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Is rising inflation a global risk?

By Abdelaaziz Ait Ali and Uri Dadush [1]

Abstract

Mounting inflation in the major financial centers have raised concerns about the consequences on macroeconomic stability, including the Central Bank response they might trigger. In line with official views, we argue that inflation will probably wind down. We show that core inflation remains below pre-Covid levels in most large economies. We also argue that emerging markets are now less prone to "sudden stop" phenomena, in part because many have already started the exit from accommodative monetary policy. However, we also warn against complacency. If the acceleration of prices is sustained for long, nominal wages are bound to follow and feed a once-familiar vicious circle of rising prices and wages; and, if this does not happen, workers will see decline in their purchasing power and a further redistribution of income towards capital.

The surge of inflation in the United States, Germany and the UK, which registered at 5.3%, 3.9%, and 3.1% year-over-year in August respectively, is alarming. Will rising prices in the world's financial centers force a sudden and sharp rise in policy interest rates and force the rest of the world to follow? After a long period of price stability, does rising inflation usher in a new era of macroeconomic volatility and stop-go monetary policies? Will emerging markets, prone to capital flight, be the worst hit?

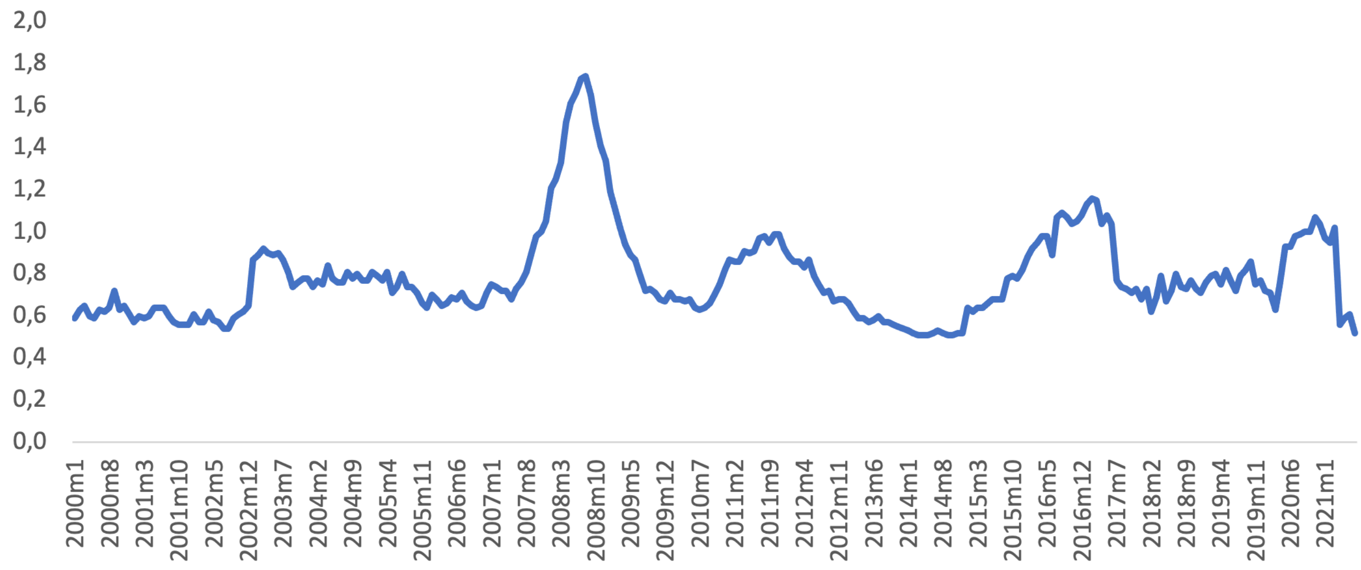
In this note, we argue – in line with the prevailing message from varied official sources - that the answer is "probably not". However, we also warn that the acceleration of prices is significant enough and sufficiently widespread that it constitutes a real risk of a change in regime, and – moreover - that the surge in prices will have harmful effects even if these risks do not materialize. The big risk is that nominal wages begin to escalate to catch, triggering a once-familiar vicious circle of rising prices and wages. The alternative to this scenario – wages do not adjust -- is not great either. The pandemic has already hit many poor families hardest, and if wages decline in real terms income disparities will be further widened.

