

BOX 1.1 The great disinflation

“The greatest threat to today’s low inflation, of course, would be a reversal of the modern trend towards enhanced central bank independence, particularly if trend economic growth were to slow, owing, say, to a retreat in globalization and economic liberalization.” Kenneth Rogoff (2003)

Emerging market and developing economies (EMDEs) have achieved a remarkable decline in inflation, from 17.3 percent in 1974 to about 3.5 percent in 2018. This achievement has coincided with an even sharper decline in inflation in advanced economies. The great disinflation in EMDEs has also been accompanied by growing inflation synchronization as evidenced by the emergence of a global inflation cycle. It has been supported by long-term trends such as the widespread adoption of robust monetary policy frameworks and strengthening of global trade and financial integration. More recently, the disruptions caused by the global financial crisis also contributed to the decline in inflation. However, a continuation of low and stable EMDE inflation is by no means guaranteed. If the wave of structural and policy-related factors that have driven disinflation since the 1970s loses momentum or is rolled back, elevated inflation could re-emerge. If the global inflation cycle turns up, policymakers may find that maintaining low inflation can be as great a challenge as achieving it.

Emerging market and developing economies (EMDEs) have achieved a remarkable decline in inflation since the mid-1970s (Ha, Kose, and Ohnsorge 2019),¹ Median annual national consumer price inflation in EMDEs fell from stubbornly persistent double-digits during the 1970s to about 3.5 percent in 2018 (Figure 1.1.1). By 2017, inflation was within or below central bank target ranges in three-quarters of the EMDEs that had adopted inflation targeting. Inflation has also fallen around the world, from a peak of nearly 17 percent in 1974 to less than 2.5 percent in 2018. The decline in inflation began in the mid-1980s in advanced economies and in the mid-1990s in EMDEs. By 2000, global inflation had stabilized at historically low levels.

Low and stable inflation has historically been associated with greater output stability, higher growth and better development outcomes. EMDEs can continue enjoying the benefits of low inflation, but only if the confluence of structural and policy related factors that have fostered global disinflation over the past decades is sustained.

Against this backdrop, this box addresses the following questions:

- How has EMDE inflation evolved?
- How important is global inflation in explaining national inflation in EMDEs?
- Can EMDEs sustain the era of low inflation?

Note: This box was prepared by Jongrim Ha, M. Ayhan Kose, and Franziska Ohnsorge.

¹The “near-universal” character of the decline in inflation since the mid-1970s was recognized at an early stage by Rogoff (2003).

Evolution of EMDE inflation: A remarkable conquest

Disinflation. EMDEs have witnessed a significant decline in inflation since the mid-1970s, with median annual national consumer price inflation down from a peak of 17.3 percent in 1974 to about 3.5 percent in 2018. Disinflation over recent decades has been broad-based across regions and country groups.² For example, disinflation occurred across all EMDE regions, including those with a history of persistently high inflation, such as Latin America and Sub-Saharan Africa (Figure 1.1.2).³ Even among low-income countries (LICs), inflation fell by two-thirds between the mid-1970s and 2017, to 5 percent.

EMDE disinflation was set against the backdrop of sharper disinflation among advanced economies, where median inflation dropped from its highest (15 percent in 1974) to its lowest level (0.3 percent in 2015) in more than 60 years. Since then, it has risen somewhat to just over 1.5 percent in 2018 but remains below the median inflation target of advanced-economy central banks. After 2008, below-target inflation and, in some cases, deflation became pervasive across advanced economies: for example, in 2015, inflation was negative in more than half of advanced economies. Some advanced-economy central banks have struggled to lift inflation back to their inflation targets over the past decade.

Drivers of low inflation. While the global financial crisis played a major role in pushing inflation down around the

²Disinflation is a decline in inflation rates, regardless of inflation being negative (deflation) or positive.

³However, inflation remains in double-digits in some relatively large EMDEs, in part reflecting currency depreciations.

