.7	1.9
EU (Euro zone)	3.3	1.7	1.1	0.8	1.5	1.8	1.8
Japan	1.6	0.9	0.3	-0.6	-0.3	-0.3	-0.1
China	9.3	2.0	1.8	1.9	2.3	2.7	2.6
Hong Kong	2.9	2.7	2.2	2.4	2.3	2.5	1.8
South Korea	4.0	4.4	3.0	2.3	2.6	2.3	2.4
Singapore	2.0	3.0	1.8	1.4	1.2	1.7	2.1
Malaysia	5.3	5.5	3.4	0.2	1.5	1.5	1.9
Thailand	4.3	2.1	0.0	0.5	2.4	2.1	2.4

Source: Consensus Forecast (70 countries) as of 8 December 2008

In Thailand, although headline inflation has declined rapidly since September 2008, such decline has been on the back of a sharp fall in oil prices coupled with the government measures to help ease the rising costs of living. Once excluding prices of oil and those affected by the above measures, the general price level has not declined. Thus, there is no clear sign of deflation in Thailand going forward. Although headline inflation in the near term may enter the negative zone, it would be because of the large decrease in the prices of oil from considerably higher levels in Q2 and 2008 Q3. In this light, the MPC assessed that the probability of deflation would be low, as appropriate and timely expansionary fiscal and monetary policies would help to prevent the deteriorating domestic demand from inducing deflation.