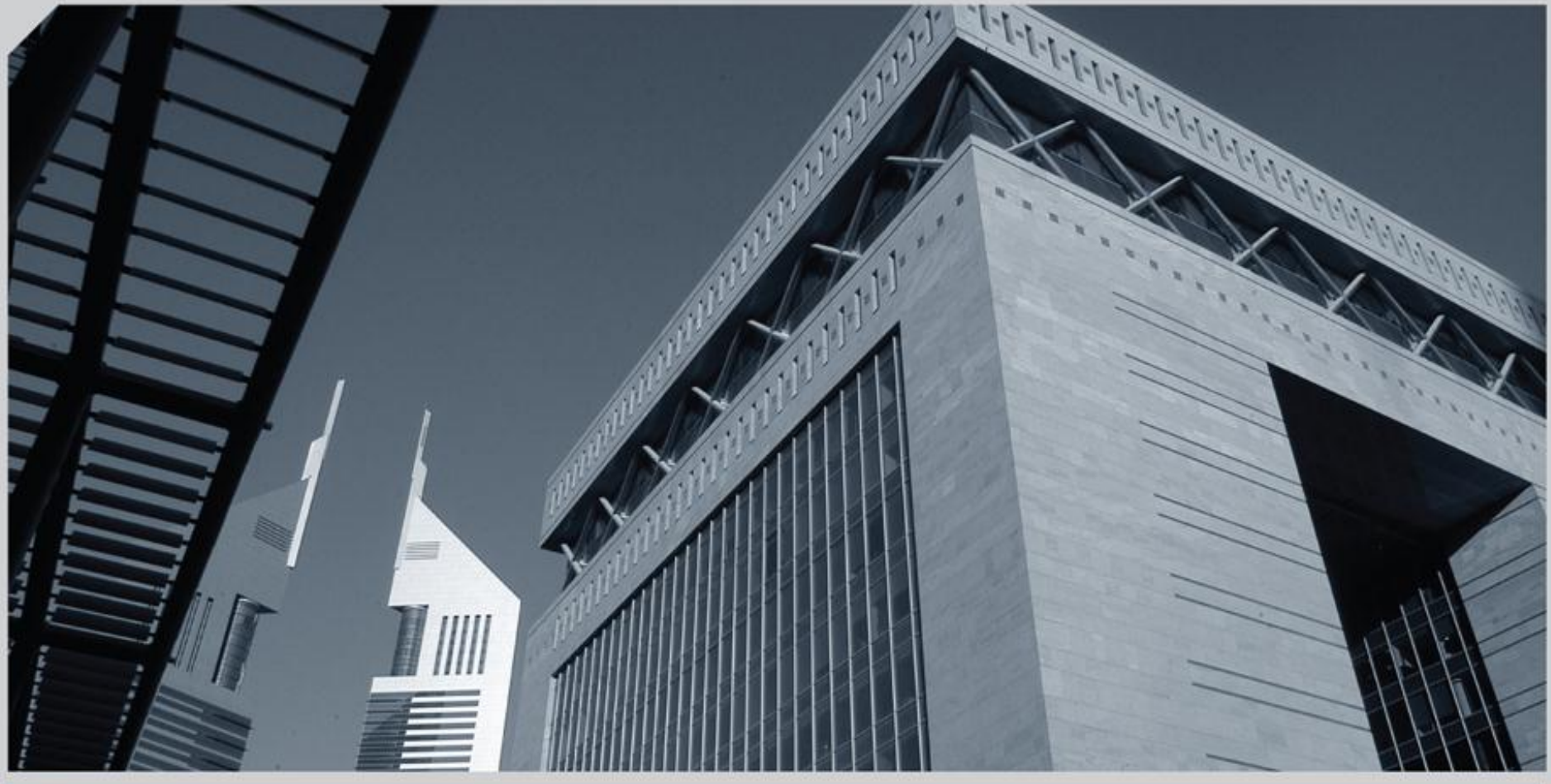


Global Inflation and Countermeasures

The 12th Seoul International Financial Forum

Dr. Nasser Saidi
Chief Economist & Head of External Relations, DIFC Authority
13 April 2011

DIFC Dubai International Financial Centre

Agenda

Global Surge in Inflation: Stylised Facts

3 Major Factors Driving Inflation

Structural change & Shift in Global Economy towards EMEs

Loose Monetary & Fiscal Policies in Advanced Countries

Need for International Monetary Reform: 'Hard SDR' Proposal

Internationalising the Yuan requires a Sequencing of Reforms:

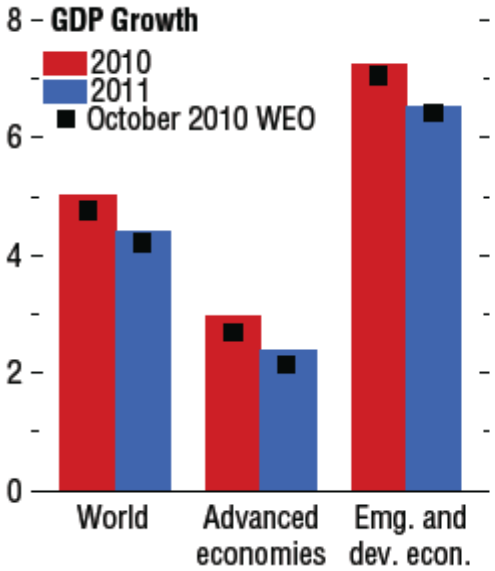
Imperative to Develop 'Redback Markets'

