

Are We on the Road to Stagflation?

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The barrage of 'bad' news about the domestic economy seems to be both unrelenting and intensifying. In the past week we have seen CPIX inflation continue its upward march, to 8,8%; petrol prices will rise to over R8 per litre this week; the rand has weakened to around R8 to the dollar; the current account deficit has widened further; and a slew of real indicators - from business confidence to new car sales - show that growth is slowing down, even before the effects of the continuing electricity crisis show up in the official data.

News from the US, UK and Europe is nearly as bad, and in some cases worse. The US economy is widely expected to enter a recession while prices are still rising. Europe seems to be following its lead, albeit with a lag.

This raises the ugly spectre of stagflation: the simultaneous occurrence of stagnation (or contraction) in the real economy together with rising price inflation.

Yet most private sector economists in SA and the Reserve Bank are still stubbornly predicting that the local inflation rate will peak within a month or two and then gradually decline towards the upper end of the target range (6%) by early next year. They also express the hope that government's infrastructure spending and the 2010 World Cup will buoy the economy even as consumer spending dips.

The optimistic inflation projections beg two questions: what is driving inflation, and are these forces likely to abate soon?

The answer to the first question is plain to all: rising energy and food prices - the latter spurred by growing demand in China and India as incomes rise, as well as by booming bio-ethanol production in the US. Biofuels have now directly bridged the food and energy markets, with potentially dire consequences for food security in poor countries. Other inflationary pressures will likely strengthen too as China exports its broadly rising prices to its foreign customers.

Will energy and food prices drop any time soon? This seems unlikely. Everyone needs food and energy, so demand for these commodities is inelastic and their prices won't come down much in a hurry.

The only way oil prices could fall substantially is if the US drags the world economy into a severe recession. Growth in China and India would have to slow down dramatically to suppress their increasing appetite for oil and food. Meanwhile the OPEC oil cartel has been unwilling - or unable - to halt the oil price rise, and looks set to defend a floor of around \$85 per barrel.

So with global inflationary pressures robust, the only thing that could lower domestic inflation is a much stronger rand or a dramatic contraction in demand for imports. With the trade deficit continuing to widen as a result of rising oil prices and capital imports, and foreign investors seeking 'safe haven' assets, the possibility of a strengthening rand looks remote.

The lagged effect of oil prices near \$100 per barrel, grain prices having doubled in the past year, and the rand's recent slide will still take some time to feed through into final inflation figures. Double-digit inflation could be just around the corner.

What's more, Statistics SA will this week release the latest Income and Expenditure Survey, which will be used to recalculate the weightings of items in the CPI basket. Surely the proportions of income households spent on food and fuel in 2005/6 were higher than in 2000, so that further hikes in prices of these items from 2009 will weigh more heavily on a reweighted CPI.

So it would appear that either the Reserve Bank and private sector economists are using faulty forecasting models, or they are deliberately trying to dampen inflationary expectations by 'talking down' inflation. They are certainly not warning of an imminent, sharp recession as an antidote to price hikes.

The monetary policy committee is in an increasingly uncomfortable position as it weighs up the risks of slower growth and faster inflation.

Part of the problem is that it insists on using one, very blunt instrument: the repo rate. Demand for credit and the money supply continue to grow rampantly (above 20%) despite the 4% increase in interest rates since June 2006. Perhaps raising banks' reserve requirements - as the Chinese have done - would be more effective. Higher interest rates do little to curb demand for essential goods like petrol and food, and therefore don't have much impact on inflation. If rates rise too high, they could induce a collapse in the housing market as is happening in the US.

The last time the world experienced stagflation was in the wake of the 1973 and 1979 oil shocks, which precipitated the most severe downturns in the global economy since the second world war. In both instances oil prices trebled after about 5% of world oil production was taken off the markets, showing how inelastic short-run demand is.

On those occasions South Africa's economy was initially buffered by a soaring gold price, but it too succumbed to recessionary pressures as demand for our exports contracted sharply after a couple of years.

The price of oil in real terms is now as high as it was at its previous all-time peak in 1980. The share of GDP being spent on oil in major industrialised economies like the US has also regained its historical peak. The oil price shock that many have been fearing for a few years seems to be kicking in at last.

The future outlook could be even bleaker. The international media and politicians in many countries are finally awakening to the reality that global oil production will peak and then decline, probably in the next decade. If production declines at a rate of 2-5% per annum, which many experts predict, the economic consequences could be devastating.

These are all signs that the current economic model is not working.

We need to replace the holy grail of perpetual growth with the goal of sustainable development and the realisation that a finite Earth imposes physical constraints. This will require a cultural shift from materialism and competition to sufficiency and equity. Linear production functions that consume ever greater quantities of non-renewable or exhaustible resources must be replaced by zero waste circular flows of renewable resources.

We need to adopt a monetary system that is less prone to booms and busts, is not inherently skewed in favour of the rich, and does not systematically discount the future. Perhaps hardest of all, humans need to reduce the size of their populations before nature does it for them.

These are some of the defining challenges of the 21st Century. Our children and theirs are depending on us for enlightened leadership.

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