

Policy Options for Addressing Inflationary Shocks

Arvind Subramanian

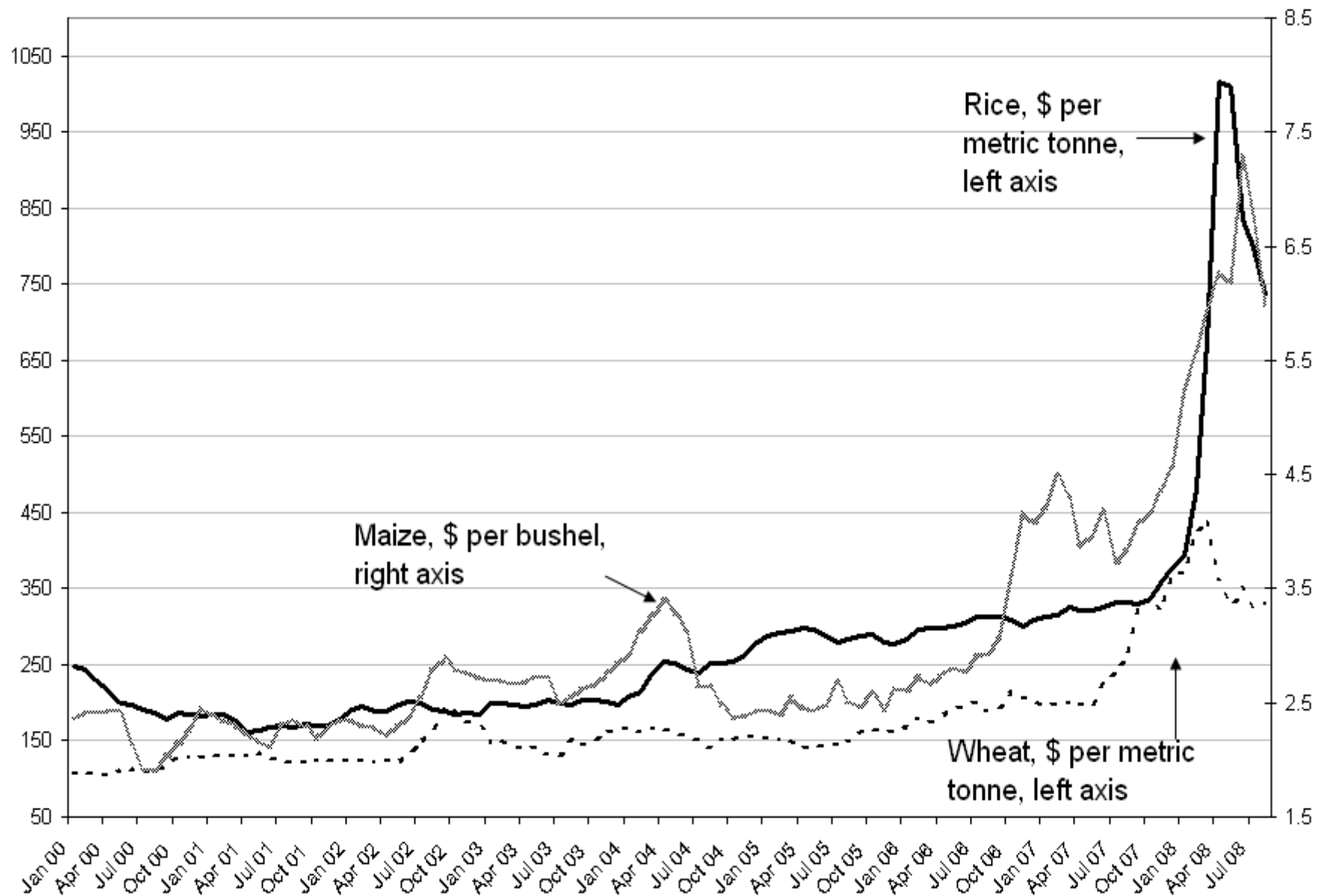
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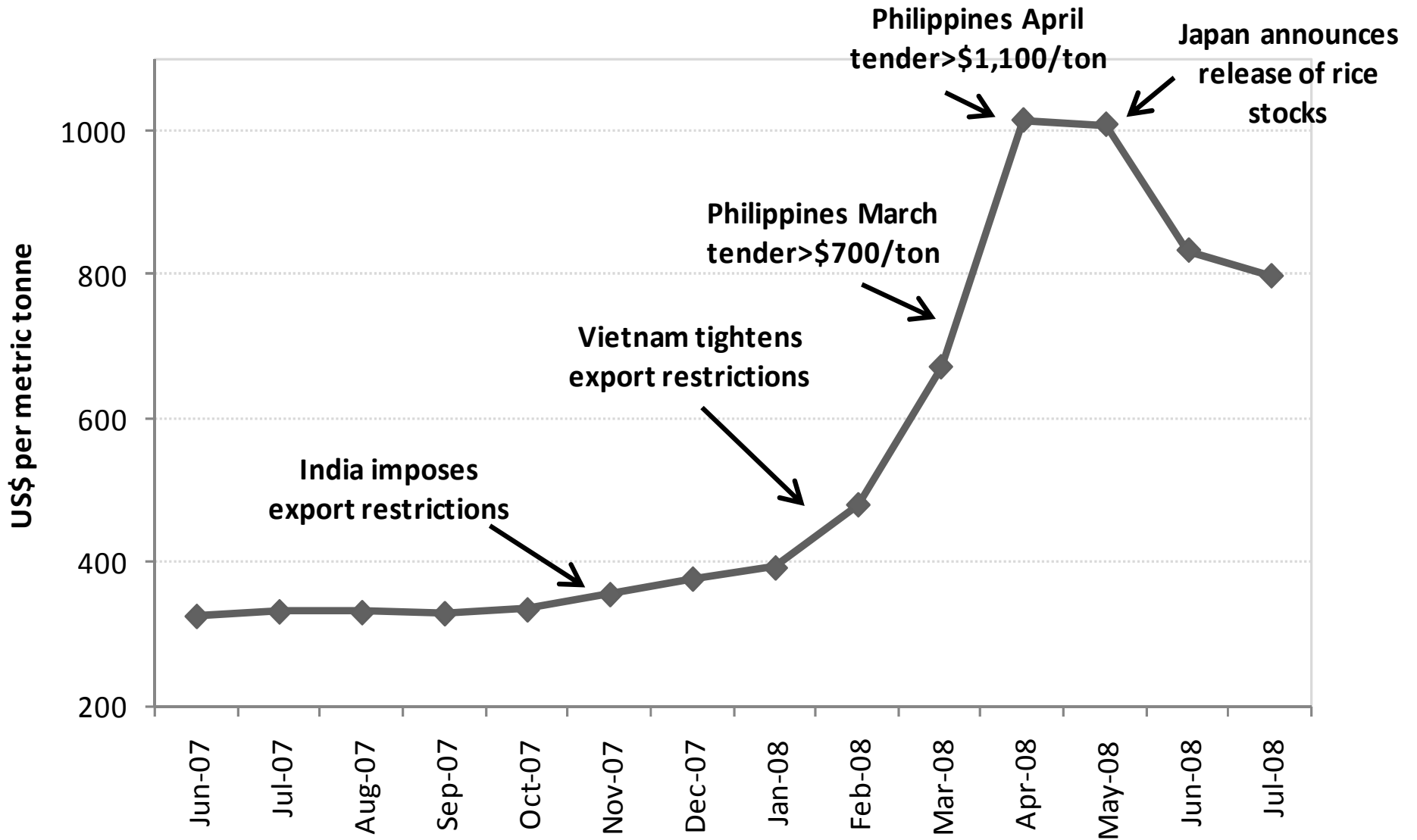
Origins

