Focus: Rising Inflation Danger in Non-Japan Asia

With inflation a growing concern in non-Japan Asia, policy makers will be forced to take stronger action – even though a global slowdown is taking hold.

Fast Growing Asian Economies With growth in ECRI's coincident indexes for North America *(↗Chart 3b, page 9)*, Europe *(↗Chart 9b, page 15)* and the Asia-Pacific region *(↗Chart 23b, page 29)* all showing significant improvement, the global economy is clearly on the recovery track. While the pace of the recovery varies across regions, it is particularly strong in the Asia-Pacific region, especially in the non-Japan Asian economies, such as China, India, Korea and Taiwan.

Chart 2a presents the GDPs of the world's major economies. The lines show the respective GDPs rebased with 100 representing the level in the third quarter of 2008. You can see that GDPs in the U.S., Europe and Japan have not reached pre-recession levels, but GDPs in the non-Japan Asian economies of China, India, Korea and Taiwan have fully recovered, and now far exceed pre-recession levels.

While inflation is not a significant issue in the major developed economies, where sluggish economic growth is more of a concern, it has been a growing concern in non-Japan Asia, where central banks must now focus on price stability. In this context, we examine the inflation risks in these economies by looking at the drivers of inflation.

Inflation on the Rise In the first quarter of 2010, GDP grew 12.0% year-over-year in China, 8.6% in India, 13.4% in Taiwan and 8.1% in Korea, driven mainly by soaring exports and strengthening domestic demand. While economic growth has accelerated in these countries, it has been accompanied by rising inflation.

Chart 2b summarizes the patterns of consumer price inflation in China, India, Korea and Taiwan. As shown in the chart, consumer inflation appears to have risen sharply in India, although it has eased somewhat recently, and is still trending up in China, while rising to a lesser extent in Korea and Taiwan.

In China (top line), consumer inflation fell significantly in 2008, with the actual price level declining in the second half of the year. But, since early 2009, it has been rising steadily and climbed to a 21-month high in May. Meanwhile, producer price

Chart 2a: Gross Domestic Product (Q3 2008=100)

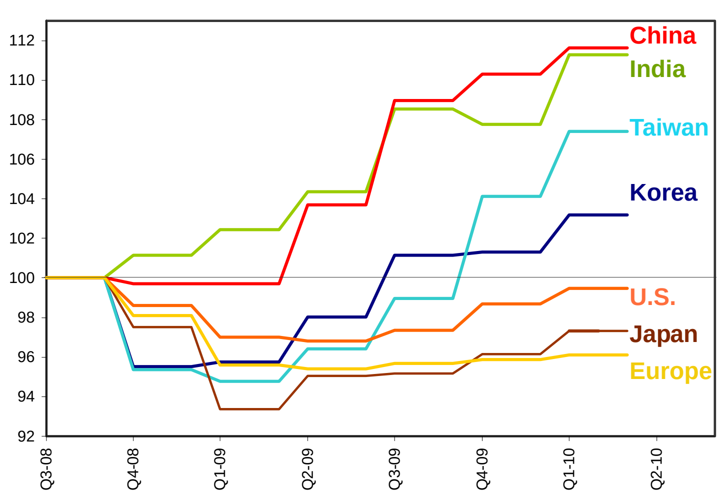
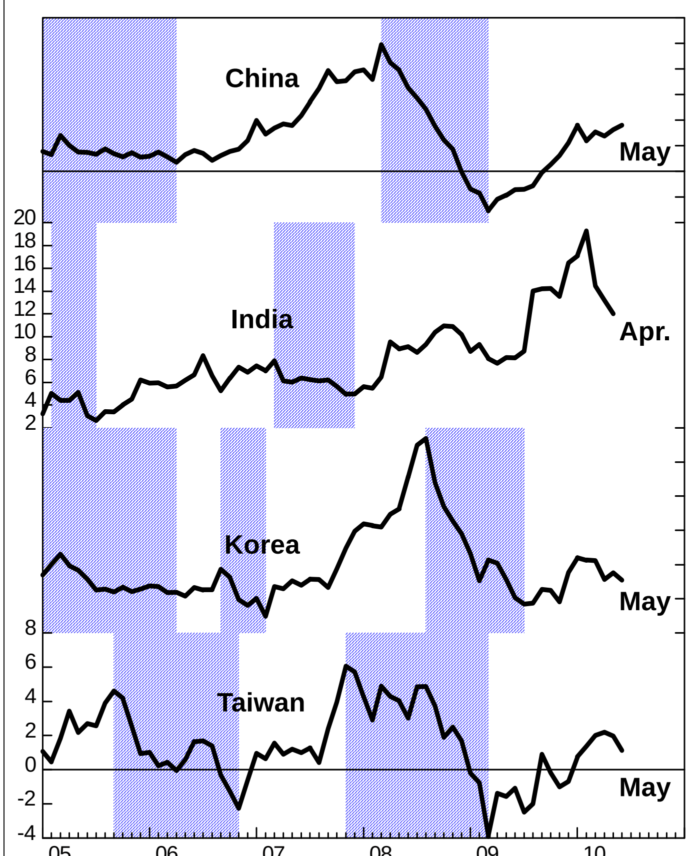


