Box II-1

Inflation developments in emerging market economies and monetary policy restraint

Over the past several years, output growth in emerging market economies has outpaced that in industrial nations. For a long time this growth was accompanied by relatively low inflation, but the situation has changed in the recent term. Inflation is currently at a six-year high and has now reached double digits in many emerging market economies.

This situation stems from a number of contributing factors. Soaring oil prices, instability in the financial markets, and deteriorating housing market conditions have undermined GDP growth in industrialised nations, particularly the US. The US Federal Reserve Bank has responded by lowering the federal funds rate considerably. This has spurred a depreciation of the dollar, especially against the euro. Many emerging and oil export nations have adopted monetary policy that entails maintaining a constant exchange rate vis-à-vis the US dollar, or at least a managed floating regime imposing considerable limitations on appreciation. The rapid reduction of interest rates in the US undermines monetary policy restraint in these countries at a time when a tighter stance is necessary. As a result, output growth has remained strong despite dwindling demand from abroad because domestic demand has continued to grow. Strong domestic demand, rising commodity and food prices, and a low exchange rate have pushed inflation sharply upwards over the past year. Therefore, the robust GDP growth of the past few years is probably not sustainable over the long term.

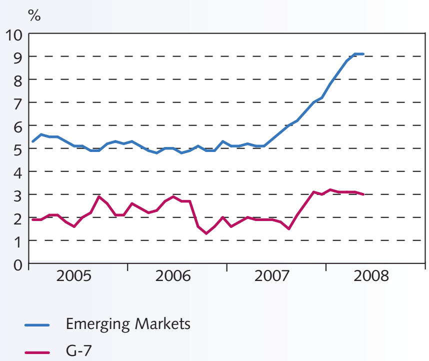
There is little margin to increase the short-term supply of commodities, and demand in emerging market economies is growing by leaps and bounds. Food commodities also constitute a much higher proportion of consumption among low-income countries; therefore, inflation that is concentrated in certain commodities can quickly evolve into a general inflation problem in emerging nations. Furthermore, inflation expectations are less securely anchored than they are in developed countries with experience of price stability, and this precipitates general inflationary effects and makes them more persistent than they would otherwise be.

Numerous factors have acted simultaneously to push inflation upwards. Oil and food prices play an important role, and growing

Chart 1

Inflation in Emerging Economies and G-7

January 2005 - May 2008

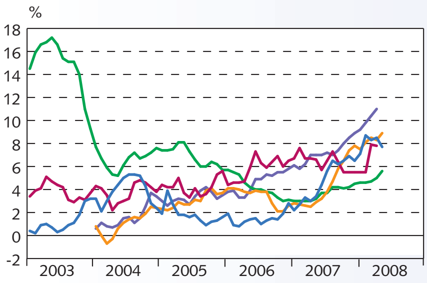


Sosurce: Global Insight.

Chart 2

Inflation in Emerging Markets

January 2003 - May 2008

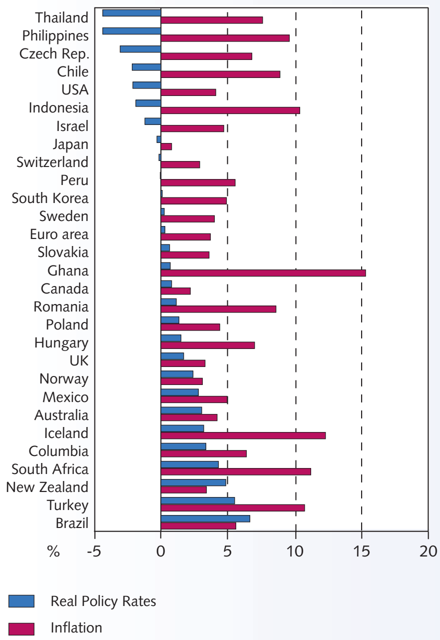


Sources: Global Insight, Reuters EcoWin.

Chart 3

Real policy rates and inflation

May 2008



Source: Global Insight, Dismal Scientist and Cental Banks websides.

demand in emerging countries has in turn pressed oil and commodity prices steadily higher. Increased commodity prices need not lead to general, long-term inflation if inflation expectations are sufficiently anchored. Negative supply shocks do not necessarily distort price stability for the long term and therefore do not necessarily require tighter monetary policy, which deepens the contraction. However, for monetary policy-makers that do not enjoy the benefit of firmly anchored inflation expectations or are managing overheated economies, there is good reason to be concerned about the second-round effects and to fear that inflation will become entrenched. In that event, it could prove necessary to tighten the monetary stance in order to anchor inflation expectations, even at the expense of a weaker economy.

