Explore how emerging economies are tackling inflation in the wake of global supply chain issues and central bank interventions.

Research Paper By Aarna Kapoor

Introduction

Post COVID-19, inflation has been a growing concern for both advanced and emerging economies. The spike can be attributed to the imbalance between the demand and supply, while the Ukraine war has further affected supply. During the pandemic, most production and distribution channels were disrupted resulting in global supply chain problems. On the demand side, developed nations embarked on excessive fiscal stimulus policies which triggered inflation globally.

The surge in inflation during 2021 and 2022 challenged central banks by putting their dedication to maintaining price stability and the reliability of their policy frameworks to the test. “Inflation in many countries rose to levels not seen for 40 years. Most central banks, particularly in advanced economies, waited to adjust policy until they were confident that the downside risks had declined. The slow response subsequently required hiking interest rates much faster and in larger increments than experienced for decades, and also led central banks to move quickly to shrink their balance sheets. This sudden, aggressive, and multifaceted tightening, however, generated new risks around financial stability and the sustainability of fiscal positions. It also created challenges for households and companies that were caught unawares by the sharp increase in borrowing costs” (Ubide et al, 2024).

For emerging economies, the inflationary pressures intensified due to several interconnected factors, including persistent global supply chain disruptions and interest rate hikes by central banks of advanced economies. “The sharp tightening of monetary policy in advanced economies, especially the U.S., has often triggered financial stress or even crises in EMs. Owing to higher credit and currency risks in EMs, global investors have typically pulled out quickly when AE interest rates have risen” (IMF, 2023). These policy adjustments in advanced economies, especially the United States, influence currency stability, interest rates, and capital flows in emerging economies.

This article explores the strategies that emerging economies are using to combat inflation in today’s complex economic landscape. The first section, Emerging Economies’ Stable Performance amid Rising Rates, examines the resilience of these economies, focusing on how they have managed to maintain stability despite rising global interest rates. The second section, Policy Responses to Tackle Inflation reviews specific actions taken by central banks and governments, including rate adjustments and targeted fiscal policies. Following this, the article presents Case Studies on Inflation in India and Indonesia, providing real-world examples of how different emerging markets are addressing inflationary pressures. The section on role of regional and global collaboration discusses how international institutions and partnerships, such as those with the IMF, support these economies in their inflation management. The final section, the Future Outlook for Emerging Economies, offers insights into the potential challenges and strategies on the horizon for sustaining economic stability in the face of global uncertainties.

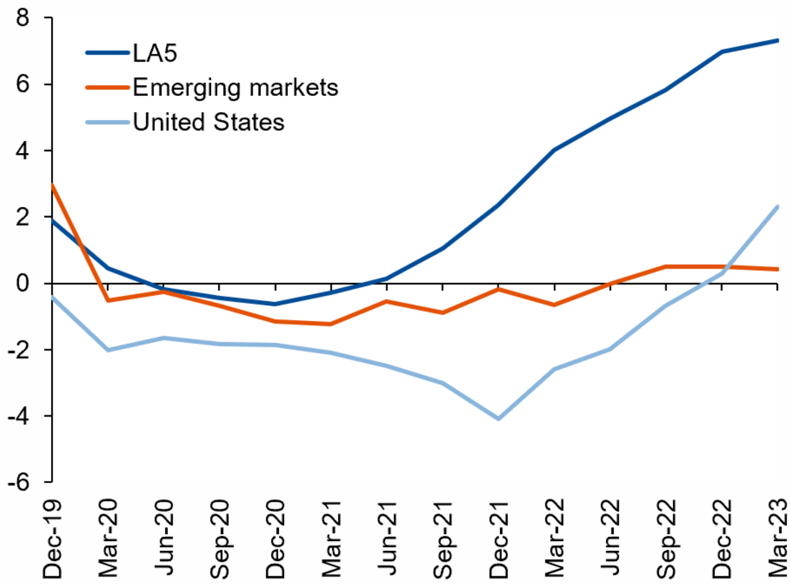
Emerging Economies’ Stable Performance amid Rising Rates

Advanced and developing economies in 2022 recorded their highest inflation rates in over a decade (Global Economic Prospects, January 2023). Global inflation soared in 2022, rising above 9 percent, from 4.7% in 2021 and 3.25% in 2020 owing to supply bottlenecks, release of post-pandemic pent-up demand, and high commodity prices following Russia’s invasion of Ukraine.

With this rising inflation, advanced economies tightened their monetary policies to curb inflation, and hiked interest rates, as a response to which, investors conventionally start pulling out of the emerging economies. “This was the case in the 1980s and again in the mid-1990s. At the time, investors had several concerns about EMs (Emerging Markets): high levels of debt, often short term in duration and denominated in foreign currency; low international reserves, and weak policy frameworks, for example" (IMF,2023).

However, recent cycle of monetary policy tightening by advanced economies unfolded different results for emerging economies. According to IMF, Emerging Markets (EMs), facing increasing domestic inflation, began raising interest rates on average around mid-2021, well before Advanced Economies (AEs) started their own rate hikes.

