24 February 2015

PRICES HAVE BEEN STICKY DOWNWARDS, BUT IT IS A STRUCTURAL PHENOMENON WORSENED BY FOOD PRICE

- *The reduction in fuel prices at the pump is widely expected to cause a general decline in prices. However, that is not happening. This is testament of the commonly observed phenomenon that prices are sticky downwards.*
- *We find four main reasons for the rigidity in price: (i) inflexible contracts and menu cost; (ii) nature of the APM mechanism; (iii) sustained strength in demand and (iv) low incidence of fuel in SME's cost structure. These are mainly structural in nature. However, general inflation has also been kept up by a fifth factor, namely food price inflation, which has been caused by supply disruptions.*
- *We do not expect prices to drop in the near term. In addition, the reduction in power tariff will take effect one month prior to GST and it will be only for four months.*
- *The lower fuel price and power tariff will not cause a disinflationary effect because of the price rigidity phenomenon. However, it will rein in inflationary expectations due to GST. We expect consumer inflation rate to be 4.1% in 2015, reflecting one-off effect of the GST.*

PRICES ARE STICKY DOWNWARDS

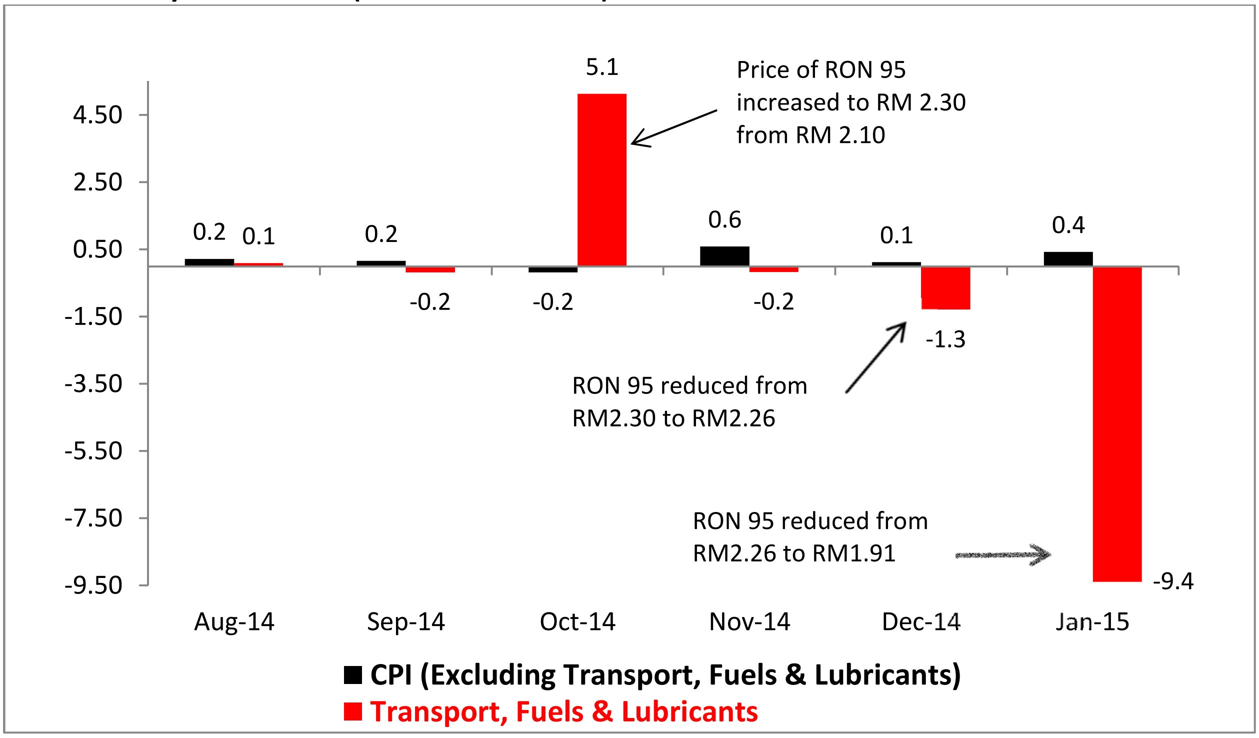
Fuel prices have receded since November 2014. Prices for RON 97, RON 95 and diesel declined by as much as 23% on average between November and January, due to the decline in global oil prices as well as the government's decision in switching to a 'manage float' fuel pricing mechanism. This has raised expectations that general prices will decline.

