Thinking the Unthinkable: A Deflationary Spiral

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Astoundingly, a couple of quarters ago w were overwhelmed by a fear of inflation, as fuel and commodities prices continued breaking records. But given the recent global spread of the sub prime crisis to the financial and real economic sectors, this has inverted to a fear of deflation. Headline inflation in January, which registered at minus 0.4 per cent, slipped into the negative zone for the first time since the inflation-targeting regime was adopted in 2000. Does this indicate that the Thai economy is facing a deflationary environment? To answer this question, let's explore the conditions that are required in the lead-up to a deflationary episode.

Deflation is defined as a general decline in prices. Accordingly, sector-specific price declines do not always generate problems for the economy, since they can be caused by an increase in productivity. However, things turn unpleasant when the price decline are common across sectors due to a drastic fall in demand for goods and services, as suppliers need to reduce prices on an ongoing basis to attract additional demand. Along the way, the thinking goes, consumers see falling prices and decide to delay their purchase, putting more downward pressure on prices. Eventually, layoffs, financial distress and recession become inevitable.

Thus, a deflationary spiral-a persistent, self-reinforcing and intractable decline in prices across the board-can be highly destructive.

Fortunately, the chances of a deflationary spiral in the Thai economy in the foreseeable future are slim, since none of the conditions has yet been met. Although headline inflation turned negative, it was primarily driven by a rapid plunge in fuel prices, while prices of goods in other sectors remain steady. Moreover, the negative inflation is not expected to be sustained in the near future, as revealed in the positive slope of the government bond yield curve, in which the long end of the curve reflects inflation expectations.

When policy-makers need to fend off deflationary recession, they may lower the nominal interest rate. In countries like the United States and Japan, where the nominal interest rate is close to zero, no further downward adjustment in the rate can occur, since lenders are unlikely to accept a negative nominal interest rate when it is possible instead to hold cash, which provides a zero return. Therefore, the central banks can no longer ease policy by cutting the interest-rate target. The inability to pursue conventional means may complicate the policy-making process and introduce uncertainty in the size and timing of the monetary-policy transmission mechanism.

In the case of Thailand, in order to avoid this situation, the Bank of Thailand has conducted intensive easing of monetary policy, in cooperation with fiscal expansion initiated by other parts of the government. An important aim of these measures has been to boost confidence, and to act pre-emptively against deflationary pressures. This crucial as the cost and effort required to shore up aggregate demand before entering a deflationary spiral are significantly less than reviving the economy from wreckage.

(Views expressed are the author's own.)

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