

Inflation Annex

Inflation has fallen in the past year, on average, in both high-income OECD and developing countries. Inflation has declined rapidly in most of the high-income countries, while outcomes have been more varied in developing countries that nevertheless show an overall, declining trend.

OECD: rapid demand-altering effects (fuels); lack of pass-through. Inflation is falling in the developed world. From April to November 2011, headline inflation in the G-5 countries dipped by nearly 2 percentage points (figure INF.1), while the earlier, rapid pass through of headline inflation to so-called “core prices” (which exclude food and fuels) appears to be abating (figure INF.2).¹ Among the G-5 countries, the United States and Germany achieved the largest decline (2 pts) in headline inflation since the first quarter of 2011; and other Euro Area countries have seen a substantial falloff of about 1.5 points, accentuated by the onset of sluggish growth there and a still fairly-strong euro to that time. Japan’s initial low levels of inflation mean its delta in consumer prices is small. Still, the shift to deflation in Japan is reflective of the slow-build-up in

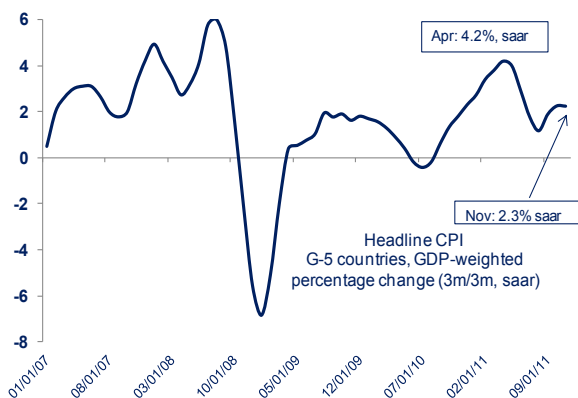
activity since the Tohoku disaster of March 2011.

The decline in inflation has been driven by real- and financial aftereffects of the first financial crisis, and importantly by related developments in commodity markets. Producers and exporters of electronics and machinery have offered substantial price discounts linked to the massive buildup of inventories during the global growth downturn of 2009. This latter effect echoes the increasing importance of global factors, particularly the expansion of manufacturing production in East Asia, in determining inflation in the rich countries.²

Moreover, commodity price shocks have had a major, sustained impact on inflation during this period among the industrialized economies. In particular, international oil prices surged to near-record highs following the cut-off of Libyan crude oil in 2011, driving both increases in fuels prices and in food prices, the latter due to higher transport costs, increased prices for fertilizers, and reduced supply--as biofuel mandates shifted land usage towards the production of ethanol.³

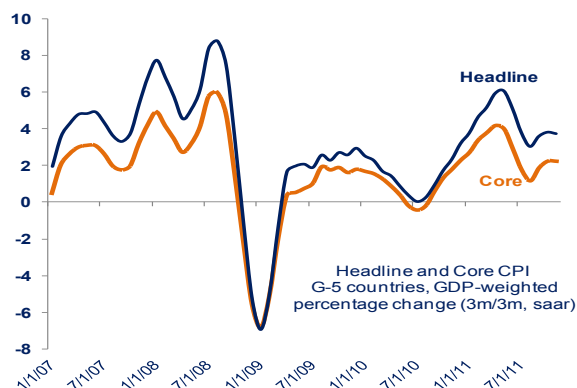
The direct effects of the hike in oil prices are seen quickly at the petrol pump. Demand for fuels softens with some lag, but also with

Figure INF.1 G-5 headline CPI drops nearly 2 points November vs April 2011



Source: Thomson-Reuters Datastream; World Bank.

Figure INF.2 Core picked up in recent recovery--but gap has widened recently



Source: Reuters-Thomson Datastream; World Bank.

substantial weight, with a shift toward e.g. public transport, improved efficiency automobiles, or “self-propelled” modes to getting places. But in contrast with conditions in developing countries, the co-rise in foods prices has smaller overall effects, given its diminished share in the OECD consumption basket. Typically, subdued inflation during a period of high unemployment should allow authorities some room for expansionary policies. However, as OECD inflation moves quickly in a broader direction toward zero (indeed the momentum of producer prices is now negative for the G-3 countries) and governments are beset by high debt burdens, authorities’ ability to undertake expansionary policies has become more limited. Further reductions in demand as consumers begin to expect lower prices in the future (as may be happening in Japan) could possibly undercut hopes for a revival of economic activity.