Transportation attracts 14.9% in the CPI basket. Fuel forms part of the 'Transport' component in the CPI basket. The 'Transport' sub-index attracts a weight of 14.9%. Fuel and lubricants make up 8.8%-point of the 14.9% 'Transport' weight. The weightage is therefore significant.

The 'Transport' index in the CPI basket is experiencing price deflation. On a monthly basis, the 'Transport' index contracted -0.2% in November, -1.2% in December and more significantly -9.4% in January 2015. Since transportation is perceived to be a large cost component, many expect the general prices for goods and services to ease in tandem.

However, other items in the CPI basket have not generally fallen. Excluding the transport sub-index, we estimate that the adjusted CPI actually rose 0.6%mom, 0.1%mom and 0.4%mom in November, December and January respectively (see chart 1 in the next page). This is evidence of the price rigidity phenomenon aforementioned. We note that **'**Food & non-alcoholic beverages' sub-index, which carries 30.3% weight in the CPI basket, expanded by 0.25% mom in November, 0.35%mom in December and 1.2%mom in January.

Chart 1. Malaysia's inflation (% month-on-month)



Source: Department of Statistics; MIDFR

REASONS FOR PRICE RIGIDITY

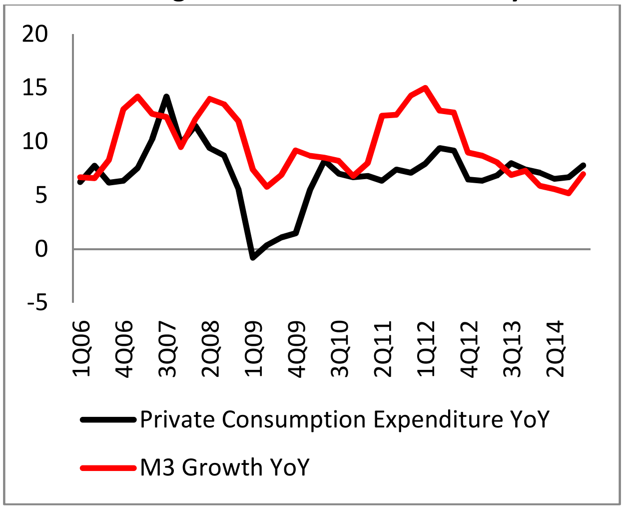
Firstly, businesses may not instantaneously adjust prices due to pre-existing contracts and the high cost of re-tagging prices. While cheaper fuel price may lower total operational costs, businesses usually enter into long term contracts in order to reduce transaction costs, prevent supply and demand shift from affecting price stability and to reduce cash flow variability (reduce possibilities of large negative asset positions), which could explain the delay in transmission of fuel cost savings into lower prices. In addition, the rigidity in price movement, could be the result of high cost associated with adjustment of prices (menu cost) and because of this expense, firms may view cost savings to be relatively minor compared to the cost of notifying the public of new price information. Therefore, businesses would rather temporarily exist in slight 'disequilibrium' than incur the menu costs.

Secondly, the Administered Price Mechanism (APM) delays price transmission. Prices of some essential goods are administered by the Government to limit the impact of price change volatility on cost of living for the low and middle income group. With the APM in place, impact of supply shocks and external price developments on domestic prices is less direct and immediate. Case in point, when the government initiated a series of fuel price reduction in August 2008, consumer prices reduced significantly after a few months lag, reflected in the CPI, which expanded by 8.5% yoy in August 2008 and slowed significantly in December 2008 to 4.5% yoy.