1. We thank M. Otaviano Canuto for his insightful comments on an earlier draft.

An unexpected journey.

The onset of the pandemic forced governments around the world to engage in unprecedented stimulus and rescue measures, designed to avoid a depression and preserve the social order. Government debt in the OECD economies has increased by 25 percentage points of GDP. Meanwhile a large part of the world's supply capacity was repressed by a combination of formal confinement measures and reluctance of workers to risk infection. The pandemic disrupted production chains in unpredictable ways as it ebbed and flowed, shifting its epicenter to different parts of the world at different times. The big concerns were maintaining activity and employment, sustaining incomes, and dealing with shortages of medical equipment. Inflation was hardly a concern. The dispersion[2] of inflation across sectors, averaged across countries, remained normal by historical standards and far below levels recorded during the global financial crisis (figure 1).

Figure (1) : inflation dispersion in %.



Source: WEO.

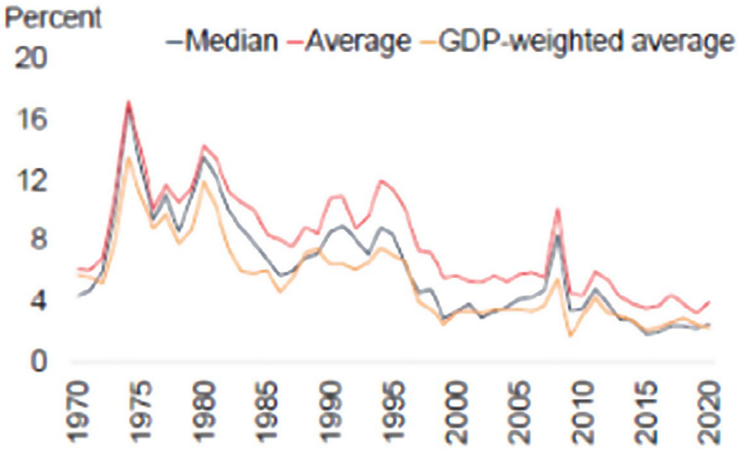
Once it became likely that the worst of the pandemic would be contained, noted economists Larry Summers and Olivier Blanchard were among the first to raise alarm about the risk of inflation. The size of the policy stimulus, reversal of private sector saving, and a hesitant and incomplete recovery of supply would, they argued, create price pressures which would be difficult to contain without a rapid change in policy direction. This is even more relevant within the new FED's monetary policy framework adopted in august 2020, in which the FED allows prices to rise above the 2% target, for a "certain period" to compensate for past downward deviation (Federal Reserve, 2020). The ECB subsequently adopted a framework along similar lines (ECB, 2021).

Reasons for Comfort

Recognizing the forces contributing to higher prices outlined above, there are nevertheless several reasons to believe that inflationary pressures are temporary and could abate over the next year or two. To start, as shown in a historical review of inflation by Ha et al. (2021) inflation has been on a downward path for some 40 years.

2. Inflation dispersion is the mean of sectoral inflation variability, across countries.

Figure 2 : Global CPI inflation



Source : Ha et al (2021)

We do not have a precise accounting of the drivers of the persistent disinflationary trend; globalization, demographics (a rise in the share of people of working age across the world), and sounder monetary and fiscal policies are the causes most often cited. If previous epidemics are a guide, the Covid-19 pandemic is a time bound event because of the immunity the virus conveys, and, this time, the early availability of vaccines. It stands to reason that the pandemic has not affected the drivers of long-term disinflation fundamentally. Insofar as one or more of the underlying trends is beginning to slow or even reverse, as may be happening in the demographics of some countries and in globalization, the effects on inflation are not likely to become immediately evident.

