Province of KwaZulu-Natal
Provincial Treasury
Infrastructure Management and Economic Service (IMES) Unit (June 2016)

Jacob Twala and Smangaliso Mncube
jacob.twala@kzntreasury.gov.za and smangaliso.mncube@kzntreasury.gov.za
033 8974605 and 033 897 4571

Inflation Rate

1. Introduction

Inflation is the rate at which the general level of prices for goods and services increases. It is one of the critical indicators that affect economic performance of a country. High inflation adversely affects consumers' disposable income which in turn reduces purchasing power. This, as a result, has a detrimental effect on a country's economic performance in terms of gross domestic product (GDP)[1].

Hyperinflation on the other hand refers to the extremely high level of inflation, usually caused by a rapid increase in money supply. High inflation, affects among others, the producer price index (PPI)[2] and the consumer price index (CPI)[3]. As correctly indicated by Statistics South Africa(Stats SA, 2013), CPI is a current social and economic indicator that measures changes in the general price levels of consumer goods and services for a representative basket of goods.

1 Higher inflation generally reduces spending on consumption (C) and thus adversely affecting economic performance as C is one of the key components of GDP. In fact C accounts for more than 60% of the South African GDP.

2 The Producer Price Index measures the average change over time in the selling prices received by domestic producers for their output (see http://www.bls.gov/ppi/, accessed on 23/04/2016).

3 CPI refers to an inflationary indicator that measures the change in the cost of a fixed basket of goods and services, such as electricity, transportation, housing, food and others.

2. Inflation

The two types of inflation commonly measured in mosteconomies are headline and core inflation. Headline inflation generally takes into account changes in the prices of food and energy which are reported monthly in most countries, including South Africa (SA). Since food and energy prices can increase rapidly, headline inflation may therefore not provide a true reflection of how an economy behaves. Core Inflation, on the contrary, measures CPI that includes prices of food and energy as well as other goods and services that display volatile movements in prices.

Given the fact that core inflation is less volatile and shows the effects of supply and demand (averages) on a country's GDP, it is therefore to a large extent, used by central banks where the South African Reserve Bank (SARB)[4] is no exception. However, most countries, including SA normally report on headline inflation.

It is therefore by no surprise that the primary mandate of the SARB is to achieve and maintain price stability in the interest of balanced and sustainable economic growth. Subsequently, the Monetary Policy Committee (MPC) of the SARB carefully monitors the inflation trends both globally and nationally by applying appropriate monetary policy instruments to maintain the targeted band. Inherently, price stability reduces uncertainty in the economy and, therefore, provides a favourable environment for economic growth and employment creation.

Furthermore, low inflation contributes to the protection ofthe purchasing power[5] of all South Africans, particularly the poor who have no means to defend themselves against continuous rising prices.

3. Causes of inflation

Inflation comprises of two types namely, demand-pull and cost push inflation. Demand pull inflation occurs whengoods and services that are demanded in an economy are less than those that are supplied in aggregate. This condition leads to a situation in which too much money is chasing few goods as production in the economy does not satisfy all the demands.

In stark contrast to demand-pull, cost push inflation[6], arises due to higher costs of production. Production costs include among others wages and salaries that are not compatible with productivity, increase in prices of intermediate goods, rise in fuel prices, the after-effects of drought and others.

4 SARB is the central bank of South Africa, which is primarily responsible for the achievement and maintenance of price stability and sustainable economic growth in the country (https://www.resbank.co.za/Pages/default.aspx, accessed on 13/05/2016).

5 Purchasing power measures the value of goods that can be bought with a specific amount of income (rand value of goods and services that can be purchased as prices change) - see http://smallbusiness.chron.com/factors-influencing-purchasing-power-economy-1575.html, accessed on 23/05/2016.

6 See http://www.yourarticlelibrary.com/macro-economics/inflation-macro-economics/3-major-gredients-of-cost-push-inflation-theory/4095, accessed on 16/04/2016.

Cost-push inflation is further exacerbated by imported capital which becomes expensive when currency is weak. This type of inflation has a negative effect on production and employment as prices increase concurrently with a decline in output, resulting in stagflation[7].This is a severe situation for any country as it cannot be resolved immediately.

4. Effects of inflation

The effects or costs of inflation are divided into three categories, namely income & wealth distribution, real economic costs and social & political costs.

4.1 Income distribution effect

Inflation affects the distribution of income and wealth among various participants in the economy. High rate of inflation usually leads to an artificial increase in consumers' nominal income, while real income[8] remains constant or decreases. Subsequent to this, inflation has a general tendency of redistributing income and wealth from lenders to borrowers. This emanates from the fact that, real value of money tend to decrease as price levelsincrease.

For an example, assume that during times of high inflation rate, a consumer borrows R5, 000 from a bank and repay the loan over five years. It must be noted that the loan taken must be repaid together with simple or nominal interest[9]. Under these circumstances, the loan paid back will worth much less than the amount borrowed. Contrary, if the real interest rate charged is lower than the inflation, then this consumer gains.

4.2 Economic effect

Inflation has various economic effects which may result in lower economic growth and higher unemployment than would have occurred. It tends to encourage speculative activity, at the expense of productive activity, while discouraging saving. More specifically, it negatively affects economic growth in the following areas.

