HIGHLIGHTS from Special Focus 2:

Low for how much longer? Inflation in low-income countries

Key Points

- *Inflation in low-income countries (LICs) has declined sharply over the past two to three decades to a median of 3.2 percent in mid-2019 from a peak of 25 percent in 1994.*
- *The decline has been supported by the move to more flexible exchange rate regimes, greater central bank independence, lower government debt, and a more benign external environment.*
- *To maintain low and stable inflation, monetary and fiscal policy frameworks need to be strengthened and supported by efforts to replace price controls with more efficient policies.*

Evolution of inflation. Median inflation in LICs has declined sharply to 3.2 percent in mid-2019 from a peak of 25 percent in 1994—broadly in line with inflation developments in other emerging market and developing economies (EMDEs). The inflation decline has been broad-based across countries as well as inflation components (e.g., food, energy). As a result, the wide heterogeneity of inflation among LICs in the 1990s has narrowed sharply (Figures 1A, B).

Factors supporting inflation developments. Improvements in LIC policies and a benign global macroeconomic environment have supported the decline in LIC inflation. The adoption of greater central bank transparency and generally more resilient monetary, exchange rate, and fiscal policy frameworks has facilitated more effective control of inflation (Figure 1C). In 1970, all but three LICs had pegged exchange rates whereas, in 2019, less than half did. In part as a result of debt relief initiatives, government debt has declined from a peak of 121 percent of GDP in 2000, on average, to 53 percent of GDP in 2019— broadly in line with the average non-LIC EMDE. Despite a growing number of LICs switching to floating exchange rate regimes, exchange rates have been considerably more stable since 1998 than in the preceding two decades (Figure 1D).

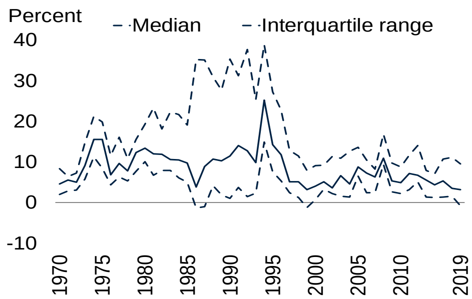
Monetary policy challenges. That said, the level and volatility of inflation in LICs have remained higher than in advanced economies and other EMDEs over the past two decades. This difference may reflect monetary policy challenges particular to LICs arising from higher economic volatility and pervasive use of administered pricing, conflicts among central bank policy objectives, and limited analytical capacity at central banks. Widespread informal sector activity and small financial systems with narrow reach limit monetary policy transmission through the financial sector (Figures 1E, F).

Policy options. If the external environment turns less benign or fiscal pressures mount, the ability of central banks in LICs to maintain low and stable inflation may be tested. Broader policy efforts aimed at strengthening fiscal and monetary policy frameworks, and improving debt management, are therefore required in LICs to safeguard low and stable inflation. Addressing monetary policy challenges in LICs requires a broader development process and includes: the development of financial markets to provide the central bank with more effective policy instruments; the improvement of systems compiling economic statistics; and capacity development in central banks and economic ministries.

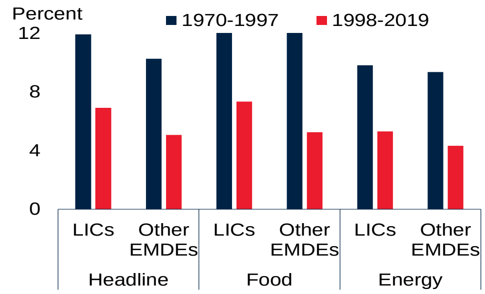
Figure 1. Inflation in low-income countries

Inflation in LICs has declined since 1970, broadly in line with other EMDEs. The decline in LIC inflation has been supported by the move to greater central bank independence and more resilient monetary, exchange rate and fiscal policy frameworks. However, small financial systems with narrow reach limit monetary policy transmission through the financial sector.

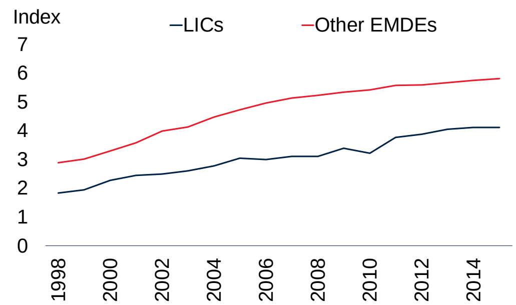
A. Inflation



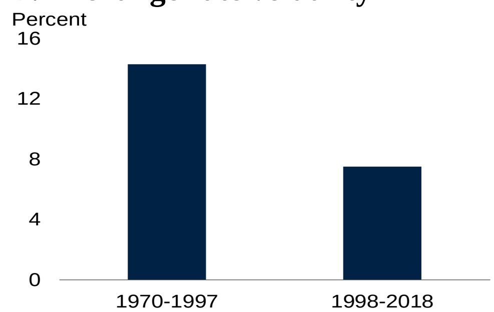
B. Inflation LICs and other EMDEs



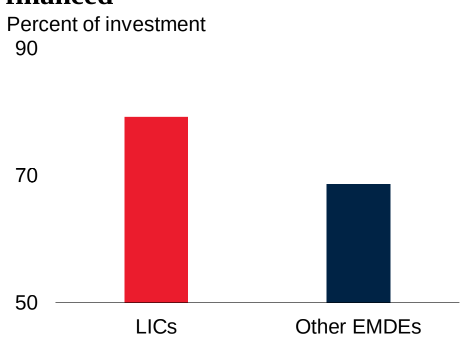
C. Central bank transparency index



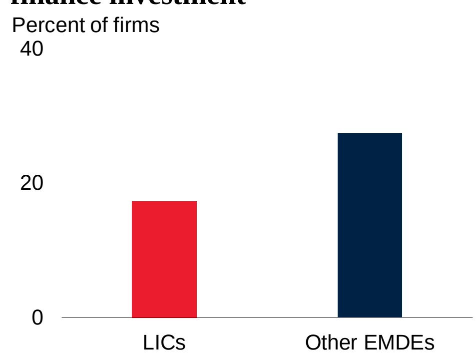
D. Exchange rate volatility



E. Share of investment that is internally financed



F. Share of firms that approach banks to finance investment



Source: Dincer, Eichengreen, and Geraats (2019); Enterprise Survey; Haver Analytics; International Monetary Fund; World Bank.
Note: Inflation refers to year-on-year inflation. EMDEs = emerging market and developing economies; LICs = low-income countries.
A.B. Data for 26 LICs and 99 other EMDEs.
A. Blue line is cross-country median of inflation; dashed lines indicate the interquartile range across 26 LICs. 2019 inflation rates are based on year-on-year inflation during the first half of 2019 in 19 LICs.
B. Cross-country medians of inflation of inflation. The differences across sample periods are all statistically significant.
C. Unweighted averages across countries. Central bank transparency index as defined in Dincer, Eichengreen, and Geraats (2019).
D. Exchange rate volatility is the cross-country average of the standard deviation of nominal effective appreciation in 28 low-income countries during each time period.
E.F. Enterprise survey based on 15 LICs and 47 other EMDEs. Proportion of investment financed internally (E) or proportion of firms using banks to finance investments (F).