Thirdly, robust demand places upward pressure on prices while GST impact on consumer spending likely to be temporary. Cheap fuel has provided a positive wealth effect and resulted in consumers increasing the amounts and distribution of their consumption. Private final consumption expenditure ascended to 7.8% in 4Q14 from 6.7% in the previous quarter, impelled by the higher consumption on food & beverages, communication and transport. With demand evidently robust, there is no compulsion for businesses to reduce product prices as consumers will be compelled to continue in making purchases at prevailing prices. But whether this is regarded as an act of profiteering is highly subjective. We think that this undesirable outcome is merely the result of free market forces.

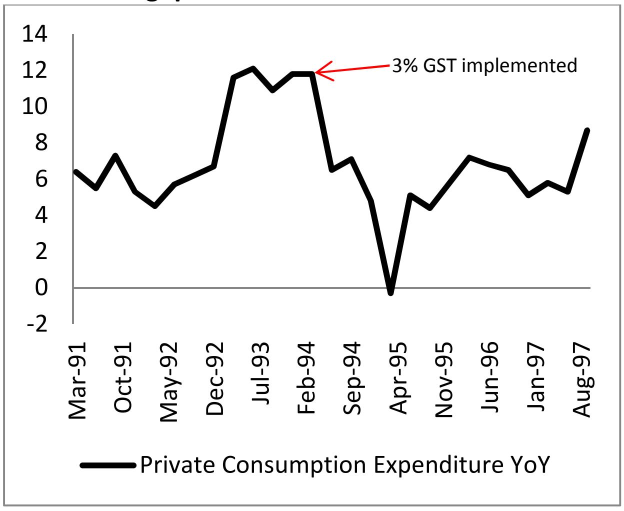
In addition, although private consumption is expected to dwindle down once GST rolls out in April, businesses may foresee its impact as transitory. Consumers are likely to adjust to the new environment rather quickly, thus making any immediate price revision ineffective. Taking example from other country's experience with GST i.e. Singapore, private consumption dropped significantly when GST was introduced in March 1994, but began to normalize the year after. Hence, we could expect the same pattern to be realized in Malaysia.

Chart 2. Strong domestic demand in Malaysia



Source: CEIC; MIDFR

Chart 3. Singapore PCE trend after GST

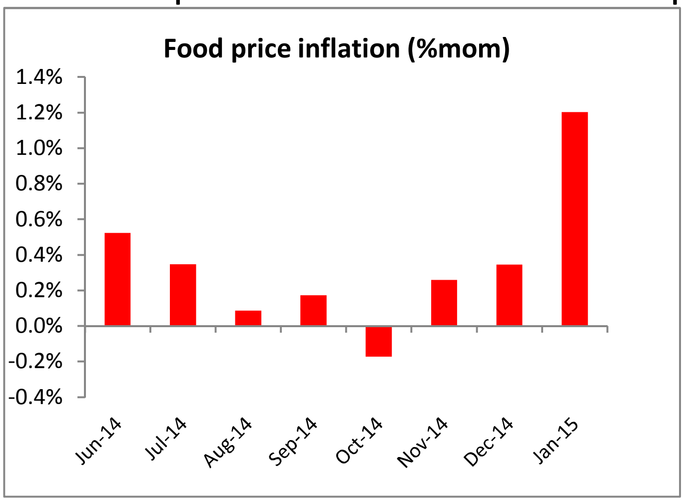


Source: CEIC; MIDFR

Fourthly, fuel is a small cost component for SMEs while other inputs such as wages have been on the rise. As a cost component, fuel, lubricants & gas for transportation, only accounts to about 4.4% of total cost to SMEs, where else employees' salaries, wages and training expenses contributed to 17.2% of total cost (see Table 1). On this backdrop, the impact of lower fuel prices on SMEs total operational cost should be minimal. In fact, any fuel cost savings is offset by the electricity tariff hike in early 2014, which was estimated to increase the monthly bill of industrial customers by 17%. Moreover, employees' payrolls have been on an uptrend and manufacturing wages alone have risen by an average of 17.14% in 2014.

