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The Right Response in Latin America to Oil and Food Price Pressures: Fight Inflation Now!

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ABSTRACT

Recent inflationary pressures, especially from oil and food, have clouded the very positive outlook experienced by Latin America since 2004. Although the global sharp increase of oil and food is a worldwide problem, an effective management of inflation is central to Latin America's capacity to continue on its path of growth and stability. There are two reasons: First, with a reputation for high and hyper-inflation from the 1980s and 1990s, the region's central banks are being challenged to prove that, this time around, they will do the job right. Second, facing a growing social discontent with the result of democracy and market-based institutions, dealing with oil and food inflation becomes all the more crucial for sustaining the economic and democratic successes achieved so far.

This essay argues that, although the upward trend in the price of oil and food responds to structural factors, the recent acceleration in these prices is mostly a monetary phenomenon associated with the emergence and management of the international financial crisis in industrial countries that started with the U.S. sub-prime crisis in the spring of 2007. The prices of oil and food will continue above their long-term trend until the financial crisis is resolved. This is, of course, bad news for Latin American countries, which are being forced to deal with the effects of a crisis generated by industrial countries' policies and regulatory deficiencies.

For once, however, Latin America is better positioned to fight inflation than the United States. In contrast to the U.S., most countries in the region can increase interest rates without fearing that their financial system might collapse. But the time of action is now, when the problem is still controllable and concerns about the sustainability of recent gains in many countries are still not making headlines.

A potential silver lining from these developments is that current efforts toward improving the global financial regulatory framework may force industrial countries and international standards setting bodies—which to a large extent comprise multilateral organizations—include proper representation from developing countries. Not doing so would seriously compromise the sustainability of the development process.

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THE RIGHT RESPONSE IN LATIN AMERICA TO OIL AND FOOD PRICE PRESSURES: FIGHT INFLATION NOW!

Liliana Rojas-Suarez

Until a few months ago, Latin America seemed little affected by adverse financial developments in high-income countries, including the U.S. subprime crisis. Improved terms of trade and a combination of self-insurance policies (including ample foreign exchange reserves and sovereign debt buy-backs) decreased the region's vulnerability to turbulence in the international capital markets. Indeed, as recently as July the IMF forecast a healthy 4.5 percent annual growth in the region for this year, even as it forecast a decline in growth in the industrial countries (from 2.7 percent in 2007 to 1.7 percent in 2008).

More recently, however, emerging inflationary pressures, especially from oil and food, have sparked concern over the region's capacity to continue on the path of growth and financial stability. With the region's reputation for high and hyper-inflation in the 1980s and 1990s far from forgotten, Latin America's central banks are being challenged to prove to the region's citizens and the world that, this time around, they will do the job right. Memories of large losses in real wealth are still fresh for many people who lived through those difficult times. Indeed, the effects linger, as the recovery of the middle class from those inflation losses is far from complete in many countries in the region.

The global spike in the price of oil and food is hurting the poor the most. While this is true worldwide, in Latin America this effect is mixed with a growing social discontent with the results of democracy and market-based approaches to development. In this context, dealing with oil and food inflation becomes all the more crucial for sustaining the economic and democratic successes achieved thus far.

What is the right policy response from policymakers in Latin America? And what, if anything, can well-intentioned policymakers outside the region, including the senior management of the international financial institutions, do to help?

In this essay I argue that the sudden global *acceleration* in food and fuel prices is the result of global excess liquidity associated with the financial crisis in industrial countries (especially in the United States) and the depreciation of the U.S. dollar. I further argue that Latin American policymakers can overcome this inflationary challenge through hikes in interest rates and allowing the region's currencies to further appreciate against the dollar—if they act decisively now. Policymakers can make these potentially unpopular policies tolerable by providing targeted support to those who need it most.

