Economics

SG: watch core inflation

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- **Full-year CPI inflation will likely be negative in 2015. Importantly, core inflation is slipping too**
- **The output gap is widening with slower growth, putting more downward pressure on core inflation**
- **If core inflation falls short of the official forecast range of 0.5-1.5%, the authorities may have to respond**

Negative inflation

Headline CPI inflation has been below zero for the past six months (Chart 1). In April it fell to -0.5% YoY from -0.3%. The main drivers of negative inflation continue to be housing, transport and healthcare, which together account for 47% of the overall CPI basket. These sectors in turn are being driven by low oil prices, a significantly less-than-expected wage growth, a cooling property market and a moderation in healthcare costs owing to the Pioneer Generation Package.

There may be more downward pressure on prices going forward. The Land Transport Authority (LTA) announced last month that COE quotas for the second quarter (May to July) will be increased by 42%. Private transport costs account for 11.7% of the CPI basket. A decline in COE premiums would have a significant impact on inflation overall.

Barring any significant uptick in oil prices, inflation will likely remain negative level for several more months. We now expect inflation for the year as a whole to be negative (-0.1%). With global growth still subdued, inflation will remain low at 1.3% in 2016.

Full year 'inflation' expected to be negative

Chart 1: Negative inflation

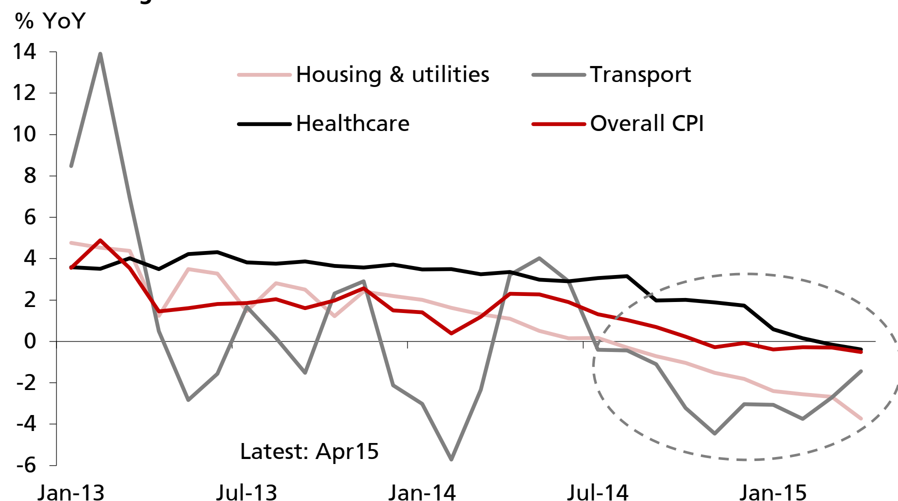

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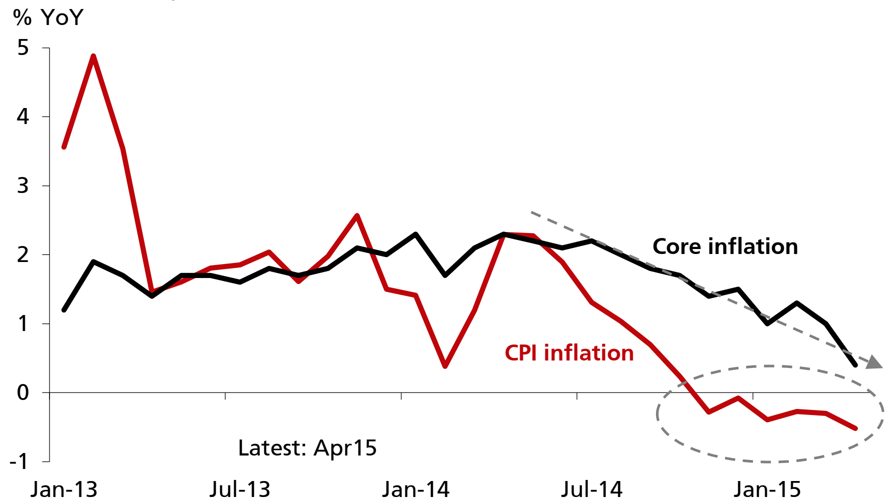
Chart 2: Steady slide in core inflation



Deflation risk?

Negative inflation will undoubtedly stoke debate about 'deflation'. But as the 2016 forecast above makes clear, we do no expect persistently falling prices. Importantly, less volatile 'core' inflation remains positive and, as with most of the world's central banks, core inflation is the key barometer that the Monetary Authority of Singapore (MAS) tracks when considering policy.

Core inflation could dip into negative territory

That said, core inflation has also slipped [1]. In Singapore's case, 'core' is defined as ex-private transportation and accommodation costs. In April, it fell to 0.4% (YoY), down from an already low 1% in the previous month (Chart 2). This was the lowest reading since Mar10 and it was not mainly due to low oil prices. Petrol is a sub-set of private transportation cost and as such, it does not enter, at least directly, the core calculations.

The decline in core inflation is related mainly to the negative output gap [1]. The output gap is turning increasingly more negative as growth wanes (Chart 3). The gap fell further to -2.3% of GDP in 1Q15, down from -0.1% in 4Q14 due to easing growth momentum. Sequential growth in the same period moderated to 3.2% (QoQ saar), from 4.9% in the previous quarter.