Ex-ante real monetary policy rates
(Percent)

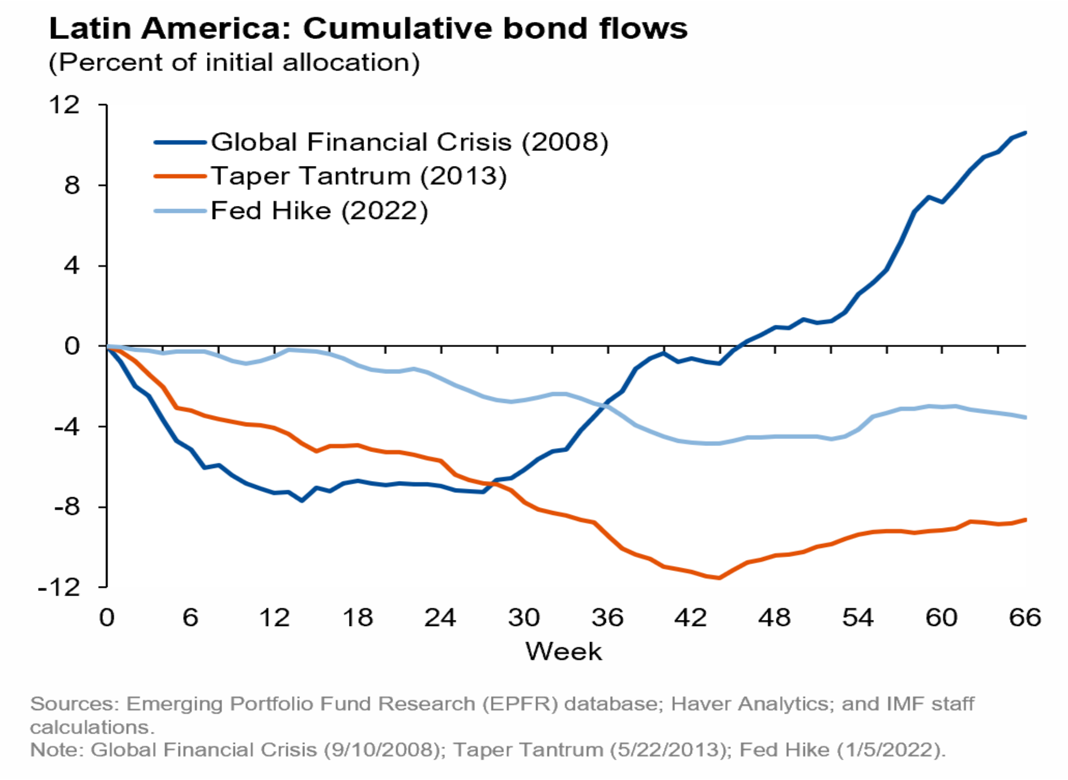


Sources: Consensus Economics; Haver Analytics; national authorities; and IMF staff calculations.
Note: Real policy rate is the difference between the nominal rate and one-year ahead inflation expectations. Aggregates are PPP GDP-weighted averages. Emerging markets = Hungary, India, Indonesia, Malaysia, Philippines, Poland, Romania, Thailand; LA5 = Brazil, Chile, Colombia, Mexico, Peru.

The above graph shows that EMs tightened their monetary policy earlier and more aggressively than AEs. "Many EMs have held up well in environment of sharply rising global rates" (IMF,2023).

Notably, Emerging Market (EM) economies have shown resilience, by having stable growth rates, to both their own monetary tightening and the rapid rate hikes by advanced economies (AEs), where rates have increased at the fastest pace in decades. EM growth remained robust in the past years and is expected to stay relatively stable in the future as well, with only limited capital outflows.

The following graph shows that due to the timely monetary policies of emerging markets, the outflows because of the withdrawal of investors have been lower as compared to previous crises. “Outflows from Latin America, for instance, have been far smaller than during the Taper Tantrum of 2013. Some EM currencies have even appreciated against the dollar” (IMF, 2023).



Policy Responses to Tackle Inflation

Improved Monetary Policy Frameworks

Central banks in emerging economies have turned to aggressive interest rate hikes to control inflation and stabilise their currencies. As IMF Deputy Managing Director Gita Gopinath noted, “Central banks in emerging markets have taken timely and forceful actions to tame inflation, thereby ensuring that inflation expectations remain anchored". This includes efforts from emerging economies like South Africa, Mexico, Brazil and India who have implemented substantial rate hikes.

