A SYMPOSIUM OF VIEWS

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Who Is Responsible for Emerging Market Inflation Improvements?

One of the pleasant surprises of recent years has been the decline in emerging market inflation. Many if not most emerging market governments during this period tied their currencies in one form or another to the U.S. dollar. Here's the issue: Did emerging markets achieve success on the inflation front by piggy-backing on the low U.S. inflation environment? Or was the reduction in emerging market inflation a phenomenon of developing world policymakers' own making, more the result of responsible monetary policy? Can the emerging markets maintain price stability if the United States doesn't?

The views of seven experts.

Enhanced domestic policy discipline was responsible.

GUILLERMO ORTÍZ MARTÍNEZ
Governor, Central Bank of Mexico, and Chairman, Bank for International Settlements Central Bank Governance Group

After the early 1990s, emerging economies exhibited a remarkable progress in reducing inflation, thus adding their own effort to the global disinflation observed after industrial countries' own inflations diminished. Diverse factors, such as enhanced competition, the growing presence of labor-abundant countries in trade and, importantly, productivity growth and improvements in monetary policy, have been argued to have contributed to this global process. Undoubtedly, these factors may have eased emerging markets' disinflation by improving the overall inflationary environment.

This does not mean that emerging markets' disinflation only reflects achievements in industrial countries and, in particular, that they piggy-backed on the low inflation environment by linking their currencies, say, to the U.S. dollar. In fact, their high inflation episodes generally occurred when rigid exchange rate regimes were in place. Once these countries adopted more flexible regimes, they also achieved reductions of inflation.

Thus domestic factors, related to a greater consensus toward stability and leading to enhanced fiscal discipline and central bank autonomy, are seen to have played a key role in the ability of these countries to sustain low inflation levels in a context of flexible exchange rate arrangements. This in turn suggests that, while global conditions were helpful, the disinflation in emerging economies is to a large extent consequence of improvements in their policy frameworks. Mexico illustrates the above. Its success in reducing inflation in a fast and sustainable manner after the peso crisis reflects three interdependent pillars on which Mexico's current stability rests: i) a flexible exchange rate; ii) an independent monetary policy; and, iii) healthy public finances.

Clearly, enhanced policy discipline in emerging economies has made them more resilient to shocks. In this context, as long as sound macroeconomic policies are maintained, these countries will be better armored to adjust efficiently to any changes in the global economic environment.

The emerging market economies have a tough choice.

TADASHI NAKAMAE
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Emerging market currencies that were pegged, officially or unofficially, to the dollar were able to avoid inflation during the first half of the decade. Most emerging market economies managed to keep their currencies floating steadily against the U.S. dollar and prevented wild fluctuations. This helped because the United States kept its own inflation in check during this period. Commodities, denominated in dollars, also dodged large price hikes, another boon. Since 2005 however, inflation started to creep up in the United States, while commodity prices jumped. Emerging market economies are now under pressure to revalue their currencies in order to halt inflation, which is already rising sharply at home.

Emerging market economies are no strangers to inflation, having suffered skyrocketing prices in the late 1990s. The Asian currency crisis in 1997, followed by the Russian crisis, caused these price woes. Emerging market currencies collapsed like dominoes, causing inflation to spread.

In response, emerging market economies were forced to tighten monetary policy and reduce trade deficits. By the beginning of 2000, these efforts started to yield results. Trade balances improved as exports to the United States grew rapidly. Currencies stopped falling and inflation waned.

Emerging markets then entered a period of export-led, non-inflationary growth. Developed economies also enjoyed growth and price stability as cheap goods flowed in from emerging markets. The U.S. economy enjoyed especially strong growth, unhindered by inflation, despite growing household debt and an expanding current account deficit.

However, since around 2005, inflation started to pick up in both emerging and developed economies. Inflation returned because large emerging markets such as China and India grew too fast, consuming huge amounts of natural resources. Energy and food became more expensive, hurting consumers, and leading to wage hikes in emerging market economies, which led to even higher inflation.

More recently, the U.S. economy has been hurt by a credit crunch. The Federal Reserve has been providing lots of liquidity while slashing interest rates, in hopes of easing the crisis. The moves have weakened the dollar, so much so that oil producers have been forced to raise prices to offset the falling value of their revenues.