BOX 1.1 The great disinflation (continued)

world over the past decade, the longer-term trend of disinflation has been supported by a wide range of structural changes. The most significant of these have been the wide-spread adoption of more effective and more transparent monetary, exchange rate, and fiscal policy frameworks as well as globalization (Figure 1.1.2).⁴

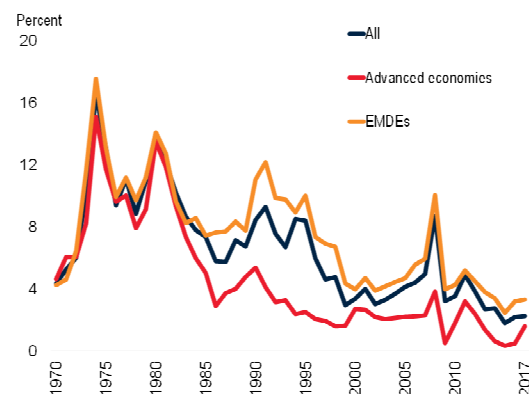
- Macroeconomic policies.** In the second half of the 1980s and during the 1990s, many EMDEs implemented macroeconomic stabilization programs and structural reforms, and gave their central banks clear mandates to control inflation. The adoption of resilient policy frameworks has facilitated more effective control of inflation (Taylor 2014; Fischer 2015). Twenty-four EMDEs have introduced inflation targeting monetary policy frameworks since the late 1990s and, in the median EMDE, the index of central bank independence and transparency rose more than one-and-a-half-fold between 1990 and 2014. Inflation tends to be lower in countries that employ an inflation targeting framework and that have more independent and transparent central banks. Changes in fiscal policy frameworks have also contributed: fiscal rules have been adopted in 88 countries, including 49 EMDEs. Other reforms, including labor market and product market liberalization, and the removal or easing of foreign exchange market controls, also assisted the disinflation process.
- Trade and financial integration.** Trade integration has contributed to lower prices, as higher shares of imports in consumption and production result in competitive pressures from foreign producers (Figure 1.1.4). Financial integration has helped discipline macroeconomic policies since more financially integrated economies are more likely to implement monetary policies targeting low and stable inflation (Kose et al. 2010). In the median EMDE, as in the median advanced economy, the ratio of trade to GDP increased by half between 1970 and 2017, to 75 percent of GDP, and international assets and liabilities tripled (although they remain only half the level of advanced economies). Inflation tends to be lower in economies that are more open to trade and financial flows.

⁴ Other structural changes have also been important (Ha, Ivanova et al. 2019). For example, technological advances, including the digitalization of services and automation of manufacturing have also transformed production processes, attenuating inflation pressures. Population aging may also have contributed.

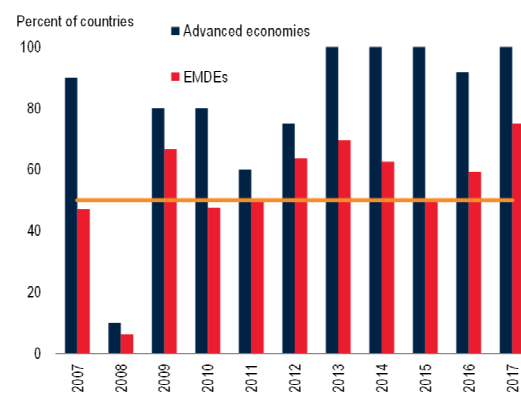
FIGURE 1.1.1 Global inflation

EMDE inflation remains near historic lows despite a recent normalization of inflation in advanced economies. Inflation is now within target ranges in the majority of EMDEs.

A. Median CPI inflation, by country group



B. Share of advanced economies and EMDEs with inflation below or within target range



Source: Bloomberg, Consensus Economics, Haver Analytics, World Bank.
 A. Median year-on-year consumer price inflation for 29 advanced economies and 123 EMDEs (including 28 LICs).
 B. All inflation rates refer to year-on-year inflation. Share of 11 advanced economies and 24 EMDEs with consumer price inflation below-target or within target range. Horizontal line indicates 50 percent.
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Global inflation cycle: Getting stronger

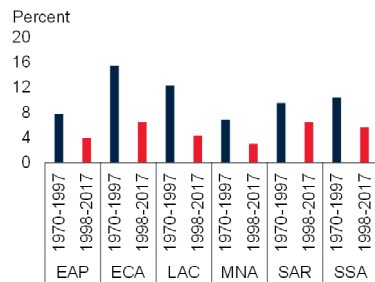
A critical feature of the international inflation experience of the past five decades has been the emergence of a “global inflation cycle” (Ciccarelli and Mojon 2010). This is reflected in a growing contribution of a common global factor to the variation in country-level inflation rates. To

BOX 1.1 The great disinflation (continued)

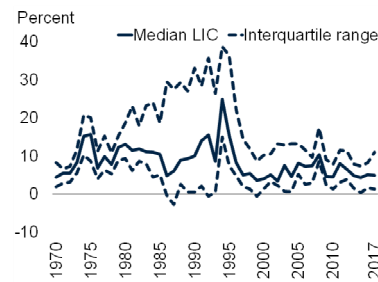
FIGURE 1.1.2 Disinflation and factors associated with disinflation

EMDE inflation has declined in all EMDE regions and low-income countries. In most EMDEs, inflation is now below 5 percent. Lower inflation is associated with greater trade and financial openness. Inflation also tends to be lower in countries that employ an inflation targeting framework and that have more independent and transparent central banks.

