A brief history of inflation

After two decades of high inflation, followed by disinflation, we are entering a new phase which, according to some, is potentially hyperinflationary

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The movement of prices over the last few decades can be broadly divided into three distinct phases. The seventies and the eighties were a period of hyperinflation. By way of illustration, US consumer price inflation averaged 8.7 per cent between 1973 and 1982, and 6.6 per cent between 1973 and 1990. This was followed by disinflation in the nineties and the first half of the current decade. US CPI inflation fell sharply to 2.7 per cent between 1991 and 2002, before rising slightly to 2.9 per cent between 2003 and 2007. Globally, consumer price inflation declined from 3.3 per cent in advanced economies between 1989 and 1998 to 1.7 per cent between 1999 and 2006. In emerging and developing countries, it declined from an annual average of 50.3 per cent in between 1989 and 1998 to 6.5 per cent between 1999 and 2006.

It now appears that we are entering a new inflationary, and according to some, potentially hyperinflationary phase. This was initially insidious, not fully captured in CPI data since the price of commodities rose even as the price of manufactured goods declined consequent to productivity gains arising from the integration of China and India in the global market for goods and services. The price of non-fuel primary commodities that showed an average annual decline of 2.7 per cent between 1989 and 1999 rose by 9.4 per cent annually between 2000 and 2006. Oil prices that declined by 1.2 per cent annually between 1989 and 1998 rose on average by 20 per cent annually between 1999 and 2006.

This sharp increase in commodity prices was fuelled by hypergrowth in emerging and developing economies whose real GDP growth spurted from an average of 3.8 per cent between 1989 and 1998 to 6.2 per cent between1999 and 2006. Advanced economies continued to average annual growth rates of below 3 per cent over both these periods. Commodity price inflation was exaggerated by the steep fall in the international value of the dollar, the currency in which commodities are traded internationally.

It is only over the past year that the sustained upswing in commodity prices is being rapidly transmitted to headline inflation. According to *The Economist*, CPI inflation over the past year has risen from 2.6 per cent to 3.9 per cent in the US, from 1.3 per cent to 3 per cent in France, from 3 per cent to 8.5 per cent in China, from 7.4 per cent to 13.3 per cent in Russia, and from 3 per cent to 5 per cent in Brazil, as of mid-May, 2008.

The hyperinflation of the seventies can arguably be explained in terms of monetary and fiscal excesses, since Keynesianism, and the associated Philips Curve, were the prevailing intellectual orthodoxy. From the eighties, however, under the intellectual influence of the great monetarist, Milton Friedman, the general perception was such that both governments and central banks largely eschewed excessive monetisation of government deficits and followed a rule-based monetary policy based on variants of the Taylor Rule. Paul Volcker, erstwhile Chairman of the US Fed, is credited with taming the monster of inflation by sucking excess liquidity out of the financial system through repeated rate increases. Why then is inflation rising again?

Excessive monetisation was inherent in the manner in which the fundamental global imbalance, which saw developing countries run huge current account surpluses, has played out. Emerging market and developing economies taken together, but excluding the newly industrialised Asian economies, still ran a current account deficit of $21.2 billion as late as 1999. This deficit was turned around dramatically into an annual surplus of $544 billion by 2006. Their cumulative surplus in the seven years from 2000 to 2006 was $1.43 trillion. These surpluses led to counterpart capital flows to developing countries; but instead of letting their currencies appreciate as a consequence, their central banks bought up these flows as part of their strategy of export-led growth. This released a tsunami of domestic currency into the system, only part of which could be sterilised. The weighted average of broad money growth in emerging and developing economies consequently rose from 15-16 per cent between 2000-03 to about 20 per cent in 2005 and 2006, way above their average nominal GDP growth of 13 per cent.

A loose monetary policy in emerging and developing countries was supplemented by a loose monetary policy in advanced countries, especially the US, which accounts for about one-fifth of global demand. The growth rate of M3 in the US, on average, exceeded nominal GDP growth by about 3 per cent between 1998 and 2006. For advanced economies on the whole, broad money growth exceeded nominal GDP growth by about 1.5 per cent between 1999 and 2006.

Monetary tightening did not take place in the US despite growing external deficits on account of, firstly, the tendency of developing countries to park their growing foreign currency reserves mostly in low-yielding but risk-free US treasuries. This enabled the US to seamlessly fund rising external deficits — and falling domestic savings — in the US by dampening interest rates. The effective US Fed Funds rate fell sharply from an average of 5.6 per cent between 1989 and 2000 to a low of 1.13 per cent in 2003.

Secondly, the changing nature of inflation in a fast globalising world was also conducive to a lax monetary policy. Disinflation was largely limited to tradable value-added goods and services. The relative prices of mostly non-tradable assets, as well as commodities — including agricultural commodities — actually rose because of hyper-growth in developing countries, another by-product of globalisation. Inflation consequently had a 'non-core' bias, whereas disinflation had a 'headline' bias on account of the predominance of tradable manufactures. Even as headline inflation was low, commodity and asset prices were entering a period of unprecedented boom. The Schiller index of real home prices (1890=100), which fluctuated within a relatively narrow band on either side of 110 between 1970 and 1997, rocketed to a peak of 200 in 2006. This insidious inflation lulled central banks into following a loose monetary policy since the US Fed, in particular, targeted core inflation that excluded commodity and food prices. A loose monetary policy also facilitated hyper-leverage, especially in the unregulated non-banking segments of the financial-sector, which further amplified liquidity and demand.

If the above diagnosis of the resurgence of global inflation is correct, the prescriptions for addressing emergent hyperinflation over the short to medium term are self-evident. Developed countries need to look beyond core and headline inflation,and also target commodity and asset price inflation while formulating monetary policy. Developing countries need to follow a more market-based approach to exchange rate management. Price and market signals should not be tampered with so that supplies of commodities, including oil and food grain, can rise and efficiency gains effected to equate demand and supply over the medium to long term.

The writer is a civil servant. The views expressed are personal. Data based on IMF, US Federal Statistics, US Federal Reserve and *The Economist* websites