Mizuho Economic Outlook & Analysis

November 17, 2021

Emerging countries pressed to tackle inflation

The expected US monetary policy change and stagflation risk

< Summary >

◆ Emerging countries are now faced with growing inflationary pressure. Demand recovery driven by the lifting of activity restrictions, resource price hikes, and supply constraints have caused inflation to rise beyond the price target in many countries.

◆ Some emerging countries have responded to higher inflation by raising interest rates. Immediate action taken by countries is divided into either raising interest rates or leaving them unchanged. Fast paced interest rate hikes may exert downward pressure on the economies of some countries in 2022.

◆ There is concern that the expected shift in US monetary policy may trigger currency depreciation in some emerging countries. With many emerging nations already struggling with a weak economy, there is the risk of short-term stagflation due to rising inflationary pressure and monetary tightening.

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1. Emerging economies exposed to inflationary pressure

The global inflationary trend is attracting growing attention as many countries enjoy a rebound in demand, thanks to the lifting of various restrictions imposed on economic activities to contain the COVID-19 pandemic, but also because of intensifying supply constraints driven by resource price hikes, including food and crude oil, downsized production particularly in Southeast Asia due to the resurging pandemic, tightening of international logistics starting from the United States, and labor shortages amid rising COVID-19 infections. In this report, we examine the inflationary trend in the major emerging countries and the current status of monetary policies with a view to forecasting future developments and risks.

We begin by confirming the inflationary trend in various countries. Looking at the year-on-year change in the consumer price index (CPI) in the major emerging economies (**Chart 1**), Hong Kong, Indonesia, Thailand, Malaysia, Vietnam and India are hovering within the price target range (or close to past average inflation rates). Although the direction of price movement varies depending on the nation, countries such as Thailand and Malaysia that experienced a sharp rise in inflation in early spring have seen prices return to the target range with the backlash effect of the coronavirus shock in the previous year (base effect) no longer a factor. Also, tighter restrictions on activities in Southeast Asia due to the spread of infection in the July to September period tamped down demand and seems to have suppressed the inflationary pressure.

On the other hand, inflation exceeded the price target in Taiwan, Singapore, South Korea, the Philippines, Brazil, Mexico, Russia and Turkey where inflation remains high or continues to rise. Particularly in South Korea, Mexico and Brazil where inflation was pushed up by the base effect in early spring, there are no signs of inflation slowing down even after the waning of the base effect.

Inflationary pressure nowadays is brought about by multiple factors. According to the IMF's October World Economic Outlook, the following factors are the drivers of rising inflation: (a) demand recovery following the lifting of activity restrictions and a contraction of the supply-demand gap (emergence of pent-up demand and drawdown from savings that swelled with fiscal support), (b) rapid increases in commodity prices, and (c) supply shortages and supply chain disruptions.

If we look at the inflation rate by item of the major countries, we can confirm the impact of the above-mentioned factors. **Chart 2** compares the inflationary trend by item for some high inflation countries (South Korea, the Philippines, Brazil, Mexico, Russia and Turkey) in the form of a heat map. More specifically, we depicted the change rates of contribution to the CPI increase rate by item in October for these countries (change from April) and coded with colors according to the trend. While the contribution trend varies depending on

