World Inflation: A New Challenge for the G-20

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World inflation is on the rise again and it is creating new challenges for policymakers in emerging and developed countries. Should the world accept a little more inflation or should it take a tough stance and fight it? Is it possible to coordinate a policy response when some economies show signs of being overheated while others are still recovering from the crisis? This is an important dimension of the macroeconomic policy coordination that the G-20 is facing.

In most countries, the rise in inflation appears to be driven by higher commodity prices, namely food and energy. One key question though is whether the increase is only temporary reflecting changes in relative prices or if instead it could lead to a permanent increase in inflation, as was the case in the 1970s.

The biggest policy dilemmas are in the industrialized countries, which are still recovering from the 2008 financial crisis. Unemployment is still high in the U.S. and in many European countries while the real estate sector remains depressed and has not recovered from the recession.

Commodity Prices Are a Key Driver of Inflation

Commodity prices have been on the rise in the last decade largely because they have been pushed upward by the high rates of growth in China and India. These two countries, and especially China, are dominating the additional demand for raw materials and putting pressures on a supply that grows very slowly.

The increase in prices has been across the board as it has included energy and fuels, metals and agricultural commodities, and it represents a turning after many years in which commodity prices were losing ground to industrial goods and services. After taking a pause during the 2008 financial crisis when the prices of some commodities fell by two-thirds, they have resumed the upward trend and they are still on the rise.

In real terms, the prices of most commodities today are at the highest levels since the 1970s. However, the rise this time has been more gradual compared to the previous episode. In addition, it was not triggered by a decision of a cartel of oil producers, the Organization of Oil Exporting Countries, to drastically increase prices but instead it has been driven by market forces.

Is This Time Different?

The oil shocks of the 1970s were accompanied by an overall commodity price boom that was short lived and led to the phenomenon that is now widely known as stagflation.

The rise in inflation in the mid-1970s was significant in many industrialized countries and raised a new and important policy dilemma: whether to accept and validate through accommodating monetary policy higher rates of inflation or to fight them and try to bring them down through a tightening in macroeconomic policies. The final answer is well known. Central banks accommodated the rise in prices and most industrialized countries ended up with double-digit rates of inflation. In addition, the rise in the prices of oil and of other raw materials created a “supply shock” that led many economies to enter into recession and the world faced for the first time the phenomenon known as stagflation.
The rise in commodity prices this time around has been less disruptive than in the 1970s. In part because it has been gradual and in part because the industrialized economies have become less dependent on oil as they have been taking energy efficiency measures for the last three decades.

While the effects of commodity prices on output have been small, as the world economy continues to move ahead propelled by the emerging market countries, the policy discussions are once again in the front page. In the industrialized countries, the main issue is whether to tighten macroeconomic policies at a time when most economies have not yet fully recovered from the financial crisis and still face high rates of unemployment. The focus is on Europe and the U.S., whether the nature of the problems is different and whether the policy response is also likely to differ.

In both cases, the inflationary effects have been limited, especially when they are compared to the 1970s since headline in January 2011 was 2.4 percent in the Eurozone and 1.6 percent in the U.S. The policy response has been different. The European Central Bank (ECB) has announced that it plans to tighten monetary policy and raise interest rates as inflation is now higher than the existing target—a decision that creates risks for the “peripheral” countries like Greece and Portugal, which are still facing deep recessions and where a tightening in policies will make the much needed recoveries very difficult. If the focus of policies is based on these countries, the tightening in policies will be a big mistake. They need a weaker euro and lower interest rates to grow. But the ECB is likely to adhere to its mandate, which is to maintain inflation within its target. This means that the problems in the peripheral European countries are likely to worsen.

The U.S. has adopted a looser monetary policy, which is a reasonable approach given that the U.S. still faces large rates of unemployment. The maintenance of very low interest rates and the adoption of the quantitative easing policy last year imply some risks in terms of inflation, but it seems that it is the right way to go. Even if these expansionary policies end up raising inflation to the 3-4 percent range, it should not be a problem, as it could be a way not only to reduce the rate of unemployment but to help the recovery in real estate prices that have remained depressed since the 2008 financial crisis.

**The Policy Dilemmas for Latin American Countries**

The rise in commodity prices is a mixed blessing for some Latin American countries—at least for the ones that are commodity exporters. The higher prices have helped the external accounts and increased real income, but they also favored higher rates of inflation and a strengthening of the domestic currencies. We are probably witnessing a remake of the 2007/08 economic scenario when the concern was agflation—inflation led by a rise in agricultural commodity prices.

This time, the policy options look easier because the underlying inflation rates are much lower than they were in the previous episode while there is room to tighten macroeconomic policies as most economies still have in place the expansionary macroeconomic policies that were implemented in 2008. Besides, growth has remained strong and there are indications that the economies are overheated as they have quickly recovered from the 2008 crisis.

In general, countries have responded to the inflation pressures by raising interest rates. Brazil probably has been one of the most aggressive countries in this area, as the policy interest rate (the SELIC) is only 25 basis points below the rates of 2008. In other countries, the policy tightening has been more gradual. Argentina is the exception, as it has maintained a very expansionary monetary stance and inflation is on the rise.

While the use of tighter monetary policy seems appropriate in these cases, it can have some undesired side effects, namely a real appreciation of the currency. In fact, this is precisely what has been
happening in most Latin American countries, where there is a concern that currencies could be overvalued and affect the performance of non-traditional exports. While this phenomenon could well be unavoidable when there is a significant improvement in the terms of trade, it can be somewhat mitigated through fiscal policy.

In fact, one better response would be to change the policy mix to one that relies less on increases in interest rates and more on a tightening in fiscal policy. Less government expenditures in domestic non-tradable goods is a way to limit the extent of real appreciation of the currency. Brazil has announced measures along these lines when it decided to tighten fiscal policy, though monetary policy is still very tight.

At the world level, it is difficult to envision a coordinated policy response to the renewal of the inflationary pressures, especially because the overall policy objectives are dissimilar in Europe and the U.S. regarding the concern about inflation and unemployment. In addition, the nature of the problems are different because while the emerging countries have overheated economies, sound fiscal balances and manageable debt burdens, the developed countries are facing high rates of unemployment and weak fiscal and debt fundamentals. It is probably desirable for the developed countries to accept slightly higher rates of inflation and maintain the stimulus, but it seems that at least Europe is unlikely to move in that direction.

In the meantime, the world is likely to continue facing high commodity prices and the bulk of the policy effort to control the inflationary effects is likely to fall on the emerging countries.