Inflation in emerging economies

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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 underestimated
- 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.
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.
• 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