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Emerging markets and interest rates

Bernanke has it easy

Developing countries have their own monetary headaches

SPUTTERING platinum smelters and dwindling diamond deposits do not rank highly on the list of concerns of the world's "big three" central bankers-Ben Bernanke, chairman of the Federal Reserve, Jean-Claude Trichet, president of the European Central Bank and Toshihiko Fukui, governor of the Bank of Japan. Both, however, feature in the latest inflation report of the South African Reserve Bank, which, as *The* Economist went to press, was expected to raise its benchmark interest rate by as much as half a percentage point, to 8%, having already raised it by the same amount in June.

The connection between tight monetary policy and troubled quarries and furnaces may seem a bit murky. But such is the lot of a central banker in an emerging economy, where troubles brew in remote places then break with unpredictable force. Platinum, palladium, gold and diamonds account for almost a quarter of South Africa's exports. But mining output struggled last year and shrank by about 6% in the first five months of this year. South Africa's lacklustre exports are one reason why its merchandise trade deficit was the worst on record in the first quarter and not much better in the second. The trade gap put downward pressure on the rand, which has, in turn, put upward pressure on prices. Hence the increase in interest rates.

South Africa's central bank is not alone in spreading its wings and sharpening its talons. The Czechs, Indians, Slovaks, Israelis, Hungarians and Turks all raised rates last month. Like their counterparts in Pretoria, central bankers in these countries face their own idiosyncratic challenges to price stability. In Israel, for example, the central bank wants to know how much slack remains in the job market. But how to calculate that, when the Israeli army might any day call up its reserves, which represent about 18% of the labour force?

These peculiarities aside, the central bankers share some common complaints. Their lives have all been complicated by Mr Fukui's recent triumph over deflation and Mr Bernanke's rearguard action against inflation. Thanks in part to their efforts, money is now harder to come by. Investors thus became less willing to throw it at emerging-market assets. As a result, currencies fell in May and June, stoking inflationary pressures.

Turkey's central bank has waged the fiercest fight. It has raised rates by as much in two months as the Fed has in two years. In December 2005, it set itself the target of reducing annual inflation steadily from 7.7% to 5% by the end of this year. By June, however, annual inflation was running at over 10%. Has Turkey been overheating? The economy grew by 6.4% in the year to the first quarter, the stockmarket boomed and the current-account deficit widened. Perhaps most telling, Harvey Nichols plans to open a luxury store in Istanbul.

But the central bank lays the blame elsewhere. In an open letter, explaining the breach of its target, it bemoans higher oil, food and gold prices. Most of all it blames the lira, which fell by 23% against the dollar between May sth and June 23rd. Were it not for this currency mischief, the bank calculates, annual inflation would have been a pardonable 8.6% in June.

The central banks of both Turkey and South Africa have promised not to allow faster inflation to persist. But so far, it seems, only South Africa's commitment is much believed. Despite the fall in the rand, South Africans expect their central bank to keep inflation within its target range of 3-6% this year and next-after all, it has done so successfully since September 2003. The weaker lira has, however, "disrupted inflation expectations" in Turkey, the central bank admitted in the minutes of its July meeting, released this week. According to its latest survey, Turks now think inflation will exceed 8% in a year, and be over 6% two years hence.

Forint or against it

As investors become pickier, keen to distinguish one emerging market from another, they may begin to see Hungary in the same light as Turkey and South Africa. It too runs a big current-account deficit, which the IMF thinks will exceed 9% of GDP this year. Indeed, on fiscal matters, the comparison is rather to Hungary's disadvantage. Turkey may labour under heavy public debts, but it is at least running a heroic budget surplus, before interest payments, estimated at 6.4% of GDP. South Africa now runs a modest fiscal deficit, but its stock of debt is quite manageable. Hungary, on the other hand, has both high debts (almost 60% of GDP in 2005) and a wide budget deficit. Nouriel Roubini, of Roubini Global Economics, calls it

an "accident waiting to happen".

Curious then, that the Hungarian forint has so far escaped the traumas visited on the rand and the lira, falling by 10.7% from peak to trough this year. Inflation remains at just 2.8% but Hungary's central bank is not taking any chances: it raised interest rates by half a percentage point on July 24th, after a quarter-point increase in June.

Mr Roubini offers three possible explanations. Perhaps the markets are complacent—but surely the turmoil of May and June woke them up? Maybe Hungary is shielded by its prospective membership of the euro—but a tie to the D-mark did not save the Italian lira or the pound sterling in the early 19905. Or the markets may be giving the benefit of the doubt to a new government, which has unveiled plans to put public finances in order.

If so, the government impressed the markets more than the IMF, which publicly cast doubt on the wisdom and credibility of Hungary's strategy. Temporary expedients would temporarily appease the markets, the fund said, but the country would remain vulnerable.

No amount of monetary rectitude can save a country from fiscal recklessness. Indeed, hard money, which preserves the real value of domestic debts, may only serve to hasten the day of reckoning. Central bankers in emerging economies must hazard faltering exports, vengeful currency markets and political tensions. But nothing troubles a central banker more than a profligate finance minister. ■

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