Fifthly, food prices have stayed up mainly due to supply disruptions: The headline inflation in Malaysia has always been dominated by food prices. Although fuel prices have declined, food prices continued to increase in November – January. In January, food prices spiked up by 1.2%mom (see chart 4). This can attributed to the flood crisis during the period. The flood in Cameron Highlands in early November, and the subsequent clampdown on illegal workers also led to a sharp decline in supply of vegetables. The increase in food prices has offset the decline in fuel prices, but this is due to supply factors and not structural in nature.

Chart 4. Food price inflation have offset decline in fuel prices

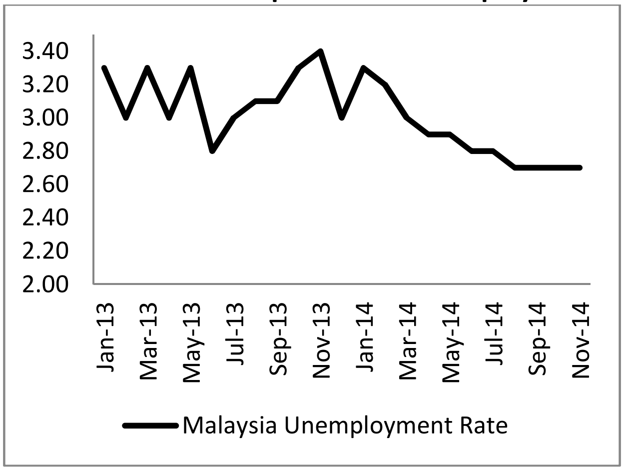


Source: CEIC

DISINFLATIONARY EFFECT OF LOWER FUEL PRICE TO BE NEGATED BY GST

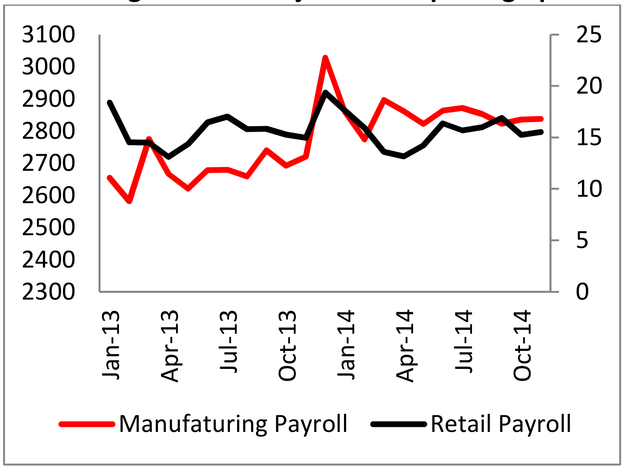
Moving forward, we do not foresee general prices to taper. The government has announced the decision to reduce electricity tariff by 5.8% in March 2015, this will only be sustained for a 4 month period before another revision is made and the hike will only be implemented 1 month before GST rolls out. Moreover, with hypermarket operators, wholesalers, traders, retailers, restaurants and food and beverage operators agreeing to reduce prices of their goods by 10 -20% in accord to the price reduction programme initiated by the Ministry of Domestic Trade, Co-operatives and Consumerism, we argue that these changes will only act as a buffer against the inflationary impact of GST. With inflationary expectation heightened on GST and the frontloading of consumer spending to place upward pressure on prices as a result, we expect CPI in 1Q15 to show stronger readings. Overall, we estimate inflation rate to be 4.1% in 2015, reflecting a one-off effect of GST. The official inflation forecast for 2015 will only be unveiled on 11 March 2015, when Bank Negara releases its Annual Report.