The situation has left emerging market economies, whose currencies are pegged to dollar—officially or otherwise—with a tough choice. They can either let their currencies appreciate against the dollar, weakening exports but controlling inflation; or maintain their currency pegs and endure higher prices at home. Weak exports would threaten overall growth unless domestic demand grows, an unlikely prospect for most emerging-market economies. Thus, the choice boils down to price stability or growth, with the former being the more preferable of the two.

It is not clear whether emerging market economies curbed inflation during the first half of the decade through responsible monetary policy or by luck (external factors such as cheap commodity prices and low inflation in the United States). Their ability to manage inflation in the coming years will show whether their past success was by design or chance.

Global factors have definitely contributed to developing world inflation.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

Inflation has been low around the world—not just in emerging markets, but in Europe, the United States, and especially Japan. It has also been low in China, which has exported an increasing volume and variety of goods at low prices, putting competitive pressure on many manufactured goods in all countries open to imports or striving to export. All these factors—low inflation in rich countries, disciplined monetary policy in many developing countries, and increased global competition in tradable goods—have contributed to low inflation in developing countries.

Will it last? A sharp rise in prices of food and raw materials will contribute to a general rise in prices—directly through imports of goods such as oil and copper, and indirectly through attempts by labor to resist erosion in real wages, especially in many developing countries through the rise in prices of staple foods. The rise in raw material prices also contributes to greater monetary stimulus in those countries that attempt to preserve their competitiveness in the non-booming sectors, especially light manufacturing. To prevent appreciation of their currencies they must add to their foreign exchange reserves, thus expanding the money supply. They also reduce the deflationary impacts of imports. The risk of a revival of inflationary expectations will keep central bankers awake around the world. In this respect, the economic slowdown in the United States will perhaps be a welcome relief from five years of a booming world economy, 2003–07.

The credit goes more to domestic monetary and fiscal policies.

JOHN WILLIAMSON
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Most countries that pegged their currencies to the U.S. dollar ended up having foreign exchange crises as a result. It was feared that these would revive inflation, as theory would lead one to expect, but the ensuing rises in inflation were generally rather modest and distinctly temporary. The fact that inflation did not take off again cannot be attributed to a policy of pegging to the dollar, since most countries did not re-peg, but stemmed from countries' own macroeconomic policies, aided and reinforced by a change in the global environment that we still do not really understand.

I would therefore put far more weight on the monetary and fiscal policies pursued by the emerging markets than I would on their policy of pegging to the dollar. But it is necessary to emphasize here that it is mainly their fiscal policies that should be credited; indeed, as long as they pegged to the dollar there was little scope for them to pick an independent monetary policy. There never were large fiscal deficits in Asia, as a result of which there were no hyperinflations, either before or after the 1997 Asian crisis. In Latin America there were big fiscal deficits in the past, but today there are not.

Can the emerging markets maintain price stability if the dollar doesn't? Of course they could, since they could appreciate and repel the threat of imported inflation. It is only if they were still intent on following policies of a nominal exchange rate pegged to the dollar that there would be a threat of renewed imported inflation. Frankly, however, the postulate of a new U.S. inflation on the scale of anything like that of the 1970s strikes me as distinctly unlikely. The current U.S. focus on avoiding recession makes it all too likely that there will be a somewhat faster rate of inflation than in the past two decades, but the higher priority now accorded to combating inflation—manifest by Federal Reserve Chairman Ben Bernanke's interest in inflation targeting—makes it highly unlikely that we will witness a rerun of the 1970s.

Low U.S. inflation was only part of the story.

STEPHEN GILMORE
New Markets Strategist, Banque AIG

A low inflation environment in the United States and other developed countries made it easier for emerging market countries to reduce inflation, especially those countries using the exchange rate as a nominal anchor during the initial stages of the disinflation process. However, low inflation in the United States was not a sufficient condition for reducing inflation. And a number of countries that did not have or abandoned currency pegs also had significant successes. Indeed, since the mid- to late 1990s, many more emerging market countries have adopted currency regimes that are generally classified as free floating or managed floats. Improvements in macroeconomic policy, particularly fiscal consolidation, the associated reduction in central bank financing of government deficits, and the willingness of authorities to run tighter monetary policies, were crucial to the disinflation process. The dramatic improvements in countries such as Brazil and Turkey stand out here.

