Inflation in emerging economies

The Economist

2008.5.24

Inflation

- Emerging economies risk repeating the same mistakes that the developed world made in the inflationary 1970s
- China's official rate of CPI inflation is 8.5%, up from 3% a year ago
- Russia jumps from 8% to over 14%
- Brazil has risen to 5% from less than 3%
- Chile from 2.5% to 8.3%
- Argentina's inflation is 8.9%, but Morgan Stanley estimates the true figure is 23%

Underestimation of inflation

- Many inflation rates are underestimted
- Widespread government subsidies and price controls
- Price data are skewed by a lack of data or government cheating
- If measured correctly, two-thirds of the world's population may be struggling with double-digit inflation

Causes of inflation

- Inflation has been caused mainly by surging oil and food prices
- In China, food prices have risen by 22% last year, whereas non-food prices have gone up by only 1.8%
- Many governments control prices, but this reduces the incentive for producers to increase supply and consumers to curb demand, and hence prolongs the imbalance of demand and supply

Central banks

- Some central banks have nudged up interest rate (reduce money supply), but not enough
- For example, Russia's interest rate is 6.5%, almost 8% lower than the inflation rate
- China's real lending rate is minus 1%

Food price and inflation

- Food price is likely to be lower later this year, but that does not mean rising inflation can be ignored
- Food accounts for 30–40% of the CPI in most emerging economies compared with only 15% in G7 economies
- Analysis by Goldman Sachs, for 1997-2007, confirms that in emerging markets, higher food prices did seem to push up other prices

Money supply

- Higher inflation is caused partly by loose monetary policy
- Were monetary conditions tighter, rises in food prices might be offset by decline elsewhere, keeping inflation under control
- The broad money supply has grown by an average of 20% over the past year in emerging economies, almost three times the pace in the developed world
- Russia's money supply has swelled by 42%

Central banks

- Add all this up, emerging economies today bear strong similarities to rich countries in the 1970s (Great Inflation)
- Central banks' credibility is weaker in most emerging economies, so that inflation expectations are less firmly anchored, and the risk of price rises is higher

Central bank independence

- Central banks of the developed economies are more independent today, but in emerging economies central banks are not fully independent
- They are often face intense political pressure to hold rates low

Exchange rate

- Emerging economies also like to hold down currencies
- When central banks adopt this policy, they have to print money to buy dollars, which boosts domestic liquidity
- The solution? Emerging markets should allow more flexibility in their exchange rate, and a stronger currency would help to curb import price