Chart 3: Output gap turning more negative

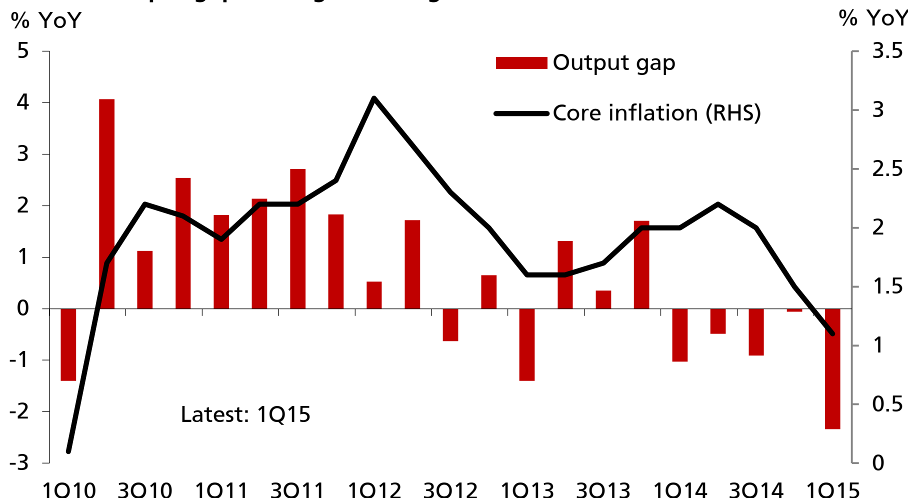
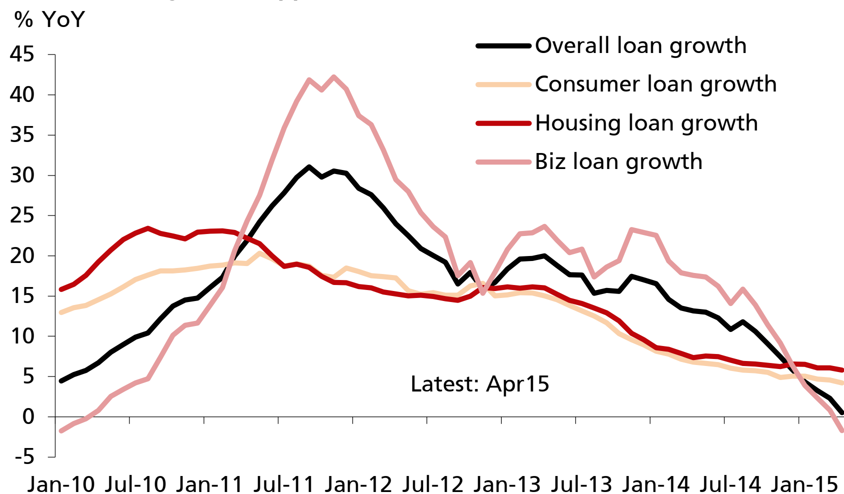


Chart 4: Loan growth dipped on contraction in business loans



The fall in core inflation amid depreciation in the Sing dollar is disconcerting. The high import content of domestic consumption implies that a weaker currency should push inflation higher. Instead, even though the Sing dollar has depreciated by about 8% over the past year, it is drifting lower.

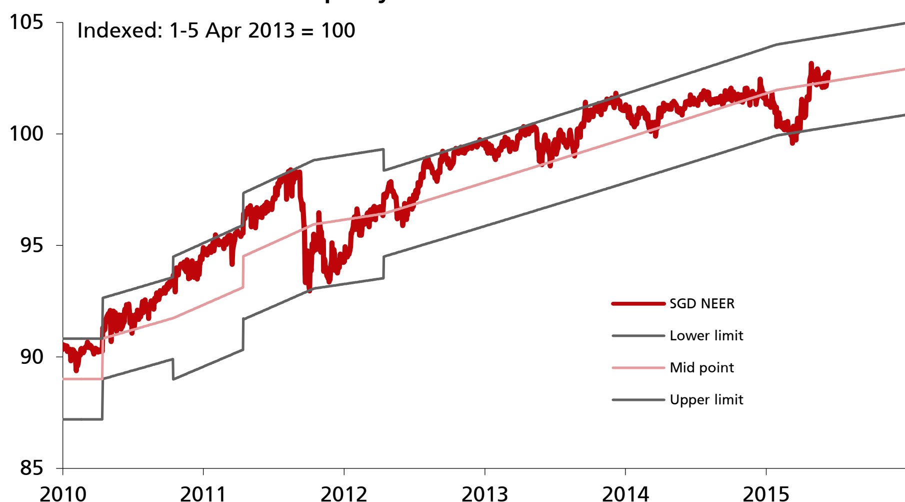
Slower growth appears to be the dominating factor. Apart from headline GDP, high frequency data also suggested that economic activities have softened. Loan growth dropped further to 0.5% (YoY) in Apr15, down from an already low 2.3% previously (Chart 4). Both consumer and business loan growth have continued to dip. This was the first time business loan growth fell below zero (-1.7%) since the Lehman crisis.

Implications on monetary policy

While the pressure on the MAS will rise with persistently negative headline inflation, it pays to note that overall CPI inflation for the year will likely remain within the official forecast range of -0.5 to +0.5%. In April, the authority had surprised the market by maintaining status quo on the exchange rate policy (Chart 5).

However, the path of core inflation in coming months could alter the dynamics. The central bank expects core inflation to fall between 0.5-1.5% for the full year. Should it dip below zero and remain there in the coming months, full year

Chart 5: DBS SGD NEER and policy band



core inflation would fall short of the central bank's target range, raising the odds of central bank action down the road.

Negative core inflation may warrant a policy response

The risk of negative core inflation is rising and it could prompt deflationary concerns. To be sure, the labour market remains tight with unemployment still low and this should put a floor under core inflation. But the labour market has been tight for some time and inflation continues to ease.

While we do not expect 'deflation' in the sense of persistently falling prices, the decline in core inflation merits watching closely and could require a policy response in the months ahead.

Notes:

[1] The output gap is derived using the Hodrick-Prescott filter

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