Compared to past post-war recessions, this episode has seen a particularly sharp acceleration of prices. This is because it came in the wake of a very sharp deceleration, reflecting the severity of the recession, the worst in the post-war period. The inflationary cycle has been amplified this time because the economic cycle has been amplified and accompanied by large supply disruption. Unprecedented monetary and fiscal stimulus measures supported the recovery. In previous post-war global recessions, global inflation continued to decline even as the recovery took hold (Ha et al. 2021) reflecting the power of the long-term deflationary trend.

This has not happened this time, so far. But it is likely that – assuming the pandemic ebbs with the increased availability of vaccines and spread of immunity (the number of deaths has declined from 13 670 per day in the 1st week of May to less than 7000 deaths per day in the first week of October[3]), the disruption in supply will be gradually resolved.

Moreover, as we show below, it is far too early to consider the surge in inflation a global phenomenon. This is reassuring because in an integrated global economy price pressures caused by excess demand in one part of the world can be partially allayed by supply from other parts of the world. To examine the issue more closely, we updated the Ha & al.'s inflation database, to April 2021[4] for a limited sample of countries where data is available. The sample covers 40 developed, emerging and developing economies accounting for over 82% of world GDP.
As the table 1 shows, headline inflation over the year to April 2021 was higher than inflation over 2017-April 2020 in 25 countries, accounting for half of the world GDP, but it was lower in 14 countries, including China, accounting for 32% of GDP. However, headline inflation includes the effect of highly volatile food and oil prices, that saw a sharp rise. These commodities are globally traded and affect prices everywhere. Since May 2020, food prices recorded a year on year increase of 32% to April 2021. Similarly, oil prices have climbed, reaching 63 $ per Barrel by the end of April 2021 for WTI and 80 $ in october, from 23 $ a year ago and 55 $ in April 2019.

3. Source: worldometers.info

4. The database was enriched by different data sources, such as central banks websites and tradingeconomics, for China, India, Brazil, Russia, Morocco, South Africa, Nigeria, Egypt, Indonesia, Turkey, Argentina.