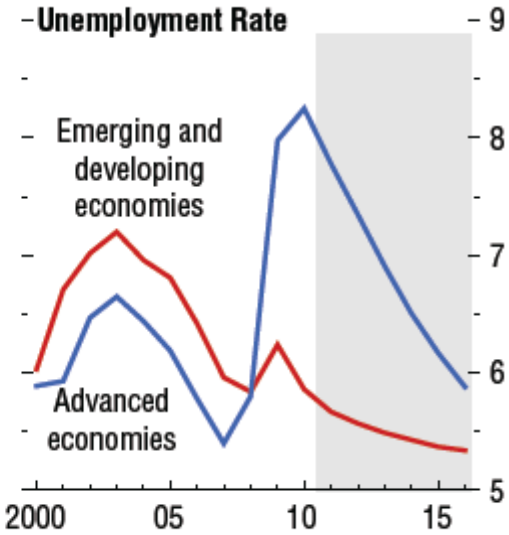
Remarks on Global Inflation Counter-Measures

Global Growth & Inflation: Stylised Facts *(IMF WEO, April 2011):*

Global growth recovery is 2-speed,

- ***Emerging economies growing twice as fast as Advanced Economies***
- ***Recovery in Advanced Economies largely jobless***
- ***Global growth in Output, Trade & Investment largely accounted for by EMEs***





Estimates & Forecasts of inflation:

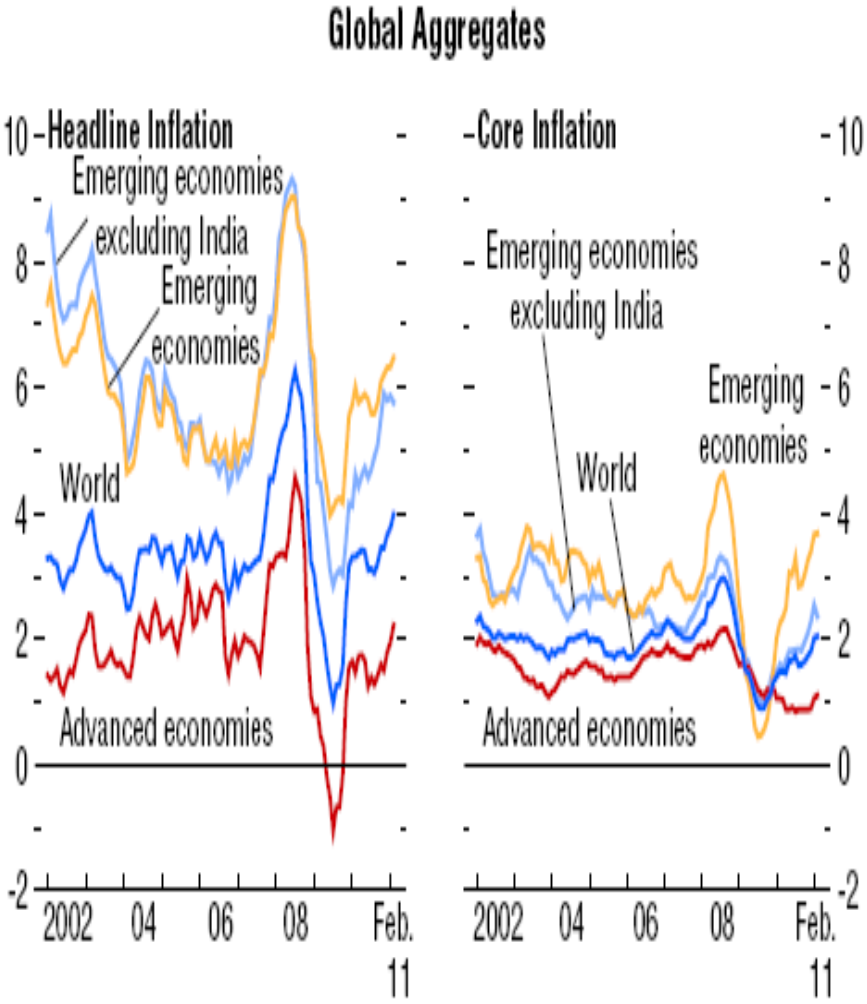
- **Global inflation rising from 3.7%in 2010 to 4.5% in 2011**
- **Rise in Inflation in Advanced Economies is more subdued: from 1.6% in 2010 to 2.2% in 2011**
- **Emerging Economies (EMEs) are facing higher & rising inflation rates from 6.2% in 2010 to 6.9% in 2011**
- **China's inflation rate is expected to rise from 3.3% in 2010 to 5% in 2011**
- **ASEAN inflation rates seen rising from 4.4% in 2010 to 6.1% in 2011**
- **MENA countries' inflation rates rising from 6.9% in 2010 to 10% in 2011**