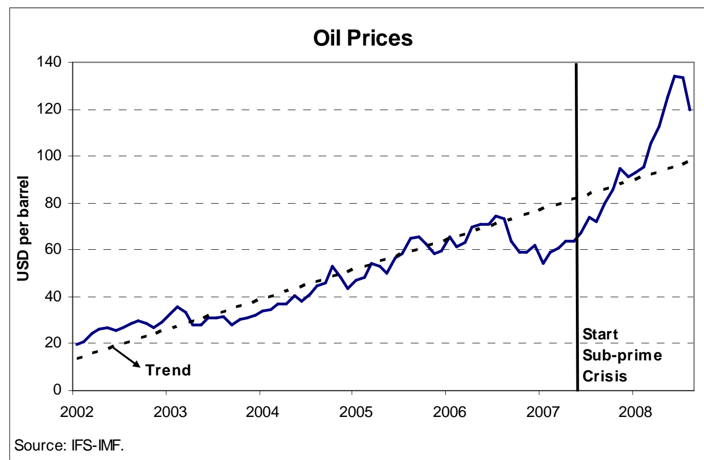
At the same time, Latin America and other developing regions should insist upon having a greater voice in shaping global financial regulations. Just as the current (inadequate) state of financial regulation in industrial countries is having an effect on developing countries, so will any new regulations that may be devised in response to the crisis. I close with specific suggestions for how the international financial organizations, particularly the Inter-American Development Bank (IDB), can accelerate the important process of giving Latin America a greater voice in the international financial architecture debate.

Why the sudden jump in food and oil prices?

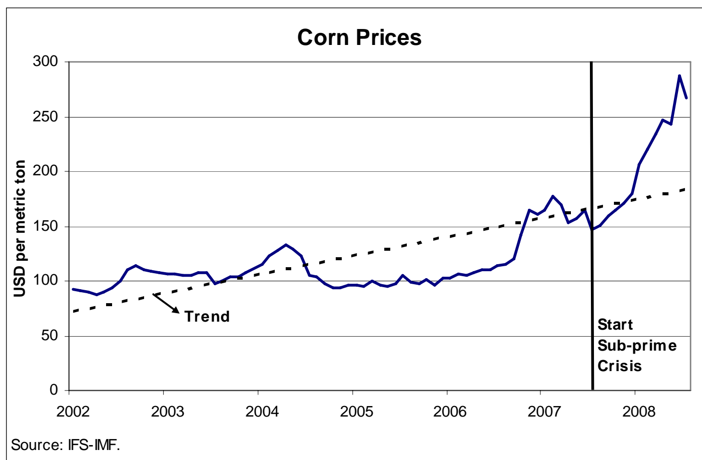
Let's start with food. Many analysts believe that the global jump in food prices is due mostly to structural factors: increased demand in big emerging market economies, such as China and India; a shift in land-use from food crops to biofuels; and droughts and floods associated with climate change. If this is true, then we are witnessing an increase in the *relative price* of food (relative to other goods and services). It would follow that there is not much of a role for monetary policy, which acts on the *overall* price level and has little effect on *relative* prices. Indeed, if this is the case, we should expect the current increase in inflation to be a temporary phenomenon, lasting just as long as is needed to bring the price of food to its new (higher) equilibrium level.

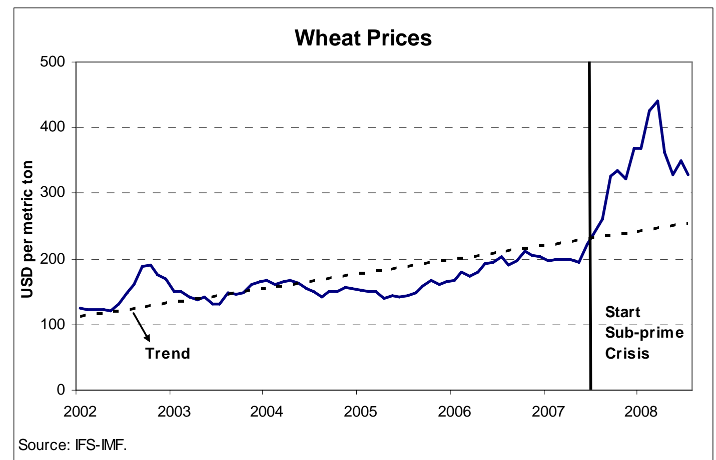
I think this understanding of the causes of the food price misses crucial elements. In May, the Latin America Shadow Financial Regulatory Committee (CLAAF is the Spanish acronym), which I chair, met at the Center for Global Development and produced a statement offering an alternative view (see www.claaf.org statement No. 18). While recognizing the role that structural factors are playing in the observed *trend* in the price of food, CLAAF argues that the recent *acceleration of these prices* (since the summer of 2007) has its origins in *monetary* factors associated with the financial crisis in industrial countries (especially in the United States) and the depreciation of the U.S. dollar. In other words, the recent sharp *jump* in food prices is part of the same phenomenon that started with the U.S. subprime crisis, the acceleration in the loss of value of the U.S. dollar, and the sharp increase in the price of oil.