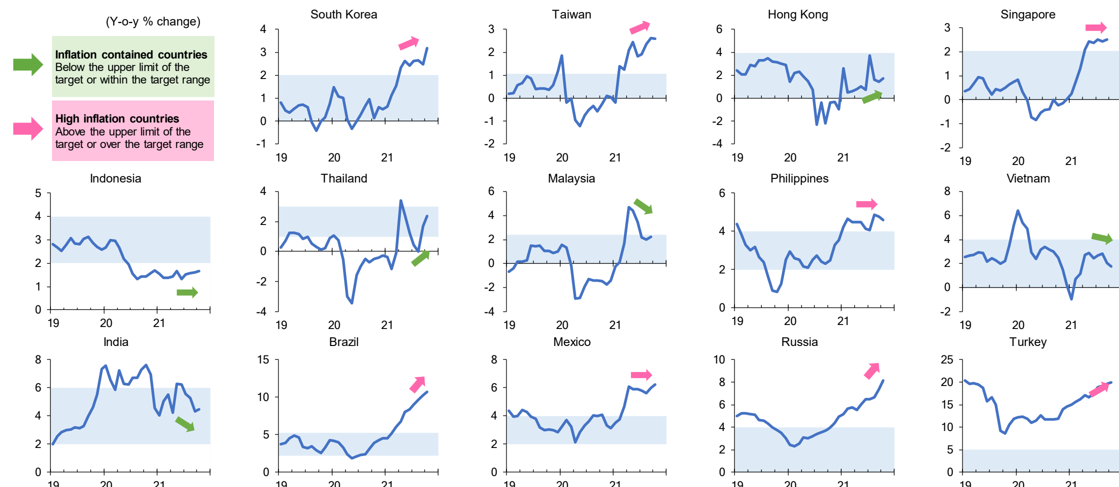
the country, we want to point out two features common to all areas: (1) expanded contribution of food and housing, fuel, light and water charges, and (2) expanded contribution of clothes, eating out, accommodation and recreation.

The above features reveal the multiple impacts of (a) lifting of activity restrictions and (b) increases in resource prices indicated by the IMF, with (1) seemingly driven more by (b) increases in resource prices, including food and crude oil. For example, food and electricity prices in Brazil are also pushed up by the weather factor in addition to global resource price hikes (Nishikawa, 2021).

Feature (2) seems to reflect the impact of (a) lifting of activity restrictions. High inflation countries tend to move quicker in easing activity restrictions and see a faster recovery in human mobility. Fewer activity restrictions generate pent-up demand in such services as eating out and accommodation, as well as repurchase demand for clothing items.

Moreover, although not included in the two features mentioned earlier, rising transportation costs (fuel and automobiles) in South Korea, Russia and Brazil are mainly caused by (b) resource price hikes and (c) supply constraints. The latter factor is a result of the tightened supply and demand situation in the automobile sector due to the pandemic and subsequent production suspensions during the summer in Southeast Asia, a major supply center for automotive parts (Matsuura and Koshiyama, 2021).

Chart 1: Inflation rate of major emerging economies (CPI all-items, y-o-y change)



Note: The shaded areas show the inflation target (level/range). For Taiwan, Hong Kong, Singapore and Malaysia where no target rates are published, we show the average inflation rate from 2014 to 2019 as a tentative inflation target.
Source: Made by MHRT based upon CEIC data.

Chart 2: Change in contribution to CPI increase by item (y-o-y change, compared to April)

(Change in contribution from previous year, %Pt)	South Korea	Philippines	Brazil	Mexico	Russia	Turkey
All items	0.9	0.1	3.9	0.2	2.6	2.7
Food and beverage	-0.9	0.2	0.0	0.8	1.6	2.1
Transportation (including automobiles and fuel)	0.4	-0.7	1.8	-1.0	0.4	-1.3
Housing, fuel, light and water charges	0.3	0.6	1.5	0.0	0.1	1.1
Clothes	0.0	0.0	0.3	0.1	0.0	-0.1
Eating out, accommodation and recreation	0.2	0.1	0.3	0.1	0.0	0.8
Others	0.9	-0.1	0.0	0.2	0.5	0.2

Contribution: Expansion – Contraction

Note: We selected each country's contribution to CPI (all items) by item as of October and depicted the change rate from April.
Source: Made by MHRT based upon CEIC data.

2. Urgent need for a monetary policy response to inflation

Many countries have responded to high inflation through their respective monetary policies. Since spring 2021, the major emerging economies have been compelled to redirect their monetary policy, with many of them raising interest rates. **Chart 3** presents changes in policy interest rates in the major emerging economies after the end of 2019. Many of the high inflation countries listed in the previous section have implemented interest rate hikes in 2021.[1] On the other hand, countries with low inflation, as well as countries with high inflation but weak recovery in domestic demand (such as the Philippines), have kept their policy interest rates unchanged. It should be noted that Turkey lowered its policy interest rate in September and October due to political pressure despite notably high inflation. This was an exceptional measure taken by a major emerging country, with one of the underlying factors being persistent currency depreciation generating high inflationary pressure.