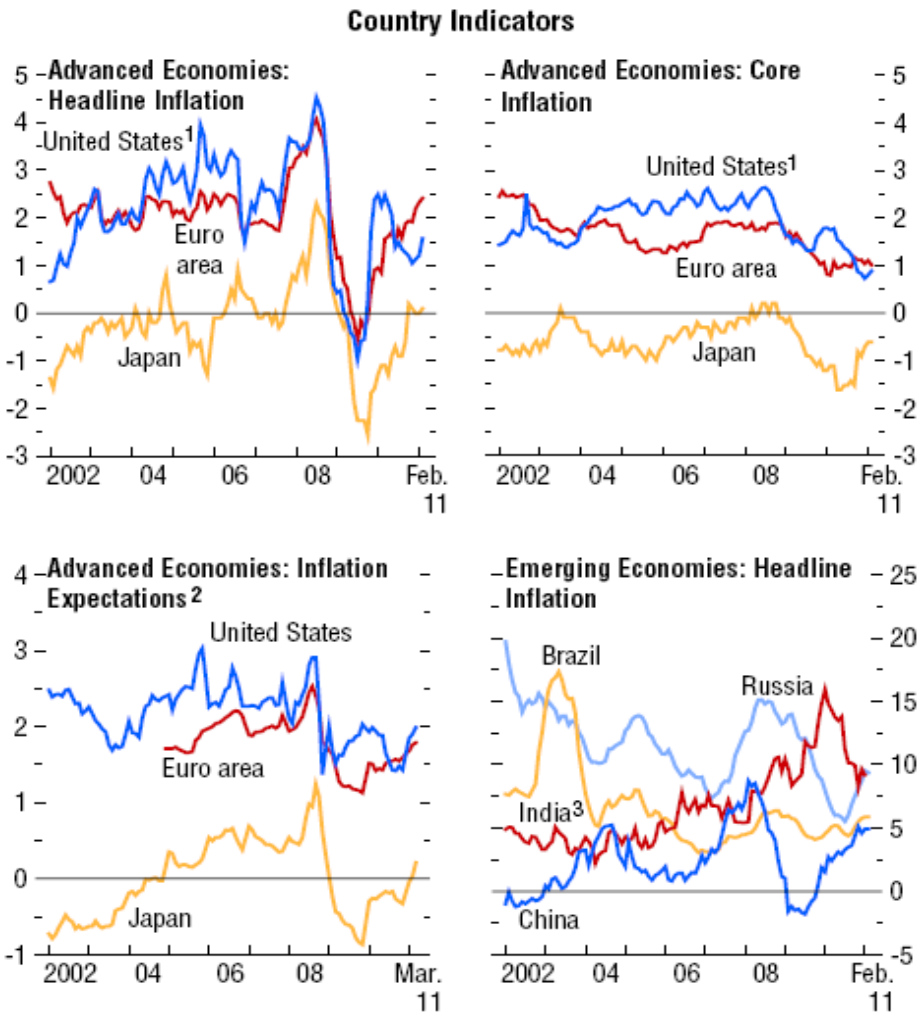
Inflation is picking up at a faster pace in EMEs & Asia

	1980	1990	1995	2000	2005	2008	2009	2010	2011	2012
World	17.3	27.6	14.6	4.5	3.8	6.0	2.5	3.7	*4.5*	*3.4*
Advanced economies	12.9	5.1	2.6	2.3	2.3	3.4	0.1	1.6	*2.2*	*1.7*
Euro area	-	-	2.4	2.2	2.2	3.3	0.3	1.6	*2.3*	*1.7*
Japan	7.8	3.1	-0.1	-0.8	-0.3	1.4	-1.4	-0.7	*0.2*	*0.2*
Major advanced economies (G7)	12.4	4.7	2.3	2.1	2.3	3.2	-0.1	1.4	*2.0*	*1.5*
Newly industrialized Asian economies	19.9	7.1	4.6	1.2	2.2	4.5	1.3	2.3	*3.8*	*2.9*
Advanced economies exclu. G7 & Euro area	18.6	6.8	4.2	2.1	2.1	4.3	1.5	2.3	*3.1*	*2.6*
European Union	12.4	27.4	5.0	3.1	2.3	3.7	0.9	2.0	*2.7*	*1.9*
Emerging & developing economies	28.3	97.8	39.2	8.6	5.9	9.2	5.2	6.2	*6.9*	*5.3*
Central and Eastern Europe	27.7	139.9	49.4	29.2	5.9	8.0	4.7	5.3	*5.1*	*4.2*
Developing Asia	12.0	6.2	12.6	2.0	3.8	7.4	3.1	6.0	*6.0*	*4.2*
China	6.0	3.1	17.1	0.4	1.8	5.9	-0.7	3.3	*5.0*	*2.5*
India	11.4	9.0	10.2	4.0	4.2	8.3	10.9	13.2	*7.5*	*6.9*
ASEAN-5	17.4	5.1	7.9	2.4	7.3	9.3	2.9	4.4	*6.1*	*4.7*
Latin America and the Caribbean	53.8	480.1	37.8	8.4	6.3	7.9	6.0	6.0	*6.7*	*6.0*
Middle East and North Africa	12.2	8.5	18.8	3.7	6.4	13.4	6.5	6.9	*10.0*	*7.3*
Saudi Arabia	4.4	2.1	5.0	-1.1	0.6	9.9	5.1	5.4	*6.0*	*5.6*
United Arab Emirates	10.1	0.6	4.3	1.3	6.2	12.3	1.6	0.9	*4.5*	*3.0*
Sub-Saharan Africa	16.8	14.3	40.1	15.0	8.9	11.7	10.5	7.5	*7.8*	*7.3*

