

Is High Inflation Here to Stay?

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Abstract

For nearly a half century, global inflation rates were headed one way: down. Since the early 1970s, supported by structural factors that included globalization, better policy frameworks, big demographic changes, and rapid technological advances, the world achieved a remarkable decline in inflation. But since late 2020, the global inflation rate has risen sharply to over 6 percent due to unprecedented policy support for inflation, the release of pent-up demand, persistent supply disruptions, and surging commodity prices. The commodity price surge triggered by 'Russia's invasion of Ukraine last month is adding to these price pressures. The consequences for growth, stability, and poverty are likely to be terrible.

Keywords: High inflation, Decline, Commodity, Prices, Demand, Supply

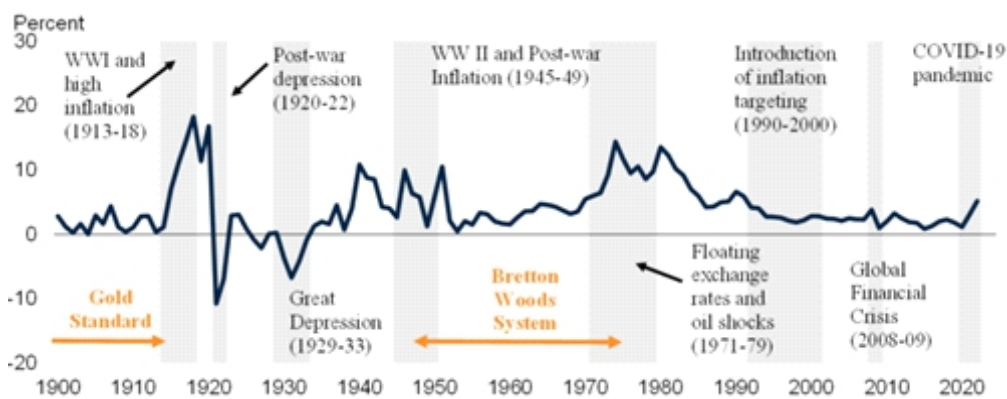
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Background to the Study

The end of the last and previous periods of sustained low global inflation are a reminder that low inflation is by no means guaranteed. Inflation has been low and stable before: during the Bretton Woods fixed exchange rate system of the post-war period up to 1971 and during the Gold Standard of the early 1900s (Figure 1). But these two earlier episodes were also followed by high inflation. For example, following the low inflation period until the early 1970s, multiple oil price shocks during the remainder of the decade accompanied a rapid acceleration in global inflation.

Figure 1: Global inflation, 1900-2022



Source: Ha, Kose, and Ohnsorge (2019); World Bank.

Note: This figure represents the median of annual average inflation in 24 countries where data are available across the full period. 2022 inflation is based on the average of January and February 2022.

The global economy once again stands at a crossroads where recent inflationary shocks could combine with a fading of structural forces of disinflation to usher in an era of higher inflation. What are the prospects for these disinflationary structural forces? And what can policymakers in emerging market and developing economies (EMDEs) do to get ahead of inflationary pressures? We believe that economic history helps to answer these questions.

Prospects for Disinflationary Structural Forces

Globalization, robust policy frameworks, demographic changes, structural factors, and technological advances were instrumental in keeping inflation low until 2020. These factors provide clues to questions about whether the current surge in prices is transitory or more long-lasting. Should these forces recede, increases in short-term inflation may become much more persistent.

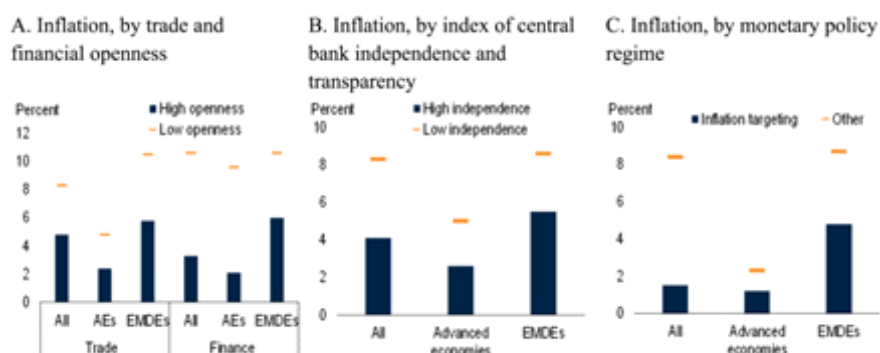
- 1. Globalization:** Over the past three decades, the entry of China and Eastern Europe into the global trading system has greatly reduced the prices of many manufactured goods. Global value chains have contributed to lower inflation through outsourcing

and greater competition. Countries that are more open to trade and financial flows have often experienced lower inflation (Figure 2A). Over the past decade, however, the maturing of global value chains has contributed to slowing trade growth. New tariffs and import restrictions have been put in place in advanced economies and EMDEs over the past six years. Thus far, notwithstanding these concerns and some severe logistics bottlenecks, global value chains appear to have remained resilient. However, rising protectionist sentiment and geopolitical risks may slow or even reverse the pace of globalization.