The following charts, which show the recent behavior of the price of oil and the price of two important food commodities, corn and wheat, help to illustrate this point. In each chart the solid line displays the actual price and the dotted line is an estimated trend.



Source: IFS-IMF.





As the graph shows, before the eruption of the U.S. subprime crisis, there was an upward trend in the price of oil and food, reflecting the structural factors described above. However, the *jump* in prices of these commodities coincides with the period surrounding the financial difficulties in the United States and the sharp depreciation of the U.S. dollar.

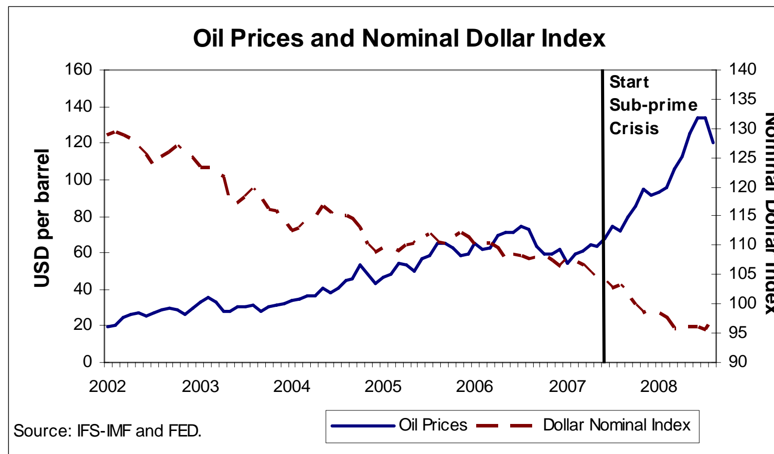
How are these events connected? The core of the argument is that an already loose monetary policy in the United States before the subprime crisis (as reflected by low interest rates) was exacerbated by the response to the financial crisis from the U.S. Federal Reserve, which began to absorb a broader range of assets in exchange for liquidity. As reported in Calvo (2008), the money supply aggregate, M2, accelerated by an annualized rate of around 10 percent in the first quarter of 2008. If Treasury Bills are included as part of liquidity, the expansion is even larger. But the excess liquidity in the United States has been generated not only by the increase in the rate of growth of money *supply*, but also by a decline in the *demand* for U.S.-dollar liquidity resulting from the activities of Sovereign Wealth Funds (SWF). In their search for higher returns, SWFs have been switching away from liquidity in favor of other less-liquid assets such as equity and commodities.

Excess supply of dollar liquidity has resulted in a depreciation of the U.S. dollar and has fueled inflationary pressures. Moreover, since investors react to *expectations*, the worsening of the U.S. financial crisis (to be further discussed below) and the perception that further liquidity injections will follow are keeping *expected inflation* high and the value of the dollar low.[1]

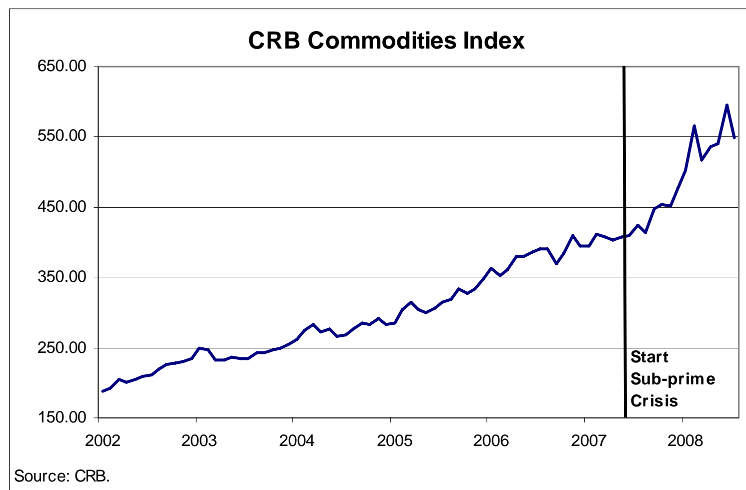
Why are inflationary pressures being reflected in the price of oil and food? The answer in the case of oil is well-known. Oil (and other minerals such as gold) has traditionally been used by investors as a hedge against losses in the value of the dollar.

[1] Although, in the last few weeks, the U.S. dollar has appreciated somehow relative to the Euro (due to a deterioration in economic and financial conditions in Europe), forward markets predict further depreciation of the U.S. dollar relative to the Yen and other Asian currencies.

