

Clear and present danger

Deflation is a real threat today, and likely to be the norm with open markets. JOSEPH CHONG has a few suggestions as to how Singapore can deal with it

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THESE are indeed confusing times. Despite ample liquidity and low nominal interest rates, global stock markets continue to sell off. Some would attribute it to Iraq, terrorism, corporate governance and poor sentiment. I believe Iraq is a relatively minor problem from a historical perspective. Iraq is not a pawn of superpower confrontation with 20,000 nuclear warheads standing off but a carcass being haggled over by the Great Powers at the United Nations. Terrorism is nothing new - it has been with us since recorded history.

Unfortunately, I believe we are facing a more serious problem - deflation and the complacency of G7 central banks with this danger. For example, the European Central Bank (ECB) is still focused on bringing inflation below 2 per cent, dismissing growth as not being their mandate.

Indeed, the Bank of Japan (BOJ) has been the most successful inflation fighter - minus 2 per cent plus per annum for prices. Look where Japan is now! Ironically, the central banks in UK and Australia which are the least fanatical about their inflation targets (2 to 3 per cent) have economies which are doing relatively well.

I believe we have lost sight as to why we were fighting inflation in the first place. It has been to ensure sustainable real economic growth. By all measures, the battle has been won. Bond markets are signaling that expected average inflation over the next 10 years to be about 1.4 per cent. Extrapolating the graphs shown here, which were published in *The Economist*, we could possibly expect nominal growth to drop below zero per cent if we are not careful.

In an open capitalist economy, disinflation is the norm because of incessant competition. This is more evident today with globalisation, the entry of China into the world economy and falling trade and capital flow barriers. Prior to the Vietnam War which was financed without raising taxes, inflation was low. The acceleration of inflation in the G7 coincided with the escalation of the Vietnam conflict.

The problem with deflation, unlike inflation, is that it cannot be fought with monetary policy as nominal rates cannot drop below zero so as to create negative real rates.

Deflation, like high inflation, is highly de-stabilising - recent studies by the International Monetary Fund (IMF) and the Federal Reserve confirm this. Who would want to invest and consume today if prices are going to be lower tomorrow?

We believe it is this fear of deflation and G7 central bank complacency while Rome burns which is driving equity markets down. Equity markets appear cheap if you assume global nominal growth of 5 per cent which most fund managers use in their projections. However, if global nominal growth falls to 2 per cent, then equity markets are fairly valued currently. With global growth potential at 2.5 per cent, nominal growth of 2 per cent is consistent with global deflation!

However, what can Singapore do, given our size and open economy, to fight deflation? Note that the consumer price index (CPI) is running at minus 0.4 per cent annually. Again, I am uncertain whether this is the reality given the way we measure changes in the quality of a basket of goods and services. For example, factoring the qualitative changes in personal computers and automobiles, these have fallen dramatically in price over the last five years.

Here are some anti-deflationary suggestions.

Land market: In addition to freezing land sales, the government should buy back some of the land sold to developers. This will put a clear floor on asset prices and help clear the backlog of 28,000 units. The state could always re-sell this at a higher price when the economy recovers, thus benefiting all Singaporeans. Even if nominal borrowing rates are 2.5 per cent annually, real or inflation adjusted cost of debt would be 7.5 per cent if prices deflate at 5 per cent per annum. A 7.5 per cent real investment hurdle rate is not an attractive proposition but a 2.5 per cent one is.

GST: Defer imposition of the goods and services tax (GST) increase indefinitely. Instead, balance the budget through reductions in expenditure. In addition, provide fiscal incentives to consume and invest. It is better to let Singaporeans decide how they want to spend their money rather than have it directed through government expenditure a la Japan. I believe it would be more efficient if the pain of balancing the budget is borne primarily by the public sector.

CPF: Lower the minimum guaranteed rates of return in the CPF accounts. You can either use interest rates (monetary policy) or foreign exchange rates to manage the economy. One cannot do both without distorting the economy. Singapore has chosen the latter. However, by setting a returns floor of 2.5 per cent and 4 per cent respectively on the CPF Ordinary Account and Special Account, we are practicing monetary policy on part of our economy but under the jurisdiction of the Ministry of Manpower!

With inflation running at -0.4 per cent, these are real rates of 2.9 per cent and 4.4 per cent on government security - the highest real rates of return anywhere in the world currently given the credit quality of sovereign Singapore.

These are real rates that one would expect during boom times and not a very slow growth economic environment. This is a distortion, as other investments which CPF members can invest in would need to beat an artificially high hurdle.

We need to fight deflation because it is far better to have jobs, growth and rising prices rather than falling prices and no jobs.

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