Economic Brief

Analysis of Inflationary Pressures in the CAREC Region

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Introduction

The year 2021 has seen a build-up of inflationary pressure in many countries, driven by demand recovery, input shortages, sharp increase in shipping costs and rapidly rising commodity prices with a magnitude and extent that have exceeded the expectations of most observers. Average annual inflation in the CAREC region accelerated from 5.9% in December 2020 to 9.2% in September 2021[1], with some countries sustaining inflation rates above double digits, such as Kyrgyzstan where the CPI rose 13.5% year-on-year in September[2]. There is sizable uncertainty about the inflation outlook due to factors such as supply disruptions, high commodity prices, higher food prices, soaring housing prices and inflation expectations. Global inflationary pressures could eventually ease because long-term inflation expectations are well anchored, but the outlook varies markedly and in some developing economies high inflation is likely to last longer mainly affected by factors such as rising food prices and currency depreciation. This Brief examines inflation in the CAREC region, the internal and external causes, and possible implications.

Global inflation continues to trend high

Recently, global inflation has continued to rise. In October, the U.S. recorded an annual inflation rate of 6.2%, staying at above 5% for the sixth consecutive month, and hit a three-decade high since December 1990. Energy prices rose 24.8% year-on-year and food prices rose 4.6%, and excluding food and energy, inflation is still as high as 4%. Supply was constrained mainly due to raw material shortages, transport bottlenecks and recruitment difficulties, whereas demand surged, business costs rose, and prices of goods and services moved higher. Euro area annual inflation has peaked to 4.1% in October, up from 3.4% in September, the highest level since September 2008, as German CPI rose 4.5% year-on-year in October, also the highest in nearly 30 years. Soaring energy prices are the main cause of inflation in the Eurozone, with natural gas prices at the Dutch TTF hub rising by almost 400% since the beginning of the year. Inflation levels in emerging and developing economies are generally significantly higher than in developed economies. The IMF's World Economic Outlook[3] expects that annual inflation in advanced economies will peak at 3.6% on average this year and return to 2% in the first half of 2022. Emerging markets and developing economies will see faster increases, reaching 6.8% on average then returning to 4%. Surging housing costs and prolonged supply shortages in advanced and developing economies, and food-price pressure and currency depreciations in emerging markets could be the main drivers.

[1]Source: CEIC, authors ‘calculation.

[2] CEIC, author’s calculation.

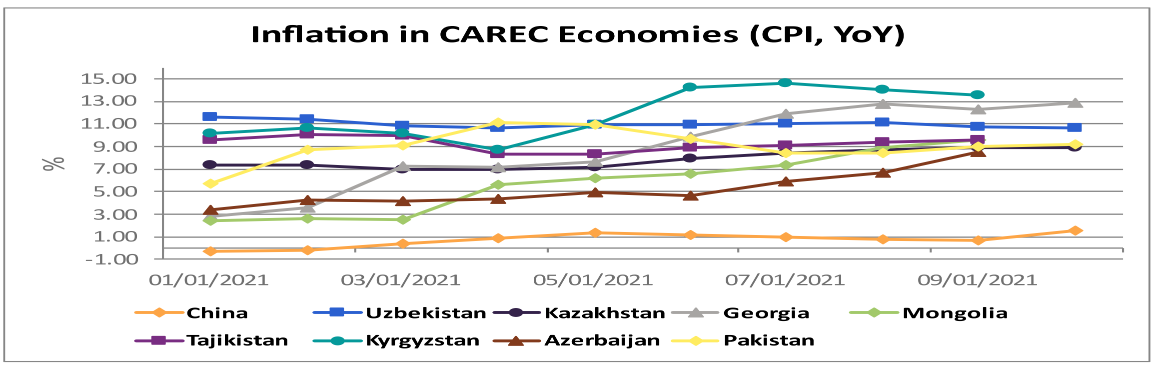
[3]IMF: World Economic Outlook, October 2021.

CAREC region faces inflation pressures[4]

Inflation in the CAREC region has generally been elevated this year amidst rising global inflation. As of September 2021, CAREC average inflation had risen to 9.2%, the highest since 2011.