Source: IMF World Economic Outlook Database, April 2011

Global Inflation: Core & Headline rates are Rising





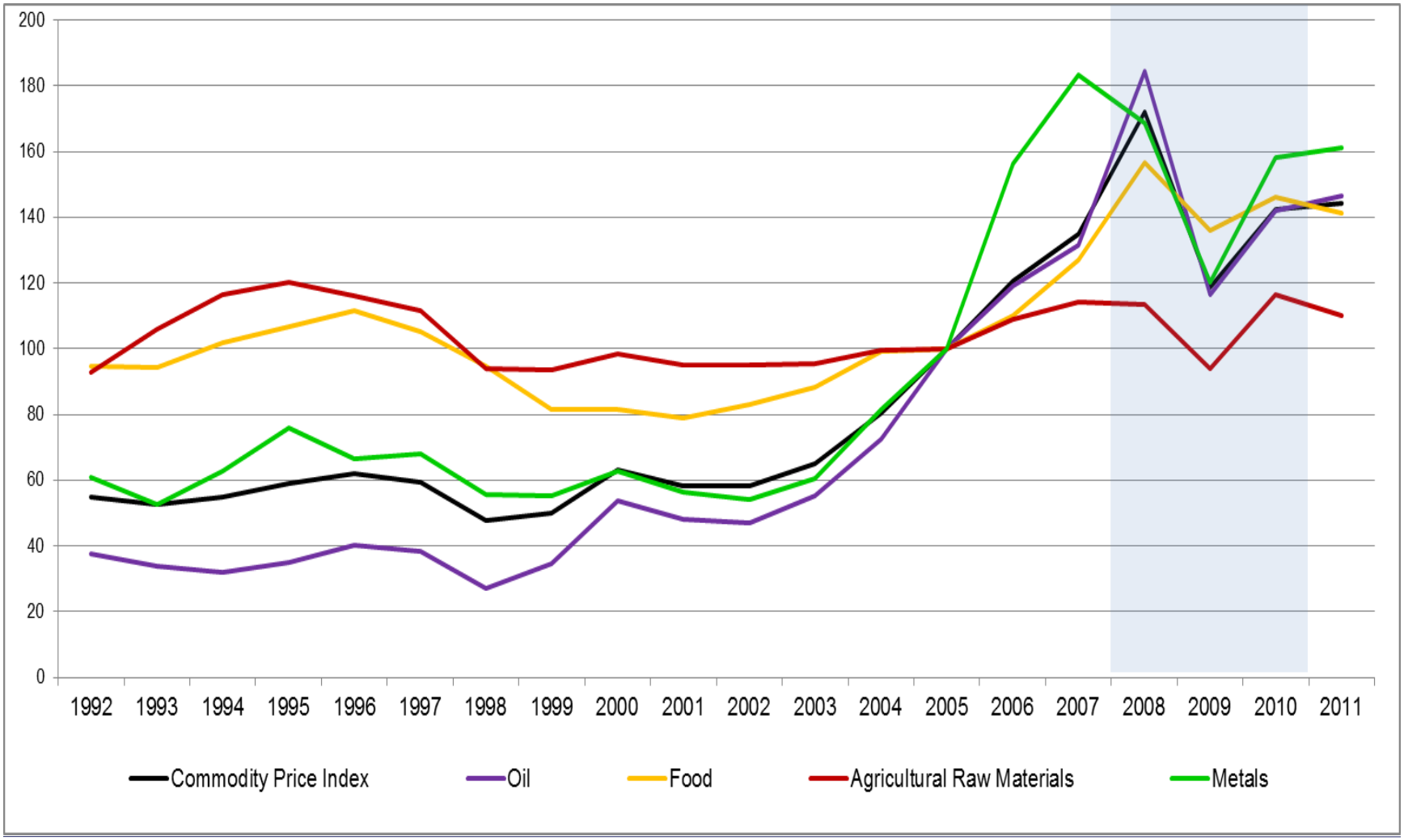
Source: IMF World Economic Outlook Database, April 2011

Inflation in advanced and emerging economies

- Global Inflation rates are rising. However, core inflation & wages remain subdued in advanced economies, held back by high unemployment. In many EMEs, inflation pressures are broadening amid accommodative macroeconomic policies and increasingly binding capacity constraints.
- Inflation in A**dvanced Economies** has declined by less than expected, considering the depth of the recession.
- In the US, the drop in core inflation from 2008-10 was about 1%, whereas the drop during the 1981–83 recession was about 4%.

  - US Bureau of Labour Statistics recorded the biggest price increase in more than 36 years (3.9%) in Feb 2011!
- Inflation in **Emerging Economies** in 2010 was partially attributable to **rising Food, Energy and Housing prices**, affecting household budgets and significantly affecting overall price inflation.
- Core inflation has been increasing systematically in many emerging economies, with the **significant risk of food price inflation passing through to core inflation** through **Wage-Price spirals**

