BOX 8
A Review of Recent Global Inflation Episodes

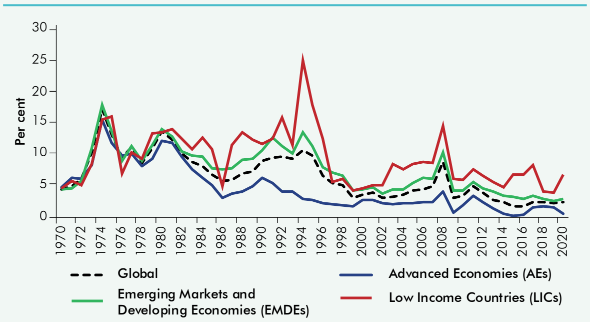
Introduction

Central banks are concerned about maintaining low and stable inflation, i.e., price stability, which is their prime objective. By design, monetary policy is biased towards acting to arrest excessive inflation and hence protecting the purchasing power of the public, particularly the poor, as inflation disproportionately harms low income and fixed income earners. With concerted policy efforts and continuous improvements to monetary policymaking, including the adoption of an inflation targeting framework, global inflation witnessed a clear downward trend in the last several decades. However, frequent high inflation episodes were witnessed globally as well as domestically due to several reasons. Having a comprehensive analysis of such recent events is vital for appropriate policy responses, which would be beneficial in encountering such episodes in the future and mitigating adverse implications.

High Inflation Episodes in History

Even though global inflation was on a downward trend in the aftermath of World War II, there have been occasional high inflation episodes in some countries due to the elimination of price controls, supply shortages, pent-up demand, and policy mistakes in some circumstances. Literature provides for different trends and characteristics of the movements in global inflation over time, based on different classes of economies (Figure B 8.1).

Figure B 8.1
Global Inflation (1970 - 2020)



Source: Ha, J. M. et al. (2021)

Note: Global inflation is the median headline consumer inflation of 193 countries; advanced economies cover inflation in 36 countries; emerging markets and developing economies covers inflation in 157 countries of which 27 countries are classified as low income.

Aggravated pressures on the US dollar due to large monetary expansion in the late 1960s as led by gold convertibility began to cause inflationary pressures on the economy and this spread to the rest of the world via the balance of payments deficit of the country. This is referred to as the beginning of "The Great Inflation" and resulted in the collapse of the Bretton Woods Agreement[1] by the early 1970s, along with the suspension of dollar convertibility to gold by the authorities of the United States. However, extended by the oil price surge in 1973 with the formation of an embargo by the Organisation of Arab Petroleum Exporting Countries (OAPEC), global median consumer price inflation peaked in 1974. Advanced economies responded to the price shock by monetary policy tightening and as a result, inflation tended to decline only in mid-1980s as policy transmission was disturbed by another surge in oil prices in the early 1980s, which was caused by the Iranian Revolution and subsequent Iran-Iraq War. Accordingly, median consumer price inflation in advanced economies, which was at double digit levels in 1974 declined to lower single digits by 1986 and assured the central bank credibility even amidst threats of deep recessions. This was reflected in the quadrupled interest rates in the United States within the five years from 1976 to 1981, which in turn resulted in a sharp contraction of the output between early 1981 and 1982. Some advanced economies in Europe also responded to this peak in inflation in a more stringent manner. The success of this containment of inflation during the period known as "The Great Moderation" is greatly attributed to the stabilisation of the macroeconomy through policy measures. It was characteristic for most of the countries who witnessed high inflation to adopt inflation targeting as their policy framework, resulting in global disinflation with lesser volatility. However, emerging markets and developing economies, and low income countries experienced a delayed correction of the high inflation rates which in general started in the mid-1990s. This was mostly due to structural issues in their economies such as the populist political culture, persistent and substantial fiscal and current account deficits, which sometimes existed in parallel to fixed exchange rate regimes, deteriorating terms of trade for commodity exporters, and supply side issues compared to industrial economies. Efforts to contain inflation in these economies also resulted in serious output losses during the period from 1989 to 1994, amidst civil wars, in some cases.