Chart 2b: Consumer Price Indexes, Growth Rates (%)



Shaded areas represent cyclical downturns in the inflation rate in the respective economies.

Chart 2c: Chinese CPI in Major Groups, Growth Rates (%)

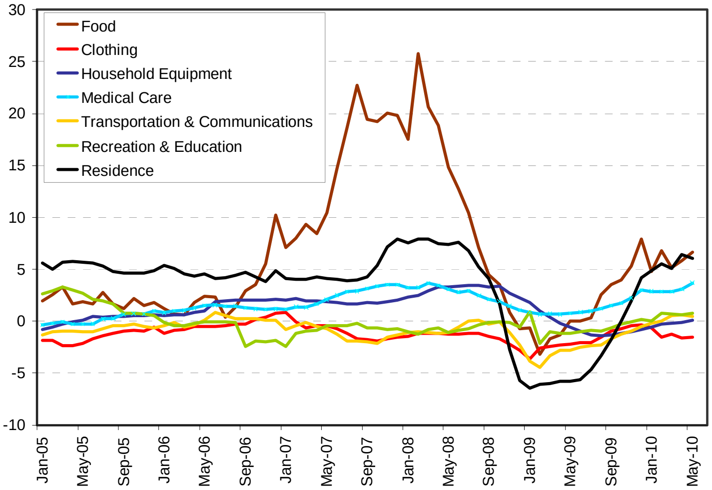
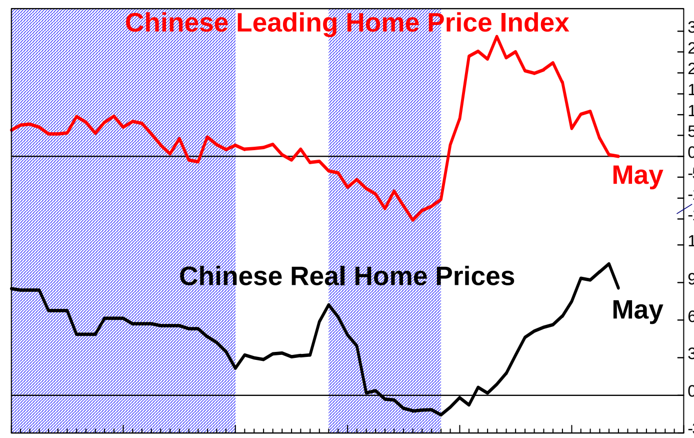


Chart 2d: Chinese Leading Home Price Index and Real Home Prices, Growth Rates (%)



Shaded areas represent cyclical downturns in the growth rate of Chinese real home prices.

inflation soared to 7.1%. Such readings have stoked concerns that China might hike interest rates to cool the overheating economy.

In India's case (second line), inflation is an even bigger concern than in China. After some moderation in late 2008 and early 2009, consumer price inflation skyrocketed to 19% in January. It has eased in recent months, but remains in double digits at 10% in April. This has increased the probability that the Reserve Bank of India will act to rein in inflation before the scheduled monetary policy review next month.

