The Inflation EconoView

By Sundar Sankaran

My previous column discussed issues related to policies that are under implementation to control inflation. Since the subject continues to make headlines, in this article I dwell on the role of different countries in creating the inflation animal.

When supply falls short of demand, price has to go up. Thus, demand adjusts itself to match the aggregate supply level, and ensure equilibrium in the economy. This increase in prices is inflation.

What supply and demand factors are at work in the current bout of global inflation?

1. **India, China and Developing Countries**

Economic activity has been up in these countries during the last decade. The higher economic activity raised the demand for oil and industrial commodities in the region.

The incremental economic activity led to higher income in the hands of the people in these developing countries. When income levels go up in the richer countries, conspicuous consumption goes up; in developing countries, when incomes go up, consumption of basic necessities rises. Hence, the rise in consumption of food.

As any vegetarian traveller to China can vouch, the country triggers vegetarian fret , and non-vegetarian pride! Much of non-vegetarian fare comes out of the body of birds and animals, which in turn survive on food and other primary commodities. Scientific research has shown that the same intake of calories, when it comes through the non-vegetarian route of consumption of animal meat, causes a much higher consumption of underlying food and primary commodities (by the birds and animals) in the economy, as compared to consumption of vegetarian food. Thus, the Indian vegetarian habits tempered the inflation in food articles, while the Chinese non-vegetarian habits aggravated it.

2. **Specifically China**

China has been involved in a superb game of supply chain security in impoverished countries in the African region, which are otherwise rich in mineral resource. The Chinese strategy of cornering supplies from these countries, limit the free supply of mineral resources in the market.

Besides, Olympics is the big upcoming event in China. The Economist reports that China is so keen to minimise the pollution levels during the event, that it has put limits on coal-fired power. Consequently, oil-fired power stations (which cause lesser pollution than coal) have been in the thick of action. Hence, a significant increase in oil purchases by China since April 2008.

3. **Iraq, Nigeria**

Both countries are saddled with security problems, which are affecting the oil exploration and supply from these countries.

Further, over a period of time, oil prices were soft. So oil exploration companies did not find it economical to explore some of the more difficult oil wells. High oil prices will now give a fillip to oil exploration activities world wide. But it will take several years for this to get yield higher oil supplies.

3. **The US**

The US, has contributed to the inflation in several ways:

a. Excessive Consumption

Why did economic activity in the developing countries go up? A significant contributing factor was higher exports to the US. This is evident from the high trade deficit numbers of the US. Why did the US import more?

I. US Asset Bubble

The cheap money policy of the US led to rise in prices of stocks as well as real estate. It is normal human

psychology that when the value of assets they own go up, people feel good, and end up consuming more.
ii. Overvalued US Dollar
Although the economy was in deficit, the US dollar was valued higher than its inherent strength. This made it
cheaper for US citizens to import. When anything becomes cheap, its consumption goes up. Basic economics!
b. Bio-fuel Policy
Worried about its energy security, the US has been incentivising bio-fuels. Free Trade Champion, the US, does
not want to import cheaper bio-fuel from its South American neighbours. It has incentivised cultivation of maize
(for conversion into bio-fuels) so much, that farmers have switched from cultivating food to cultivating maize.
This has impacted supply of food grains within the US.
c. Speculation in Oil Futures
When anything becomes cheap, its use goes up. Again, basic economics! In the US, the minimum cash outlay
for oil futures was so low, that anyone's servant could dabble in oil futures. The holding of such contracts has
mounted.
A purist would argue that these futures ultimately get reversed. So, there is no net addition to demand for oil. So
futures are not a contributing factor to increase in oil prices. The argument of a purist is right in a micro sense.
But then, if each increase in oil prices leads to more people joining the gang of oil futures speculaters, then the
bubble will keep getting bigger.
When will the bubble burst? After the elections in the US this November?
The complex relationship between the different factors can be seen in the chart below.