Table 1: Inflation in a sample of countries, per period

Country	Headline_2017-april 2020	Headline_april 2020- april 2021	Core_2017-april 2020	Core_april 2020-april 2021	change in headline	change in core
Argentina	40.4%	46.3%	40.3%	49.8%	5.8%	9.5%
Nigeria	12.8%	18.2%	10.9%	13.3%	5.4%	2.4%
Turkey	14.1%	17.1%	12.4%	17.8%	3.0%	5.3%
United States	1.8%	4.2%	2.0%	3.0%	2.3%	1.0%
Hungary	2.9%	5.1%	3.1%	3.7%	2.2%	0.6%
Iceland	2.6%	4.5%	1.8%	4.2%	2.0%	2.4%
Mexico	4.3%	6.1%	4.0%	3.4%	1.8%	-0.5%
Canada	1.7%	3.4%	2.0%	1.6%	1.7%	-0.4%
Spain	0.6%	2.2%	0.8%	-0.1%	1.7%	-0.9%
Brazil	3.4%	6.8%	3.3%	3.3%	1.6%	-2.6%
Finland	0.6%	2.1%	0.6%	1.5%	1.4%	0.9%
Korea, Rep.	1.0%	2.3%	1.1%	1.1%	1.3%	0.0%
Norway	2.0%	3.0%	2.1%	1.7%	0.9%	-0.4%
Chile	2.6%	3.3%	2.3%	2.9%	0.7%	0.5%
Luxembourg	1.4%	2.1%	1.4%	1.2%	0.6%	-0.2%
Denmark	0.9%	1.5%	1.1%	0.9%	0.6%	-0.2%
Germany	1.4%	2.0%	1.4%	1.3%	0.6%	-0.1%
Morocco	0.9%	1.4%	0.9%	0.8%	0.5%	-0.1%
Ireland	0.7%	1.1%	0.8%	1.0%	0.4%	0.2%
Israel	0.4%	0.8%	0.4%	0.5%	0.4%	0.1%
South Africa	4.2%	4.5%	4.3%	3.0%	0.4%	-1.3%
Czech Republic	2.7%	3.1%	2.5%	4.1%	0.3%	1.6%
Italy	0.8%	1.1%	0.8%	0.4%	0.3%	-0.4%
Austria	1.7%	1.9%	1.8%	1.6%	0.2%	-0.2%
France	1.1%	1.2%	0.8%	0.7%	0.1%	-0.1%
Netherlands	1.9%	1.9%	1.8%	1.8%	0.0%	0.0%
Switzerland	0.4%	0.3%	0.4%	0.2%	-0.1%	-0.2%
Lithuania	2.7%	2.5%	3.1%	2.6%	-0.2%	-0.5%
United Kingdom	1.8%	1.6%	1.8%	1.5%	-0.2%	-0.3%
Estonia	2.3%	1.9%	1.8%	1.2%	-0.4%	-0.6%
Belgium	1.7%	1.2%	1.7%	1.1%	-0.5%	-0.6%
Latvia	2.2%	1.7%	2.3%	1.0%	-0.5%	-1.3%
Greece	0.3%	-0.3%	0.5%	-1.5%	-0.6%	-2.0%
Costa Rica	1.8%	1.2%	2.1%	0.7%	-0.6%	-1.4%
India	6.1%	5.1%	4.6%	5.3%	-0.9%	0.6%
Japan	0.5%	-0.4%	0.2%	-0.3%	-0.9%	-0.5%
China	2.4%	0.9%	1.6%	0.7%	-1.5%	-0.9%
Indonesia	3.1%	1.4%	2.9%	1.2%	-1.6%	-1.7%
Colombia	3.9%	1.9%	3.9%	1.5%	-1.9%	-2.4%
Egypt, Arab Rep.	12.9%	9.7%	4.1%	3.3%	-3.2%	-0.8%

Source : Ha et Al (2021), Central Banks websites and Trading Economics

Stripping out food and oil prices from the headline index, reveals a somewhat more differentiated picture, one which better reflects domestic circumstances in each country. In only 12 countries, accounting for 31% of world GDP, core inflation is higher than the three years preceding the pandemic, while it is lower in 27 countries, accounting for 50% of world GDP. Core inflation is higher in the United States, but is lower in China, Germany and the UK. Were price pressures already widely reflected in wages, core inflation measures would likely reveal this, but they do not.

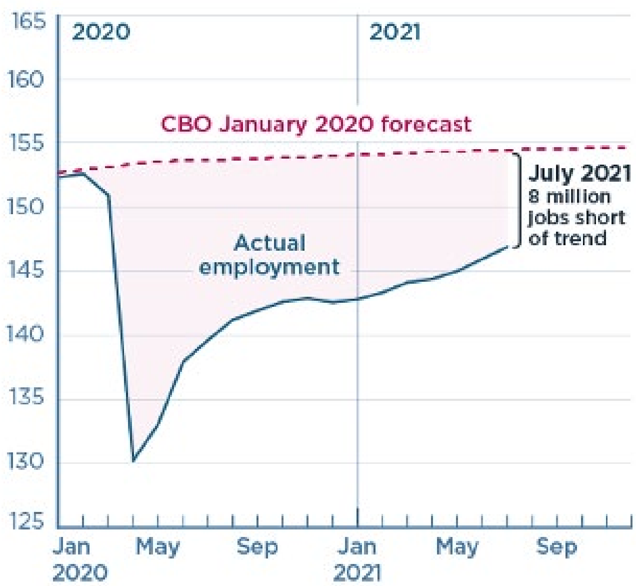
The available data on the US labor market suggest that wage pressures remain contained. According to Atlanta Federal Reserve's Wage Growth Tracker, average wages are evolving broadly along the recent historical averages and are not displaying significant jump (figure 3).

