POLICY BRIEF

FINANCIAL AND FISCAL COMMISSION (2023)

Escalating Global Inflation: The Sources and Spill overs

EXECUTIVE SUMMARY

The global economy experienced a substantial drop in inflation over the past four to five decades, particularly in the earlier period of the COVID-19 pandemic. Since then, resurgent commodity prices, supply-chain interruptions, labour deficiencies, and an upturn in domestic demand have jointly spurred inflation to unprecedented apexes. Most Emerging Markets (EMs), including South Africa, are enduring a sharp upsurge in food prices, representing a significant portion of their consumption basket. Core inflation has also risen in many Ems as currency depreciation impacts imported goods' prices. This study examines international inflation trends, sources, and international inflation spillovers in the South African economy.

The paper's findings reveal that inflation impacts different groups of households in various ways. The poor are much more likely to be affected by inflation than the rich. Inflation indirectly impacts poverty and inequality through the economic growth channel. The findings also show that global inflation has fallen substantially in the past four decades, but since early 2020, global inflation has accelerated. Global demand shocks have explained most fluctuations in global inflation since 2008. Domestic shocks have explained most domestic inflation fluctuations.

In the wake of the COVID-19 pandemic and the Russian-Ukraine geo-political tensions, the global economy has entered a period of persistently high inflation and weaker economic growth. Demand shocks were the leading driver in the deceleration of inflation in the first half of 2020. However, oil price shocks and supply shocks have become more prominent in the acceleration of inflation since early 2021.

The findings show that US Federal Reserve defines the path of global nominal spending growth because while its mandate is domestic, its impact is progressively global. An expansionary conventional or unconventional monetary policy in the US reduces the South African long-term rate, signalling a decrease in risk towards emerging markets assets. Consequently, the US monetary policy is responsible for some South African policy rate variation.

While direct trade between South Africa and Russia and between South Africa and Ukraine is not significant, the shock to global trade resulting from the war in Ukraine will impact the country's exports and imports. It is also complicating the role of monetary policy authorities in

FINANCIAL AND FISCAL COMMISSION

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The Financial and Fiscal Commission is a body that makes recommendations and gives advice to organs of state on financial and fiscal matters. As an institution created in the Constitution of the Republic of South Africa, it is an independent juristic person subject only to the Constitution itself, the Financial and Fiscal Commission Act, 1997 (Act No. 99 of 1997) (as amended) and relevant legislative prescripts. It may perform its functions on its own initiative or at the request of an organ of state.

The vision of the Commission is to provide influential advice for equitable, efficient and sustainable intergovernmental fiscal relations between national, provincial and local spheres of government. This relates to the equitable division of government revenue among three spheres of government and to the related service delivery of public services to South Africans.

Through focused research, the Commission aims to provide proactive, expert and independent advice on promoting the intergovernmental fiscal relations system using evidence-based policy analysis to ensure the realisation of constitutional values. The Commission reports directly to both Parliament and the provincial legislatures, who hold government institutions to account. Government must respond to the Commission's recommendations and the extent to which they will be implemented at the tabling of the annual national budget in February each year.

The Commission consists of Commissioners appointed by the President: the Chairperson and Deputy Chairperson, three representatives of provinces, two representatives of organised local government and two other persons. The Commission pledges its commitment to the betterment of South Africa and South Africans in the execution of its duties.

maintaining price stability without choking growth. The South African Reserve Bank (SARB) has already commenced a hiking cycle to reign rising inflation. The findings reveal that Inflation is negatively correlated to joblessness while positively correlated to the exchange rate.

Hence, the Commission recommends that fiscal policy support be implemented, attuned, and aligned with a credible medium-term fiscal framework; strengthening of social protection; monetary and fiscal policy coordination, and targeted cash transfers to those particularly exposed to higher energy and food prices.

BACKGROUND

The global economy experienced a significant deceleration in inflation over the past four to five decades. Global inflation trends reflect that the median annual national consumer price inflation declined significantly between 1974 and 2019. However, since the beginning of 2020, global inflation has been unstable. In the first quarter of 2020, global inflation decelerated by approximately one percentage point, owing to the decline in demand and falling oil prices. In the middle of the second quarter of 2020, global inflation marginally accelerated, driven by a rally in oil and food prices and a rebound in economic activity resulting from easing the lockdowns instituted at the beginning of the COVID-19 pandemic.