World commodity prices: Accelerated growth after 2008 peaks

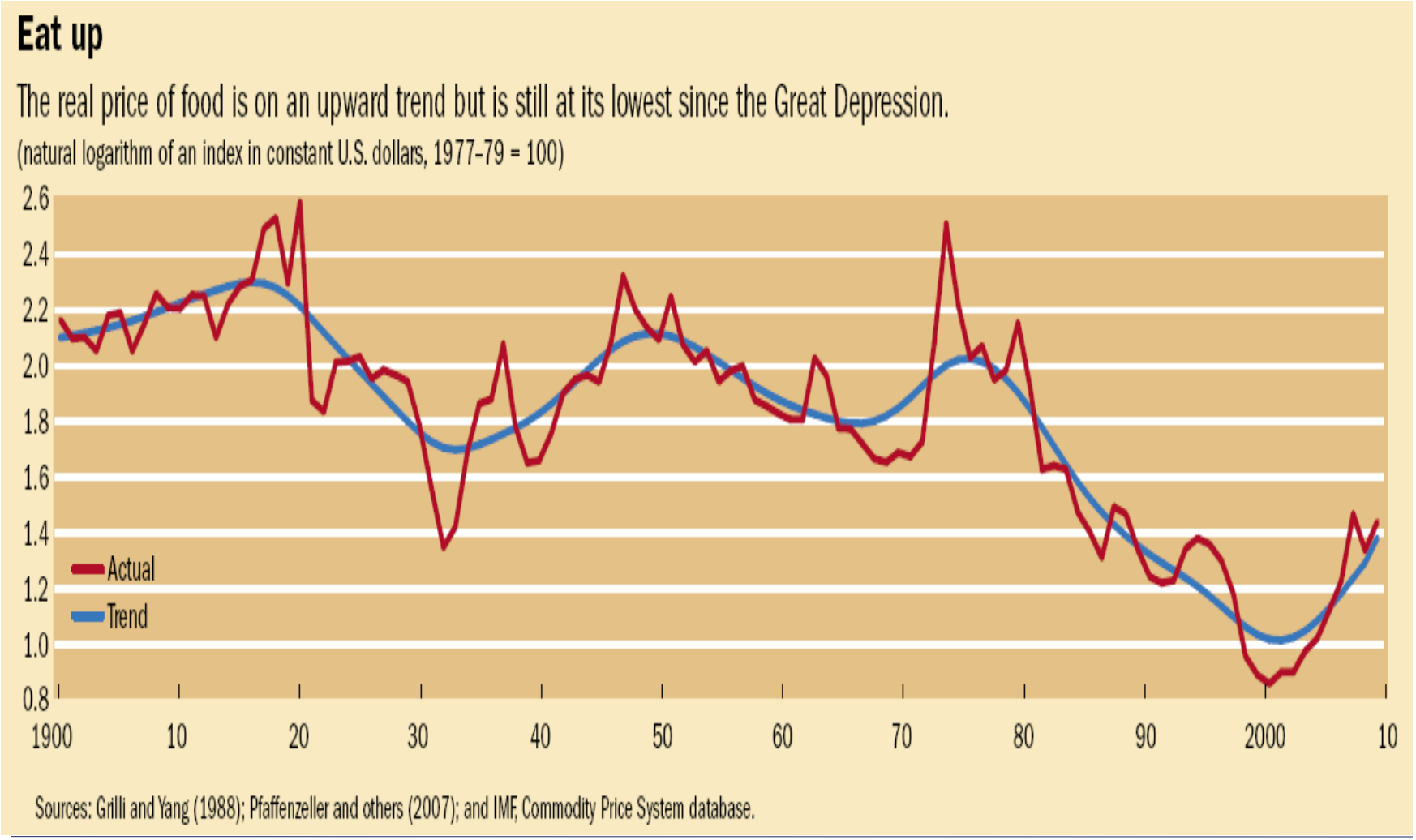


Source: IMF; Note: 2005=100

Recent patterns of inflationary movements

- In 2008, the world experienced the biggest surge in inflation since the late 1980s and the worst economic downturn since 1990-91, both occurring almost simultaneously.
- Post-crisis slump in inflation was soon followed by considerable recovery of commodity prices, which raised the level of consumer prices during 2010-2011.
- Currently, Brent oil is above $120 a barrel, copper prices remain near recent highs (9500 $/LB), Gold is at a historical high and the UN FAO Food Price Index hit a historical record in February 2011.
- Fears about inflation have risen to the highest level since records began in the mid 1980s. Inflation expectations are higher now than they have been since 1985, despite the fact that the cost of living has been through double digits in that period.
- Upward pressure on prices is projected to persist in 2011, due to continued strong demand and a slow supply response to tightening market conditions.

Real Price of Food: Lowest since Great Depression but Rapidly Surging over the Past Decade



But Food prices remain a significant component in CPIs

Source: UN FAO

Food prices are seeping into Core inflation

- Food & energy prices are generally excluded from “Core” inflation measures due to transitory nature or higher volatility.
- In EMEs & lower income countries, **food price inflation** is not only **more volatile** but also on average **higher than non-food inflation** and **more persistent**. Unlike developed nations, emerging nations can spend as much as 40-50% of their income on food: Developing countries are impacted more significantly, because of **food’s greater share of household budgets** (in conformity with Engel’s law).
- Under these conditions a monetary policy focus on measures of core inflation that exclude food & energy prices leads to **misreading inflation pressures** and a downward bias to forecasts of future inflation and lags in policy responses. However, higher inflation rates lead to higher inflationary expectations, upward Wage pressure and a Wage-Price spiral affecting “core” inflation.
- In constructing measures of core inflation, **excluding food & energy price inflation will not provide a clear picture of underlying inflation trends**, particularly in EMEs.

Risks of a pass-through from rising food prices to core inflation are low for advanced economies, but significant for emerging and developing nations.

Food Prices & Political Instability

- Food price inflation can have severe socio-economic and political effects in emerging countries, well illustrated in recent events in rioting, demonstrations and political changes in MENA countries. e.g. In Egypt, food represents 40% of household budgets & food price inflation hit 20% resulting in near 10% decline in purchasing power.
- "Inflation targeting" cannot neglect food price inflation: Inflation cannot be dealt purely through monetary policy. Macroeconomic policies **cannot be shaped in isolation from measures to ensure social safety nets** are in place and that the poorest people are protected.

"Food Prices & Political Stability", IMF WP 11/62 April 2011:

We examined in this paper empirically the effects that changes in the international food prices have on measures of democracy and intra-state stability in a panel of over 120 countries during the period 1970-2007. Our main finding was that during times of international food price increases political institutions in Low Income Countries significantly deteriorated. To explain this finding we documented that food price increases in Low Income Countries significantly increased the likelihood of civil conflict and other forms of civil strife, such as anti-government demonstrations and riots.

3 Sets of Factors Affecting Global Inflation

3 Sets of Factors are Affecting Global Inflation and Prospects:

1.Shift in Global Economy Towards the East and EMEs which implies an Increasing Weight of EMEs in Contributing to Global Inflationary Conditions, Outcomes and developments

2.Structural Factors due to the Rise of EMEs and their different Demand & Supply Conditions and Characteristics which impact commodity prices and export prices of EMEs

3.Monetary & Fiscal Policy laxity in Advanced Economies leading to increased global liquidity due to High Budget Deficits and rising Levels of Public Debt