CAREC member countries vary significantly in their level of inflation. Since the beginning of the year, CAREC members, with the exception of the PRC, have generally experienced rising inflation, with some members recording persistent double-digit annual inflation. The PRC's CPI was down 0.3% year-on-year in January, up 1.3% in May, and returned to higher 1.5% in October. Among other CAREC economies, inflation continued to accelerate in countries such as Kyrgyzstan, Georgia, Mongolia and Azerbaijan, where inflation was respectively 10.1%, 2.8%, 2.4% and 3.3% year-on-year in January and accelerated to 13.5%, 12.3%,9.6% and 8.5% in September, respectively. In some countries, such as Uzbekistan, Kazakhstan, and Tajikistan inflation continued to fluctuate around elevated levels, with annual inflation coming in at 11.6%, 7.4% and 9.5% in January and10.8%, 8.9% and 9.6% in September, respectively. Compared to annual inflation of 5.4% in the U.S. and 3.4% in Eurozone in September, inflation levels in the CAREC region were significantly higher.

Figure 1: Consumer Price Inflation in CAREC Economies



Source: CEIC, author's calculations

Kazakhstan. Driven by rising global food prices and imported inflation from major trading partners as well as a marked recovery in domestic demand, Kazakhstan's inflation has stayed at high levels with fluctuations, recording annual inflation rate of 7.4%, 7.9% and 8.9% in January, June and October, respectively. Retail turnover recovered its growth rates and in September 2021 amounted to 5.6% in annual terms. Food prices were the main driver of rising inflation in Kazakhstan, they rose 11.3% year-on-year in October, versus 7.8% for non-food prices, and 6.9% for paid services prices. The country's currency has been relatively stable, with the monthly average exchange rate against the USD fluctuating only in the 418-

[4]Inflation figures for the following CAREC economies are quoted and updated according to central banks and government statistics agencies. For Afghanistan and Turkmenistan, the data are not publicly available, or incomplete and untimely from the countries' official websites. Therefore, the Brief does not discuss situation in the two countries.

430 range in the first nine months of this year without a significant impact on inflation.

Pakistan. Inflation has fluctuated at high levels so far this year, with annual inflation in January, April and October at 5.7%, 11.0% and 9.2%, respectively. Food and energy prices have played a major role in pushing up inflation. Currency depreciation also contributed to rapid inflation since the value of the Pakistani rupee (monthly average) has fallen from Rs 153.1 against the USD in April to Rs 171.7 against the USD in October. Domestic demand has recovered strongly since July, but inflation fell from 9.7% in June to 8.4% in August because of the base effect and slower increases in controlled energy prices following reductions in excise and sales tax rates on petroleum products. Reflecting the significant effect of food imports on Pakistan's CPI, lower prices of imported wheat and sugar helped bring down food prices with the food and non-alcoholic beverages inflation rate standing at -1.8% month on month and the CPI decreased by 0.3% month-on-month in June, followed by an annual inflation rate at 8.4% in July which decreased from 9.7% in July. Pakistan's central bank believes that inflationary pressure in the country is temporary and supply-driven and that the inflation outlook is largely dependent on domestic demand, prices of controlled commodities such as fuel and electricity, and global commodity price movements. Due to price pressures from disruptions to supply chain and higher energy prices, as well as demand-side pressures on inflation and inflation expectations , the central bank decided to raise the policy rate to 8.75% on 19th , November. [5].

Kyrgyzstan. The CPI rose 9.7% year-on-year in January and 14.6% in July, the highest since August 2011, then falling back to 13.5% and 12.5% respectively in September and October. The surge in consumer demand along with rising global food prices caused inflation to accelerate to 14.1% in August 2021 from 9.7% in December 2020. The prices for food and non-alcoholic beverages rose by 23.4% and 17.4% year-on-year in July and October respectively. Demand has been supported by solid remittances inflows. In the first six months of 2021remittances were 41.0% above the same period in 2020[6]. The National Bank of the Kyrgyz Republic raised its policy rate to 6.5% in April 2021 and 7.5% in July to curb the inflation pressure.