Consumer price inflation in Korea (third line), despite some easing in recent months, is a bit above its recent low, but remains in the target range of 2% to 4% set by the Bank of Korea. In Taiwan (bottom line), inflation declined significantly in 2008, with the actual level of consumer prices declining in 2009. Deflation risks have receded in Taiwan since then, with the inflation rate rising steadily through early 2010, and remaining in a cyclical uptrend.

Drivers of Inflation In order to understand what is fueling the rise in consumer price inflation in non-Japan Asia, we examine the CPI breakdowns for these economies. In China (Chart 2c), the rise in price inflation appears quite broadbased, with a notable price increase in food items, mainly grains and vegetables, which rose over 10% and 20%, respectively, in their recent readings. Meanwhile, home price inflation, clearly another important driver of China's overall inflation, has been soaring since late 2008. This surge in real home prices (Chart 2d, bottom line) has been driven in part by government stimulus spending aimed at helping the Chinese economy through the recent slowdown. However, with growth in ECRI's Chinese Leading Home Price Index remaining in a clear cyclical downturn (Chart 2d, top line), the pace of home price inflation is likely to moderate in the months ahead.

Meanwhile, as Chart 2e shows, India's high inflation has also been the result of increases in food and housing costs. Although food price inflation has eased recently, price increases in specific food groupings are still hovering at around 20%, except for vegetables and fruits.

While overall consumer price inflation remains modest in Korea (Chart 2f), price increases are notable in food (mainly in fresh vegetables and fruits) and the transportation sector (mainly in fuels for transport equipment). To a lesser extent, prices in the housing, water and fuels sector have risen, driven mainly by gas and fuels. In fact, with the Korean Future Inflation

Chart 2e: Indian CPI in Major Groups, Growth Rates (%)

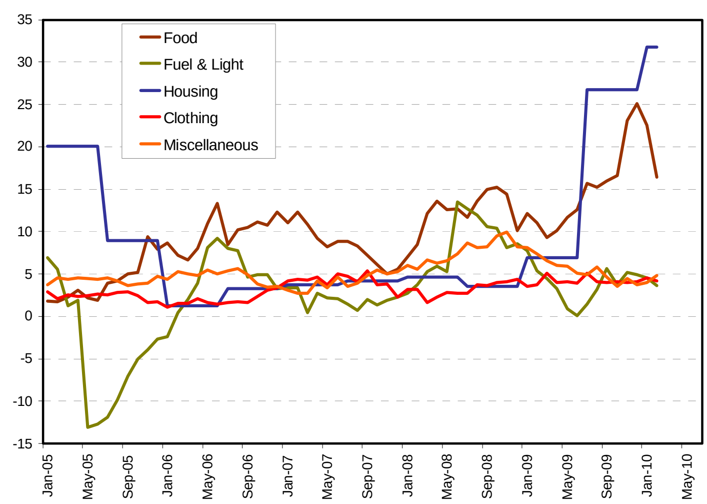


Chart 2f: Korean CPI in Major Groups,
Growth Rates (%)

