

# ✕ The Big Bulge: The Myth of Prosperity

No evidence supports the claim that rising inflation is a sign of growing prosperity. Most economic booms tend to be disinflationary in nature



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US senator and former ambassador to India, Daniel Patrick Moynihan once quipped that there are some mistakes only someone with a Ph.D. can make. Well, it does not require a doctorate to know that China's economic boom has been disinflationary with its inflation rate averaging a mere 2% over the past decade. Yet, it is amazing to watch how India's top policymakers, despite their great academic credentials, keep propagating the line that the country's inflation problem is a sign of growing prosperity.

China's low inflation experience is not just an exception; it is the broad rule for the high growth cases in post-World War II history. In the three high growth decades since 1950 — the 1960s, 1970s and the past decade — a dozen developing countries have managed to expand at an average pace of more than 7%. East Asian nations have featured most prominently on the top economic league tables and, of late, countries from Africa and central Asia have enjoyed similar success. Back in the 1960s and 1970s, some Middle Eastern states too grew at a robust pace.

Low inflation is a hallmark of boom periods and when prices do begin to rise meaningfully, it is often a sign that the good times are ending. The classic example is that of Brazil, the only other Latin American country apart from Venezuela, to grow at an average rate of 7% or more for a decade. Brazil was one of the major economic stars in the 1970s but a runaway rise in government spending, the willingness of monetary authorities to monetise the mounting debt, regressive policies favouring import substitution and the end of the reform cycle set the stage for terrible bouts of hyperinflation in the 1980s and 1990s. Interestingly, even in Brazil where inflation has been perennially higher due to its relatively lower savings and investment rates, no acceleration in inflation occurred during the high growth period; when prices spiralled out of control, economic growth collapsed.

The few countries where inflation tended to be relatively high during their growth spurts were the oil and commodity-based economies such as Saudi Arabia in the 1970s and Angola, Azerbaijan and Mozambique over the past decade. These countries found it hard to manage the excess liquidity generated from the commodity price boom. However, in all these cases, the rate of inflation actually decelerated compared to the pre-boom experience. After all, many of the nations such as Angola, Azerbaijan and Armenia all had hyperinflation in the 1990s.

The Growth Commission report sponsored by the World Bank, details 13 economic success stories of countries that were able to sustain an average growth rate of 7% or more over at least a 25-year period. The familiar Asian examples such



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as Japan, South Korea, Taiwan, China, Hong Kong, Singapore, Indonesia, Malaysia and Thailand dominate the list but countries from every other region also make the cut, from Botswana in Africa and Malta in eastern Europe, to Oman in the Middle East and, of course, Brazil in Latin America.

During their respective boom periods, inflation in these countries was lower than their emerging market peers 70% of the time. Further, Brazil skews the average. In other countries, inflation decelerated steadily through the high growth periods and was, in fact, lower at the end of the boom than at the start.

A surge in investment is a common characteristic of economic miracle stories as high investment rates imply enough capacity creation to meet rising demand. Investment-to-GDP ratios averaged nearly 30% during the economic booms in the 13 countries mentioned in the Growth Commission report, and in many Asian nations — from Japan in the 1970s to Malaysia in the 1990s — it peaked at above 40%. That's why, in much of east Asia, inflation has largely not been an issue. South Korea was somewhat of an exception in the 1960s and 1970s, when inflation did average around 10%. But that was mainly due to the severe oil shock and the generally high global inflation in those decades; South Korea tended to import inflation as it was then moving away from a policy of import substitution to export promotion. When inflation came off globally in the 1980s, South Korea's rate too fell dramatically and that helped extend the strong growth spell.

India too, it appeared, was following the east Asian path for much of the past decade. The country's investment as a share of GDP accelerated from below 25% in 2003 to over 35% in 2007, spurred on by the easy money flows and the emerging market boom during that stretch. Economic growth then rapidly rose to average 9% while inflation was quiescent and tracked around 5%. The robust investment rates gave policy-

makers and many economists a false sense of comfort that India could sustain high rates of non-inflationary growth as many of its east Asian peers did for at least a couple of decades. The Indian economy's resilience during the Great Recession of 2008-09 further strengthened that belief.

However, beneath the surface, the plates were shifting. India's relative outperformance on the growth front in 2008 and 2009, at a time when the global impulse had weakened compared to the 2003-07 period, was due to large government spending that propped up both consumption and investment. High investment rates have no predictive power for economic growth as was most apparent in the Soviet Union in the 1970s when investment as a share of the economy was well over 30%, but it was largely malinvestment. Even in east Asia, strong economic growth often preceded a pick up in the investment-to-GDP ratios rather than the causality working the other way.

With Indian policymakers in the post-financial crisis environment relying on fiscal and monetary policy stimulus to meet the lofty growth targets of the 2003-07 phase, the stage was set for a pick up in inflation. In contrast, the economic and accompanying investment booms in east Asia lasted for long periods, as those countries were able to systematically implement productivity-enhancing reforms. In addition, it is important to remember that there was no stickiness in their investment rates. Thailand's high investment-to-GDP ratios lasted for barely a decade from 1988 to 1997 while China's have prolonged for more than three decades, with investment as a share of its economy exceeding 30% and the latest reading is a record high 46%.

Just like China, a large increase in savings of the corporate sector fund-

ed the acceleration in India's investment rates in the 2000s with household savings remaining stable at around 20%. The one difference has been the divergent performance of the government's finances: in China, the government saves a lot more than in India. Over the past year, corporate savings too have begun to decline in India due to factors including the global slowdown, and that helps explain the fall in both the domestic investment and economic growth rates. In China, meanwhile, inflation is less of an issue despite its continued high economic growth, as both the investment and savings rates are still very strong.

To be sure, China now faces the same risk as some of the east Asian countries did in the mid-1990s when overinvestment led to its own problems but soaring inflation was not one of them. India's poor inflation performance of the past few years, where the pace of price increases have on average been nearly twice that of emerging markets in general, is a sign of the investment malaise that has plagued the country rather than a reflection of prosperity.

Attributing rising inflation to greater intake of protein-rich foods by more affluent consumers is a tough sell, as the sketchy data on this topic shows hardly any change in volumetric measures of per-capita protein consumption. Prices of items such as milk too have been soaring despite no shortages as the cost of production has risen. Even if food prices were indeed increasing due to higher incomes, such pressures on overall consumer prices should normally be offset by lower inflation in other categories (especially manufactured goods) due to the high investment rates, as was the case in the miracle economies of east Asia. There is just no historical relationship between rising levels of development and higher consumer prices, and to suggest otherwise is a rather basic mistake.

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