Tajikistan. Year-on-year CPI inflation came in at 9.5% in January, 8.3% in April, 9.1% in July, 9.4% in August and 8.7% in October. The rapid CPI growth was mainly driven by rising food prices which were up 9.0% and 12.4% in April and July, respectively, versus 9.2% and 7.0% for non-food prices and 5.3% and 3.9% for services prices. The inflation rate grew sharply from 6.7% in September to 9.8% in November 2020 and then fluctuated at high levels. Therefore, Tajikistan's central bank raised its benchmark interest rate from 10.8% to 11.0% in February 2021 and kept increasing it to 13.3% in October 2021. The inflation rate then dropped to 8.3% in April but trended up again subsequently. The central bank said it would effectively use monetary tools and implement a balanced monetary policy to prevent inflationary pressure[7].

Uzbekistan. Retail sales grew by 9.8% in the first nine months 2021 as domestic and

[5] Monetary Policy Statement (September 20, 2021); Monetary Policy Statemen (July 27, 2021), Monetary Policy Statemen (November 19, 2021), Monetary policy committee, State Bank of Pakistan.

[6] EBRD, Regional Economic Prospect (November 2021)

[7] Monthly Inflation Review (July 2021), National Bank of Tajikistan

foreign demand picked up due to increased economic activity and an improving Covid-19 situation. At the same time, inflation has stayed at high levels amid rising global inflation and food and energy prices. Annual inflation was 11.6% in January， 10.8% in September and 10.6% in October, with September recording a year-on-year increase of 14.4% in food prices and 23.2% in energy prices. Non-food and services prices grew 7.7% and 8.8% year-on-year respectively, which helped dampen inflation. In addition to government measures to stabilize food prices and contain imported inflation, the central bank said that it would maintain a moderately tight monetary policy to push inflation downward and strive to achieve the 10% inflation target at the end of the year.

Mongolia. Driven by domestic economic recovery, as well as temporary factors such as the base year effect and higher commodity prices, inflation has continued to accelerate rapidly so far this year, from 2.4% year-on-year in January to 9.6% in September. Food and non-alcoholic beverage are the largest component of Mongolia's CPI (accounting for 39.7%), followed by clothing and footwear (15.3%) and housing, water, electricity, gas and other fuels (10.8%). The central bank sees continued risk of general inflation, expecting the base year effect and temporary factors to drive inflation further up. A stronger than expected global economic recovery, international supply chain and logistics disruptions and global food and gas price increases could lead to both higher demand-pull and cost-push inflation. The central bank expects inflation to stabilize around the target level of 6% by the second half of 2022.

Georgia. Inflation has continued to accelerate since the beginning of the year, with the CPI rising 2.8%, 7.2%, 11.9% year-on-year in January, April, and July, respectively, and rising to 12.8% in October, the highest since May 2011. The central bank said that the high inflation was mainly due to one-off factors, including rapid increases in international food prices, oil prices and international transport costs since the beginning of the year[8]. Despite mild currency appreciation, import prices increased far more rapidly year-on-year (18.7%) than domestic price increases (8.2%) in August. The central bank expects inflation to remain high in the later months of this year, but to fall significantly in the spring of 2022.

Azerbaijan. Inflation has been rising in Azerbaijan from the beginning of the year, with the CPI rising 3.3%, 4.4%, 5.9%, 10.0% year-on-year in January, April, July, and October respectively, food and non-alcoholic beverage inflation rate standing at 4.6%, 4.4%, 6.3% and 13.0% in the same period. Food inflation is mainly driven by high global food prices. Inflation has been accelerated from June (4.68%) and kept increasing to 10.0% in October. The factors contributing to the upward trend in annual inflation include the dynamics of global food and non-food prices, intensification of postponed demand, liberalization of state regulated prices and tariffs. Due to lingering inflationary pressure, rising prices in global markets, high inflation rate in trade partners and rising inflation expectations, the central bank decided to set the policy rate, refinancing rate at 7% from 6.5% in September on 29 October. [9]

Why have inflation levels remained high in the CAREC region?