Developing countries: hysteresis and vulnerabilities. As is widely recognized, rising food prices contribute more to inflation in developing than in advanced economies, because food’s share of the consumption basket in the former tends to be much larger than in the latter. For example, food accounts for 15 percent of the U.S. (CPI) basket but 50 percent of the consumption basket of the Philippines. Moreover, there is evidence to suggest that there is a more significant pass-through of food prices to non-food prices in developing countries compared with OECD economies--where there is almost none. An example of this possible transmission mechanism is higher food prices triggering protests for higher wages across Northern Africa, elsewhere in Africa, and the Middle East during 2007-08.⁴

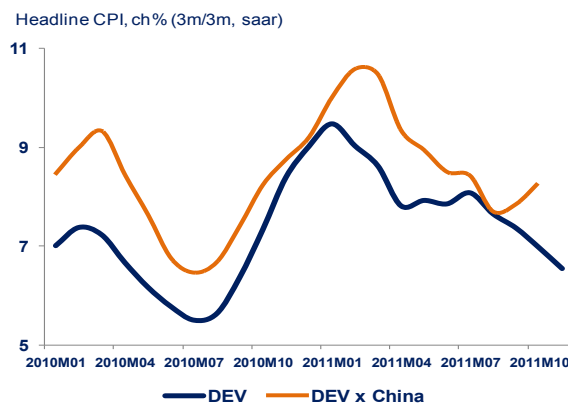
Roundup of inflation trends across developing regions

For developing countries as a group, headline inflation rates have eased at a somewhat slower pace than for the advanced economies, falling by 3 percentage points since the start of 2011 and 1.3 percentage points from April through November (figure INF.3). The decline is moderately less if China is excluded from the

group: while inflation in China in the first quarter was well below the average 10 percent rate in other developing countries, since then inflation in many countries has fallen sharply, but in China these have fallen more rapidly still—a reversal of recent price trends for the developing world. Easing price pressures in most developing countries should serve to boost domestic demand (over time), as well as provide additional headroom for staving off more severe effects of potential global economic difficulties ahead (for example with real interest rates now rising, monetary authorities could opt to cut nominal rates further).

- In East Asia and the Pacific, easing inflation is now the watchword in the wake of a period when higher Chinese inflation was “holding up” the index at higher levels. For China, the ASEAN countries and others in the region, underlying momentum in headline CPI is now diminishing: China to 2.8 percent over the three months to November (saar); for countries excluding China to 4 percent. The increase in the East Asian CPI reached a recent peak of 8 percent in January 2011 under increasing food and fuel price pressures, as well as still strong domestic demand, and is now running at rate below 3 percent thanks to developments in China. With economic activity now anticipated to continue fairly strong, accompanied by lower commodity prices,

Figure INF.3 DEV inflation eased by 3 points since Jan 2011 to 6% by November



Source: : World Bank.

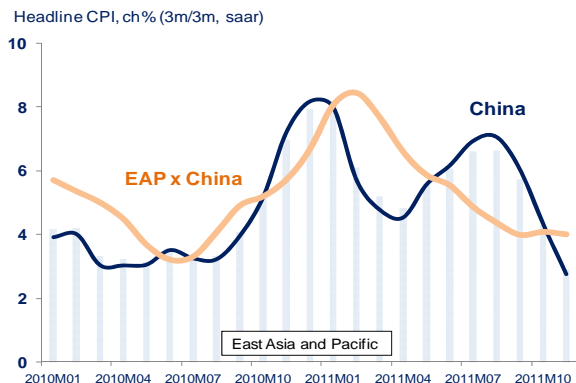
we may expect a continuing deflationary trend through 2012 at a minimum (figure INF.4).