In South Africa, high inflation is repetitively correlated with sluggish growth. The general increase in prices is also associated with weaker investor confidence disincentives to save and thus resulting in the deterioration of the public sector balance sheet. Most importantly, the devastating impact of high inflation falls disproportionately on the poor because poorer households are heavily dependent on wage income, with limited access to financial instruments, such as interest-bearing bank accounts, that generate buffers to high inflation. This means that high inflation implications correlated with low growth and poor development outcomes warrant investigation, particularly in the context of high unemployment, increasing income inequalities, and incidences of poverty.

RESEARCH FINDINGS

Effects of inflation on inequality and poverty

Inflation impacts different groups of households in varied ways. The poor are much more likely to be affected by inflation than the rich. Poorer households experience more significant losses in the actual value of their income and wealth because of inflation than wealthier households resulting from the composition of income, assets, and consumption baskets; thus, inflation increases inequality. There are long-term variances in real inflation rates between the poorest and wealthiest households, signalling that the inflation rates faced by the poor surpass those of the rich. Inflation indirectly impacts poverty and inequality through the economic growth channel. Consequently, low and stable inflation, combined with well-anchored inflation expectations, correlates with greater long-term growth and employment stability.

Evolution of global inflation

Global inflation has fallen substantially between 1974 and 2017. This deceleration in global inflation commenced in the mid-1980s in advanced economies and was shortly followed by similar declines in emerging and developing economies (EMDEs) in the mid-1990s. The inflation trends also reveal that in 2019 before the COVID-19 pandemic, inflation was within the target ranges in almost all inflation-targeting advanced economies. Similarly, in approximately 50 per cent of inflation targeting EMDEs, inflation was within target ranges every year from 2012 to 2019.

However, since early 2020, global inflation has been vastly unstable. In the first quarter of 2020, global inflation declined because of a sharp decline in demand and oil prices collapsing. However, in May 2020, global inflation accelerated because of a recovery in oil and food prices and an economic activity revival resulting from the lifting of the lockdown restrictions needed to control the first wave of the pandemic. The spike in commodity prices due to the war in Ukraine and supply interruptions owing to a new wave of the pandemic, and reinstated movement restrictions in China have further increased the price of food and energy, thus increasing inflation.

Currently, global inflation is at its highest level since 2008. In advanced economies, inflation is currently at its highest level since 1982. In EMDEs, inflation is at its highest level since 2008. As of April 2022, inflation was above target in all advanced economies, and almost 90 per cent of inflation targeting EMDEs. In EMDEs, the acceleration in inflation this year has been most marked in Europe and Central Asia due to recovering demand in advanced-economy Europe, interruptions of the war in Ukraine, and the commodity price hike. In contrast, in East Asia and the Pacific, where frequent lockdowns have been implemented, inflation has increased but remained within the target ranges.

Drivers of global and domestic inflation

Global demand shocks have explained most fluctuations in global inflation since 2008, and oil price swings have accounted for 60 per cent since 2010. Oil price shocks and global demand shocks contributed 80 per cent translating into almost 40 per cent each, to the variation in global inflation between 1970 and 2016. Since then, the contribution of global demand and oil price shocks has intensified significantly over time, while that of global supply shocks has retreated. Domestic shocks have explained about 75 per cent of domestic inflation fluctuations and more in EMDEs.

Drivers of recent inflation developments

In the wake of the COVID-19 pandemic and the Russian-Ukraine geo-political tensions, the global economy has entered a period of persistently high inflation and weaker economic growth. The drivers of inflation have changed since January 2020, and disruptions related to the demand, supply, and oil prices have impacted different inflation measures. Demand shocks were the leading driver in the deceleration of inflation in the first half of 2020. However, oil price and supply shocks have become more prominent in the acceleration of inflation since early 2021.

International inflation spillovers

The US financial system has two critical roles in the globalised economy. First, the US financial system has become the principal manufacturer of safe assets for the global economy. Second, the Federal Reserve has become a monetary superpower that sets global monetary conditions. This means that the Federal Reserve, more than any other central bank, defines the path of global nominal spending growth because while its mandate is domestic, its impact is progressively global.

An expansionary conventional or unconventional monetary policy in the US reduces South African long-term rate, signalling a decrease in risk towards emerging markets assets. It also increases the net purchase of stocks by non-residents showing capital flows from the US and other developed markets to emerging markets and an appreciation of the Rand against the US dollar.