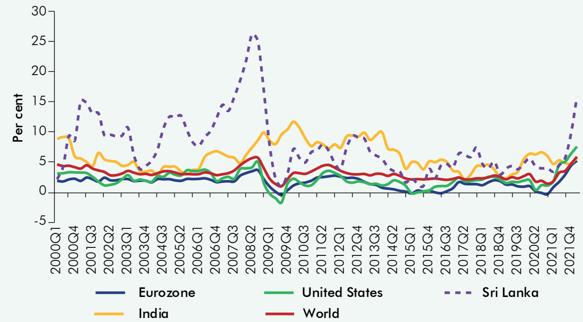
1 In July 1944, delegates from 44 countries met in Bretton Woods, New Hampshire, United States to agree on the Bretton Woods System, where gold was determined as the basis for the United States dollar and other currencies were pegged to the United States dollar value.

Period	Reasons for High Inflation
1973 - 1982	Two oil price surges; first due to an embargo by the Organisation of Arab Petroleum Exporting Countries (OAPEC), and second due to the decline in oil production caused by the Iranian Revolution and Iran-Iraq War.
2008	Global demand driven factors, including increased food prices and tripled oil prices during the period from 2004 to 2008 which was also contributed by the spillover effects of extra loose monetary policy conditions in the United States.
Current episode (since 2021)	COVID-19 pandemic related disruptions to supply chains, increased energy and commodity prices, increased fertiliser prices, disturbances due to elevated geopolitical tensions and reviving demand conditions due to normalising activity.

The downward trend in global inflation discontinued for a while in the early 2000s until economies were heading towards the Global Financial Crisis, when global energy prices and food prices were soaring. This was particularly due to rapid growth in emerging and developing economies that relied mostly on commodity-intensive economic growth. Strong demand persistently pushed energy prices and food prices upward until they collapsed with the financial crisis. The energy price surge was mostly driven by sluggish supply performances where the production and distribution capacity were slow to build-up as a response to rapidly increasing demand. Food prices also contributed to the prevailing high inflation, alongside demand from emerging and developing economies, and a number of other factors, including unfavourable weather conditions and growing use of export restrictions by food exporters, such as export restraints implemented by major grain exporting countries, including China, Ukraine, and Argentina.

However, in aftermath of the crisis, inflation reached low levels, where the global annual average median inflation reached 2.6 per cent by 2017. Particularly, about half of the advanced economies reported negative inflation rates in 2015, and every three out of four advanced economies reported low single digit inflation (Jongrim Ha et al., 2019). In emerging markets and developing economies, including those that were practicing inflation targeting, disinflation was prominent, and every three out of five economies recorded inflation rates below the target level.

Figure B 8.2
Global Inflation Dynamics since 2000
(Y-o-Y Quarterly Consumer Price Inflation)



Source: Global Projection Model Network
Department of Census and Statistics of Sri Lanka

High Inflation Episode since 2021

The current high inflation episode appears to be far wider and more persistent than previous episodes as it was triggered by several cost driven, and demand driven factors in combination. Supply side disruptions to major commodities, including energy related and agricultural commodities, due to the COVID-19 pandemic, supply chain issues, shortage of labour and increased demand for goods and services arising from normalisation of activity from the pandemic are the key contributors to this episode. Geopolitical tensions over the Russia-Ukraine war since late February 2022 pushed inflation trajectories further up on multiple fronts stemming from uncertainty, and commodity price hikes also contributed to inflation.

Along with these supply related causes of inflation, ample policy stimuli provided by monetary and fiscal authorities across the globe as well as additional policy support from the multilateral organisations to support the economies during the pandemic appears to have fueled inflation further, causing inflation originated from supply factors to persist for longer than initially anticipated. The combined effects of these forces lead to inflation recording several folds higher than the inflation targets and historical averages in many economies, regardless of economic status. Accordingly, in 2021, global inflation reached a near 14-year high. The United States experienced the highest inflation in 40 years with a year-on-year increase in the Consumer Price Index recording 7.9 per cent in February 2022. By February 2022, recording 6.2 per cent and 5.9 per cent increases over the last 12 months, the United Kingdom and New Zealand economies also experienced the highest level of inflation recorded in last three decades. The trend is set to continue as the leading economies, as well as the emerging market economies are expected to experience inflationary pressures in 2022 as well. Inflation in the Eurozone too mounted to a record high of about 5.0 per cent in 2021.