- In Europe and Central Asia, Turkey is the outlier in this group of diverse economies, experiencing higher inflation (at 13.8% in November, saar) on the back of robust growth and recent reductions in interest rates. At the same time, inflation in Russia has eased rapidly from a 10 percent annualized pace in the first quarter of 2011 to 3.9 percent by October, but picked up in November, possibly reflecting ruble depreciation. Here, slowing growth and weaker oil prices have driven the sharp earlier fall in inflation. In the remainder of the region (Central Asian oil- and commodity exporters) inflation has trended down well into single digits essentially linked to similar developments in their larger neighbor, Russia. Regional inflation eased from 10.7 percent (saar) at end-2010 to a low of 7 percent in April, before returning to 9.6 percent by November 2011 (figure INF.5).
- In Latin America and the Caribbean, Brazilian inflation, which had been running at an overly-rapid 8 to 10 percent pace for most of 2011, eased to below 6 percent by August, owing to somewhat slower growth and determined monetary tightening (though

the Central Bank recently has cut rates). A moderate uptrend has set in during the fall months, carrying inflation above 6.8 percent by November, which is nonetheless expected to be short-lived, given anticipated step-down in economic growth. In similar fashion, Mexico's recent upturn is more likely than not to be temporary. Average inflation for the region now lies at 7.5 percent (owing to continued double-digit advances for both Argentina and Venezuela), albeit down from 9 percent in the first quarter of the year (figure INF.6).

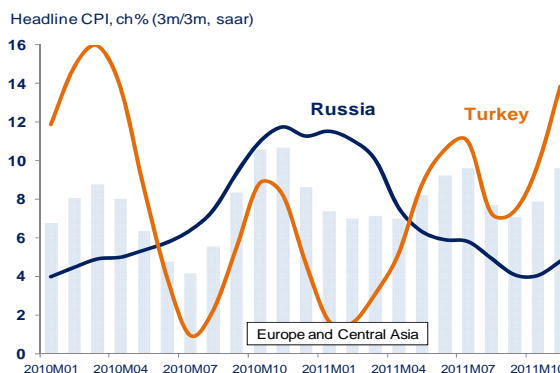
- In the Middle East and North Africa, higher food and oil prices, disruptions to economic

Figure INF.4 China shows sharp slowing of CPI momentum carrying East Asia & the Pacific to below 3%



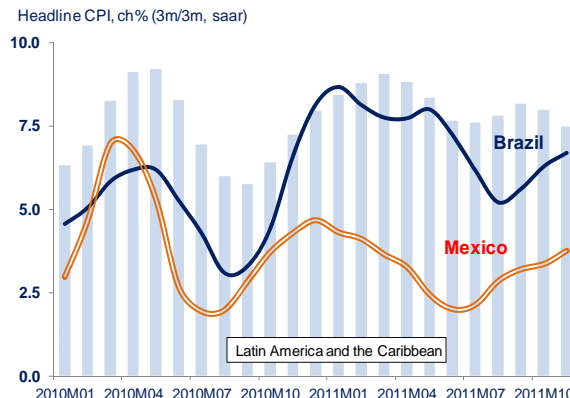
Source: World Bank.

Figure INF.5 Softer oil prices, slower growth start to weigh on Europe & Central Asia CPI-- Turkey an outlier



Source: World Bank.

Figure INF.6 Brazil and Mexico still experience modest uptrend-- short lived?

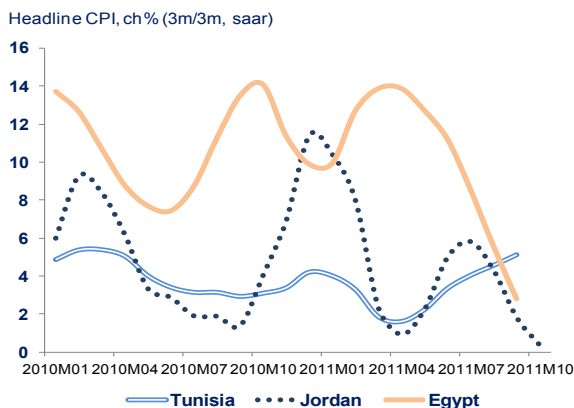


Source: World Bank.

activity occasioned by the “Arab Spring”, as well as continuing violence in countries such as Yemen and Syria, have boosted regional inflation (as defined by limited data available for all countries of the region) to a 20 percent range as of June (3m/3m saar). As such data is less meaningful now that more recent indicators for Egypt, Morocco and Tunisia have become available we focus here and find that headline inflation in these economies show a clear tendency toward easing. However, consumer prices measured at the market are exceptionally biased by large-scale government subsidies for food and in some cases fuel that move such indicators lower. Underlying pressures are indeed much higher, but the cost is being borne by local governments. Still the region remains highly exposed to further food price hikes, weighing down budgets, leading to worsening trade deficits at a time of concern about MENA’s largest trading partners in Europe (figure INF.7).

