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MACROCOSM

What Did They Do To Deserve This?

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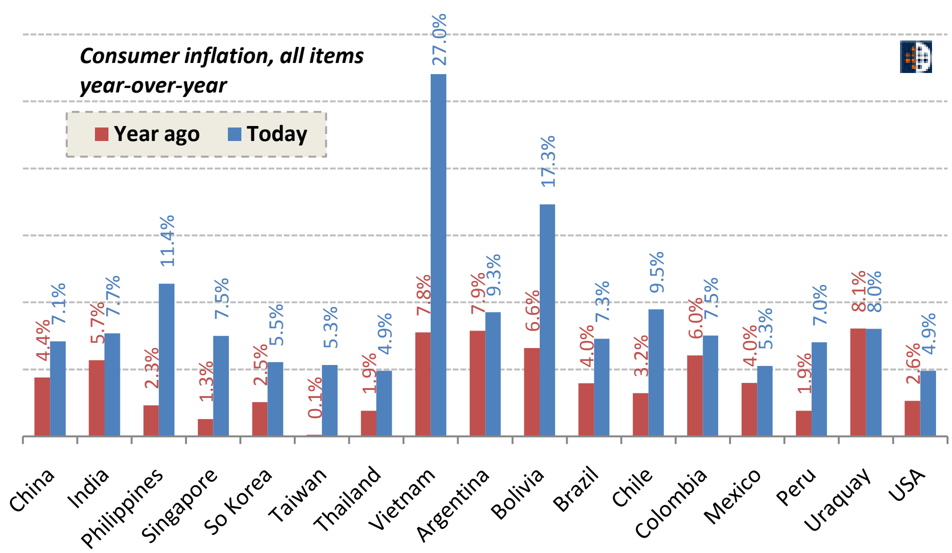
First we exported our inflation to the emerging markets. Now are we hoping to import their rate-hikes?

Update to strategic view
EMERGING MARKETS MACRO: Emerging economies are beginning to find the courage that our Fed has not -- to raise interest rates to combat inflation. As in the US, at first normalizing rates is salutary -- but there is the risk that our exported inflation is already so embedded that only true tightening will do the job, at the cost of continued growth.
[see Investment Strategy Dashboard]

In March, we detailed the rising trend among emerging market economies -- with currencies traditionally closely linked to the dollar -- toward appreciation of their exchange rates, so as to quell the inflation arising from their ties to a dollar which was seeing its real purchasing power steadily worn down by an exceedingly accommodative Fed (see "Emerging Markets, Emerging Dollar Inflation" March 13, 2008). In subsequent months, however, it has become apparent that the degree of currency strengthening instituted was an insufficient buffer against the inflation pressures unleashed by the eroding dollar. Now, a growing number of developing countries are being compelled to undertake rate-hiking campaigns as they endeavor to root out inflation that is running at multi-decade highs in many of these economies.



The inflation acceleration now rippling through the emerging markets is stunning -- a gruesome magnification of what is happening in the United States, where inflation at 4.9% has nearly doubled from 2.6% a year ago. In Asia, where regaining monetary stability and credibility was a years-long project following

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the "Asian flu" financial crisis of the late 1990s, the disquieting inflation environment is threatening to undo the substantial progress that was made. On average across eight major Asian emerging market economies, consumer price inflation is now running at 9.6% year-on-year; a year ago it was at 3.3%. The worst is Vietnam, the budding jewel of Southeast Asia with a free-market reform program fashioned after the "China model," which is now posting a 27% inflation rate, up from 7.8% a year ago. The Philippines is at 11.4%, compared with 2.3%, and Singapore 7.5%, versus 1.3%. In Latin America, the story is much the same, with 10 countries now averaging consumer inflation of 8.9%, up from 5.2% a year ago. Chile, considered a model among the emerging market economies, has seen its inflation rate nearly triple over the last year, from 3.2% to 9.5%. Brazil is at 7.3%, up from 4.0% a year ago.