Figure (3) : hourly wage growth in the US, in %.

Source : Atlanta Federal Reserve's Wage Growth Tracker.

This is not surprising, since the US labor market is still far from completely recovering. It falls short of over 8 million jobs to return to its-pre-pandemic trend (figure 4). The latest data of job creation in August and September have disappointed, falling well below analyst predictions. Available data for some advanced economies reflects the same trend (WEO update of July).

Figure (4) : Actual employement vs projected emploment, millions of jobs



Source : PIIE (2021) | CBO stands for congressional Budget Office

Note that among the arguments in favor of contained inflation we have shied away from stressing the importance of "well anchored" inflationary expectations, commonly referred to in official publications. Though it is true that various measures of medium-term inflationary expectations remain low, we believe that inflationary expectations are best considered a lagging indicator, i.e. responding to other underlying factors with a significant time lag. Were these underlying factors to change and inflation to become sustained, higher inflationary expectations would soon follow. The argument that inflationary pressures will remain low because inflationary expectations are low may be valid in the context of short-term forecasting but is of little help in forecasting inflation out beyond a year or two.

Emerging Market Response

Emerging markets have been badly hit by the pandemic, though not as badly as advanced countries. Although their population is younger, and less exposed to serious Covid-19 disease, their medical systems are less capable.
Many emerging market economies are vulnerable to a sharp rise in international interest rates which can lead to financing difficulties ('sudden stop") and to large scale capital outflows. Even only the prospect of tighter monetary policies can trigger these events, as seen -for example – during the 2013 "Taper Tantrum". So far, however, signs of stress in emerging markets remain confined. To take one important indicator of financial stress, only few large emerging economies such as Colombia or Argentina have witnessed a two digits nominal exchange rate depreciation since the start of the year (table 2). Systemically important emerging economies with developed financial markets, such as Brazil, India, or Mexico, saw nominal appreciation of their currencies.

Table(2) : Nominal Effective exchange (NEER) rate for a sample of countries, by august 2021

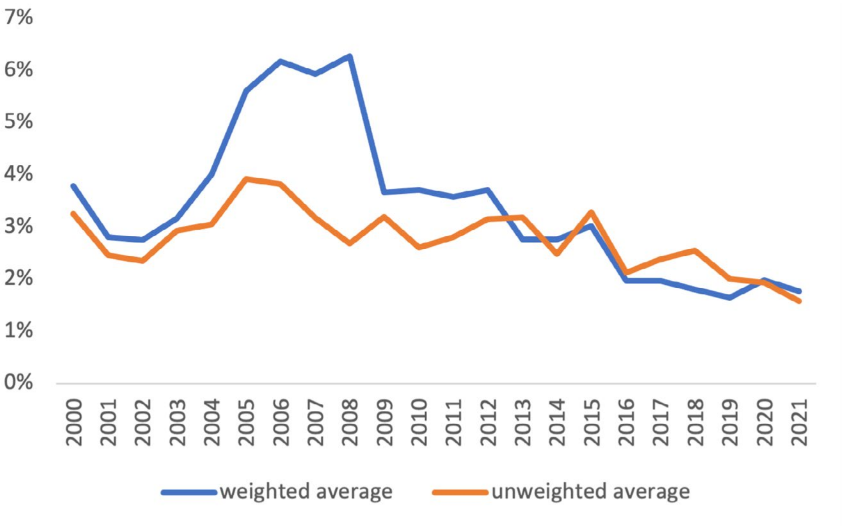
Ranking	Countries	2021/2020 change in NEEN
2	Venezuela, RB	-73.2%
7	Argentina	-13.2%
10	Colombia	-9.2%
12	Thailand	-7.0%
13	Turkey	-6.4%
15	Nigeria	-5.6%
23	Chile	-2.4%
30	Malaysia	-1.8%
31	Romania	-1.7%
51	Estonia	-0.7%
72	Bulgaria	-0.4%
80	Ghana	-0.1%
84	Croatia	0.3%
87	Mexico	0.4%
104	Indonesia	1.0%
106	Brazil	1.2%
113	India	1.3%
119	Bangladesh	1.8%
129	South Africa	2.3%
135	United Arab Emirates	2.6%