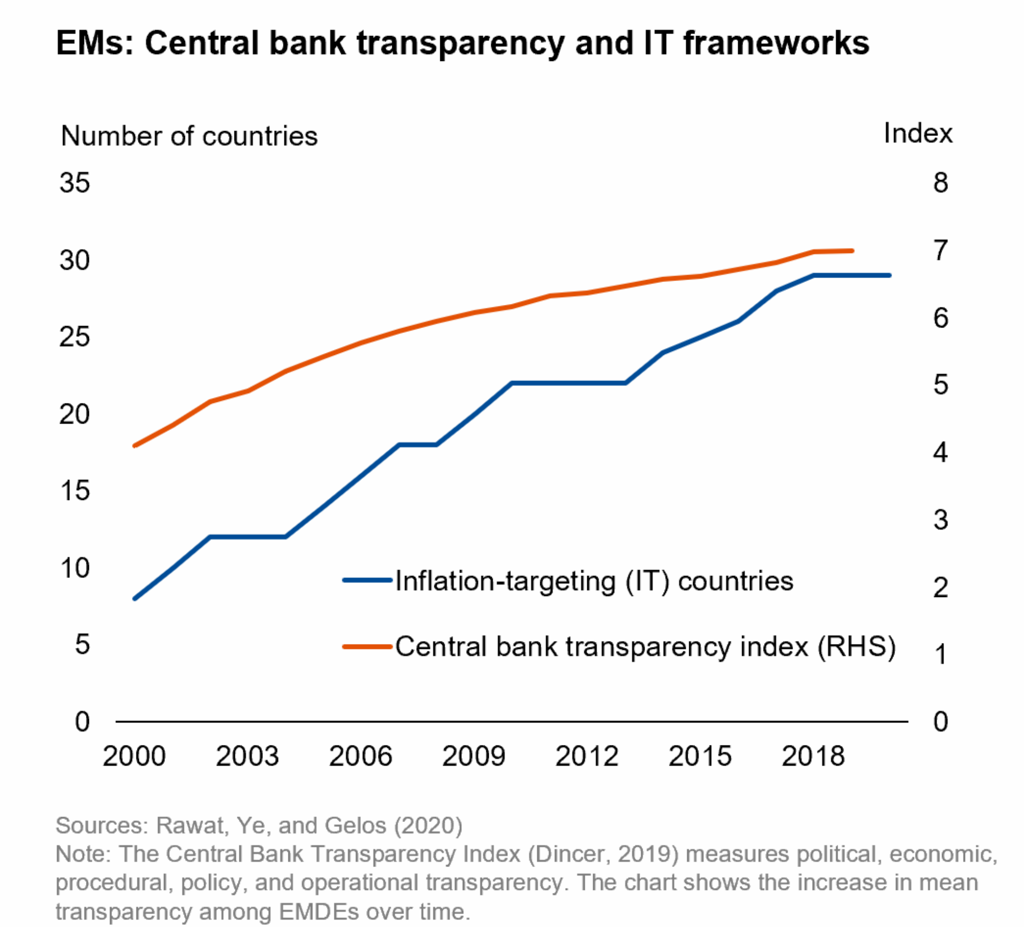
These aggressive rate hikes help curb inflation by making borrowing more expensive, which in turn reduces consumer spending and slows down demand. However, this approach comes with trade-offs. Higher interest rates can slow economic growth and reduce employment opportunities, particularly in economies still recovering from the pandemic. “While monetary policy has tightened substantially in many EMs, activity hasn’t slowed that much, leaving unemployment near historic lows” (Gopinath, 2023).

Policy Reforms

Increased Transparency

Increased policy transparency in emerging markets has made it easier for investors to understand and evaluate the risks associated with these economies. Because central banks in these countries now communicate their plans and policies more openly, investors feel more informed and confident about the stability of the financial environment. “Improved credibility of monetary policy frameworks has helped ease tradeoffs for central banks” (Gopinath, 2023).

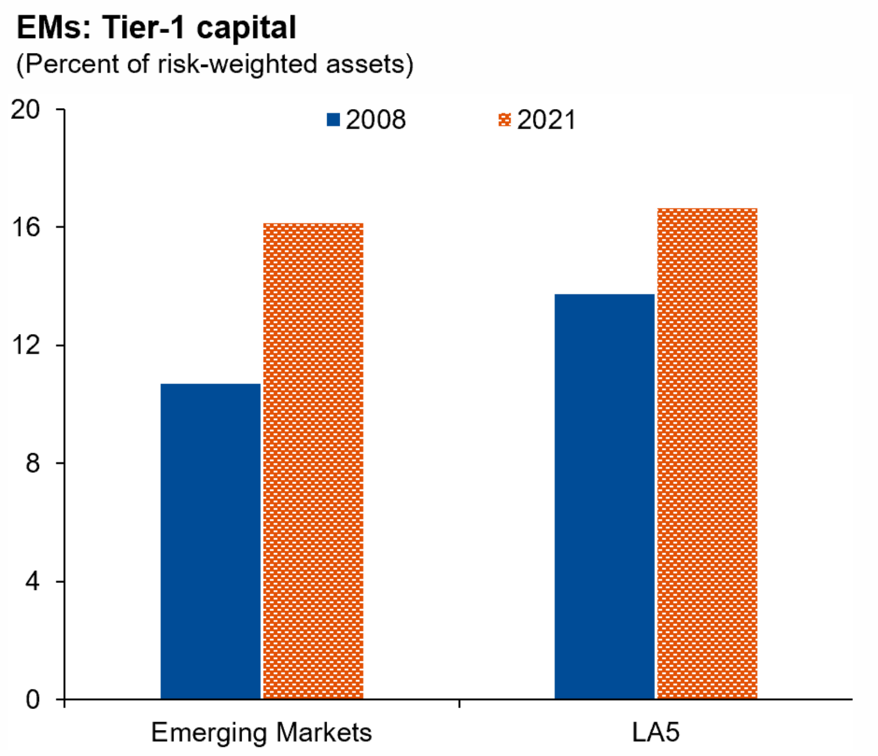
The following graph shows how the frameworks in EMs have improved markedly in the past two decades.