- Global demand shocks:
 - Growth in large emerging markets (China, India)
 - Savings glut plus loose monetary policies
- Global supply shocks (Agriculture)
 - Global warming
 - Declining agricultural productivity
 - Oil prices
- Global supply shocks (Oil):
 - Rising cost of extraction
- Policy shocks
 - Export restrictions
 - Biofuels policies in US (and EU)
- Short term factors
 - Speculation/exchange rates

Chart. Prices of Three Major Commodities, Jan. 2000-Aug 2008



Impact of Policies



National Responses

- How important is inflation?
 - Political comfort zone
 - Societal impact/distributional consequences
- What are other objectives?
 - Growth
 - Financial stability
- What policy instrument set is available and feasible?
 - Macroeconomic, microeconomic, and social
- What international response is forthcoming?
 - Aid/financing

National Responses--Microeconomic

- Aim and logic of micro-actions: Controlling price levels and levels of selected commodities
- Policies: Price controls (energy)
 - Impairs efficiency, creates fiscal costs (“automatic stabilizers”), and is usually regressive
- Import liberalization, domestic tax reduction
 - Fiscal costs and change incentives
- Export restrictions
 - Second-best because producer incentives affected and implicit consumer subsidies available to all consumers (not targeted)
 - As temporary measure can work for one country but not all
- Targeted transfers: Social safety nets

National Responses--Macroeconomic

- Aim and logic of macro-actions: Controlling rate of change of general prices
- Do nothing: Allow higher inflation
 - Especially if cause is an external supply shock
- First round and second round effects
 - Do price increases pass through to wages?
 - Is there inflation-fighting credibility?
- Tighten monetary policies/allow exchange rate appreciation
 - Exchange rate regime-fixed or floating
- Tighten fiscal policies
 - Is there fiscal space (debt sustainability)
 - Can it be timely and targeted?
 - In energy economies
- Systemic response: Inflation targeting (IT)?
 - Requirements for IT: flexible exchange rate, no fiscal dominance

International Responses

- Need for multilateral action on export and import policies
 - Imposing restrictions could work for one country but not all
 - WTO rules deal with import side not exports
- Biofuels policies in US and EU
 - Eliminating tariffs on sugar-based ethanol
- R&D on agricultural research
 - Funding key and undersupplied public good
 - Example of green revolution

Conclusion

- For small economies, policy options will be tough and geared to country circumstances
- Inflation is a macroeconomic phenomenon, requiring macroeconomic instruments (monetary, exchange rates, and fiscal policies)
- Microeconomic instruments will be inferior and adversely affect incentives
- Targeted transfers can help avoid inefficient microeconomic policies