In the aftermath of COVID-19, major economies rolled out massive fiscal stimulus

[8] "The National Bank of Georgia keeps its monetary policy rate unchanged at 10.0 percent" (27.10.2021), National Bank of Georgia.

[9] Monetary policy decisions, Central Bank of the Republic of Azerbaijan.

programs and resorted to loose monetary policies. As a result, the global economy recovered, consumption gradually picked up and demand rebounded rapidly. However, supply chains never returned to pre-pandemic levels, with a global mismatch between supply and demand coupled with an overabundance of liquidity leading to rapid increases in commodity prices and labor costs in some economies. For example, the Employment Cost Index, the broadest measure of labor costs in U. S, surged 1.3% in the third quarter this year and the worker pay has increased almost 5% during the past year, according to the Reuters and the CBS. Massive inflation spreads from developed economies to the rest of the world including CAREC region.

Extraordinary stimulus in developed economies ripples across the world. Countries around the world, especially major developed economies such as the U.S. have implemented massive fiscal stimulus programs and ultra-loose monetary policies in response to the pandemic, resulting in a severe global liquidity surplus. According to the BIS[10], since January 2020, countries have announced a total of US$16.91 trillion in financial support in response to the pandemic, representing 16.4% of the GDP of these countries. According to Geoffrey Okamoto, the first deputy managing director of the IMF, governments had spent $16 trillion providing fiscal support amid the pandemic, and global central banks had increased their balance sheets by a combined $7.5 trillion from March 2020 to June 2021.[11]

Supply and demand mismatch drives inflation higher. With increasing vaccination coverage and falling infections, coupled with a loose policy environment, global demand has quickly recovered, but supply chain disruptions have remained unsolved in most economies due to the pandemic, with the faster recovery in demand than that in supply leading to a supply-demand mismatch that has kept prices rising. Factors such as chip shortage and soaring freight costs have put upward pressure on commodity and durable goods prices. In the U.S., for example, due to constraints from labor shortage nonfarm payrolls increased only 235,000 in August, far short of the market expectation of 750,000.

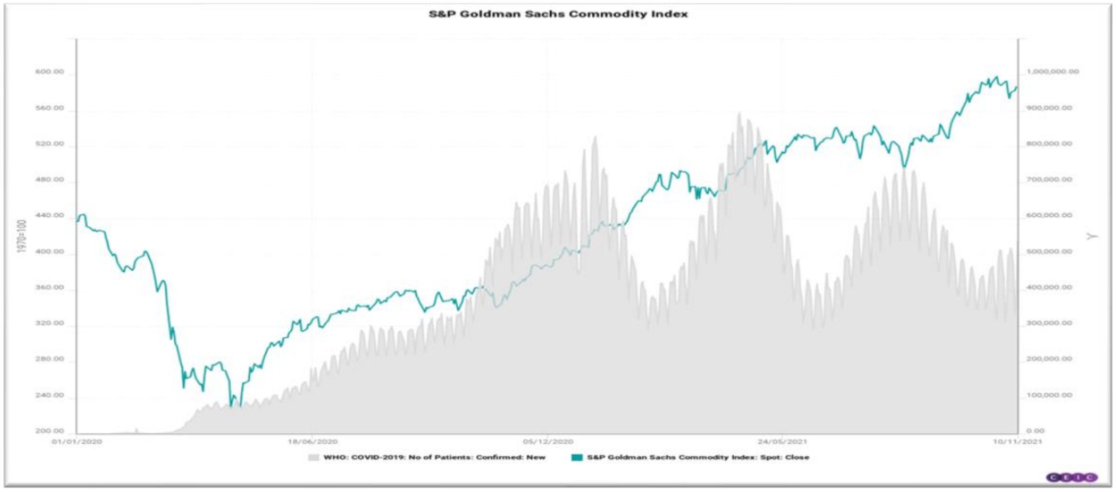
Commodity prices continue to rise. Driven by double-barreled fiscal and monetary stimulus policies adopted by major developed economies, commodity prices such as food and oil prices have been steadily on the rise. The FAO Food Price Index rose for 12 consecutive months, averaging 130 in September, up 32.8% year-on-year; demand for crude oil has risen sharply due to the recovery in the transport sector, but supply has increased relatively slowly, with oil prices generally gaining momentum and rising further since late August due to extreme weather; prices of internationally priced commodities such as copper and aluminum have also continued to rise from already high levels. A spike in commodity prices is usually a harbinger of inflation, and rising oil prices have been reflected in CPI data. The Eurozone CPI rose 3.0% year-on-year in August, the highest since November 2011, with the ECB citing higher oil prices since the middle of last year as an important contributing factor[12].