Sharply rising inflation has led to low – or even negative – real interest rates

After a period of low inflation, it appears as though the recent inflation burst has caught central banks in many emerging nations off guard. As a result, policy interest rates have not changed in line with inflation. Real policy rates have therefore dropped and have turned significantly negative in many of these countries. As a result, lending is still on the upswing in most emerging market economies, in spite of worsening financial conditions in the US and Europe. Although many emerging nations have been slow to respond to increased inflation, some of them have raised their policy rates recently in an attempt to combat it. Real policy rates are high, however, in countries such as Brazil and Turkey, which have recently raised their interest rates. At the same time, inflation expectations have risen sharply – especially in those countries where real interest rates have fallen the most – and in many instances are far above the inflation targets set by the central banks concerned.

In many emerging nations, subsidies, price controls, or exportation limits have been imposed in order to contain inflation. In Asia, for example, government subsidies of food and oil have become quite burdensome. In addition, they delay the establishment of balance between supply and demand; in other words, they only restrain inflation temporarily. However, the authorities appear ready to take on the resulting short-term expenditures for political reasons, as rising food and energy prices cause significant tension on the domestic front.

In China, output growth is expected to taper off slightly this year as export growth slows down. Nonetheless, the Chinese have tightened monetary policy, both with policy rate hikes and with increased reserve requirements. Because rising food prices have been one of the main drivers of inflation in China, the Chinese government has initiated various supply-stimulating projects in order to ease inflationary pressures.

In April, inflation hit a nine-year high in India, measuring 7.8%, which is considerably above the Reserve Bank of India's inflation target. Wholesale price inflation (WPI) has also risen substantially, reaching a 13-year high of 11% in the beginning of June. GDP growth has been robust, and domestic demand has increased rapidly. Food prices have risen astronomically, partly because of scanty domestic supply. Ceilings have been imposed on the exportation of rice and other grains. Food is an important component in the Indian consumer price index, and energy weighs heavily as well. In an unexpected move on June 11, the Reserve Bank of India (RBI) raised its repo rate by 25 basis points to 8%, the first hike in 15 months, and by a further 50 basis points at the end of June. The RBI has also increased reserve requirements and is expected to continue on this path.

In South America as well, rising inflation has called for monetary policy measures. In Chile, inflation hit a 14-year high in May, measuring 8.9%. In comparison, inflation was only 2.5% in Chile a year ago. In June the Chilean central bank, Banco Central de Chile, raised its policy interest rate by 0.5 percentage points to 6.75%, after holding it unchanged since December.

Inflation has also increased in Brazil. The Banco Central do Brasil has issued strong messages stating that inflation will not be allowed to run free and that the bank will raise its interest rates as necessary to combat it. The Banco Central raised its overnight lending rate by 0.5 percentage points twice, first in April and then again in June, to the current level of 12.25%. Brazil's real policy rate is among the highest in the world, but GDP growth has nonetheless been robust in the past year.

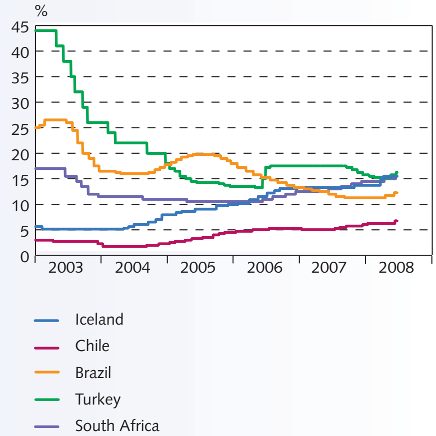
The South African Reserve Bank (SARB) also raised its prime interest rate in June, by 0.5 percentage points, in response to a sharply deteriorating inflation outlook in the recent term. The increase was the tenth prime rate hike since June 2006. In all, the SARB has raised its prime rate by 5 percentage points to the present 15.5%, its highest point in five years.

Monetary authorities in emerging market economies are therefore faced with serious challenges. Inflation has risen swiftly and GDP growth prospects have worsened. Market expectations concerning policy rate developments are changing, reflecting the market's apparent assumption that a tighter monetary stance will prevail in the near future. Bond yields suggest that the market retains confidence in the will and ability of most central banks to contain inflation. If that confidence is lost, the cost of underpinning price stability will likely be considerably greater.

Chart 4

Policy Rates in Iceland and some Emerging Markets

Daily data January 1, 2003 - June 20, 2008



Sources: Reuters EcoWin, South African Reserve Bank, Central Bank of Iceland.