Macro Notes – Is Lower EM Inflation Here to Stay?

November 27, 2019

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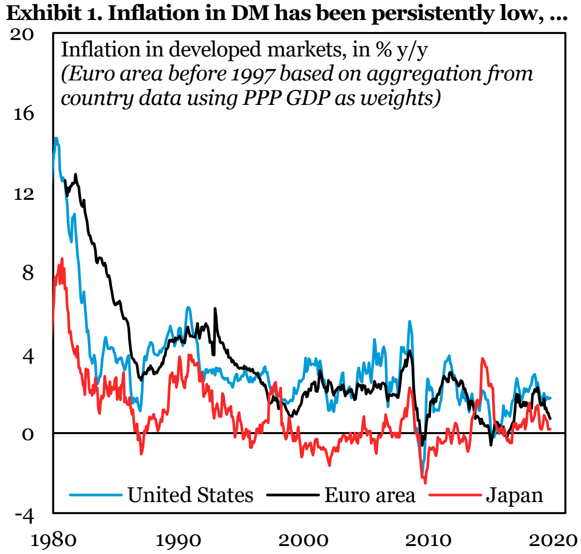
- Inflation is trending down in many emerging markets.
- This is partially due to higher central bank credibility.
- EM inflation has also become increasingly synchronized.
- Persistently lower inflation could allow for more easing.
- Risk of reversals and country-specific shocks remains high.

Accommodative policy by developed market central banks and falling inflation across the globe have allowed monetary authorities in emerging markets to cut rates. With the Fed and ECB now hinting at a pause, is there more room for EM central banks to ease? More broadly: are we on the cusp of a synchronized trend decline in emerging market inflation? In this ***Macro Notes*** we present stylized facts that suggest that this may indeed be the case.

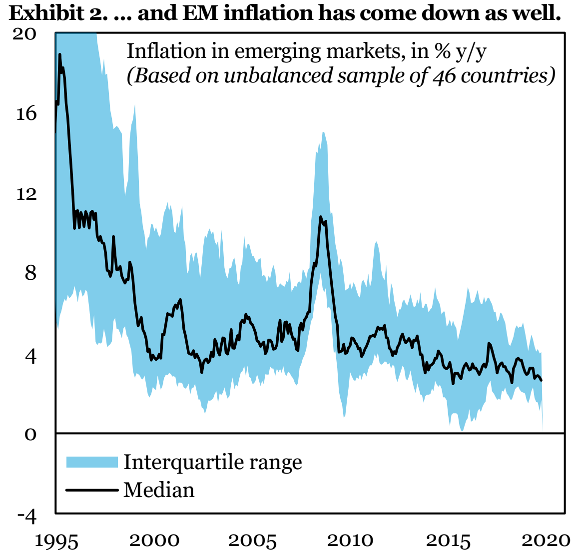
We have seen a pronounced trend decline in DM inflation since the 1980s, and inflation persistently remains below targets in many countries (Exhibit 1). Inflation in emerging markets has significantly fallen as well, and median inflation in our sample of 46 EMs now lies below 3% (Exhibit 2). At the same time, EM inflation has become more synchronized (Exhibit 3). A continuation of the trend decline could have meaningful implications for EM policy rates. Most central banks are still concerned about elevated inflation and only few have considered policy tools to fight the persistent undershooting of targets. Boosting inflation via a currency depreciation may not be an option where foreign investors hold a significant share of domestic bonds.

Exhibit 1. Inflation in DM has been persistently low, …



Source: Haver, IIF

Exhibit 2. … and EM inflation has come down as well.



Source: Haver, IIF

What could be the factors behind falling EM inflation? First, monetary policy credibility has improved with the adoption of inflation targeting in many countries. Second, structural reforms led to greater opening of domestic product and labor markets, allowing for lower prices as a result of competition. Third, as EM became more integrated into the global economy, spillovers from DM disinflation into EM became more pronounced. Finally, other structural factors pushing down inflation in DM, such as demographics and technological change, are likely also at play in some EMs.

Monetary policy credibility has contributed to lower EM inflation. Over 25 emerging markets have adopted inflation targeting since the 1990s. Empirical studies suggest that inflation is lower after the adoption of inflation targeting (Exhibit 4). Furthermore, exchange rate pass-throughs have fallen to low single digits for most key emerging markets compared to more than 20-30% in the past. Nonetheless, some EM central banks still pay close attention to FX risks. However, this is likely due to high foreign ownership of local bonds rather than exchange rate pass-through effects.