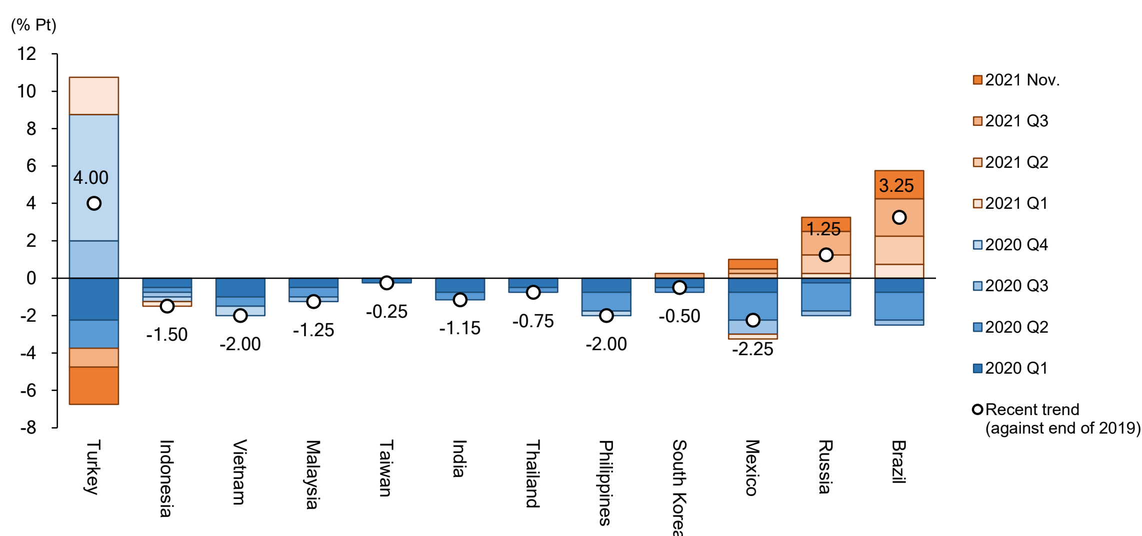
Looking at the stances of the emerging economies' central banks, we expect monetary policies to be divided between raising policy interest rates and leaving them unchanged for the time being. Countries that have started to raise interest rates are projected to continue with interest rate hikes through the end of 2021, stopping in 2022 after confirming that inflationary pressure has weakened. Countries where inflation is under control are expected to keep their policy interest rates unchanged, with rates starting to rise once their economies enter a full-fledged recovery phase after mid-2022.

The impact of interest rate hikes on the economy will likely surface in some of these

[1] Although Singapore does not have a policy interest rate, it slightly raised the slope of its currency policy band to conduct monetary tightening in the monetary policy meeting in October 2021.

countries in 2022. In Brazil and Russia, their policy interest rates have already surpassed the level recorded before the COVID-19 crisis. Since the nominal interest rate,[2] which is considered a neutral rate, has also exceeded the pre-pandemic level, their monetary policy environments have shifted to tightening, and we expect downward pressure on their economies to emerge in 2022. On the other hand, for Mexico and South Korea where interest rates remain low compared with the pre-pandemic level leaving room for further interest rate hikes, the impact of rising interest rates on their economies is considered to be limited should the pace of rate hikes be gradual.

Chart 3: Changes in policy interest rates in major emerging economies



Note: The chart depicts the change rate from the end of the previous quarter as of each quarter-end. The latest cut-off date is November 17, 2021.
Source: Made by MHRT based upon CEIC data.