150	Russian Federation	3.2%
156	China, Mainland	3.6%
160	Vietnam	3.6%
161	Jordan	3.7%
164	Egypt, Arab Rep.	3.8%
166	Angola	4.2%
167	Taiwan	4.8%
171	Ukraine	7.5%
172	Armenia	7.9%
173	Georgia	8.4%

Source: Bruegel.

In an environment where world trade is recovering rapidly, the prices of commodity exports are rising, and domestic demand continues to be subdued in many cases, calm in nearly all emerging markets has been maintained. Besides, Emerging Markets macroeconomic fragilities are relatively contained and the reversal of monetary stance in the US might not cause panic, as in the 2013 episode (Canuto, 2021). Current account imbalances are moderate and lower than at any time since 2000 (figure 5).

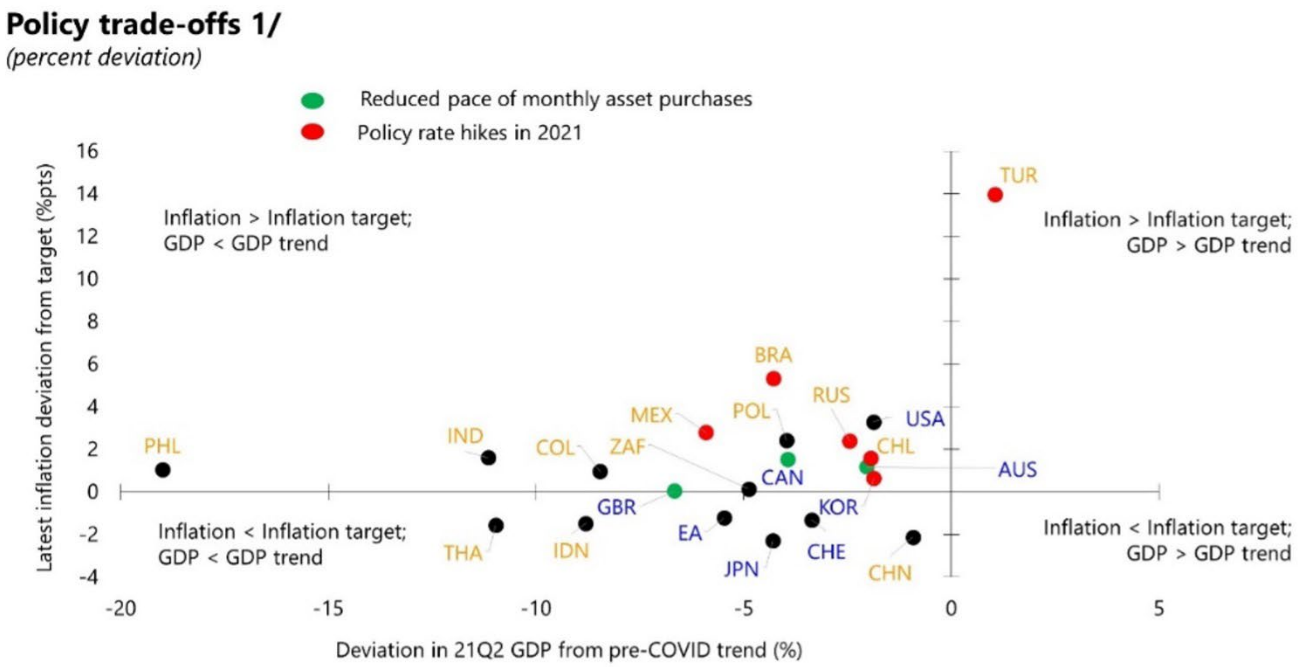
Figure (5) : Emerging markets external imbalances, in % of GDP



Source : WEO and authors calculations.

