

Inflation Outlook: A Global View

Varying price pressures in different economies pose a challenge to monetary policymakers

One of the most hotly debated topics among economists is when or whether inflation may rear its head and become a risk for the U.S. economy. The debate becomes even more complicated if you broaden the discussion to a global perspective, assessing the impact that rising inflationary pressures in some developing countries could have on the U.S. economy.

Inflation is muted in developed world

Most of the developed world—including the U.S., Europe and Japan—show few signs of significant inflationary pressures. Across European developed countries, the most recent average rate of headline inflation was 1.4%, while Japan is actually experiencing a -1.1% inflation rate—meaning deflation or falling prices. In the United States, the consumer price index (CPI) rose 2.4% in March 2010 (versus March 2009), boosted by higher crude-oil prices, but the core rate

of inflation (excluding food and energy) rose only 1.2%.ⁱ Historically, these current readings are well below the historical averages for both headline and core inflation, both of which have averaged around 4% during the past several decades.ⁱⁱ The generally low expectations for economic recovery in the developed world have served to reinforce a perception that inflation will remain muted [the International Monetary Fund predicts only 2.3% real gross domestic product (GDP) growth for the developed world in 2010 compared to 6.3% for emerging economies].ⁱⁱⁱ

Why is U.S. inflation low?

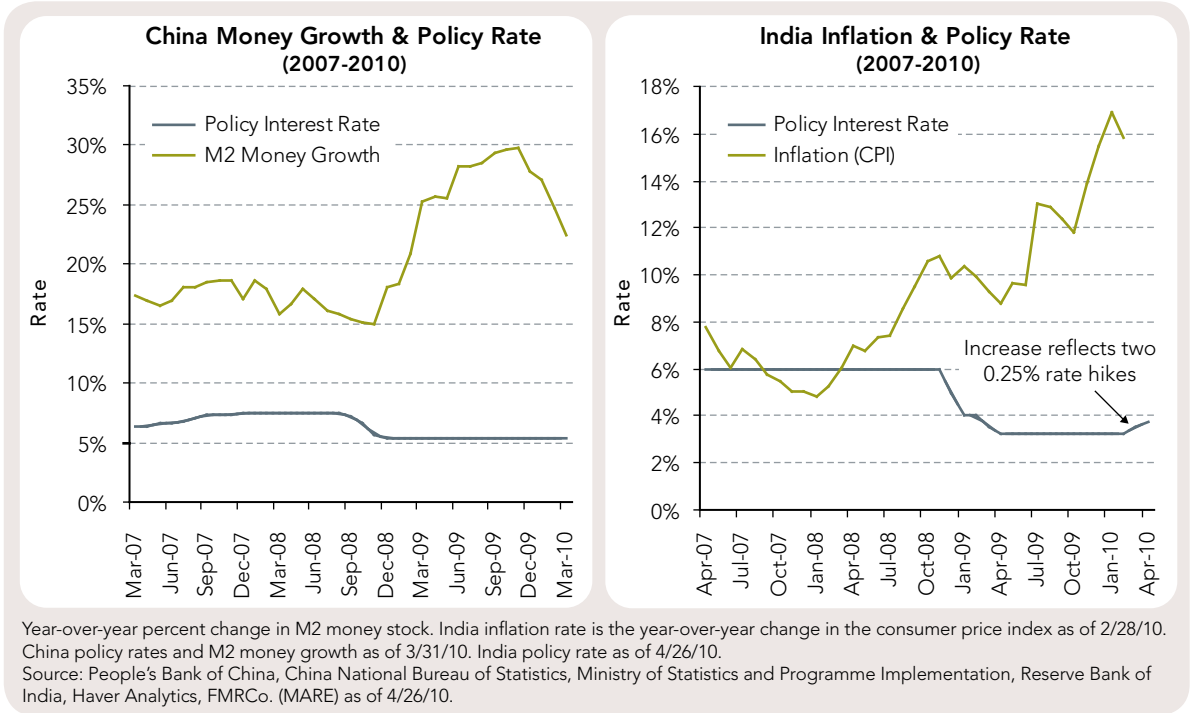
Low U.S. inflation rates are mostly attributable to two factors. First, there continues to be a significant amount of slack (underutilized capacity) in key areas of the economy, most notably in the labor markets. In the United States, unemployment remains high at nearly 10%, putting downward pressure on income growth and consumer demand. Second, the aftermath of the financial crisis has precipitated a massive financial de-leveraging, whereby financial institutions seek to lower their debt levels and clean up their balance sheets. This process has provoked an outright decline in U.S. bank lending, a contraction of credit that has a deflationary impact.^{iv}

As a result of these factors, the unprecedented monetary stimulus enacted by central banks, including the U.S. Federal Reserve, has been somewhat blunted. The Fed expanded its balance sheet by more than \$1 trillion to aid the ailing financial sector, but most of that extra money now shows up as “excess reserves” held by banks as opposed to being lent out into the economy. Despite the Fed’s quantitative easing efforts and near-zero percent interest rate policy, the money supply (M2) is growing at only a 1.5% year-over-year rate—certainly not inflationary territory.^v

KEY TAKEAWAYS

- As global policymakers consider when and how to rein in the extraordinary level of monetary stimulus injected into the world economy, they confront different inflationary backdrops depending on geography.
- The United States and many advanced economies are experiencing low inflation amid high unemployment, while India, China and other developing countries are facing rising inflationary pressures.
- While broad-based inflation remains relatively muted overall, the potential for strengthening economies, rising commodity prices, and still-loose monetary policies to push inflation up may be higher than expected.