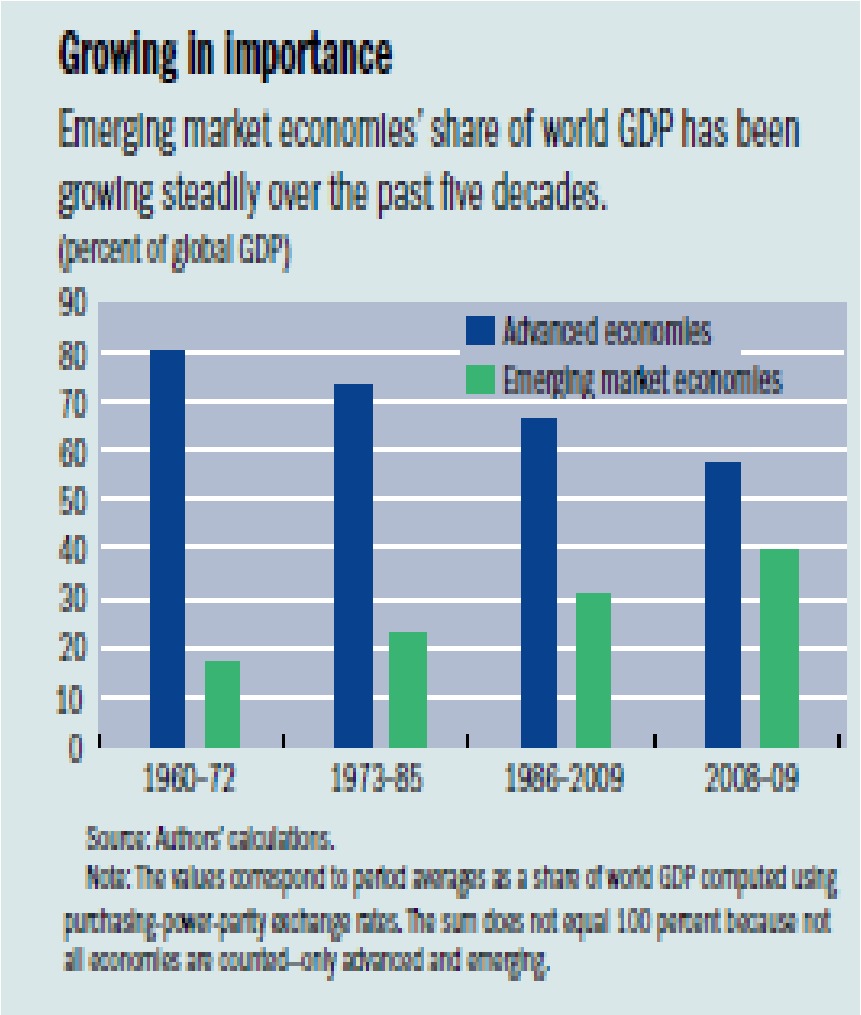
Factors Affecting Inflation I: Shift Toward EMEs & Asia

Global centre of economic geography has shifted East, with Asia producing the bulk of world output: 40% of global output at PPP rates

Aggregate Demand & Supply and Monetary conditions in EMEs are major contributors to global inflation

•Macro & Trade policies of EMEs will increasingly affect global conditions: China's Inflation rate & export prices will matter more than those of advanced economies given its openness & dominance of manufacturing

•Factors that affected last global inflation episodes in 1980s not relevant for analysis & Determining Inflation prospects in the decade of 2010s: model & framework have changed



Factors Affecting Inflation II: Structural Change

- Recent **surge in Food and Energy prices** reflect structural changes in the global economy that will not be reversed soon:
  - **Global economy has shifted East & toward EMEs increasing demand for raw materials & commodities**
  - **High & Growing Demand** from fast-growing EMEs for new sources of food and biofuels
  - **Rise in living standards** in **EMEs** & middle-income countries
  - Increase in fuel prices impact all stages of production, including agriculture
  - **Slowdown in agricultural productivity growth**
  - **Increase in world population & continuing urbanization**

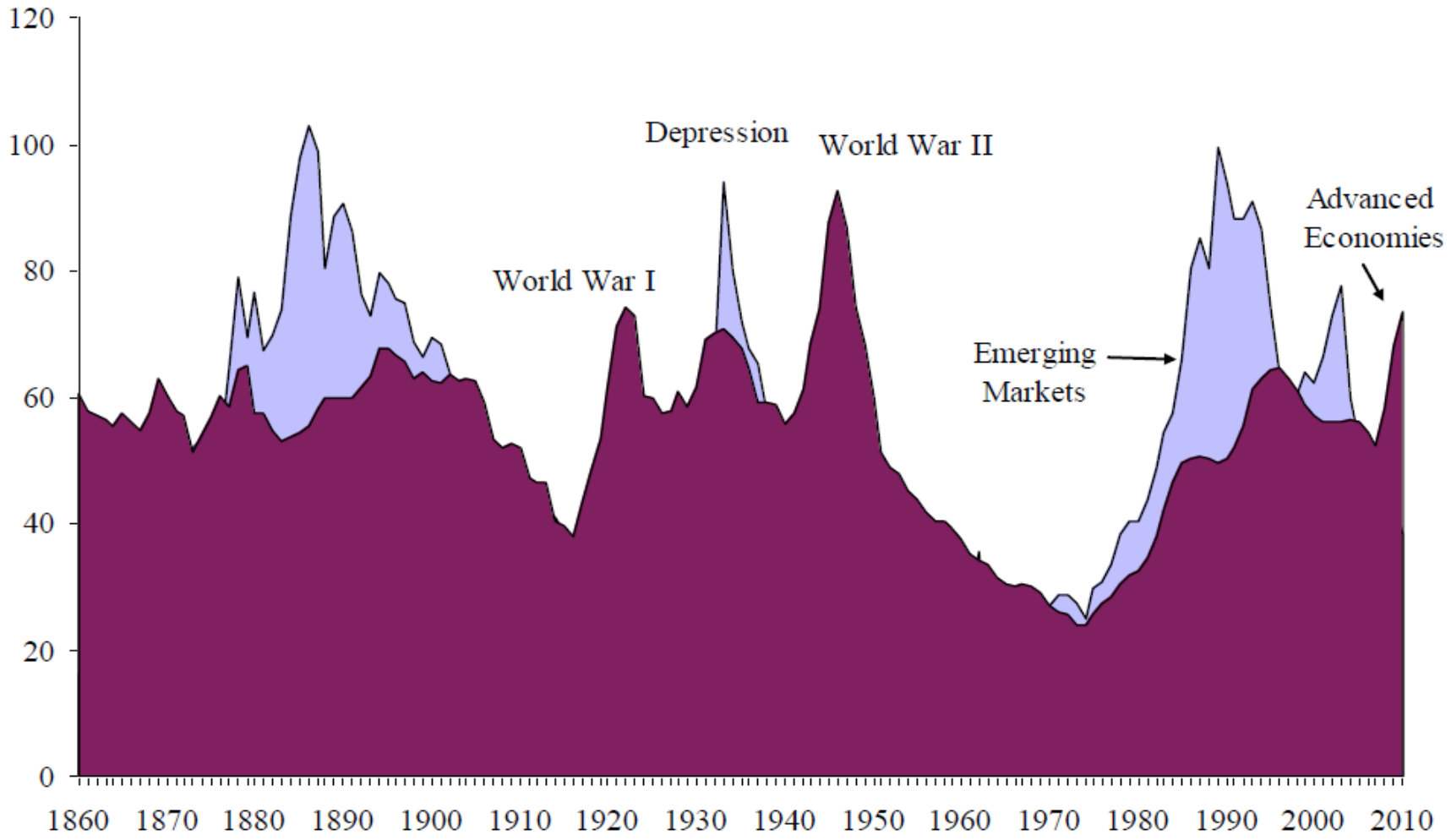
are leading to **long-term demand pressures unlikely to be overcome by rapid Technological Change & Innovation**– and therefore to **higher relative prices of food & energy** over the medium & long term.