3. New challenges in the aftermath of the COVID-19 crisis

The situation of rising inflation and monetary tightening happening simultaneously in the emerging countries is similar to what occurred during the economic recovery phase after the collapse of Lehman Brothers. In 2010, while the world economy was picking up from the global financial crisis and the sharp recession that followed, resource prices surged trigged by political instability in the Middle East. From the latter half of 2010 through 2011, there was a movement to raise policy interest rates among many of the major emerging economies (**Chart 4**). In 2012, monetary tightening became a deceleration factor affecting domestic demand, but it also contributed to achieving the goal of tamping down inflation. Inflation in the major emerging countries mostly declined after peaking out in

[2] The nominal neutral interest rates are 6.0% to 6.5% in Brazil and 5.0% to 6.0% in Russia. These figures are based on remarks by the deputy governor of the Brazilian Central Bank (as of April) and on the Monetary Policy Guidelines of the Russian Central Bank (see reference), respectively.

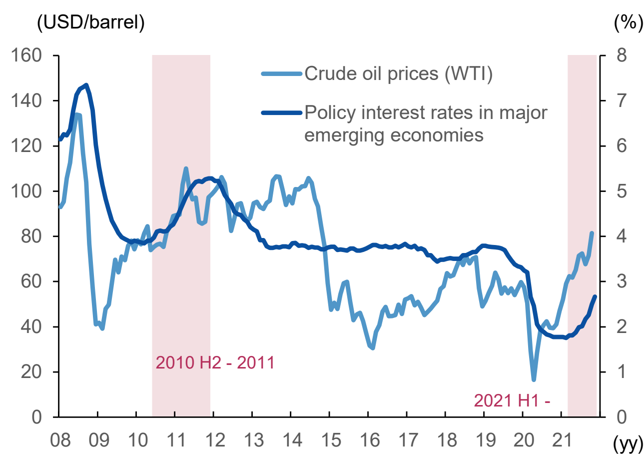
mid-2011, putting an end to the monetary tightening cycle.

We expect the current inflationary trend to follow the same path we saw in 2011. Inflationary pressure fueled by resource price hikes and supply constraints likely stems from the temporary mismatch of supply and demand affected by the COVID-19 pandemic as activity restrictions loosen or tighten. Even for the current high inflation countries, inflation is predicted to peak out in the beginning of 2022, and inflationary pressure will likely loosen thereafter on the back of slowing domestic demand as a result of monetary tightening.

Meanwhile, emerging countries currently face two harsher conditions compared with the 2011 inflation. The first condition is the weakness of their own economies. **Chart 5** depicts the supply and demand gap (real GDP deviation from the trend) in the major emerging economies. Although we need to interpret the values in the chart with a certain latitude due to simplified calculations, the supply and demand gap in the July to September period of 2021 shows more countries with a larger negative range compared to the average values from the latter half of 2010 to the first half of 2011. While many nations have survived the worst of the coronavirus pandemic, many emerging countries continue to harbor weaknesses in their economies, and the economic environment has become even more challenging than in 2011.

The second condition is the expected interest rate hike in the United States. The interest rate increase in the US is projected to be implemented earlier than the timing taken in the 2011 phase when the country adopted the position of maintaining its monetary easing policy.[3] In June of that year, although Quantitative Easing 2 (QE2) was finished, the hurdle to begin raising interest rates was high due to the impact of the European debt crisis and concerns over the US economic