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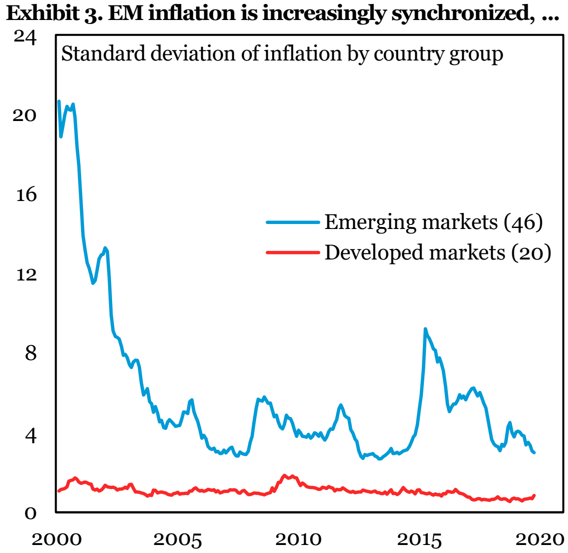
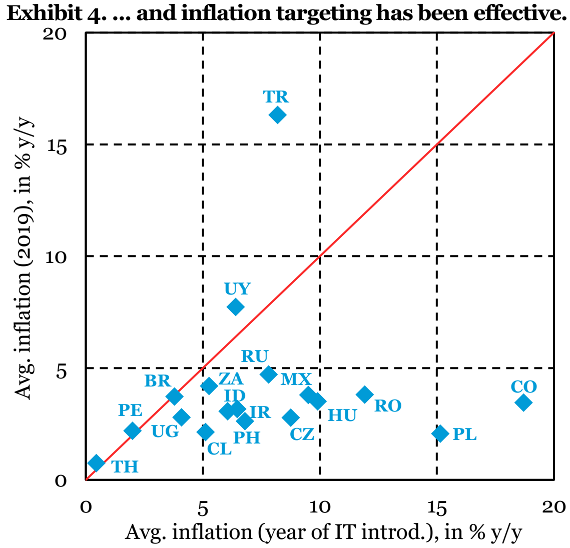
Exhibit 3. EM inflation is increasingly synchronized, ...



Source: Haver, IIF

Exhibit 4. ... and inflation targeting has been effective.



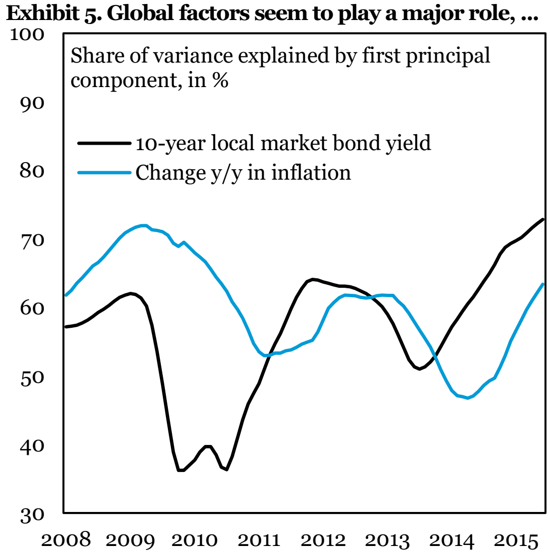
Source: Haver, IMF, IIF

Globalization appears to have changed domestic inflation processes. (Dis)inflation is increasingly becoming a global phenomenon. A growing number of DM-focused empirical studies have shown that global factors are important for modeling country-specific inflation. Studies of "missing inflation" in DM have incorporated the role of globalization such as global slack and global supply chains. Some of the common factors responsible for the synchronization of DM disinflation may also be at play in EM.

A principal component analysis of EM inflation finds that a common component explains an increasing portion of inflation over time, suggesting that EM inflation cycles have become somewhat more synchronized in recent years (Exhibit 5). Using a simple rolling correlation between EM and DM inflation suggests a renewed alignment between inflation dynamics (Exhibit 6). Global spillover factors have become increasingly important for EM rates as well, as the share of foreign ownership of local bonds has increased significantly. As a result, we find that co-movement in local 10-year bond rates has nearly doubled in recent years.

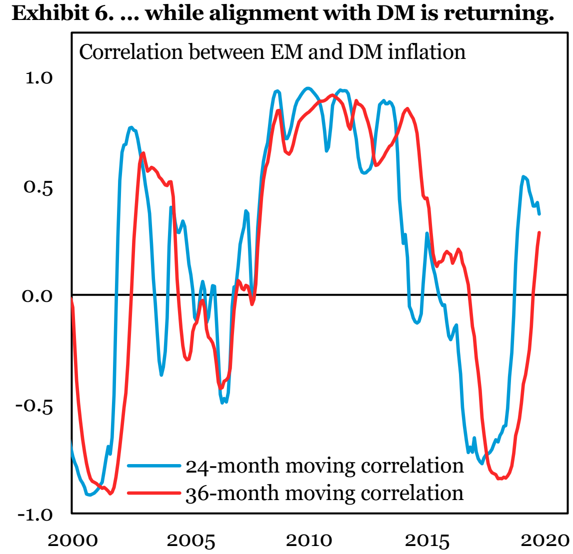
In EM, more so than in DM, the risk of inflation reversals remains high. First, inflation expectations are often not well-anchored. Second, exchange rate pass-throughs and the effects of commodity price shocks still play an important role. Third, policy reversals in EMs are more common. Nonetheless, the synchronized downward trend in EM inflation is becoming an important phenomenon for policymakers and markets alike.

Exhibit 5. Global factors seem to play a major role, ...



Source: Haver, IIF

Exhibit 6. ... while alignment with DM is returning.



Source: Haver, IIF