The ongoing sharp depreciation of the U.S. dollar then goes hand in hand with the increase in the price of oil.



But, why are food prices accelerating too? The truth is that *all types of commodities* (oil, gas, industrial metals, precious metals, and agriculture!) are experiencing sharp increases in prices. Food is making the headlines because of its deep social impact. But with the current financial distress and expectations of a continuation of the expansionary monetary policy, inflation is being reflected in those goods with the highest price flexibility: commodity prices.



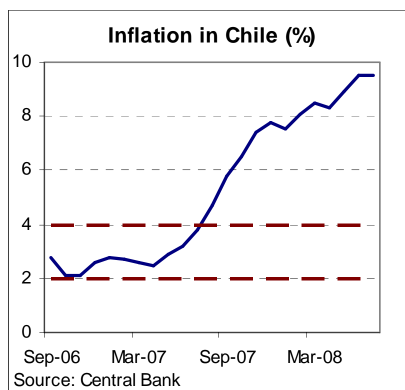
Ironically, countries' concerns about the impact of high food prices on the poor have led some governments (including some in Latin America) to impose policies that further curtail the global net supply of food. I am talking, of course, of export taxes, export quotas, and bans.

Recession fears in the United States contain and delay the pass-through from a loose monetary stance to the Consumer Price Index
Inflation in the United States so far has been largely contained to oil and food because the adjustment to the financial crisis has also entailed a slowdown in economic activity and an increase in unemployment. Under these conditions, pressures for labor cost increases have remained subdued. Thus, rather than a generalized price inflation, commodity inflation is currently absorbing excess liquidity in the United States.

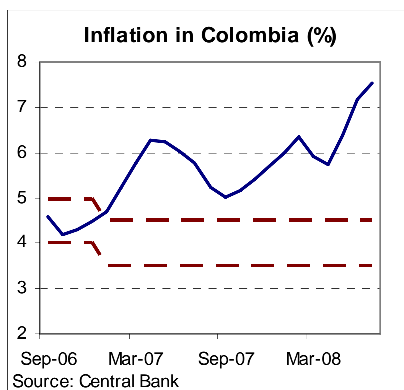
So, to bring everything together: in the early 2000s, structural factors affecting the demand and supply of oil and food have resulted in an upward trend in the prices of these commodities. The financial crisis that started in the summer of 2007 brought about excess liquidity, diminished confidence in the U.S. dollar and accelerated the inflationary pressures that have been reflected in goods with the most flexible prices. Bans on food exports and other controls on food have only exacerbated the increase in the price of this commodity. In the United States, a rise in the unemployment rate has, so far, contained the pass-through of a loose monetary policy to wage inflation.

What is next?
The short- to medium-term, as I see it, is not very promising. Very recent events are signaling that the financial crisis is not only far from being resolved, it is also expanding to a wider set of institutions. The failure of IndyMac Bank, and several other small banks, is a scary example. The troubles with Fannie Mae and Freddy Mac are even scarier in that their resolution might entail policies that will further weaken the dollar, leading to a further reduction in the demand for the U.S. currency and reinforcing inflationary pressures. At the top of the policy agenda are (1) a significant additional injection of liquidity by the Fed, and (2) a considerable increase in the fiscal deficit if resources are used to rescue/restructure Fannie Mae and Freddie Mac and/or increase the capital of the Federal Deposit Insurance Corporation (FDIC), if further use of the federal deposit insurance is needed to deal with troubled banks. In the midst of this financial uncertainty, the talk of the day points to an increased probability of further economic slowdown and increased inflation. Whether stagflation (the combination of recession and higher inflation) will materialize is certainly unknown.

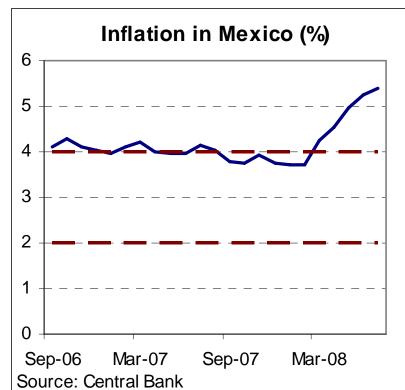
What is happening in Latin America?
In contrast to industrialized countries, where the economic slowdown is delaying the pass-through effect from oil and food inflation into the consumer price index (CPI), the buoyant economic growth of the region in recent years is resulting in a rapid increase in CPI inflation. Indeed, many countries in Latin America are missing their inflation targets. The graphs below show this for Chile, Colombia, and Mexico; the solid lines indicate the recent evolution of inflation, while the dotted lines show the "inflation target band."