Chart 4: Crude oil prices and policy interest rates of emerging economies

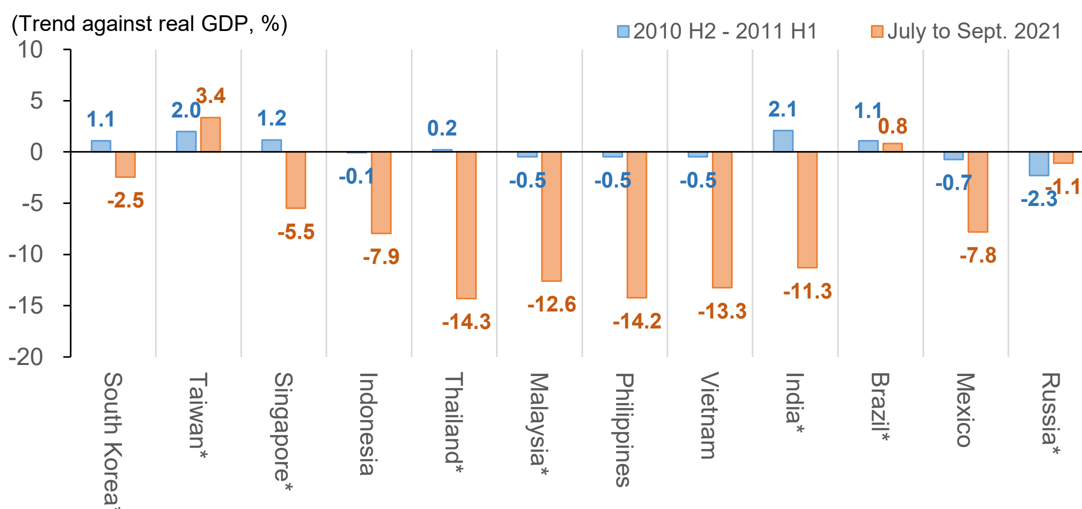


Note: Average policy interest rates (nominal) of 13 major emerging economies (South Korea, Taiwan, Hong Kong, Thailand, Malaysia, Vietnam, India, Brazil, Mexico, Poland, Czech, Hungary and South Africa)
Source: Made by MHRT based upon CEIC data.

[3] If we look back at US monetary policy following the collapse of Lehman Brothers, the policy interest rate was lowered from October 2007 through the end of 2008, ultimately dropping to a "zero interest rate" in January 2009. Later, after conducting three rounds of quantitative easing (QE1: December 2018 to March 2010, QE2: November 2010 to June 2011, and QE3: September 2012 to October 2014) and adopting a reinvestment policy, the FRB finally started raising interest rates in December 2015.

slowdown.[4] On the other hand, in the recent phase, the Federal Reserve decided to start tapering the purchase of assets in November,[5] and the possibility of increasing interest rates within 2022 has heightened, as announced after the September meeting that half of the FOMC participants forecast that the conditions to raise interest rates would be met by the end of 2022. In fact, US interest rates started to rise after hitting bottom in August 2021, and the market has already priced in the expectation of an interest rate hike in 2022.

Chart 5: Supply and demand gap in major emerging economies



Note: Trend against real GDP is an extension of HP filter's estimate (from 2000 to 2019). For the July to September result of the economies marked with *, we used supplementary values based on the market forecast as of November 15.
Source: Made by MHRT based upon CEIC data and Bloomberg.

An interest rate increase by the United States ahead of schedule, or even mounting speculation of a rate hike, will create inflationary pressure for emerging economies through the interest rate hike in the US and the subsequent currency depreciation. In this case, the emerging countries' central banks will have to shift their policy stance in a hawkish direction by accelerating or front loading their interest rate increases. As described above, many emerging countries suffer from their own economic weaknesses, and if inflationary pressure strengthens as monetary policy is tightened, these countries may plunge into stagflation in the short term. This risk appears to be high in Brazil and Russia where the downward impact on their economies is already unavoidable. Also, among the major emerging countries, nations with low vaccination rates, such as the Philippines,[6] carry the

[4] The FOMC statement in August 2011 argued that economic conditions "are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013."

[5] In the November FOMC, the Committee decided to begin tapering the pace of asset purchases in November. The actual starting date was set for the latter half of November.

[6] The vaccination rates of the major emerging economies are as follows (1st/2nd shots). Countries are listed in the order of high second shot vaccination rate as of November 15. Singapore (87%/86%), South Korea (82%/78%), Malaysia (78%/76%), Brazil (76%/60%), Taiwan (75%/42%), Vietnam (66%/36%), Thailand (65%/53%), Hong Kong (62%/59%), Mexico (58%/49%), India

risk of an economic downturn amid the resurgence of the pandemic, and we need to continue paying close attention to these areas. Emerging countries will face new challenges during the course of recovery from the COVID-19 crisis.

(54%/27%), Indonesia (47%/31%), Russia (42%/35%), and Philippines (30%/23%). Source: Our World in Data.

Reference

Refer to the original Japanese report by clicking the URL below for the reference material.

https://www.mizuho-ir.co.jp/publication/report/2021/pdf/insight-eg211117.pdf