EXHIBIT 1:
Despite rapid money supply growth in China and rising inflation in India, policy interest rates set by central bankers in these countries remain low and extremely accommodative of further economic growth.



Rising price pressures in emerging markets

In contrast, some developing economies have returned to high, pre-crisis growth rates, particularly in China and India where growth is in the 6%-to-12% range.^{vi} Inflationary pressures have begun to appear, and policymakers have started to retract the extraordinary stimulus employed to counter the global recession in 2009. India's consumer price index, which is heavily influenced by rising food prices, was up 16% on a year-over-year basis as of February 10, 2010, prompting the Indian central bank to raise interest rates twice so far in 2010 (see Exhibit 1, above). China's CPI still shows relatively low consumer price inflation, but rapid money growth and rising real estate prices have provoked the government to curb the level of bank lending and take measures to mop up liquidity.

What's causing inflation to build?

Part of the uptick in inflation can probably be attributed to a rebound in commodity prices after their major price correction in late 2008. For instance, nearly half of India's consumer price basket is composed of food, which means rising commodity prices will have a significant impact on the country's overall level of inflation. However, there is also the possibility that strengthening emerging-market economies and still-loose monetary policies are incubating inflationary pressures that may just be at the beginning of pushing their way through the local pipeline. For instance, China wages rose 14% on a year-over-year basis through

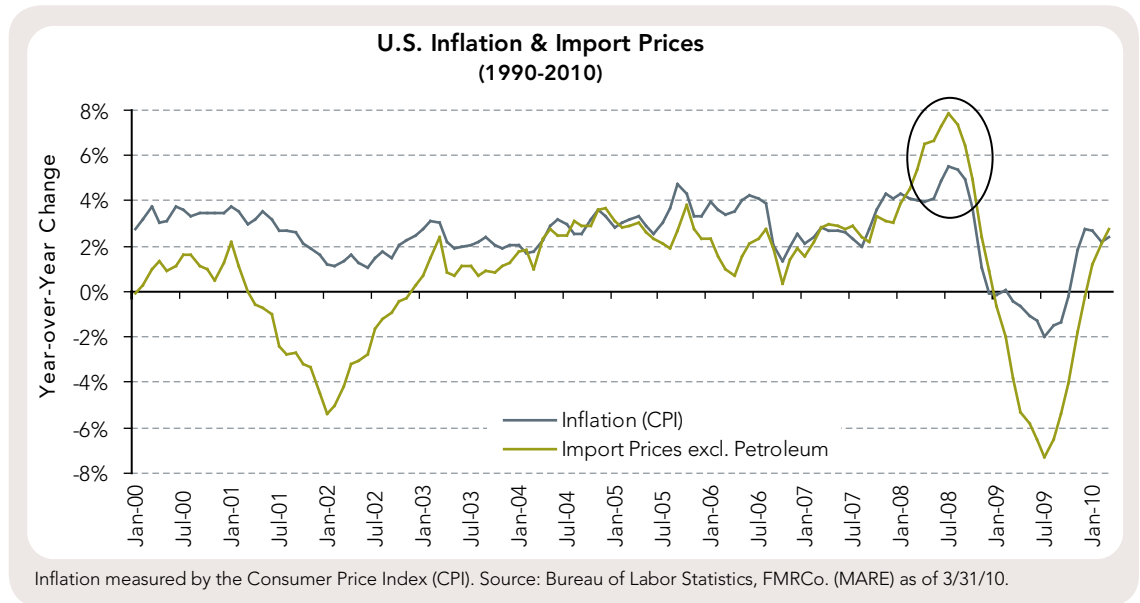
the third quarter of 2009.^{vii} Meanwhile, according to India's consumer price index calculation, housing costs rose 33% in February 2010, compared to the prior year. Meanwhile, although China is pulling back on bank lending from its extraordinary 2009 levels, its target for new loans in 2010 is still more than 50% higher than for any other year prior to 2009. Growth in China's money supply—though moderated from last year—was still nearly 23% higher in March 2010, and official policy lending rates in China remain near all-time lows (Exhibit 1). Further, even after two central bank rate hikes in India, the current 3.75% lending rate is far below its current rate of inflation, implying negative interest rates and easy money policy.

Overall, large developing economies that have returned to high rates of economic growth still have extremely accommodative monetary policies by historical standards. Policymakers in these emerging markets appear to be depending on muted growth in the developed world to moderate global inflationary pressures.