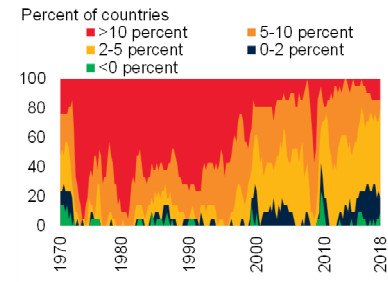
A. Median CPI inflation, by region



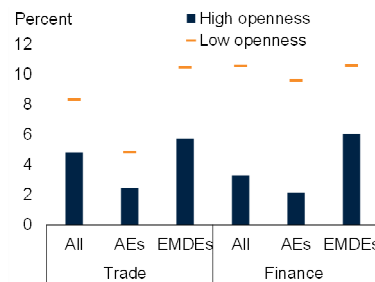
B. Inflation in low-income countries



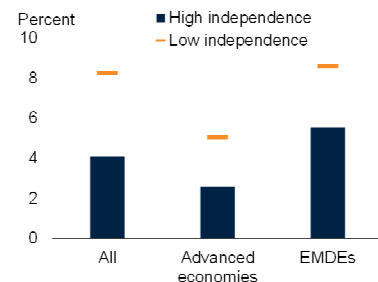
C. Distribution of inflation in EMDEs



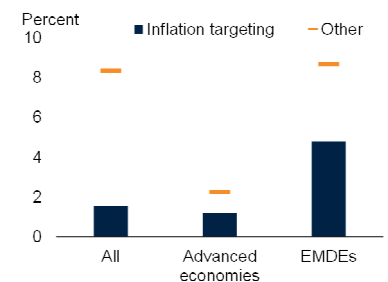
D. Inflation, by trade and financial openness



E. Inflation, by index of central bank independence and transparency



F. Inflation, by monetary policy regime



Source: Ha, Kose, and Ohnsorge (2019); Haver Analytics; IMF International Financial Statistics and World Economic Outlook databases; OECDstat; World Bank.

Note: Median headline CPI (consumer price index) inflation of 29 advanced economies and 123 EMDEs.

A. All inflation rates refer to year-on-year inflation. EAP = East Asia and the Pacific, ECA = Eastern Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, and SSA = Sub-Saharan Africa.

B. Solid line shows median year-on-year headline inflation and dotted lines refer to interquartile range, based on 28 LICs.

C. Inflation refers to quarter-on-quarter annualized inflation. Sample includes 50 EMDEs.

D. Columns indicate median inflation in countries high trade-to-GDP ratios ("Trade") or financial assets and liabilities relative to GDP ("Finance") in the top quartile ("high openness") of 175 economies during 1970-2017. Horizontal bars indicate countries in the bottom quartile ("low openness"). Differences are statistically significant at the 5 percent level.

E.F. Columns indicate median inflation in country-year pairs with a central bank independence and transparency index in the top quartile of the sample (E) or with inflation targeting monetary policy regimes (C). Horizontal bars denote medians in the bottom quartile (B) or with monetary policy regimes that are not inflation targeting (F). Differences are statistically significant at the 5 percent level.

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analyze its importance, a dynamic factor model is estimated for annual consumer price inflation rates in 25 advanced economies and 74 EMDEs during 1970-2017 (Ha, Kose et al. 2019). The model includes a common global factor as well as group factors specific to advanced economies and EMDEs. The presence of group factors allows the model to account for the large differences in country characteristics between advanced economies and EMDEs.

Global inflation factor. Inflation has become increasingly globally synchronized (Figure 1.1.3). The contribution of the global factor to inflation variation has grown over

time: since 2001, it has almost doubled, and now accounts for 22 percent of inflation variation (Ha, Kose et al. 2019). It has explained about one-fifth and one-quarter of EMDE and advanced economy inflation variation, respectively, since 2001. Over the past four decades, an EMDE-specific factor has also become more prominent. The rising importance of these global and group-specific factors indicates that inflation synchronization has become more broad-based over time.