- Dealing with growing Global inflation requires dealing with underlying structural changes in global economy and distribution of income across and within countries.

Factors Affecting Inflation III: Loose Monetary & Fiscal Policy

- Advanced economies undertook monetary, fiscal and financial policy measures to rescue their banking & financial sectors and provide fiscal impulse to spending to combat Great Recession and unemployment.
- US quantitative easing measures (QE1 and QE2) and EU/ECB measures boosted economies, vastly inflated central bank balance sheets (3 to 4 times pre-crisis levels) and injected liquidity into economy and banking & financial system.
- **Loose fiscal policies resulted in high budget deficits and rise in Debt/GDP ratios and unsustainable fiscal deficits. Large Public Debt ratios are raising inflation expectations** given the incentive for governments to reduce the value of their debt obligations through inflation
- However, **loose monetary policies and continued US$ pegging is generating higher inflation rates through capital movements into EMEs -** where expected yields are higher than in Advanced Economies- leading to **rising money and credit growth in EMEs**

Gross Central Government Debt as a % of GDP: Advanced and Emerging Market Economies



Source: Reinhart & Rogoff (2011): "A Decade of Debt"

Build-up of Public Debt and its consequences: *Reinhart & Rogoff (2011): A Decade of Debt*

- **Through 2010, Public Debt-to-GDP ratio average for advanced economies surpassed the pre-WW2 peak; bank debts have become a contingent liability for the public sector.**
- **High and rising public debt levels + the protracted process of private deleveraging => the ten years from 2008 to 2017 will be called the decade of public debt.**
- **Debt-to-GDP ratios are reduced by relying on fiscal austerity or debt restructuring, rather than consistent robust economic growth.**
- **For most advanced countries, dismissing debt concerns or pretending "no restructuring will be necessary", at this time is equal to ignoring the "elephant in the room".**
- ***Public debt follows a lengthy & repeated boom-bust cycle; bust phase involves higher incidence of sovereign debt crises. Public sector borrowing surges as the crisis nears.***
- **Needs of governments to reduce debt rollover risks and curb rising interest expenditures + an aversion to more explicit restructuring => revival of financial repression: more directed lending to government by captive domestic audiences (e.g. pension funds), explicit or implicit caps on interest rates & tighter regulation on cross-border capital movements.**

Source

Inflation Counter-Measures

•Advanced Economies will need to implement sustainable, credible programmes to reduce budget deficits and public debt ratios

•Advanced Economies will need to move away from monetary easing to raise nominal and real interest rates

- To prevent **importing inflation**, **EMEs can take short-term measures** – greater exchange rate flexibility & ST capital controls and monetary & credit tightening.

- G20 and EMESs should **agree on International Monetary Reform and work towards lowering their dependence on US financial markets & pegging to the US$.**

- **EMEs need to develop their Local Currency Financial Markets in order to reduce their dependence on the 'hub' markets of London and New York and gain greater control of local liquidity & monetary conditions**

- **DIFC is a live & successful example of how to develop a financial sector compliant with best international practices & standards www.difc.ae**

Need for International Monetary Reform

The Triffin Dilemma posits that the country issuing the reserve currency is bound to run an ever increasing current account deficit as world trade and payments increase in order to allow reserve accumulation and until its foreign liabilities become unsustainable.

- Currently, the US cannot continue to run indefinitely a current account deficit without jeopardizing the stability of the world economy and exacerbating global imbalances
- In a multipolar world the size of a single country would not be large enough to sustain its role as supplier of the dominant reserve currency and international liquidity.
- Alternative: to devise a financial system relying on several major currencies. But should such a multi-currency system be solely anchored to fiat monies controlled by sovereigns or could it benefit from being anchored to an asset such as gold?