Financial Stability

"Reduced financial vulnerabilities also contributed to resilience of EMs" (Gopinath, 2023). Emerging markets have strengthened their financial stability by making sure banks have more capital on hand. This extra capital acts as a safety net, helping banks handle tough economic times and reducing the risk of financial problems spreading through the system. This approach makes these economies more resilient when unexpected shocks hit. "They have taken many steps to strengthen regulatory, supervisory, and macroprudential frameworks to limit risk-taking and foreign exchange (FX) mismatches" (Gopinath, 2023).

The following graph shows the increased capitalisation of EM banking sectors.



Sources: IFS, WEO, IMF staff calculations.
Note: Aggregates are PPP GDP-weighted averages. Emerging markets = Hungary, India, Indonesia, Malaysia, Philippines, Poland, Romania, Thailand; LA5 = Brazil, Chile, Colombia, Mexico, Peru.

Fiscal Policy Measures

Emerging economies have focused on providing targeted support to vulnerable populations, reducing broad fiscal measures that could contribute to inflation. This approach helped allocate resources more efficiently without inflating demand. By tightening fiscal policies, they were able to reduce inflation without raising interest rates, fostering economic stability. Additionally, many governments worked to lower excessive debt, which helped manage inflation expectations and supported central banks in maintaining price stability.

Emerging economies like India have implemented targeted measures to support vulnerable populations, such as providing free rations to the poor under the Pradhan Mantri Garib Kalyan Yojana. Other examples include direct cash transfers to low-income groups, subsidies for essential goods, and food security programs. These policies help ensure that the most vulnerable are protected without overstimulating the economy and worsening inflation.

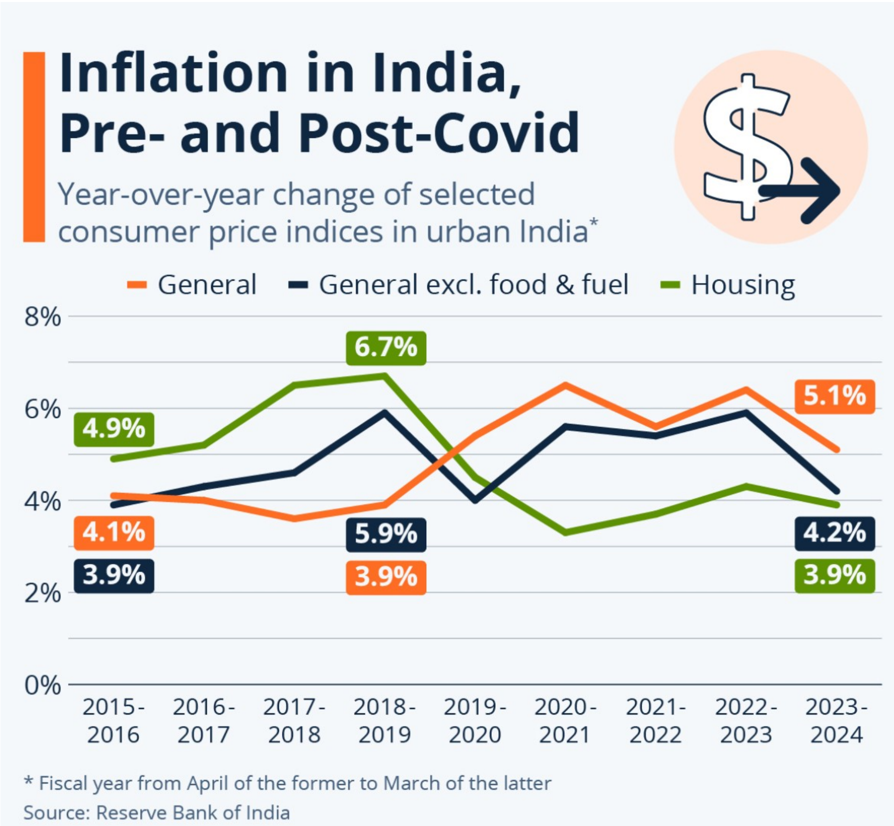
This fiscal discipline enabled better coordination between fiscal and monetary policies.

Case Study: Inflation in India

Overview of India's Inflation Management

"India has managed to keep retail inflation at 5.4% in FY24, the lowest in four years since the COVID-19 pandemic" (PIB, 2024). According to Ministry of Finance, This rate is lower than both emerging markets and the global average, demonstrating effective inflation control measures.

The following graph shows India's inflation trend over the years.



Central Bank's Role

The Reserve Bank of India (RBI) has committed to price stability, gradually increasing the policy repo rate by 250 basis points from May 2022 to February 2023. This approach aimed to absorb excess liquidity and align inflation with its target range of 2-6%.

Core inflation, which excludes food and energy prices, has seen a significant decline, dropping to 3.1% in June 2024 from higher levels in previous years. This reduction is attributed to effective monetary policies such as raising interest rates, tightening liquidity and improved supply conditions. “Assessing the emerging patterns of price pressures, the RBI increased the repo rate gradually by 250 basis points since May 2022 to curtail inflationary pressures, leading to reduction of around 4 percentage points in core inflation between April 2022 and June 2024” (PIB Delhi, 2024).