Could emerging-market inflation spread to developed countries?

A key question is to what extent inflation pressures are transmitted globally as opposed to resulting simply from domestic factors in the home economy. Emerging markets, such as China, have generally been considered deflationary for the global

EXHIBIT 2:
 Back in mid-2008, a decade-high peak in non-petroleum import prices coincided with the highest U.S. inflation (CPI) reading since 1991. More recently, non-petroleum import prices have been on the rise.



economy through the export of low-priced goods. However, while there is little current evidence that developing countries are exporting higher prices abroad, that doesn't mean it can't happen.

Inflation via rising global commodity prices

In the United States, the core measure of inflation (excluding food and energy) has remained low in significant part due to the quirky methodology of calculating housing inflation, which has led to housing deflation in recent months despite the stabilization in home prices. If housing is removed from the calculation, core CPI was up 1.7% in March (versus 1.2% with housing). Removing housing from overall consumer inflation would have raised CPI to 3.8% (versus 2.4% with housing).^{viii} Thus, imperfect housing inflation calculations may be masking some incipient signs of rising inflation in the United States, particularly commodity-induced pressures largely attributable to growth in China and other emerging economies.

Inflation via non-commodity foreign imports

A potentially bigger problem than volatile commodity prices would be if exports from goods producing countries such as China stop providing the deflationary impact they have generally had over the past decade. The U.S. consumer price index has shown a high correlation with the import prices of non-petroleum products, implying non-commodity import prices have some influence over U.S. domestic inflation. This generally has helped mute inflation over the past decade, as cheap imported goods contributed to low inflation. When U.S. CPI hit 5% in

mid-2008—its highest level since 1991—most experts attributed this solely to the record spike in crude-oil prices. However, this inflation spike occurred around the same time as decade-high spikes in U.S. non-petroleum import prices, China's overall inflation rate, and in the prices of China's consumer-good exports (see Exhibit 2, above). In other words, when low-cost goods producers, such as China, experience higher inflation, they can transmit that inflation abroad through their non-commodity exports. The conclusion for the United States and the rest of the developed world is therefore that emerging-country inflationary pressures are not something that can be completely ignored.

Investment implications

For now, initial signs of rising prices are welcome evidence that the world economy continues to recover from the worst global recession since the 1930s. Whether the increase in prices remains gradual and controlled may depend in large part on whether developed economies in the United States and Europe continue to exhibit some price-deflating weakness even amid general improvement. However, if the global economy does not end up being as weak as expected, the inflation outlook may become more complicated. In particular, monetary authorities and investors in the developed world may want to pay attention to how effectively emerging-market countries combat rising inflationary pressures. Their success in reining in stimulus has the potential to impact the inflation, interest-rate and economic outlook for the rest of the world. ■

ENDNOTES

- [i] All references to inflation in this article are represented by the year-over-year change in the respective country's Consumer Price Index (CPI). European developed country inflation uses European Union inflation data as a proxy. Most recent inflation data for Japan are as of 2/28/10. Source: European Central Bank, Japan Ministry of Internal Affairs and Communications, Bureau of Labor Statistics, Haver Analytics, FMRCo. (MARE) as of 3/31/10.
- [ii] The U.S. headline and core CPI historical averages are calculated using data from January 1957 to March 2010. Source: Bureau of Labor Statistics, Haver Analytics, FMRCo. (MARE) as of 3/31/10.
- [iii] Source: International Monetary Fund, Haver Analytics, FMRCo. (MARE) as of 4/28/10.
- [iv] The U.S. unemployment rate was 9.7% as of 3/31/10. U.S. bank loans in 2009 were \$87.2 billion lower in 2009 compared to 2008. Source: Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics, FMRCo. (MARE) as of 3/31/10.
- [v] The Federal Reserve increased its balance sheet by \$1.4 trillion from 8/31/08 to 3/31/10. Excess bank reserves stood at \$1.1 trillion as of 3/31/10. Source: Federal Reserve Board, Haver Analytics, FMRCo. (MARE) as of 3/31/10.
- [vi] India real GDP year-over-year growth rate for 2009 was 6.5% as of 12/31/09. China GDP year-over-year growth rate was 11.9% as of 3/31/10. Source: India Central Statistics Organization, China National Bureau of Statistics, Haver Analytics, FMRCo. (MARE) as of 3/31/10.
- [vii] Most recent data for China wage growth are as of 9/31/09. Most recent data for India inflation are as of 2/28/10. Source: India Ministry of Statistics and Programme Implementation, China National Bureau of Statistics, Haver Analytics, FMRCo. (MARE) as of 2/28/10.
- [viii] Core CPI excluding Homeowners' Equivalent Rent was 1.7% in March 2010. CPI excluding Shelter was 3.8% in March 2010. Source: Bureau of Labor Statistics, Haver Analytics, FMRCo. (MARE) as of 3/31/10.

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