As the dollar has weakened and commodity prices have surged, many emerging market countries have faced increasing inflationary pressures—particularly those countries that operate currency pegs or resist nominal currency appreciation. The problem is also compounded as households in less-wealthy countries tend to spend relatively more of their incomes on items such as food and energy which have been subject to some of the strongest price growth. The near-term pressure on prices persists. Nevertheless, with the United States likely in recession and global growth slowing, some of those inflationary pressures will abate over the next year or two, notwithstanding the actions of the Federal Reserve to pump liquidity into the system. Also, one should not underestimate the potential for emerging market currency nominal appreciation to help offset inflationary pressures. An equally weighted basket of the twenty most liquid emerging market currencies has strengthened on the order of 40 percent in nominal terms against the dollar since the latter part of 2002.

The U.S. dollar had little to do with developing economy inflation success.

ANNE O. KRUEGER
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Several factors help explain lower inflation rates in emerging markets (and also in low-income countries). They include: 1) the very bad experience with the high inflation rates of earlier years; 2) the success of those countries such as South Korea and Chile that had earlier succeeded in bringing down their inflation rates without high costs in terms of recession or

foregone growth; 3) the attainment of better fiscal discipline which enabled the monetary authorities to conduct monetary policy out of the shadow of fiscal dominance; and 4) the successful reduction of inflation in the OECD countries.

Tying to the U.S. dollar has had little to do with it. Many now-low-inflation countries, including Chile, Mexico, Brazil, and Turkey, have floating exchange rates. Indeed, many more emerging market and low-income countries tied their currencies to the U.S. dollar during the high-inflation periods and had to resort to large discrete devaluations.

Of the four factors I listed, the very negative experience with high inflation was probably the most important in many countries. In some, however, gaining fiscal control (often under an IMF program after a crisis) was clearly central to enabling independent monetary policy. Further, in the high-inflation countries, there was a now discredited school of thought called "structuralism" which held that inflation would support accelerated growth by removing rigidities. As experience with disinflation mounted and was positive, with smaller short-term costs than had been anticipated, policymakers elsewhere became increasingly willing to adopt similar policies.

That said, lower inflation rates have characterized all but a few countries in recent years. A "contagion of ideas" also undoubtedly played a role among all countries. Who can say why the U.S. rate fell? But the size and prominence of the American economy was doubtless important in influencing thinking and policy worldwide.

Pegging the exchange rate does not guarantee price stability.

HORST SIEBERT

President-Emeritus, Kiel Institute for the World Economy; and Heinz Nixdorf Professor in European Integration and Economic Policy, Johns Hopkins, SAIS Bologna Center

The inflation rates of some developing countries have come down with a decline of the inflation rate in the United States. One reason for this is that the major central banks no longer see a solution to economic ills in inflation. Indeed, a developing country can attempt to import monetary stability if it pegs its currency to an anchor currency.

There are, however, conditions attached to that. The most important one is that in the long term the domestic inflation rate in the developing country does not exceed that in the anchor currency country, that is, in the United States. Consequently, monetary policy must make sure that the inflation rates remain in line. Moreover, one has to prevent a too-strong credit expansion. In addition, wage policy and fiscal policy must follow the anchor currency. If these conditions are violated, market participants will expect a depreciation of the developing country's currency, capital flight will set in, and a currency crisis will break out. Witness the Asian currency crisis in 1997 and the Brazilian crisis in 1999.

A further condition is that the situation in the real economy does not turn against the pegged exchange rate. Take the experience of Argentina where the pegged exchange rate in the currency board proved not to be sustainable. Thus, we have quite a few cases in which developing countries did not manage to maintain a pegged exchange rate, independently of a low inflation rate in the United States. In China, the actual inflation rate comes close to 9 percent.

I conclude that pegging the exchange rate does not guarantee price level stability in the long run. Of course, a pegged inflation rate will import inflation if the anchor currency does not follow the goal of price level stability. Witness the international situation when the United States gave up its anchor role in the late 1960s. ◆