This emerging market inflation reality confronts much of the conventional wisdom which holds that these places must be enjoying unalloyed prosperity resulting from the commodity price boom. While strong real demand growth has been a contributing factor in that boom, the dark side is that much of it can be explained by the inflationary effects of dollar weakness.

Indeed, this latest threat to economic stability in the emerging markets is, in one important respect, much like the experience of the late 1990s. It is not a home-grown phenomenon but rather is rooted in monetary error emanating from the Federal Reserve. The difference is that a decade ago, these economies were battered when they could no longer sustain their currencies' pegs to a dollar that was enduring a relentless real appreciation under the deflationary policy approach of the Greenspan Fed. Today, the trouble confronting these countries is the consequence of the dollar's deep depreciation resulting from the reckless inflationary monetary machinations of the Bernanke Fed.

There seems to be little, if any, appreciation at the Fed itself for the problems it is fostering in the emerging markets. In June, Fed vice chairman Donald Kohn attempted to evade any accountability for the consequences of the dollar's erosion when he asserted that these countries should take action on their own to restrain commodity price increases (see "Fail-Safe" July 2, 2008). It is as though, after we exported our inflation to them, they ought now to export disinflation back to us, even at the cost of slowing their economies.

Policymakers in many of these emerging economies -- no doubt informed by the experience of the 1990s -- recognize what is at stake and are acting to keep the inflationary impulses from becoming more deeply entrenched. But these policy actions are not being taken to please Donald Kohn. They are being taken to maintain these economies' capital market credibility and to avoid the political and social instability that could result from loosing the inflationary demons.

It's not a course, however, that comes without risk. Growth in most of these economies remains strong, with growth rates exceeding 5% for the most part. But the pace has already come off its best levels in recent quarters, due mostly to the slowdown in the developed world. A sustained hiking of interest rates at some point would further subdue growth, and as reported yesterday in the *Wall Street Journal*, the perceived threat to expansion is already giving rise to conflict between inflation-fighting central bankers and politicians in several of the Asian emerging markets.

To date, the market response has been mixed. The Brazilian central bank has been the most aggressive, lifting is policy rate by 125 basis points since April, to 13%. The Brazilian real has appreciated by more than 11%, but the Bovespa stock index is now trading at a 6-month low. In Indonesia, rates have been lifted by 75 bps since May, to 8%, in an effort to quell an 11% inflation rate. The action has been a positive for the rupiah, which has appreciated by some 2.7%. But the Jakarta stock exchange has slumped by some 11%. It's important to recognize, though, that these markets are not behaving much differently than many others around the world in places where there have been no rate hikes. In fact, South Korea -- one of the emerging markets where rates have stayed put this year -- has seen its stock market lose 18% since April. To this point, the rate hikes have not put real rates at levels that can be considered prohibitive to growth. A crucial determinant in the outlook for the emerging market economies will be whether the central banks can bring inflation down without getting objectively tight and putting their economies at risk. We'll be monitoring the process and reporting on key developments in the emerging markets' battle against inflation.

The emerging markets would be significantly aided in their efforts, and could avoid the potential pain of an extended tightening episode, if the Fed initiated action to reverse its excessive easing of the past year. In working to restore monetary equilibrium, the Fed would also provide a lift for the dollar, which would have the effect of at least moderating the inflationary influences bearing down on these economies. But today's FOMC meeting is unlikely to give comfort to those seeking a signal that the central bank is preparing to begin normalizing its policy posture. If anything, in fact, the message today is likely to lean in a less hawkish direction than at the last meeting in June, when the FOMC stated that "downside risks to growth appear to have diminished somewhat." Given the recent mix of data -- as ambiguous as it actually is -- that's probably no longer the consensus view among our monetary mavens (see "All Cross, No Current" August 1, 2008).

BOTTOM LINE: The emerging market economies are on the front lines of the global inflation produced by the Fed's heedless easy money policy venture, and their central banks are now executing the necessary response. At this point, growth in these economies remains robust, but markets cannot overlook the potential economic consequences of an extensive rate hiking exercise. The risk to which these economies are now being exposed can be seen as another price to be paid for the Fed's inflationary monetary error.