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Fear of falling price level

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Yet another advanced country is in the grip of fear of falling price level.

On Tuesday, May 3, the Reserve Bank of Australia (RBA) reduced its benchmark interest rate to 1.75 percent from 2.0 percent: the lowest rate ever.

Interest rates charged by Australian banks for loans to consumers and businesses would come down, either in full measure of the cut at 25 basis points or less. The National Bank of Australia (NBA) was the first one to reduce its variable rate for housing loans from 5.60 percent to 5.35 percent.

Critics remarked: Is Australia going to join the zero-interest club soon?

Their reference is to advanced economies, including Euro zone and Japan and a few Scandinavian banks, which have been pursuing zero or even negative interest rate policies. Readers may recall we reviewed the negative interest rate policy as an anti-recession measure in this column.

Only in December last year, the US Federal Reserve (the Fed) decided to come out of its seven-year old rut of zero to 0.25 percent range of its benchmark interest rate known as federal funds rate. It raised the range to 0.25 percent-0.5 percent. It was expected that the US Fed would further increase it as the signs of US economy were positive. Last month, the Fed decided to hold it on the grounds of low inflation, both domestic and global.

It followed the IMF predictions of poor global growth in 2016 with low inflation and incredibly near zero interest rates. IMF gave the name to the 2016 growth expectations: “new mediocre”.

Sounds familiar? Six months ago China called it: “new normal”.

Two measures

Advanced countries have target rates of inflation. Some have a point target of 2 percent. Some others, including Australia have a target range: 2 percent to 3 percent. Inflation lower than the target range is not worrisome, as long as the gross domestic product (GDP) grows at 3 percent with unemployment rate below 6 percent level; business and investment conditions fairly reasonable; and a stable housing sector outlook.

The 2016 first quarter price level changes, all of a sudden stoked the fear of deflation.

There are two measures of inflation. The headline inflation is the one we are all familiar with. It measures changes in consumer price index (CPI) of basket of goods and services of a general consumer. The other one is the underlying inflation, also referred to as core inflation. It excludes changes in prices of goods, found to be subject to frequent fluctuations. These are petrol and diesel and other petroleum based products.

The CPI for the first quarter of 2016 (January to March) contracted by 0.2 percent. This is not as disturbing as the fall in underlying or core measure of inflation.

The core inflation, excluding all volatile items, fell by 1.55 percent, the lowest level, which is a record. It is the decrease by a huge fall in underlying inflation which causes concerns, since economists look upon underlying inflation indicating a long term trend as distinguished from CPI which is a short-run measure.

Inflation is caused by supply and demand factors. Shortages and excess supply may cause changes in price level. If fall in price level is due to excess supply of fruits, or electronic goods or computer games, which have been pointed out as reasons for fall, it is good for the consumer. In fact, if GDP growth is steady; if unemployment rate continues to remain the same; and if wages are unchanged, any fall in core inflation is good for everyone: real wages are rising!

One swallow does not make a summer. No need to panic.

Why then the fear of deflation?

Oil is tradable good. Australia imports 90 percent of its oil requirement. The fall in oil price has been a blessing for all countries. Oil price is an important component of CPI. But, the biggest fall in prices of all Australian tradables are fruits. The fall in fruits price was 11 percent, as against the fall in the price of all tradable items: 1.4 percent. Fruits are an exportable item.

The CPI includes non-tradable items. These include house rents, fast foods, utilities charges, health and education. Their prices had risen only by 1.7 percent. The only reason that could be attributed to is the falling demand for non-tradable items.

Is the country's aggregate demand on the decline? That is the fear.

It is the expectations that matter for economic growth. They govern both investment and consumption decisions. In any situation of falling price levels, either caused by prolonged and sustained fall in oil prices or fall in overseas demand for country's exports or fall in domestic demand for non-tradables, no investor would take a decision to invest when future returns are uncertain.

So too the consumer! Expecting further falls in price level, the consumer would try to postpone his purchase of durable goods, such as house, or semi-durables such as refrigerators or cars.

The would-be borrower always looks at the expected real rate of interest after factoring in expected inflation. Real interest rate is the real cost of borrowing: the nominal rate of interest minus the expected inflation. For example, if one were to borrow in January 2016, his expected real interest rate would have been the RBA rate of 2 percent in January minus the expected inflation then of 0.2 percent. That is 1.8 percent on 2 May, before the 3 May RBA cut. Given RBA rate at 2 percent, and with inflation in May at a negative –minus 0.2 percent, the real rate of interest is 2.2 percent. That is actually more than the January expected real rate of 1.8 percent by 0.4 percent!

The RBA knows investors are worried about real rate of interest. It has got to adjust the expectations by a cut. The benchmark rate has been lowered to 1.75 percent.

The Monetary Policy Statement of May 3 issued by RBA acknowledges "low inflation with subdued growth in labour costs and very low cost pressures elsewhere in the world", which point to a lower outlook for inflation than previously forecast. So RBA eased the monetary policy further.

Since the interest rate was cut, Australian dollar went down in value. It was US76.68¢ on Monday, May 2. After RBA cut on May 3 , it fell to US76.27¢. On Wednesday, it was US75¢. Depreciation will be welcomed by traders as it improves the export competitiveness of Australia.

Implications for Fiji and other PICs

Since general price level has been declining in Australia together with depreciating Aussie dollar, we can expect imported goods from Australia to be cheaper than before. These would include fruits and medicines.

With the rising local vegetable prices in the wake of TC Winston, one may find fruit salad made from fresh imported fruits cheaper than local vegetable salad.