Whereas monetary policy in South Africa is independent and responds primarily to local inflation, economic activity, and financial conditions, variance decomposition shows that the US monetary policy is responsible for some variation of the South African policy rate. This correlation emphasises the structural issues in the real sector, political uncertainty, and limited households' balance sheets. It is also a reflection of the persistent sluggish economic growth which has resulted in South Africa being unable to take advantage of the low inflation and global economic recovery.

International trade and inflation channels

Whereas direct trade between South Africa and Russia and between South Africa and Ukraine is insignificant, the shock to global trade will impact the country's exports and imports. A sudden hike in investor risk aversion resulting from the Ukraine war could trigger capital outflows from South Africa, activating the depreciation of the exchange rate, dropping stock prices, and increasing risk premiums in bond markets, thus exacerbating fiscal consolidation risks. The war further complicates the role of monetary policy authorities in maintaining price stability without choking growth. SARB has already commenced a hiking cycle to reign rising inflation. What is becoming more evident is that SARB is consistently hiking interest rates and tightening liquidity to wrestle inflation, with minimal effect on cost-push inflation, thus risking a hard landing.

Inflation evolution in South Africa, determinants, and consumption and unemployment impacts

The determinants of inflation in South Africa reveal that domestic inflation depends on internal and external factors. Internal factors, such as inflation expectations, government consumption expenditure, GDP, and unit labour cost, are important determinants of inflation in South Africa.

Critical determinants include external factors such as import price and exchange rate. This means that the rand's depreciation exacerbates the effect of imported inflation. It also means that cost-push factors are dominant in determining domestic inflation compared to the demand-pull inflation factors. Exogenous monetary policy tightening has minimal effect on the consumption of individuals at the lower ends of the consumption distribution. In contrast, individuals with higher consumption levels tend to be negatively affected by lower labour income, weaker asset price performance, and higher debt service costs.

Inflation is negatively correlated to joblessness, while positively correlated to the exchange rate. This translates into a quid pro quo between inflation and joblessness. Whereas the correlation between inflation and unemployment is aligned with the framework of the Phillips curve, the relationship between inflation and exchange rate suggests that a weak rand in the foreign exchange market accelerates the rate of inflation in South Africa. South Africa's heavy reliance on imported capital and intermediate goods and a weak exchange rate hurt domestic industries. The macro fundamentals reveal that unemployment in South Africa is structural because there is a mismatch between the labour market demand and supply. This means the economy is unreactive to either monetary conditions or domestic absorption.

Whereas unemployment is a severe challenge in South Africa, it is incongruous to address it by increasing inflation. Tackling unemployment warrants wide-ranging macroeconomic policies, including an institutional devotion to price stability and targeted interventions in the labour market.

CONCLUSION

The sharp increase in food and energy prices which commenced in 2021 and was worsened by the war between Russia and Ukraine, has occasioned governments' response to high inflation. Since 2021, global oil prices have doubled, natural gas prices in Europe have risen significantly, and the price for fertilisers has tripled.

Rising food and energy prices have increased the cost of living, reducing real incomes across most countries. Consequently, concerns about potential social unrest have been elevated, many households have been pushed into poverty, and millions of people are at risk of food shortage. The impact has differed across countries, subject to whether they are net importers or exporters of commodities. The effects have also differed across individuals within a country because an increase in food prices affects low-income households, particularly those who spend a significant portion of their income on food. Increasing prices of necessities and basic staples have a devastating and long-lasting effect on people.

RECOMMENDATIONS

The Commission makes the following recommendations:

Fiscal policy

1. *The Commission recommends that National Treasury continues to focus fiscal consolidation on expenditure and revenue mix appropriate for debt reduction. This should be done by targeting a primary surplus to significantly reduce debt, foster economic growth, and restore fiscal sustainability. Moreover, the Commission recommends that National Treasury crafts a medium term fiscal framework that must maintain long-term debt sustainability through consolidation, improving debt transparency, advancing debt management functions, and enhancing revenue collection and spending efficiency.*

Social protection

2. *The Commission recommends that National Treasury, in conjunction with the Department of Social Development, design a comprehensive social security programme to protect those segments of the population particularly exposed to the negative impact of rising inflation, including higher energy, fuel and food prices. In the interim, National Treasury and the Department of Social Development should address the challenges of access constraints of the current social protection measures, particularly the Special COVID-19 Social Relief of Distress Grant.*

ENQUIRIES:

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