Strategies Employed

Administrative Measures: The Indian government has implemented price cuts for essential commodities like LPG, petrol, and diesel, which have contributed to lower inflation rates in these sectors.

Food Security Initiatives: To combat food inflation, which rose due to supply chain disruptions and climate-related challenges, the government extended the Pradhan Mantri Garib Kalyan Anna Yojana, providing free food grains to over 81 crore beneficiaries. This initiative aims to ensure food security to vulnerable populations.

Monitoring Global Prices: The Indian government actively monitors global commodity prices, especially for edible oils where over 50% of consumption is imported while efforts are being made to balance imports with domestic production through initiatives like the National Mission on Edible Oils.

Challenges Faced

Geopolitical Tensions: Ongoing geopolitical issues have disrupted supply chains globally, contributing to volatility in food and fuel prices despite domestic efforts to stabilize inflation.

Climate Impact on Agriculture: Extreme weather events have affected agricultural output, leading to increased food prices. The government has taken proactive measures such as open market sales and timely imports to manage these pressures.

Interstate Variations: There are significant variations in inflation rates across different states in India, particularly in rural areas where food items constitute a larger portion of consumption baskets. This disparity complicates nationwide inflation management strategies

Future Projections and Recommendations

Source: PIB Delhi

Long-term Stability Goals: The RBI and IMF project a gradual alignment of consumer price inflation towards targets of around 4% by FY26, assuming stable external conditions and normal monsoon seasons.

Reducing Import Dependence: The Economic Survey suggests enhancing domestic production of edible oils and pulses to reduce reliance on imports and mitigate risks associated with global price fluctuations.

Improving Storage and Processing Facilities: Recommendations include developing modern storage solutions for perishable goods like vegetables to prevent losses and stabilize prices during supply shocks.

Enhanced Data Monitoring: There is a call for improved data collection on prices at various stages—from farm gate to consumer—to enable swift governmental responses to price surges in specific commodities.

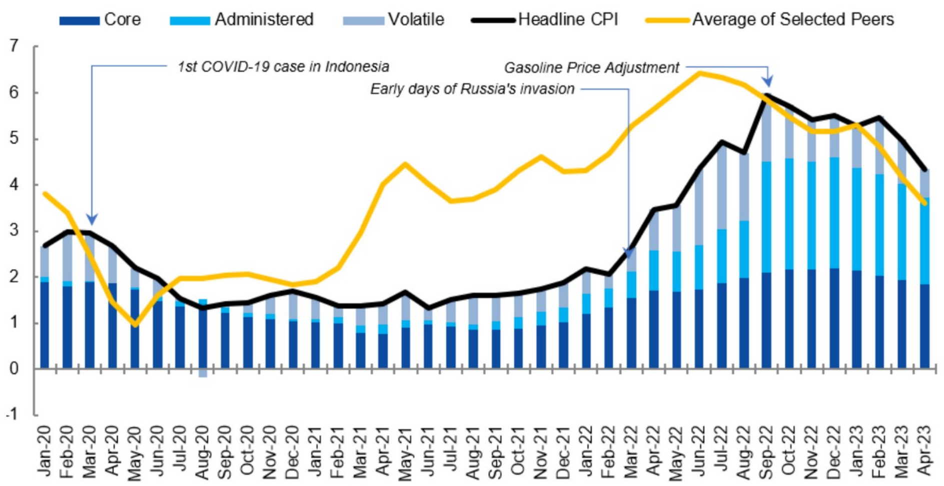
By focusing on these strategies and challenges, India showcases how emerging economies can effectively manage inflation amid global supply chain disruptions while ensuring economic stability and growth.

Case Study: Inflation in Indonesia

"Indonesia's inflation rate bucked the global trend by peaking at 5-6 percent in the second half of 2022 despite pressures from increasing demand and rising input costs. Unlike its peers, Indonesia's inflation rate remained broadly flat and only started to pick up with rising global commodity prices in early 2022" (Ilman et al, 2023)

The following graph shows this trend:

(contribution to inflation, percentage points)



Source: BPS, CEIC, World Bank staff calculations.

Note: Selected peers are Brazil, China, Malaysia, Philippines, India, and Thailand. Administered inflation is defined as increase in price of goods and services whose price development is regulated by the government. Volatile inflation is defined as increase in price of goods and services that experience high volatility (i.e., foods).

As can be seen in the above graph, the strategies used by has helped it in avoiding a severe cost-of-living crisis despite high inflation as opposed to many countries within the subcontinent. Several factors have contributed to this:

High Consumer Confidence

“In Indonesia, the consumer the confidence index has soared in last two years, from about 80 percent in 2020 to about 120 percent by the end of 2022” (Santoso et al, 2023). This increased optimism has buffered the impact of inflation on the cost of living, as consumers are less likely to panic despite inflationary pressures. The rise in consumer confidence in Indonesia can be attributed to supportive monetary policies that stabilized inflation, creating a more resilient economic environment. The positive consumer outlook has helped Indonesia maintain stability even in the face of global economic uncertainties.

Experience with Inflation

Emerging economies like Indonesia are more accustomed to inflation than advanced countries. While advanced economies have not faced significant price shocks for over a decade, inflation is a regular occurrence in Indonesia. This familiarity with inflation means consumers and businesses are better prepared to adapt to rising prices without causing severe economic disruptions.