2. **Policy Frameworks:** Over the past four decades, many advanced economies and EMDEs implemented macroeconomic stabilization programs and structural reforms, improved fiscal frameworks, and gave central banks clear mandates to control inflation. In the context of inflation, these reforms have produced clear dividends: Countries with stronger monetary policy frameworks and more independent central banks have tended to experience lower inflation (Figures 2B and 2C). A shift from a mandate of price stability to objectives related to the financing of government would undermine the credibility of monetary policy frameworks and raise inflation expectations. Mounting public and private debt in EMDEs in the past decade could weaken commitment to disciplined fiscal and monetary policy frameworks. EMDE sovereign credit ratings have continued to deteriorate, with some falling below investment grade, reflecting concerns about rising debt and deteriorating growth prospects. Populist sentiment could inspire a move away from prudent fiscal and monetary policies.
3. **Demographic Changes:** Rapid labor force growth, due to population growth and increased participation of women, helped dampen increases in wages and input costs. The disinflationary benefits reaped from this process may, however, now be at an inflection point as the share of the working-age population stabilizes even in EMDEs. Global aging is expected to lower saving rates and raise inflationary pressures. Aging in some large emerging markets may amplify this trend. In addition, recent data from advanced economies indicate that a growing proportion of population is choosing to leave the labor force early—the “Great Retirement.”
4. **Structural Factors:** In both advanced economies and EMDEs, the large-scale shift of labor and other resources from agriculture to higher-productivity manufacturing offered productivity gains. Over the past decade, however, momentum for productivity-enhancing factor reallocation has faded. Declining unionization of the labor force, smaller collective bargaining coverage, and greater labor and product market flexibility have dampened wage and price pressures over the past decade.
5. **Technological Advances:** Automation, the increasing adaptability of computers, robotics, and artificial intelligence have improved production processes in many sectors. At the same time, these factors have lowered demand for routine production and clerical workers and lowered wage and price pressures. In some advanced

economies, disinflation has also been attributed partly to price transparency and competitive pressures introduced by the growing digitalization of services, including e-commerce or sharing services. In contrast to the other structural factors listed here, the pandemic is likely to have given renewed impetus to technological advances that may continue to dampen inflationary pressures.

Figure 2: Factors associated with disinflation



Sources: Ha, Kose, and Ohnsorge (2019); Haver Analytics; IMF International FinancialStatistics and World Economic Outlook databases; OECDstat; World Bank.

Note: “AEs” = advanced economies; “EMDEs” = emerging market and developing economies. A. Hyphens indicate median inflation in countries with high trade-to-GDP ratios (“Trade”) or financial assets and liabilities relative to GDP (“Finance”) in the top quartile (“high openness”) of 175 economies during 1970-2017. Horizontal bars indicate countries in the bottom quartile (“low openness”). Differences are statistically significant at the 5 percent level. C. Hyphens indicate median inflation in country-year pairs with a central bank independence and transparency index in the top quartile of the sample (B) or with inflation targeting monetary policy regimes (C). Horizontal bars denote medians in the bottom quartile (B) or with monetary policy regimes that are not inflation targeting (C). Differences are statistically significant at the 5 percent level.

What should Developing Economies do?

EMDE policymakers are facing the first serious global monetary policy tightening cycle after more than a decade of highly accommodative external financial conditions. The tightening cycle might be coinciding with shifts in some structural forces that have been instrumental in keeping inflation low over the past four decades. Should these forces recede, recent increases in short-term inflation may become more persistent, and thus threaten the anchoring of long-term inflation expectations. In light of the multiple sources of uncertainty and the time lags in the transmission of economic shocks EMDEs may find themselves in a steep and prolonged monetary policy tightening cycle. Communicating monetary policy decisions clearly, building and leveraging monetary policy credibility, and strengthening monetary policy frameworks including by safeguarding and further buttressing central bank independence will be critical to manage inflation.

Monetary policy does not operate in a vacuum. Inflation expectations are unlikely to remain well anchored when fiscal sustainability is at risk. The withdrawal of pandemic-related fiscal support needs to be finely calibrated and closely aligned with credible medium-term fiscal plans. Policymakers need to address investor concerns about long-run debt sustainability by strengthening fiscal frameworks, enhancing debt transparency, upgrading debt management, mobilizing government revenues, and improving spending efficiency.

Reference

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