- In South Asia, headline inflation for India and several other countries remains high, for the former within a 5-6 point range (saar), and for Pakistan between 10-and 11 points. But when measured on a seasonally adjusted annualized rate, inflation in India has fallen by 2.5 percentage points since the start of 2011, to 5.2 percent in November. Inflation remains more problematic in Pakistan; but

Figure INF.7 MENA inflation easing as food subsidies distort "markets"

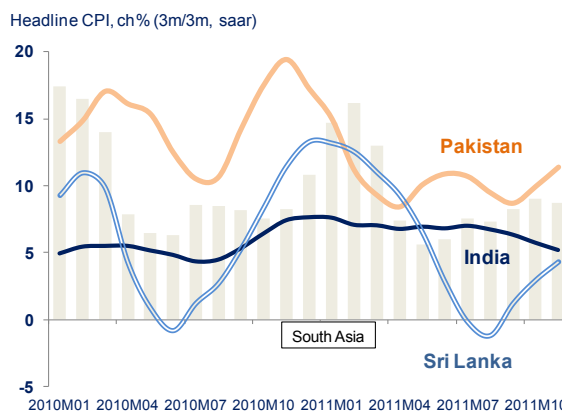


Source: World Bank.

had earlier softened in the “post-conflict” environment in Sri Lanka (figure INF.8).

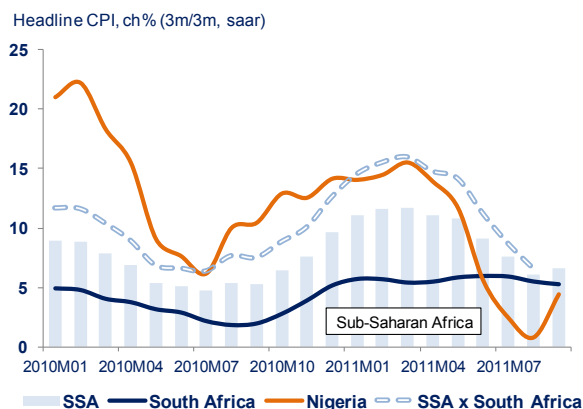
- And in Sub-Saharan Africa, South Africa and Nigeria, representing the bulk of the region’s GDP, have shown opposing movements of late, with South African headline inflation moving to a range of 6 percent from 2 percent at the start of the year; in contrast, inflation is plummeting in Nigeria owing to lower oil prices, revenues and disposable incomes. For the region outside of South Africa, inflation remains elevated, but falling, currently ranging near 10 percent, in large measure due to developments in Kenya (figure INF.9).

Figure INF.8 India showing deceleration, but South Asia region still at high rates near 9%



Source: World Bank.

Figure INF.9 African inflation making some strides, but still high at near 7%



Source: World Bank.

Notes

1. Headline' inflation refers to price changes for all goods in an economy. 'Core' inflation excludes fuels and foods from that basket. G-5 headline CPI growth (inflation) is a GDP-weighted measure of price changes, computed as a 3m/3m "rolling quarter" and annualized "seasonally adjusted annualized rate", or SAAR. This method helps to remove what could be biased "base effects" from year-over-year calculations, as well as to present a clearer picture of turning points in the data.
2. "Globalization and Inflation in OECD Countries". Pehnel, Gernot; ECIPE Working Paper No 04/2007.
3. "A Note on Rising Food Prices". Donald Mitchell. World Bank Policy Research Working Paper. No. 4682. July 2008. The World Bank. Washington DC.
4. Guimaraes, Roberto. Osorio Buitron. Carolina; Porter, Nathan; Filiz, Unsal D. and Walsh, James. "Consolidating the Recovery and Building Sustainable Growth". Chapter 2, Washington DC: International Monetary Fund, October 2010, pp. 41-55.