DIFC's Proposal: international liquidity should be supplied on a large scale by an international currency such as the SDR, whose value should be tied to a basket of major currencies and gold, with the weight of the latter set at 20-25%. See: DIFC Economic Note 13: The Role of Gold in the New Financial Architecture

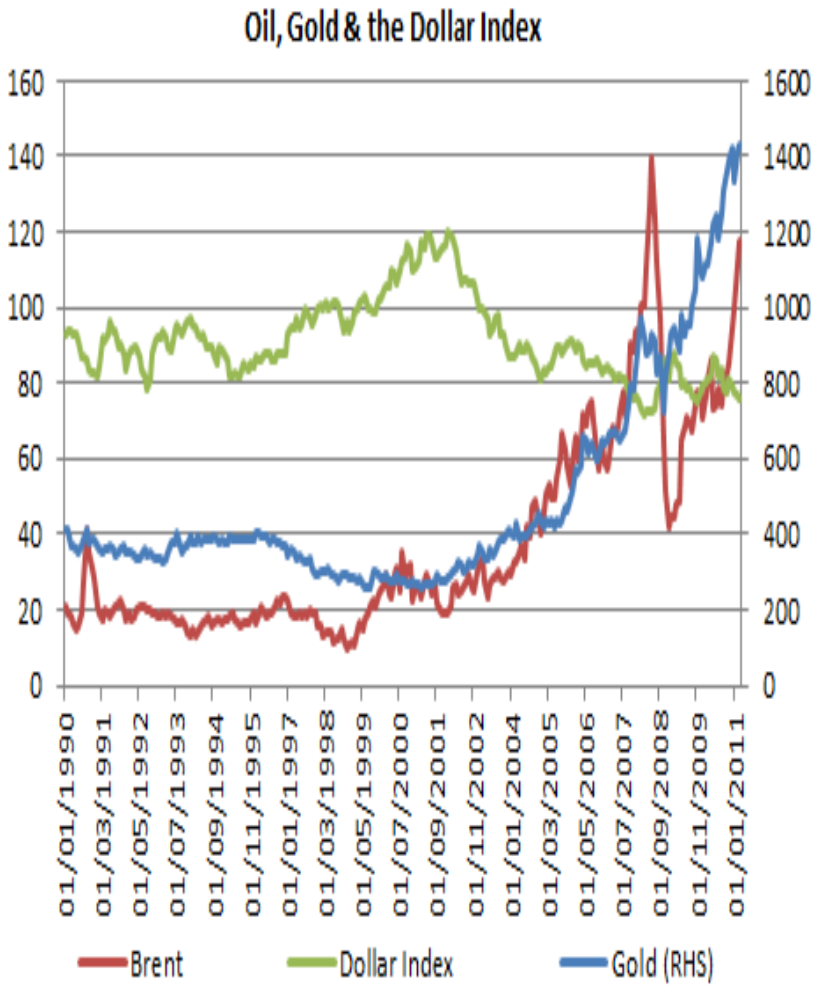
Role of Gold as an Anchor

A single reserve currency issued by a country whose relative economic share is dwindling exposes the world to severe instability & becomes a source of global systemic risk.

Can gold play a role in a multi-currency fiat currency environment resulting from a multi-polar economic map?

Gold - two stylized facts:

1. **Gold price tends to be counter-cyclical**: it tends to spike in conjunction with high inflation periods or at times of severe slumps threatening to turn into depression and/or triggering a deflation.
2. **Gold is perceived as a hedge against extreme events;** hence its price is dictated by the assessment that investors or some classes of investors make of those “tail risks”



Source: Bloomberg, DIFC Economics

Moving to a “Hard SDR”

- Currently the SDR is a currency basket composed of US$, Euro, Yen and the GBP but does not reflect new economic geography
- For SDR to be an alternative reserve currency: (a) Total issuance needs to be boosted; (b) Needs additional backing and arrangements –a “hard” version of the SDR must be created; (c) Include Chinese Renminbi.
- It is **desirable to create a new SDR basket** and include in it an asset whose value is largely uncorrelated with the value of fiat currencies. Gold would be the natural candidate with backing for the gold proportion coming initially from the IMF’s substantial gold stock. **An SDR basket where the weight of gold would be between 20-25% is feasible and provide a new international monetary anchor.**
- **“Hard SDR” Proposal: SDR would be based on US$, Euro, Yen, Yuan and Gold**
- **“Hard SDR” proposal implies internationalisation of Yuan**

Emergence of the Redback & Sequencing of Reforms

- **Sequencing of Economic & Financial Reforms**: pressure on China to move to a flexible exchange rate for the Yuan is misplaced. China cannot open to foreign capital flows without, first, removing domestic banking & financial distortions, reforming its domestic banking & financial sector and developing its financial markets.
- **China needs to develop its domestic financial markets** –debt, money and capital markets- before it internationalizes the Redback and open its capital account.
- **Development of China's financial markets is necessary for domestic reasons**: Savings (running at 40% of GDP) would be channeled into capital markets and new financial instruments.
- **Development of China's financial markets necessary for international reasons & to help resolve global imbalances** : development & growth of 'Redback markets' would enable China to internationalise the Yuan; need 'breadth, depth & liquidity' of Redback markets to rival greenback markets; opening of Redback exchanges would allow China to export its capital on a global basis
- **G20 should help China develop its Redback markets** not focus on foreign exchange value of Renminbi and targets for Trade or Current Account.

Some final remarks

- EMEs are more vulnerable to higher inflation due to high aggregate demand pressures than advanced economies facing continuing high unemployment rates & anemic growth.
- EMEs are likely to continue/initiate monetary tightening & higher interest policy rates along with upward revaluation of their exchange rates.
- High and rising energy, fuel and other commodity relative prices are reflecting structural changes in global demand due to rise of EMEs
- Loose Monetary policy & Low interest rates in advanced economies, along with pegged exchange rates to the US$, are driving capital flows into EMEs generating inflation of commodity & asset prices are main factors driving global inflation
- Build up of Government Debt/GDP ratios in advanced economies is leading to a substantial rise in global inflation & expectations of higher future inflation rates
- Reducing Global Inflation necessarily requires tightening of Monetary & Fiscal policy stance in EU and US
- New Global Monetary & Financial Architecture requires a new anchor other than US$: move towards a 'Hard SDR' with Gold (20-25%), US$, Euro, Yen and Yuan
- Internationalisation of Yuan should be preceded by developing 'Redback financial markets'
- G20 should work with China on developing 'Redback markets' not on freeing Yuan

Thank You!

nasser.saidi@difc.ae

감사합니다