At the outset of the current high inflation episode, it was a widespread belief that these inflationary pressures are temporary, hence the need to respond through monetary policy would not arise as it could hamper growth recovery in the post-pandemic period. However, inflation worldwide is expected to persist for a longer period at a greater magnitude, than previously envisioned by global think tanks, due to ongoing supply chain disruptions and high energy prices. This made policymakers rethink prioritising stability over economic growth, and most central banks from advanced, emerging and developing economies commenced unwinding policy stimuli and started adopting a hawkish stance by tightening policy interest rates sharply and communicating their commitment for further tightening through forward guidance to fight inflation. The resultant tight global financial conditions are anticipated to contain global inflation back to the desired level with a policy lag. In addition to demand side measures, some countries are seeking possibilities of implementing certain supply side measures, such as change in conventional agricultural practices expecting to maintain realistic buffer stocks and revising import policies to avoid price rises of essential commodities.

Policy Responses in General and in Developing Countries

In general, monetary measures have been taken by central banks to address high inflation episodes

Figure B 8.3
Inflation by Country Characteristics

Source: Ha, J. M. et al. (2019)

supported by appropriate fiscal policies by governments. Central banks increase policy interest rates to increase the cost of borrowings and thereby discourage aggregate consumer spending. On the fiscal front, governments reduce inflationary pressures by increasing taxes and reducing government spending to address the demand-pull inflation. Also, price controls and subsidies play a major role in minimising the cost of production in controlling cost push inflation.

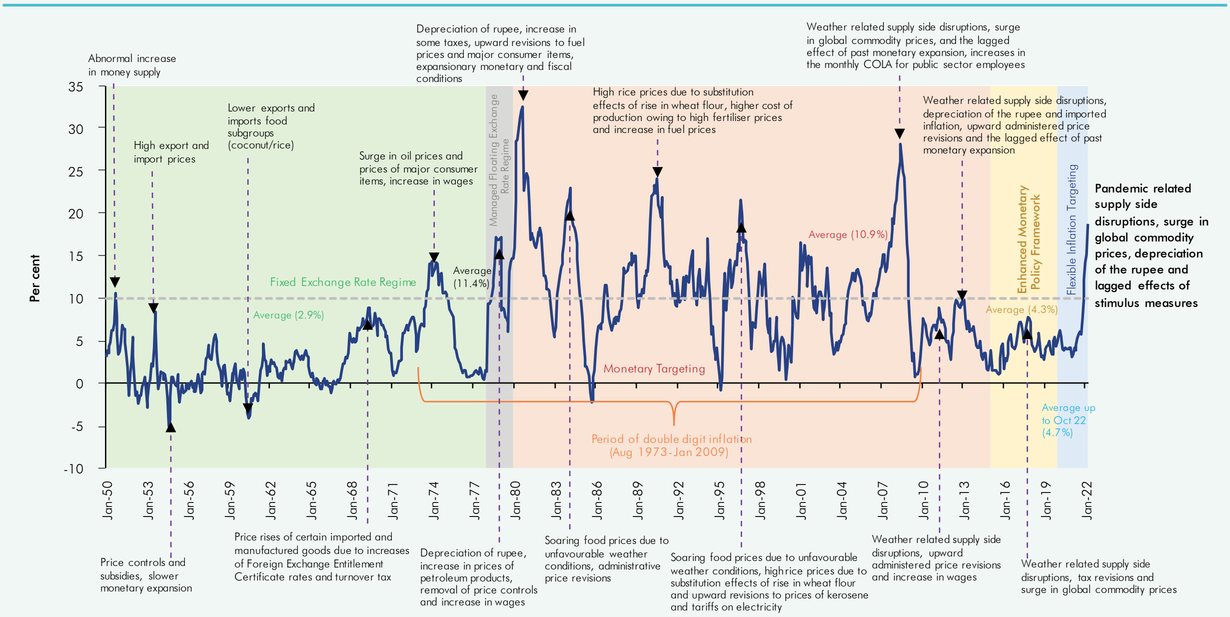
More importantly, transparent and independent central banks have been able to reduce inflation at a faster rate by anchoring inflation expectations through established credibility among economic stakeholders. Numerous assessments on the impact of central bank independence on macroeconomic stability support the assertion of a negative relationship between the central bank independence and inflation (Brumm 2002, 2011; Garriga and Rodriquez 2020; Berger, de Haan, and Eijffinger 2001). Empirically, central bank transparency has also been found to help anchor inflation expectations in advanced economies, thereby stabilising inflation and reducing uncertainty in inflation. (Weber 2016). Overall, appropriate stabilisation policies such as strengthening institutions, greater autonomy in central banking, and establishing an appropriate fiscal environment help decelerate structurally persistent inflation. Moreover, such policy commitments have been instrumental in successfully handling intermittent supply driven inflationary pressures as these pressures are perceived to be transitory by economic agents with well anchored expectations.