Global inflation versus global business cycle. Inflation synchronization is sizable by comparison with global business cycle synchronization. The international business

BOX 1.1 The great disinflation (*continued*)

cycle literature has established the presence of a well-defined global business cycle (Kose, Otrok, and Prasad 2012). In the sample used here, the global business cycle, as captured by a common global factor in output growth, has accounted for 5 percent of national output growth fluctuations since 1970—less than half the degree of inflation synchronization.

Tradables versus non-tradables. The role of the global factor has been more prominent in price baskets with a larger tradables content. The global factor's contribution to inflation variation was largest for import prices (54 percent in the median country) and smallest for core CPI inflation (5 percent). Between these two extremes, the global factor's contribution to variation in PPI inflation was 42 percent and that for GDP deflator growth was 13 percent and comparable to that for headline CPI inflation.

Maintaining low inflation: A greater challenge

The achievement of low inflation cannot be taken for granted (Rogoff 2014; Draghi 2016; Carstens 2018). If cyclical and structural forces become less disinflationary over the next decade than they have been over the past five decades, inflation could rise globally. Through the strengthening global inflation cycle, this may put upward pressure on EMDE inflation. More importantly, structural and policy related factors that have helped lower inflation over the past several decades may lose momentum or be rolled back amid mounting populist sentiment.

- **Slowing globalization.** The rising protectionist sentiment of recent years may slow or even reverse the pace of globalization. New tariffs and import restrictions have been put in place in advanced economies and EMDEs since 2017. The possibility of further escalation in trade restrictions involving major economies remains elevated.
- **Weakening monetary policy frameworks.** A shift from a strong mandate of inflation control, to objectives related to the financing of government, would undermine the credibility of monetary policy frameworks and raise inflation expectations. Among EMDEs, a decline in central bank independence and transparency has been associated with significantly less well-anchored inflation expectations and greater pass-through of exchange rate movements to inflation.
- **Weakening fiscal policy frameworks.** Growing populist sentiment could lead to a move away from

rule-based fiscal policies. Fiscal rules can become ineffective once commitment to them falters (Wyplosz 2012). Mounting public and private debt in EMDEs could also weaken commitment to strong fiscal and monetary policy frameworks. Government and/or private sector debt has risen in more than half of EMDEs since 2012, including in many LICs (World Bank 2018a). EMDE sovereign credit ratings have continued to deteriorate, with some falling below investment grade, reflecting concerns about rising debt and deteriorating growth prospects.

If unwanted inflation makes a comeback, policy frameworks may be tested in EMDEs: their inflation expectations are less well-anchored, and the absence of strong monetary policy frameworks in many of these economies means that inflation is sensitive to exchange rate movements (Kose et al. 2019; Ha, Stocker and Yilmazkuday 2019). Growing inflation synchronization also increases the risk of policy errors when the appropriate response differs depending on the origin of the underlying inflation shock (IMF 2018a).⁵ EMDE central banks may struggle to contain inflationary pressures and may not receive adequate support from fiscal policy in stabilizing the business cycle. For some EMDEs, a significant increase in inflation could set back poverty reduction efforts.

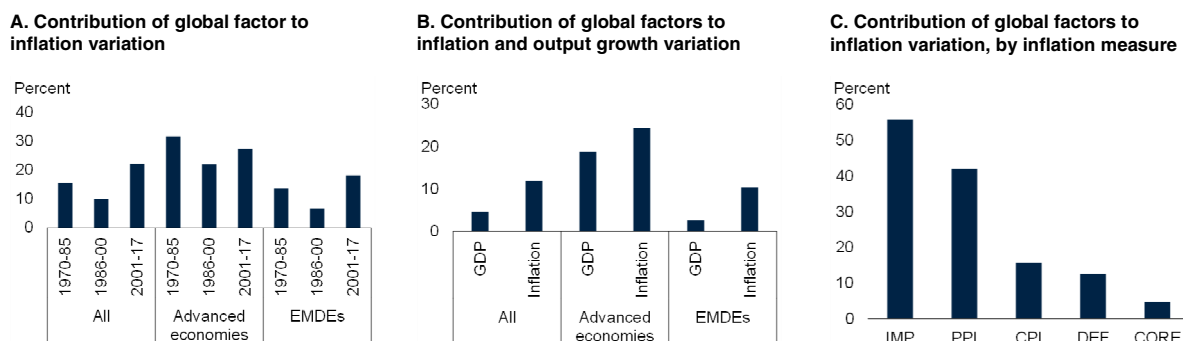
The demise of previous periods of sustained low inflation is a reminder that low EMDE inflation is by no means guaranteed. Inflation has been low and stable before: during the Bretton Woods fixed exchange rate system of the post-war period up to 1971 and during the Gold Standard of the early 1900s (Figure 1.1.4). Yet directly following the low inflation period that ended in the early 1970s, the sharp increase in oil prices in 1973-74 led to a rapid acceleration in global inflation and sharp declines in growth in many countries (Kose and Terrones 2015). Global inflationary pressures also led to a significant increase in domestic inflation in developing economies, including those that experienced relatively low and stable inflation in the late 1960s and early 1970s (Cline 1981). All three episodes of sustained low inflation are characterized by inflation below 5 percent for an extended period. It is notable, however, that the two earlier episodes were followed by sharply rising inflation. This illustrates