Menu Cost Theory

A key explanation for Indonesia's resilience to inflation is its firms' reluctance to adjust prices frequently, as explained by the Menu Cost theory. "According to one study, Menu Cost can account for price stickiness of about 30 days, which is significantly less than the 7 to 24 month stickiness shown in services and retailing" (Santoso et al, 2023). This "price stickiness" helps prevent inflation from translating directly into higher costs of living.

Core vs Non-Core Inflation

Inflation in Indonesia is measured by dividing it into core and non-core inflation. Core inflation is driven by fundamental economic factors, excluding government-set prices and volatile product prices. Non-core inflation, on the other hand, includes volatile food inflation and administered price inflation, which is heavily influenced by government policies such as fuel subsidies. In 2022, the administered price group was the largest contributor to inflation, driven by increased fuel prices and energy costs. "To contain budget subsidies, the authorities partially removed caps on fuel prices in September 2022, resulting in a 30 percent increase in gasoline prices. This led to the highest inflation level in seven years. However, inflation has since tapered down and by July 2023, it fell below the upper bank of Indonesia's inflation target range of 2-4 percent" (Ilman et al, 2023). To control inflation within the administered price group, Indonesia reinforced price caps on essential goods and services, which helped limit the direct impact of rising producer costs on consumer prices.

External Factors

Indonesia's inflation also rose in 2022 due to external factors, including global supply chain disruptions and rising crude oil prices. However, the biggest contributors to inflation were domestic issues like food price fluctuations, caused by seasonal weather patterns, supply chain inefficiencies, and changes in public demand, especially around holidays.

Inflation and Cost of Living

Indonesia’s experience with inflation is shaped by its long history with price changes, high consumer confidence, and specific factors like food and fuel price volatility. While inflation in Indonesia reached 5.95% in 2022, it remained within the government's target range. However, the increase in volatile food prices, combined with rising fuel costs, has put pressure on consumer expenditures. The government’s continued focus on managing food price stability and limiting the impact of supply-side inflation remains crucial in preventing a significant cost-of-living crisis.

While the government faced challenges in managing inflation, its approach emphasizes maintaining price stability without overwhelming consumers.

“Indonesia’s relatively low inflation primarily stems from the low transmission of producer price inflation to consumers. This could partially be attributed to price caps for certain goods and services. Whilst price interventions may help contain near-term inflation, they may also pose challenges for the monetary policy response. Over the longer-term, sustained price interventions can hinder allocative efficiency” (Ilman et al, 2023). While the government faced challenges in managing inflation, its approach emphasized maintaining price stability without overwhelming consumers.

Role of Regional and Global Collaboration

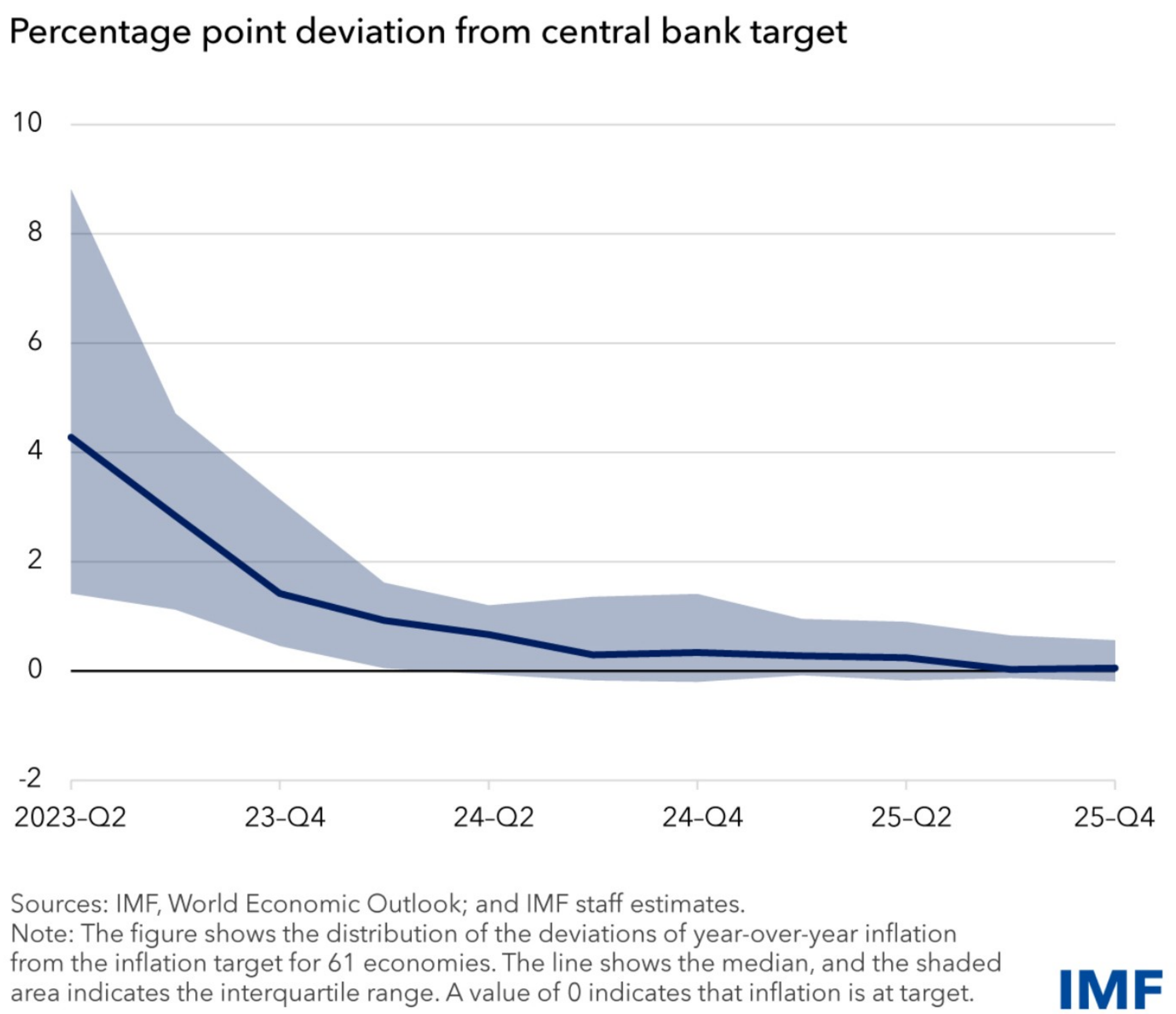
Regional cooperation is also essential for managing inflation in emerging economies. By forming regional trade alliances, countries can reduce dependency on distant markets and benefit from more stable regional supply chains. “As the global economy is in turmoil due to the COVID-19 pandemic, creation of the vast AfCFTA regional market is a major opportunity to help African countries diversify their exports, accelerate growth, and attract foreign direct investment” (World Bank, 2020). Such alliances strengthen economic resilience and offer a buffer against global inflationary pressures. “The AfCFTA promises broader and deeper economic integration attracts investment, boost trade, provide better jobs, reduce poverty, and increase shared prosperity in Africa” (Echandi et al, 2022).