[10] The BIS summarized the main fiscal measures announced or taken by governments in G20 developed and emerging economies, 26 non-G20 developed economies, 82 non-G20 emerging economies, and 59 low-income economies in response to Covid-19 as of 27 September 2021, including COVID-19 related measures introduced since January 2020 and implemented in 2020 and 2021 and to be implemented after that.

[11] https://blogs.imf.org/2021/07/20/seizing-the-opportunity-for-a-pro-growth-post-pandemic-world/

[12] Economic Bulletin Issue 6, 2021, "Economic, financial and monetary developments", ECB.

Figure 2: S&P Goldman Sachs Commodity Index[13]



Sources: CEIC，Standard & Poor's S&P which publication? Link?

Rising inflation in CAREC member countries is also influenced by their specific economic structures.

When commodity prices rise across the board, developing countries tend to experience higher levels of inflation than developed countries and are also more vulnerable to inflationary shocks. This is because developing countries, which often have unbalanced industrial structures and undeveloped supply chains, are less able to absorb inflationary pressures in the face of rising prices of production. Most of the 11 CAREC member countries, with the exception of the PRC, have mining, agriculture and tertiary industry as their economic pillars, rising freight costs and imported goods prices, and insufficient inventories to meet recovering consumer demand have combined to accelerate inflation to levels higher than in developed economies. On the other hand, some CAREC countries, such as Kazakhstan, Mongolia, Turkmenistan, and Uzbekistan have benefited from rising global commodity prices, given that they are large exporters of oil, natural gas, metal ores and grains, and Kyrgyzstan and Tajikistan that are dependent on natural resource exports such as gold and horticulture products, and also strongly depend on remittances from Russia the economy of which is strongly influenced by commodity prices too. In these countries, the surge in remittances, while bolstering consumer demand, has also stoked inflationary pressures.

Food prices in the CAREC region have risen faster than the CPI, making them an important driver of the sustained high CPI. Food and non-alcoholic beverage price in

[13] S&P acquired the GSCI from Goldman Sachs on February 2, 2007; subsequently the index was renamed the S&P GSCI® (formerly the Goldman Sachs Commodity Index). The S&P GSCI is designed as a benchmark for investment in the commodity markets and as a measure of commodity market performance over time. It is also designed as a tradable index that is readily accessible to market participants. The S&P GSCI is calculated primarily on a world production-weighted basis and comprises the principal physical commodities that are the subject of active and liquid futures markets.

Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Mongolia, Pakistan, Tajikistan and Uzbekistan rose respectively by 10.3%, 15.9%, 11.5%, 19.9%, 15.4%, 10.2%, 10.4% and 14.4% year-on-year in September, generally higher than their CPI increases in the same period. For example, the main contribution to the acceleration of annual inflation continues to be made by the increase in food prices (4.5 percentage points out of 8.9%) in September in Kazakhstan.[14]

Where is inflation heading in the CAREC region and what challenges might this bring?

Recent inflationary pressures in the CAREC region are mainly due to pandemic-relater factors and temporary supply-demand mismatches, the future direction of inflation will be influenced by a combination of factors, including inflation in trading partners, intensity of fiscal stimulus, global supply-demand dynamics, and food and fuel prices.