⁵ Major advanced-economy central banks have also acknowledged the need to consider the global environment in setting monetary policy in light of the highly synchronized nature of global inflation (Bernanke 2007; Draghi 2015; Carney 2015).

BOX 1.1 The great disinflation (continued)

FIGURE 1.1.3 Inflation synchronization

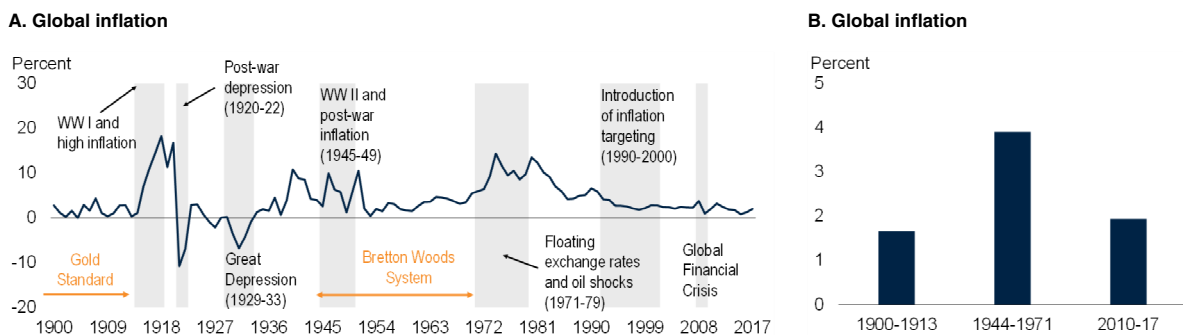
Inflation has become increasingly globally synchronized. The global factor accounted for a greater share of the inflation variance in advanced economies than in EMDEs. The global factor was more important in explaining the variance of price indices with a greater tradable goods and services content. The synchronization of inflation has been stronger than the synchronization of output growth, especially in EMDEs.



Source: World Bank; Ha, Kose, and Ohnsorge (2019).
 A.B. The results are based on a two-factor dynamic factor model with inflation (A,B) or output growth (B) using a sample of 99 economies (25 advanced economies and 74 EMDEs) for 1970-2017. The model includes global and group inflation factors. All numbers refer to median variance shares of total inflation (A,B) or output growth (B) variance accounted for by the global factor.
 C. The global inflation factors are estimated with two-factor dynamic factor models for annual inflation for each measure in 38 countries (25 advanced economies and 13 EMDEs) for the period 1970-2016, the size of the sample being constrained by data availability. "IMP" = import price index, "PPI" = producer price index, "CPI" = headline consumer price index, "DEF" = GDP deflator, and "CORE" = core consumer price index.
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FIGURE 1.1.4 Low inflation episodes

Global inflation has been low and stable before: during the Bretton Woods fixed exchange rate system in the post-war period up to the early 1970s, and during the gold standard of the early 1900s.



Source: World Bank; Ha, Kose, and Ohnsorge (2019).
 A. Median of annual average inflation in a sample of 24 economies for which data are available across the full period.
 B. Cross-country average of annual average inflation. 1900-13 spans the gold standard, and 1944-71 the Bretton Woods system.
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that maintaining low inflation can be as great a challenge as achieving low inflation.

EMDE policymakers need to recognize the increasing role of the global inflation cycle in driving domestic inflation. Options to help insulate economies from the impact of

global shocks include strengthening institutions, including central bank independence, and establishing fiscal frameworks that can both assure long-run debt sustainability and provide room for effective counter-cyclical policies. Low inflation in EMDEs in the past two decades is no guarantee of low inflation in the future.

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