Moreover, some emerging markets central banks have already started tightening monetary policy, consistent with their inflation targeting framework, and despite the uncertain aggregate demand and pandemic prospects (figure 6). In several instances emerging economies have raised policy rates, even as GDP remains well below the pre-crisis trend. This can be read as a reassuring sign that Central Banks are affirming their independence. For example, the Central Banks of Brazil and Russia raised their policy rates five and four times respectively this year.

Figure (6) : Emerging Markets Leading exit from Accommodative policies



Sources: IMF, *World Economic Outlook*; Haver Analytics; and IMF staff calculations.
1/ Emerging Markets are labeled in orange; Advanced Economies are labeled in blue. Latest inflation data as of August 2021.

Among the lower-middle income economies, Morocco, which has managed the pandemic relatively well, provides an interesting case. The Covid crisis has not materially affected price dynamics in Morocco, reflected in a small rise in headline inflation, and stable core inflation. Headline inflation rose from an average of 0.9% over 2017-April 2020 to 1.4% by April 2021, owing essentially to the acceleration of prices in the transport sector to 9.5%, reflecting the rise in world oil prices. The increase in food prices was muted until April, then picked up to register a year-over-year increase of 2.2%, the highest since mid-2018. Core inflation has not changed relative to the pre-crisis period, hovering around 0.9%. In the Moroccan case, it could be argued that a moderate increase in the inflation rate is desirable, providing monetary policy with more leeway. Since 2009, Morocco's inflation has varied near 1%, well below the 2% benchmark registered 2000 to 2009 prior to the global financial crisis. The deceleration in prices was associated with a decline in Morocco's long-term growth rate of more than 1 percentage point. Unanticipated and persistent low inflation can raise the real interest rates, depressing the willingness to invest. Overall, a 1 percentage surge in headline inflation or even core inflation will not have significant negative implications in Morocco.

No Room for Complacency

There are significant risks associated with our rather benign assessment of inflation prospects. The possibility that new vaccine-resistant variants will emerge could create new supply and transport disruptions against a background where shortages are evident in sectors ranging from natural gas to semiconductors, accentuating and prolonging the pressure on prices. Oil prices are presently at a 7 year high. Policymakers, driven by political imperatives – e.g. looming elections against a background of discontent with the way the pandemic is managed – could be tempted to extend stimulus policies beyond those warranted by the state of aggregate demand. The evident deterioration in global trading relations, symbolized by the ongoing trade war between China and the United States, does not bode well for consumers, importers of essential inputs, and the efficient operation of global supply chains. Policies of decarbonization, needed to address an existential threat, can – if not adequately planned and executed – cause unintended energy shortages which add to price pressures. More simply, the mere persistence of inflationary pressures into 2022 and beyond is bound to lead to increased wage demands.

Suppose, however, that wages are not adjusted. This would imply a further redistribution of income away from labor and towards capital. In the United States, for example, real median wages have been growing steadily up to April 2021. Since then, wage growth has been outpaced by inflation. Meanwhile, since December 2019, the S&P 500 is up by 35% and the price of housing is up by 25%. Development economist concluded long ago that inflation hurts the poor most. Sadly, in countries where the inflation ushered in by the Covid-19 pandemic is most pronounced, the evidence so far is in line with that conclusion.

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The PCNS advocates the concept of an open, responsible and proactive « new South »; a South that defines its own narratives, as well as the mental maps around the Mediterranean and South Atlantic basins, within the framework of an open relationship with the rest of the world. Through its work, the think tank aims to support the development of public policies in Africa and to give experts from the South a voice in the geopolitical developments that concern them. This positioning, based on dialogue and partnerships, consists in cultivating African expertise and excellence, capable of contributing to the diagnosis and solutions to African challenges.

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