Some CAREC countries will face inflation-related challenges, such as food security issues and increased debt burden due to food inflation. Rising food prices due to the pandemic have significantly negatively impacted food security and nutrition in developing countries. Tajikistan, for example, experienced substantial increases in staple food prices in July, with prices of animal and vegetable oils, sugar, eggs, vegetables, and meat and meat products rising 66.1%, 43.1%, 20.2%, 18.6% and 15%, respectively, which led to much higher expenditures on basic consumption. **Government debt in some countries may get worse due to the pandemic.** Some CAREC countries, such as Kyrgyzstan, Mongolia and Tajikistan, have introduced relevant fiscal support policies to cope with the impact of the pandemic and stimulate economic recovery. However, these countries, with weaker fiscal positions, will face increased debt risks due to risen levels of public debt.

Some measures taken by countries to address inflation could affect regional economic recovery. The central banks of CAREC member countries are under pressure to raise interest rates to fight inflation and ease the depreciation of their home currencies. Following Kazakhstan and Kyrgyzstan, the central bank of Tajikistan recently raised its benchmark refinancing rate for the third time in the year to 13% in an effort to curb inflation. However, interest rate hikes come at a price. Tightening monetary policy will inevitably push up financing costs, which may make the post-pandemic recovery process more difficult. On the flip side, keeping monetary policy loose risks letting up on or even exacerbating inflation, hitting consumer purchasing power and fueling stagflation. In addition, in the face of global inflation, central banks in major economies, such as the U.S., may adjust their monetary policies with increasing expectations of interest rate hikes and higher bond yields, which would subject developing countries including CAREC member countries to a series of challenges, such as capital outflows, a tightening financial environment, higher costs of debt and an increased debt burden.

How to deal with regional inflation? Both domestic policy and international cooperation are important

In anticipation that elevated inflation in the CAREC region is likely to persist for a

[14] National Bank of Kazakhstan, Press-release №20.

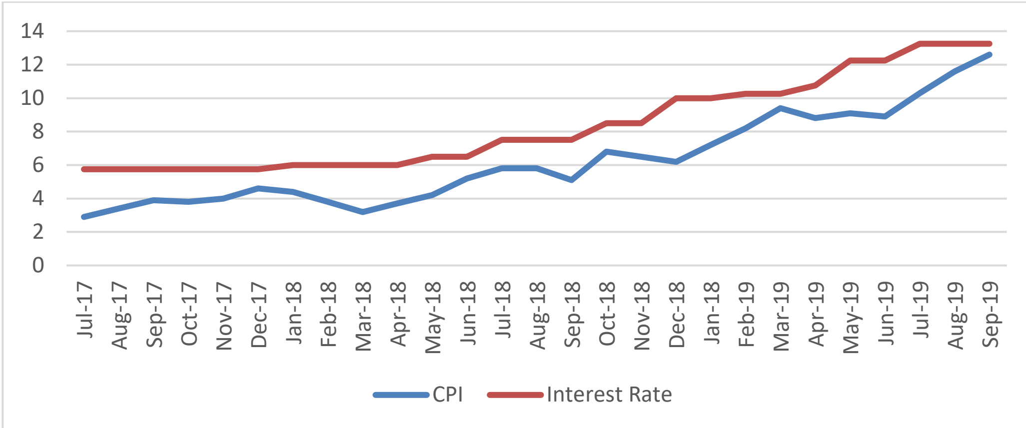
longer period of time, national authorities of the member countries should move with counteractions. The IMF recently warned that global inflation could last longer than expected[15] and that central banks should take active steps to moderate it. Any major shift in monetary policy of major developed economies may come with significant spillover effects which will likely lead to sudden global financial tightening, corrections in financial markets, increased market vulnerability, and massive asset bubbles, trigger capital outflows from developing and emerging economies with increasing depreciation pressure on currencies and rising debt servicing and refinancing costs and risks, and affect the ability of developing countries to provide sustainable fiscal support for Covid-19 control and economic recovery. In the short term, some countries could resort to preemptive actions such as controlling capital flow volatility via the temporary use of broad-based Capital Flow Management Measures (CFMs), restrictions on residents' investments and transfers abroad, and repatriation and surrender requirements on export proceeds.[16] In the long term, a more prudent fiscal policy should be considered, coupled with better targeted measures, such as spending to stimulate specific economic activities, taxation to decrease specific economic activities and taxation to redistribute wealth and income to ensure price stability, guard against pro-cyclicality, maintain necessary support for vulnerable sectors, and maximize the protection for vulnerable groups via social safety nets. Measures also should be taken to address structural imbalances like lower investment levels, trade deficits, such as improving environment for doing business, promoting human capital development and increasing investment in basic science to boost productivity over the long term. For the economies with high dependence on remittances which could be heavily exposed to external shocks including global inflation, governments also could play an active role to manage the risks by promoting financial education, encouraging saving of remittances recipients and leveraging remittances for investment, etc.