Source: Central Bank



Source: Central Bank



Source: Central Bank

Since 2007 in Chile and Colombia, and since early 2008 in Mexico, inflation has surpassed its target and a correction is not yet in sight. This trend is also evident in most other countries in the region.

For Latin America, the right way to go is a strong fight against inflation

For the first time in many years, Latin America is in a good position to fight inflation. This time around, many countries have the right tools: flexible exchange rate systems and the possibility of raising interest rates without the concern of weakening the banking system. Indeed, in contrast to many other past episodes when the region faced severe external shocks, a number of countries can now allow their domestic currencies to appreciate in order to neutralize, to a large extent, the *imported* content of food and energy price increases.

The response so far, although headed in the right direction, has been too timid. Many countries are not letting the exchange rate appreciate as much as needed, nor are they increasing interest rates as much as required under the current circumstances. The obvious reason is that these corrective policies will slow the economy. Facing significant discontent from large segments of the population, governments fear that an economic slowdown will stir social unrest and undermine political support.

While these concerns are justified, the optimal policy choice in Latin America is clear: fight inflation and offer protection to the poor. Carefully designed and focalized programs (ensuring adequate transfers to targeted populations), rather than distortionary subsidies and price controls, is the way to go. Many countries in the region have sufficient expertise and resources to expand and deepen these types of programs and to adequately account for them in the fiscal budget. For those countries where expertise is lacking, the multilateral organizations are more than happy to help.

But the fight against inflation needs to speed up now, while the problem is still controllable and while concerns about the sustainability of recent gains have yet to make headlines.

Latin America, at least, can increase interest rates without the fear of an imminent recession. That is a luxury that the United States cannot afford.

A parting thought: global financial regulation needs to incorporate developing countries' concerns

Nobody knows how the current international financial crisis will end and how much it will cost in terms of lost output. But one thing is certain: the financial turmoil generated in the United States and other industrial nations is adversely affecting the development efforts of many countries in the world. Latin America is not an exception. This time around, the need for macro-policy adjustment, and the slowdown in economic growth that it will entail, is not the result of unsustainable fiscal deficits or uncontrolled monetary expansion in the region. The source of the problem lies in important macro/financial deficiencies in industrial countries, particularly the United States. The current debate on how to reform financial sector regulation reflects an acknowledgement

by financial sector authorities and supervisors in industrial countries that *doing business as usual* is no longer acceptable.

Just as the current (inadequate) state of financial regulation in industrial countries is having an effect on developing countries, so will any new regulations that may be devised in response to the crisis. Surely developing countries deserve a voice in the intensifying debate about appropriate financial regulation in a globalized world.

A few years ago, I argued in a CGD working paper (Rojas-Suarez, 2005) that certain key international financial regulations could actually destabilize financial markets in developing countries. In particular, I had (and still have) serious concerns about capital adequacy requirements as recommended in both Basel I and Basel II. As in many crisis episodes, the current one is providing an opportunity for change and reform. This time around, industrial countries and international standards setting bodies, which include multilateral organizations such as the Basel Committee on Banking Supervision, the IMF and the World Bank, should take advantage of the opportunity to adequately include proper representation from developing countries in improving the global regulatory framework. From my point of view, that would be a huge contribution to the sustainability of the development process.

Finally, current events call for an active role for the Inter-American Development Bank (IDB). In a report produced by the Latin American Shadow Financial Regulatory Committee (CLAAF), in collaboration with CGD (the CLAAF-CGD Report) we recommended that the president of the IDB take a clear economic position on global issues affecting Latin America. These recommendations are more germane now then ever before. In particular, we urged that the IDB president "formally request that the IDB become a full member of the International Monetary and Financial Committee and the World Bank Development Committee" (CLAAF-CGD, 2006, p. 11). We also proposed that the IDB should participate in other relevant discussions, be those at the Bank for International Settlements, the Basel Committee, the Financial Stability Forum, or in G-8 and G-20 discussions of the international financial architecture. Further, we called for the president and staff of the IDB to provide an independent view that reflects the interests of Latin American and Caribbean countries in order to mitigate the risks of contagion and attain a more stable financial environment. I cannot think of a better opportunity to implement these important recommendations.

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