Challenging inflation across the globe

As price pressures gather pace, the East needs tighter monetary policy but the West is left with little room to hike rates

By GERARD LYONS

ACROSS the emerging world, rising food and energy prices are forcing many central banks to tighten policy. These pressures are more severe in some economies than others, with South Asia a particular worry, as seen from recent further tightening in India and Pakistan.

Yet not all countries are resorting to higher rates. Some, like China, prefer tighter loan quotas, as they are fearful of attracting inward speculative flows if rates increase too far. But China, India and a number of other countries also need to face up to the issue of energy subsidies, as they continue to subsidise the full cost of higher oil prices from feeding through into their markets.

Whilst credit crunch worries overhang markets in the West, firm growth and rising costs are pushing central banks across the emerging world to tighten policy. Across the emerging economies, where growth is strong, interest rates have either risen or need to rise further.

Whether it is South Africa, across South Asia, the Middle East or parts of East Asia tight or tighter monetary policy is needed. There is no argument.

Across Asia, while the immediate inflation threat should not be under-estimated or played down, "di-flation" may be a better description of the conflicting issues being seen across the region. For while inflation is evident in food and energy prices, there is still intense competitive pressure in many other areas.

Although inflation appears to have only become a recent concern, the reality is that inflation has been an issue for some time, although not in the headline price indices.

In recent years, we have seen a combination of factors lead to low headline inflation and, in turn, relatively low interest rates, particularly in the West. While headline inflation rates were low, there was inflation in terms of asset prices, particularly real estate.

Yet given that central banks in the West had not kept monetary policy tighter amid the positive supply-side shocks, asset price inflation became evident. Some might argue that this means central banks should tighten policy in response to rising asset prices.

But what it really suggests is that central banks should be aware of the impact of positive supply shocks and should have aimed to keep headline inflation lower. One could use a similar line of argument to suggest that governments should run fiscal surpluses in times of economic boom; cyclically adjusted.

Now, we are seeing inflation in terms of rising food and energy prices. This poses big problems for not only central banks but governments across Asia, as rising food prices hit the poor.

Whether higher food and energy prices feed through into higher inflation depends crucially on wages and to some degree on inflation expectations, and also on whether central banks accommodate the pick-up in inflation. If wages do not increase then rising food and fuel prices will reduce the amount of money that people have to spend on other items.

This, in turn, would likely see retailers and corporates take any increase in costs, such as fuel, on their margins. Hence, the "di-flation" word that is used currently across some Asian countries.

However, if one looks at manufacturing and other areas there is intense competitive pressure. Supply chain optimisation is taking place, as firms try and squeeze costs. According to US import price data, China is getting more expensive, though not the most important source of import inflation. However, if the yuan appreciates further, then goods coming out of China will become even more expensive.

AFP

Heavy burden: *Porters carrying goods at a wholesale market in New Delhi's old quarters on June 9, 2008. Rising food costs are hitting emerging economies and posing huge problems for central banks and govts across Asia.*

Yet, the goods in China are taking market share, displacing others. Overall, China has moved from being deflationary to being modestly inflationary in terms of what it produces. And in terms of what it needs and consumes, as the economy grows and income levels rise, it is becoming more inflationary.

But in the West, the situation is different.

Although cost push inflation is back, the financial and economic environment is very different. Yet, it is the rise in costs that has recently created a gathering bandwagon for higher interest rates in the West.

The European Central Bank (ECB) talks tough, signalling a one-off rate hike, as does the Bank of England. Even the US Federal Reserve has appeared more hawkish. We believe there is a genuine risk of higher rates in Europe and the UK, but we don't think the US can afford a hike any time soon, though it may like to be seen as ready – probably for the sake of lending support to the dollar.

Although parts of the US economy are doing well, such as big firms, the export sector and many farmers, the fragile financial sector and poor prospects for consumers should still concern the Fed; the jobs data, in particular, strike us as of key importance.

In recent years, CPI figures around the world should have been renamed China Price Indices – such was the impact of that country on global inflation. Strong deflationary pressures were exported. Faced with such a positive supply side shock central bankers in the West should really have had tighter monetary policies. They didn't. As headline inflation stayed low, asset price inflation was rampant.

Now we have a negative supply-side shock in the form of high food and energy prices. Some believe it makes a case for higher rates in the US. But two wrongs do not make a right! Because rates were too low in good economic times does not mean they should be pushed too high in bad economic times!

Yes there has been a small rise in inflation expectations and that needs to be taken into account. But where are the rampant wage increases? After most people have paid their higher food and fuel prices they have little to spend!

In this environment many firms will have to take higher energy costs on the chin, and see their margins squeezed. Higher rates in the UK or US now would hit hardest those unable to cope, whether they are small firms or hard-up households..

Thankfully the Fed's mandate explicitly takes this into account, but not the Bank of England's or the ECB. Politicians in the West should watch closely to ensure that central banks behave in a responsible way that merits their independence and their mandate.

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