Nevertheless, the authorities face difficulties regulating inflation through monetary policy. For one thing, central banks face a dilemma about monetary policies whether or not to raise the rate to anchor the inflation. They tend to give more weight to the effects of interest rates on economic growth and employment generation than they do to inflation pressures. Secondly, the effects of policy interest rate may not be significant in some CAREC countries where the policy rate channels are weak. For example, there seems no relationship between the policy rate and the inflation rate in Pakistan.

[15] IMF: Inflation scares in an Uncharted Recovery .

[16] Monetary and Financial Policy Responses for Emerging Market and Developing Economies: Thomas Harjes, David Hofman, Erlend Nier, and Thorvardur Olafsson

Figure3: Inflation rate Vs. Policy rate in Pakistan



Source: Inflation and Interest Rate Outlook, Ghulam Samad, Research Economist, PIDE and Muhammad Zeshan, Senior Research Fellow, PIDE

In addition, coordinated international efforts can also play an important supportive role. On the monetary policy side, in view of the impact of policy spillovers, developing economies should consider adjusting their reserve currency composition. In respect of unusual capital flows, it might be advisable to coordinate liquidity arrangements with the help of supportive actions from advanced economies and international Financial Institutions, providing timely access to liquidity such as currency swap arrangements, rapid financing instruments like the new Short-term Liquidity Line (SLL), and for policy advice and capacity development, helping to expand fiscal space including through grants and debt forgiveness to fight against the pandemic, meet critical social needs and accelerate economic recovery.

On the regional cooperation side, CAREC Corridors remain very important, especially when we consider that most CAREC economies are landlocked countries. Corridors can help to release the potential for regional cross-border trade, investment domestically and internationally, employment generation, and lower transportation costs. Policies and measures should be taken to promote trade facilitation and logistics along CAREC trade corridors on infrastructure, services, and procedures or processes, including investments in infrastructure, modification of policies and regulations related to trade facilitation [17], governments' capacity building to manage the infrastructure and regulate the flow of goods, and enhancement of the private sector's ability to provide services, etc.

Conclusion

Most CAREC economies have encountered increasing inflation rate this year amidst rising global inflation. Factors, pushing inflation forward has been the combination of global and domestic issues including effects of stimulus policies, surging energy and commodity prices, pandemic-induced supply-demand mismatch, currency depreciation and unbalanced industrial structures in some economies, etc.

[17] Connectivity, Logistics & Trade Facilitation, World Bank.

Recent inflationary pressures in the CAREC region are mainly due to pandemic-related factors and temporary supply-demand mismatches, the future direction of inflation will be influenced by a combination of factors, including inflation in trading partners, intensity of fiscal stimulus, global supply-demand dynamics, and food and fuel prices. However, the resurgence of the pandemic and new variants, such as Delta or Omicron, have greatly increased uncertainty of inflation and recovery in CAREC economies, as well as global economic prospects.

Since elevated inflation in the CAREC region is likely to persist for a considerable period of time, the authorities of the member countries should get ahead of inflationary pressures and move with counteractions to control inflation and address the spillover effects of major shift in monetary policy of major developed economies. In the long term, more targeted policies should be considered to ensure price stability, guard against pro-cyclicality, maintain necessary support for vulnerable sectors, and maximize the protection for vulnerable groups via social safety nets. Coordinated international efforts can also play an important supportive role.