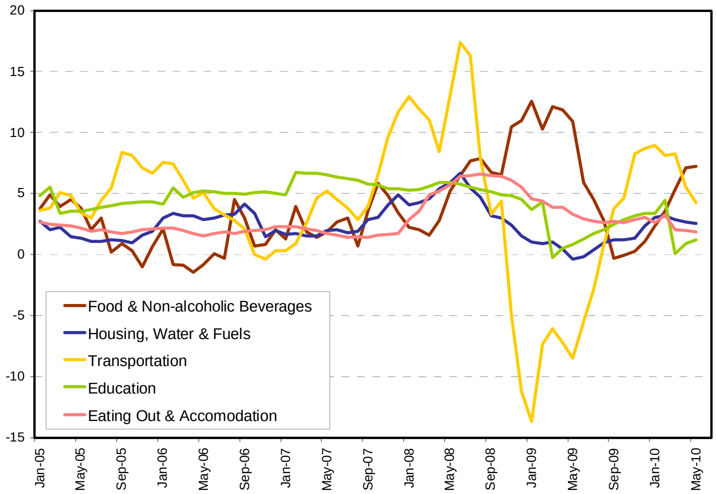
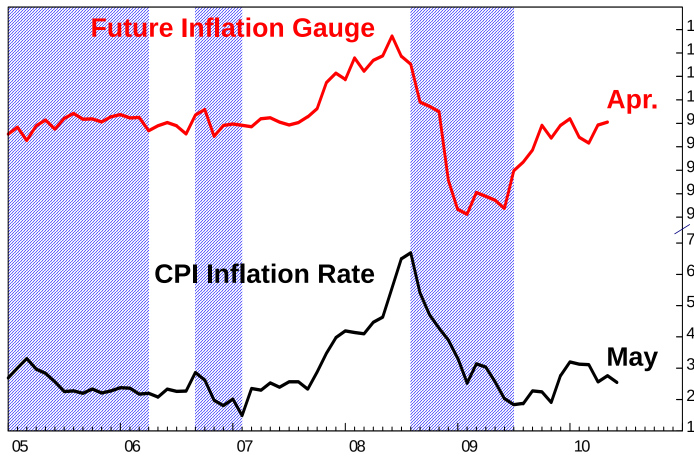


Chart 2g: Korean Future Inflation Gauge (1992=100)
and CPI Inflation Rate (%)



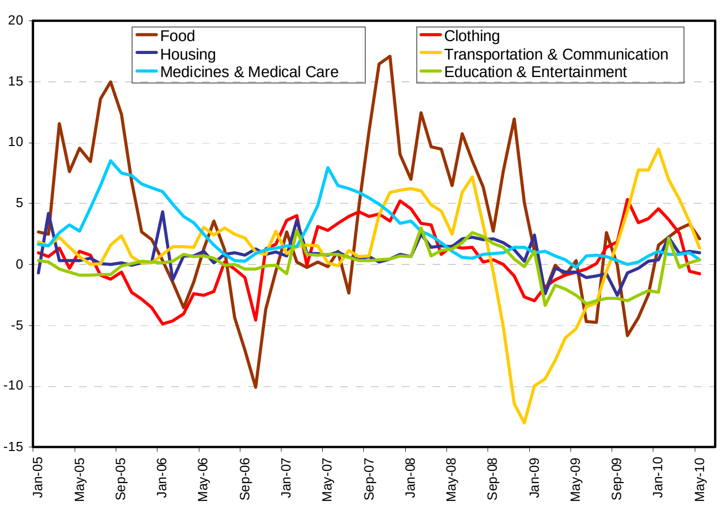
Shaded areas represent cyclical downturns in the Korean inflation rate.

Gauge remaining in an upswing, inflation pressures in Korea remain fairly elevated (Chart 2g), suggesting that Korean inflation will continue to trend up in the months ahead.

Finally, in Taiwan's case (Chart 2h), much of the modest increase in Taiwanese inflation has been driven by food (mainly in fruits and vegetables), transportation and communication (mainly in oil and gas), and housing.

In sum, food is the key driving force of inflation in all four countries, while rising home price inflation is a major factor in China, India and Taiwan. Fuel is a significant driver of overall inflation in Korea and Taiwan.

Chart 2h: Taiwanese CPI in Major Groups,
Growth Rates (%)



Implications of Current Inflation Trends The above analysis reveals that in China and India, which have experienced a steady rise in consumer inflation, food price inflation appears to be one of the main culprits, as food accounts for roughly a third and almost half, respectively, of overall CPI. In contrast, food items make up only 13% of the CPI basket in Korea.

As we discussed in this publication in the context of the Katona effect (↗*Vol. III, No. 9, September 1998*), increased price volatility, especially when driven by food and energy, can have a pronounced effect on consumer spending growth. As both food and energy expenditures are non-discretionary, their price volatility tends to induce consumers to save more in such an uncertain price environment, squeezing discretionary spending budgets.