According to the IMF, "International cooperation is essential for stabilizing global inflationary pressures, as many challenges are interconnected and require coordinated solutions". Additionally, the IMF and World Bank provide technical assistance and policy guidance, helping countries design and implement effective inflation management strategies.

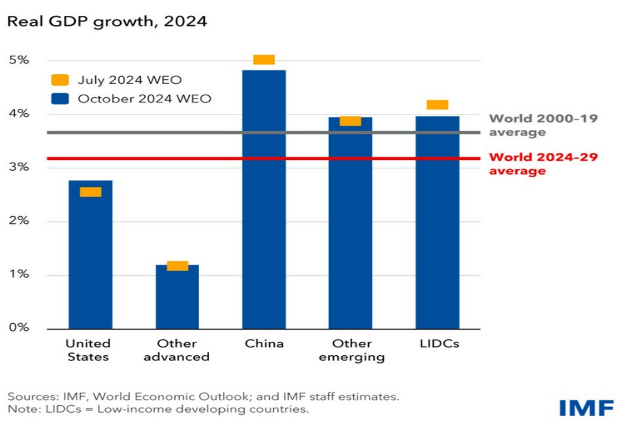
Future Outlook for Emerging Economies

According to IMF, inflation has receded and is close to global central bank targets. In most countries, inflation is now hovering close to their central bank targets, paving way for monetary easing by way of reduction in interest rates and other such measures across major central banks. “After peaking at 9.4 percent year-on-year in the third quarter of 2022, we now project headline inflation will fall to 3.5 percent by the end of next year, slightly below the average during the two decades before the pandemic” (Gourinchas, 2024).

The following graph shows the percentage point deviation of the inflation target of central banks of 61 economies.



While the decline in inflation without a global recession is a major achievement, for the economies, the following graph shows the future growth outlook, which remains at its weakest level in decades due to unprecedented events like COVID-19.



However, the recovery from the pandemic shocks looks promising. “In advanced economies, growth in the United States is strong, at 2.8 percent this year, but will revert toward its potential in 2025. For advanced European economies, a modest growth rebound is expected next year, with output approaching potential. The growth outlook is very stable in emerging markets and developing economies, around 4.2 percent this year and next, with continued robust performance from emerging Asia” (Gourinchas, 2024).