Chart 5. Continued improvement in employment



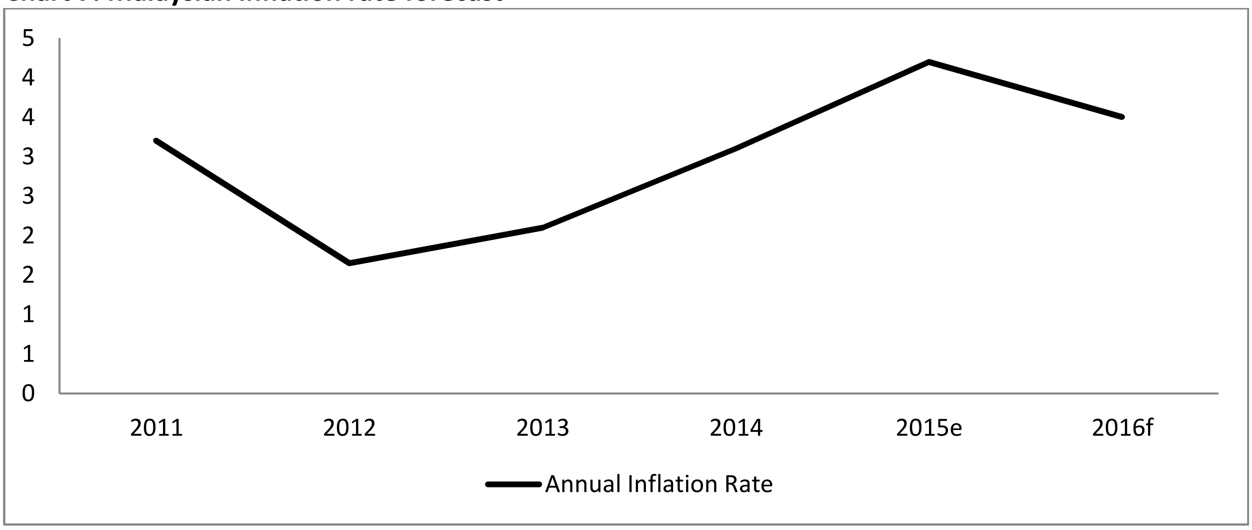
Source: CEIC; MIDFR

Chart 6. Wages across major sectors picking up



Source: CEIC; MIDFR

Chart 7. Malaysian inflation rate forecast



Source: Bloomberg consensus forecast for 2016; MIDFR estimate for 2015

Table 1. Breakdown of SMEs total operational cost (% share)

Goods, materials & services (input costs)	49.7%
Malaysian workers' salaries & wages	13.8%
Foreign workers' salaries % wages	2.2%
Staff training expense	1.2%
Electricity bills	4.2%
Water bills	3.2%
Fuel, lubricants & gas for transportation	4.4%
Other transportation cost (maintenance, etc)	2.8%
Rental of buildings and vehicles	5.7%
Advertising and marketing expenses	1.9%
Finance and borrowing costs	4.8%
Other costs	6.1%
Total	100%

Source: SME Corporation Malaysia

Table 2. Price administered goods

Price Control Act, retail price determined by government *Items*	**Items where any change in prices require Government approval** *Items*
Food	Alcoholic beverages & tobacco
Rice	Beer
Flour & other cereal grains	Wines
Fresh meat	Spirits & liquors
Evaporated/condensed milk	Cigarettes, cigars etc
Oils	Tobacco
Sugar	Housing, Water, electricity, gas and other fuels
Non-food	Water supply
Gas	Electricity
Fuels & lubricants	Communication
	Telephone and telegraph services
	Telephone and telegraph equipment
	Postal services
	Transport services
*** Currently, price administered items constitute 29.3% of the CPI basket.**	Passenger transport - rail
	Passenger transport - road
	Passenger transport - air
	Passenger transport - sea
	Other transport charges

Source: Bank Negara Malaysia

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