Furthermore, rising food prices can put significant upward pressure on wages, boosting international inflation through higher export prices. For example, in China, average earnings are on the rise, up 13.1% from a year ago in the first quarter of 2010. According to one study, minimum wages in Shanghai are $141 a month, compared with $77 in Mumbai and $74 in Hanoi. Thus, in the lower-end export industries, China is in the process of losing the competitive wage advantage it had previously.

But China has already started taking measures to combat inflation. While interest rates have been held steady, the People's Bank of China (PBC) raised reserve requirements three times this year to 17% at present. Also, the PBC decided this week to let its currency, which had been pegged to the dollar since July 2008, trade more freely. In addition, in an effort to cool the overheating real estate market, the Chinese government has introduced multiple measures, including curbs on loans for third-home buyers and higher down-payment requirements for second-home purchases.

Meanwhile, in India, hoping to tamp down inflation without stalling the economic recovery, the Reserve Bank of India has increased the banks' cash reserve ratio and the repo rate twice so far this year.

The Bank of Korea (BoK) has kept its benchmark interest rate unchanged at 2% so far. However, the continuing economic recovery has spurred a shift in the BoK's stance on the inflation danger, inducing them to signal a rate hike as early as July. On Thursday, Taiwan's central bank unexpectedly raised its key interest rate from a record low. This was its first rate hike in two years.

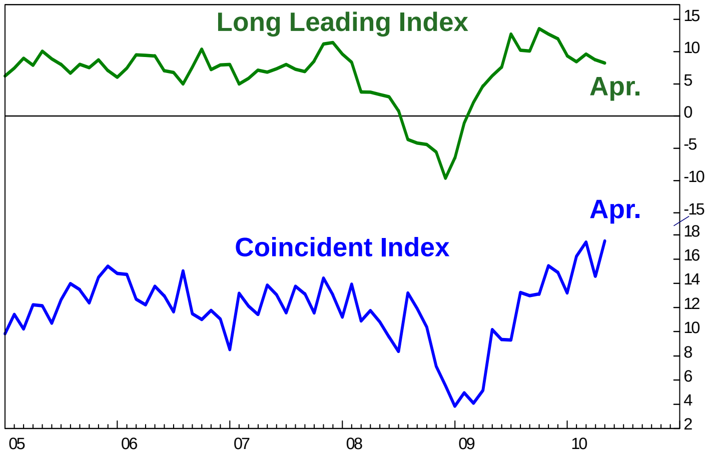
In sum, while inflation is a non-issue in the major developed economies, it is a serious concern in much of non-Japan Asia. Specifically, rising food and energy price inflation could put a severe strain on consumers in China and India, where food accounts for a large chunk of the overall consumer basket, while putting upward pressure on export prices through wage inflation. Consumer price inflation in Korea and Taiwan is likely to be more affected by global economic growth than inflation in food, which is a much smaller part of the consumption basket than in China and India.

While current economic growth in these non-Japan Asian economies remains resilient, what few realize is that it is likely to throttle back. As shown in Chart 2i, the growth rate of the Four-Country Coincident Index (bottom line) covering China, India, Korea and Taiwan, has surged, and remains in a strong cyclical upswing. However, growth in the Asia-Pacific Four-Country Long Leading Index has declined considerably since last fall, and is in a clear cyclical downturn (top line). In other words, Asian economic growth, although still in an uptrend, is likely to start easing, at a time when inflation concerns are inducing policy makers to tighten policy.

The challenge now for these central banks relates to policy timing, as they try to balance growth and inflation. In this context, it is important to monitor ECRI's array of leading and coincident indexes of growth and inflation for these economies for early clues to their likely course.

In the major developed economies, there will be no letup in the pressures to maintain accommodative policies for an extended period of time. Meanwhile, in

Chart 2i: Asia-Pacific Four-Country Long Leading and Coincident Indexes, Growth Rates (%)



non-Japan Asia, the major pressures will be to tighten policy. It is against this backdrop that the global shifts in exchange rates and economic power are set to unfold in the foreseeable future. ■