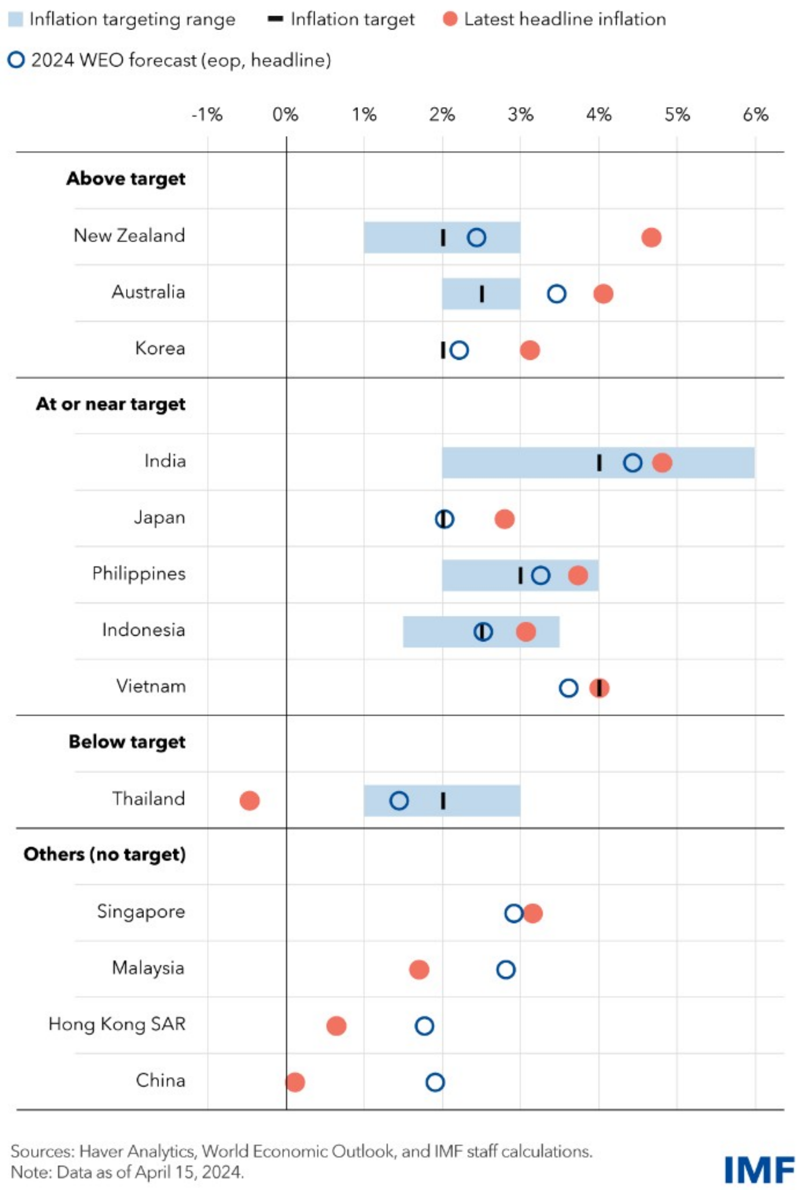
A lot of the recent drop in inflation is due to the fading of past shocks and better labour availability. But monetary policies also played a crucial role by keeping inflation expectations anchored. The impact of earlier monetary tightening, a global decline in commodity and goods prices, and the reduction in supply-chain disruptions after the pandemic, all contributed to this outcome.

“Since June, major central banks in advanced economies have started to cut policy rates, moving toward a neutral stance. Lower interest rates in major economies will ease the pressure on emerging market economies, with their currencies strengthening against the US dollar and financial conditions improving. This will help reduce imported inflation, allowing these countries to pursue their own disinflation path more easily” (Gourinchas, 2024).

However, inflation in services still remains elevated, almost double pre-pandemic level according to IMF, while a few emerging economies are still suffering from inflationary pressures and are adopting contractionary monetary policy by raising interest rates to tackle inflation.

Disinflation has been uneven. “In some advanced economies—notably New Zealand, Australia, and Korea—persistent services inflation has kept inflation above target. By contrast, in Thailand and China, consumer prices have fallen. Inflation excluding food and energy is low, which, in China, reflects legacy issues from the pandemic and the property sector correction. Elsewhere, inflation is close to target” (Srinivasan, 2024).

The following graph demonstrates the uneven inflation outcomes across various countries, highlighting the importance of differentiated monetary policy responses.



“In economies where inflation is still elevated, central banks may need to keep interest rates higher for longer. In economies where core inflation is at or close to target, space for lowering interest rates may emerge later in the year. By contrast, where inflation is undesirably low, an accommodative stance is called for. Central banks should focus firmly on domestic conditions and avoid making decisions overly dependent on the expected path of US interest rates: while following the Federal Reserve could limit exchange rate volatility, it risks that central banks would fall behind (or move ahead of) the curve and destabilize inflation expectations” (Srinivasan, 2024)

While tracking the Federal Reserve might reduce exchange rate volatility, an independent approach allows central banks to better manage domestic inflation expectations. Therefore, central banks should prioritize their own economic conditions over aligning closely with U.S. interest rate moves.

Conclusion

Emerging economies have been facing an exceptionally challenging environment as they strive to tackle inflation amid global supply chain disruptions and central bank interventions. These challenges are compounded by the limited fiscal and monetary tools available to many emerging economies, forcing them to implement difficult measures such as aggressive rate hikes and subsidies.

“It is critical for EM authorities to refine and strengthen their monetary, fiscal, and financial policy frameworks. Central bank independence should be maintained, alongside further enhancements in transparency and communication. Better policy frameworks—both monetary and financial—have allowed EM central banks to pursue countercyclical policies during both the Global Financial Crisis and COVID pandemic. These frameworks have helped EMs hold up well in the face of the sharpest tightening of monetary policy in advanced economies in several decades. And they should continue to serve as an anchor of stability to help navigate the challenging road ahead" (Gopinath, 2023).

The policy responses of emerging economies have varied, ranging from central bank interventions aimed at stabilizing currencies and controlling inflation to government fiscal measures providing support to vulnerable groups.

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