When investigating historical inflationary trends, it can be observed that compared to developed and emerging economies, many developing or low income countries have experienced high unvarying inflation over time. Therefore, it is a significant challenge for central banks in these countries to achieve low and stable inflation and to anchor inflation expectations. Although inflation in developing countries is more susceptible to external shocks such as energy prices and food prices, some of the reasons adduced for the sustained and persistent inflation rates in many developing countries are structural, including high budget deficits and financing such deficits by the central bank, high government expenditure, high military expenditure, low productivity, frequent weather shocks, high persistent inflation expectations by the economic agents, excess money supply and unstable exchange rates.

Figure B 8.3 shows the impact of global factors in driving inflation in domestic core inflation, which measures the underlying demand driven component of inflation, across countries.

Tight monetary and fiscal policies and control prices have helped control inflation; the impact of inflationary pressures was reduced via safety net interventions such

Figure B 8.4
Inflation based on the Colombo Consumer Price Index (CCPI) (Y-o-Y Changes)



Sources: Department of Census and Statistics, CBSL Annual Reports

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as cash transfers and food subsidies, at times to some extent. In many developing economies, active use of countercyclical policies including fiscal rules have aided insulation of economies from the impact of global shocks.

High Inflation Episodes in Sri Lanka

The Sri Lankan economy also has not been an exception to global inflation dynamics, cost push factors and structural limitations in demand management. Sri Lanka, too experienced, high inflation episodes during several periods due to transitory supply side disruptions, especially weather related, and surge in international commodity prices together with the lagged effect of monetary expansion largely to support deficit financing. Nevertheless, Sri Lanka maintained low and stable levels of inflation for over a decade, abetted by continuous improvements to policy formulation and policy communication, while addressing supply concerns temporarily through government intervention by reducing certain taxes on essential commodities, importation of certain commodities, imposing maximum retail prices for certain commodities, even within the limited fiscal space. The Central Bank has deployed monetary policy measures to contain demand driven inflationary pressures. Adopting a flexible inflation targeting (FIT) monetary policy framework aids the Central Bank to conduct monetary policy in an increasingly forward looking manner with the aim of maintaining inflation at low and stable levels in the medium term, thereby supporting to attain sustainable economic growth while ensuring Central Bank transparency and accountability. Since FIT involves the aim of achieving the envisaged inflation targets, which can be closely monitored through inflation forecasts, the monetary policy decision making process is facilitated by a forward looking model based comprehensive analysis on the deviations of the inflation forecasts from the desired targets. Therefore, shocks to such deviations can be addressed through proactive policy measures in a timely manner to bring inflation back to the desired target levels, while properly anchoring inflation expectations.

Similar to many countries across the globe, Sri Lanka is currently experiencing high levels of inflation. In addition to COVID-19 provoked circumstances, the recent acceleration in inflation was driven by supply side factors stemming from international commodity prices, which include fuel and some essential imported commodities. The removal of price controls and their spillover effects and the buildup of demand driven inflationary pressures stemming from pandemic related policy stimulus measures also contributed to inflation. Reflecting growing pressures from underlying demand conditions, core inflation, which does not capture volatile food prices, energy and transport costs, witnessed an increasing trend similar to other countries. Such demand driven pressures are taken care of through proactive policy measures taken by the Central Bank and the policy communication to reiterate commitment to revert inflation to the targeted range at the earliest. As such, the Central Bank increased policy rates in an aggressive manner, while devising preemptive policies to ensure that inflation returns to the targeted level at the fastest possible pace with minimal disruptions to economic recovery. Nonetheless, the government's intervention also remains vital to overwhelm the supply side concerns, while enabling monetary policy driven measures to arrest excessive inflationary pressure in the economy, and hence robust and coordinated policies are required to be adopted in a timely manner. The intervention of the Central Bank is vital to contain inflationary pressures building up from speculation by economic agents, and hence inflation expectations. It is important to have a mechanism established by the government, to detect early and take proactive policy decisions to contain any adverse inflationary developments arising from supply side disturbances. Such a policy mix is crucial for any country that wishes to quickly move back to targets to enjoy the luxury of stable and healthy levels of inflation, thereby ensuring sustainable economic growth which ensures high living standards of the public.

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