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ASIA CONFRONTING INFLATION CHALLENGE

By Gerard Lyons*

Asia is finally waking up to its inflation challenge. Recent weeks have seen a further round of monetary tightening, with a succession of central banks raising interest rates, or taking other measures to put a cap on rising prices. India, in particular, has taken tougher action than before, with a large rate hike, whilst others such as China have again pushed up reserve requirements.

The policy challenge is never easy. Is this a case of too little, too late: taking action after inflation has already taken off and when there are expectations of more to come? Or is it, too much, too soon - as there are tentative signs the world economy has started to slow, in turn taking the heat out of commodity markets, with food and energy prices easing off?

The world is two years into an economic recovery. But in many places it doesn't feel that way. This recovery has been led by emerging economies and by policy easing in the West. But, it is a divided and disconnected world, as different growth prospects, high rates of unemployment and recent problems in North Africa and the Middle East testify. And it is a world of policy dilemmas. In the West, where economies are fragile, a double-dip recession is the fear. Across Asia, and large parts of the emerging world, the risks are on the upside: inflation.

The inflation challenge is greater in Asia for many reasons. Last year the region grew strongly, and the slack in Asian economies is far less than in the West. Strong domestic demand allows retailers and producers the opportunity to pass on higher costs and to sustain or boost their margins by raising prices. Whilst this is a concern, rising wages and good labour market conditions are allowing people to pay higher prices. This is akin to a wage-price spiral, albeit in the early stages, but it can get out of hand if not addressed quickly enough. Then there is the very issue of food and energy prices itself. Higher prices of these staples hit hard into spending and can cause problems, in particular for the poor and those on low incomes. Thus, in many countries, there are complex subsidies in place, on areas such as food, fertilizer and fuel. These subsidies need to be phased out, but it is difficult politically to do this. Although subsidies may ease the pain for some, they complicate the inflation picture, and often add to it.

To these domestic inflation drivers, there is the additional challenge for Asia and for many emerging regions of how to cope with capital inflows. This came to the fore as an issue last year, when money flooded in. Although less of a concern this year, this may soon change. This has been called 'America's year' by some investors, as the third year of a Presidential term is often good for the US equity market. That optimism has been enhanced by the additional stimulus measures America received at the start of this year. But now, as policy stimulus wears off, and as debt still needs to be repaid, greater challenges lie ahead. Add in the debt crisis overhanging parts of Europe, and it is easy to see why capital may start flowing back to emerging economies. This suggests that the problem of how to absorb capital inflows will again become a key concern for Asian countries.

Often challenges are most apparent in property prices. When money flows in from overseas, it seeks out a home, and all too often this is in equities, or in real estate, adding to existing domestic pressures.

A recent analysis by Standard Chartered of Asian property prices shows the pressure points. That study used the idea of traffic lights to put countries into green, amber and red categories. For those in red, prices are already too hot, and policy-makers must stop them. Singapore, Hong Kong and Beijing top this `property bubble-o-metre'. For Hong Kong and Singapore, this reflects the focus of both economies on the exchange rate, resulting in interest rates being too low for domestic needs. Thus, in both places, there is increased use of macro-prudential measures. These are targeted policies aimed at curbing property prices and can include, amongst others, controls on loan-to-value ratios and curbs on buying multiple properties. China, too, is making use of such measures, as it faces an inflation challenge in its first-tier cities. Hence, this year, China is experimenting with property taxes. Overall, though, property prices across China are in the amber territory, as indeed they are in many countries across the region.

Thus Asia faces inflation challenges on two fronts: in asset prices, especially in property and equities; and in general terms, across the whole economy, impacting everyone. Central banks across the emerging world need to avoid the lethal combination of cheap money, leverage, and one-way expectations. If they don't, inflation could take off, initially in property but then across the wider economy. This justifies recent policy tightening. It also supports the case for stronger Asian currencies, as economic fundamentals are good and as a way of curbing imported inflation.

While there are many reasons to be positive about emerging market prospects, nothing can, or should, be taken for granted. The business cycle exists. Setbacks can occur. One fear has been the setback from high oil prices. This oil shock has hit relatively early in the cycle, when profit margins are high and monetary policy is not already tight, so there is ample scope for economies to cope.

Asia should not under-estimate the inflation risks from recent strong growth and the possible fall-out. Europe's failure to cope with the oil price shock in the early 1970's was followed by a prolonged period of stagnation, in which economies under-performed.

ot surprisingly, high energy and food costs were a hot topic at the recent annual Asian Development Bank (ADB) meeting in Hanoi. This four-day meeting attracted a record turnout of 4,000 people from across the public and private sector. The annual ADB meetings provide an occasion to focus on the opportunities and challenges ahead.

Two years ago, the meeting in Indonesia focused on the need for Asia to rebalance, by boosting domestic demand. Then, three issues were identified: the need for social safety nets, to discourage excess saving; the need to help small and medium-sized firms as they are key for job creation; and the need to deepen and broaden Asia's bond markets. By last year, the focus at the meeting in Tashkent was on regional integration and paying for Asia's huge infrastructure bill. All of these issues were important at this year's meeting, plus there was a strong focus on inclusive growth. This can take many facets, such as bringing more people out of poverty. The three Asian economies that have witnessed the biggest improvement in Human Development Indices are Nepal, China and Bangladesh. Yet inclusive growth is also dependent upon credible macro-economic policies that help keep inflation in check and achieve sustainable growth.

For Asia, the message should be clear. All of these longer-term issues count for nothing if macro-economic policy does not confront the immediate challenges ahead: and the most important of those is the need to address inflation. Although there is further to go, recent actions by central banks suggest Asia is moving in the right direction.

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