7 Stagnation occurs when prices of goods and services continually increase, many people do not have jobs, and businesses are not very successful (.www.merriam-webster.com/dictionary/stagflation, accessed on 16 May 2016).

8 Real income is the Income level (nominal) which is calculated by taking into account inflation rate.

9 The difference between the nominal interest rate and the inflation rate is called the *real interest rate*. If the nominal interest rate is lower than the inflation rate, the real interest rate is negative. For an example an example, assuming a nominal interest rate of 12%, while inflation rate is estimated at 15%, real interest rate is thus negative 3%. In a case whereby real interest is positive, then there would be no redistribution of income from the lender to the borrower.

Firstly it creates balance of payments[10] constraint through higher cost for exporting industries and import competing industries. If inflation is higher domestically than that ofthetrading partners and international competitors, the result would be loss of international competitiveness.

Secondly, inflation tends to deteriorate purchasing power[11] given that prices increase overtime which cause people to buy less goods. This in turn affects employers in a manner that wages would be required to increase to cope with the rate of inflation to compensate employees and maintain purchasing power for increasing prices.[12]

4.3 Social and political effect

Evidence across the globe indicates that inflation is generally socially harmful, as it widens the gap between the rich and the poor. Rising prices have a tendency of creatingdissatisfaction among ordinary people in the form of services such as rents, transport costs, derailed households budget and others. Pressed by the rising cost of living, workers and people in *en masse*resort to strikes which lead to loss in production and property destruction.

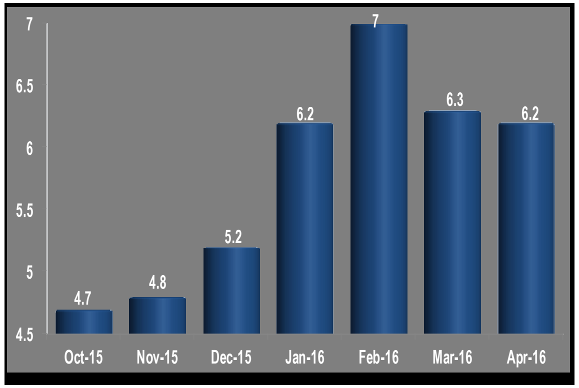
5. Global inflation rate

According to the International Monetary Fund (IMF, 2016) advanced economies experienced the lowest inflation in 2015, since the global financial crisis. Inflation was 0.3% in 2015, far below the average 1.5% in March 2014. This could be attributed among other things to commodity prices which sharply declined in 2015. Inflation in emerging markets and developing economies is projected to be 4.5% this year compared to 4.7% in 2015 (IMF,2016).

6. Inflation rate in SA

As indicated in section one of this newsletter, the SARB is responsible for the achievement and maintenance of price stability in SA with an intention of containing inflation within the targeted band of 3% to 6%. The country's lowest rate of inflation was estimated at 3.9% in February 2015 before escalating to 5.2% in December, closer to the upper limit of the targeted band. This was however, still below 6.1% and6.6% rates reported in April and June 2014 respectively (Stats SA, 2016).

Figure 1. Headline inflation rate in SA year-on-year, October 2015 to March 2016



Source: Stats SA, 2016

Figure 1, reflects the national headline inflation, whichbreached the targeted band and accelerated slightly to 6.2% in January 2016, up from 5.2% in December 2015. Disturbingly, inflation further rose to 7% in February which apparently created more concern to the MPC, as it proclaimed that it was the highest inflation the country endures since the global financial crisis of 2009 (SARB, 2016).

The level of inflation rate, however, dropped moderately to 6.3% in March before slowing down slightly to 6.2% in April this year. Hence, the burden to the central bank still remains unresolved as the rate continuously moves beyond the targeted range.

Nonetheless, the slight downward trend does not signal any relief to consumers and the country at large, especially the poor who are living under extremely unbearable pressure. The central bank further maintains that among contributory factors to this continuous rise in the level of prices could be counted exchange rate depreciation, higher food prices and prevailing severe droughts in the country.

The SARB revised upward its forecast of inflation for this year to 6.7% from 6.6% earlier this year. Contrary, their forecast for 2017 showed downward movement to 6.2% on average from 6.4% in January this year. This shows that inflation should be expected to remain beyond the upper limit for the entire forecast period (SARB, 2016b).

Table 1 below shows that, despite headline inflation easing, food inflation hit a highest record of 11.3% in April 2016, from 9.8% in March year-on-year. This is mainly due to shortages because of the drought and a weak rand, which made imports more expensive. Higher food prices were driven mainly by vegetables (23%), fruit (19.6%), oil & fats (19.5%) bread & cereals (14.9%) as well as unprocessed food (14.1%).

The second highest prices were those of alcohol beverages (7.3%) and miscellaneous goods & services at 7.1%. Transport costs accelerated to 2.7% in April, with its index increasing by 2.6% month-on-month, mainly due to the 88 cent increase per litter in the petrol price (table 1 & Stats SA, April 2016).

Table 1: Consumer price indices for all urban areas (percentages), March 2016 to April 2016 and April 2015 to April 2016

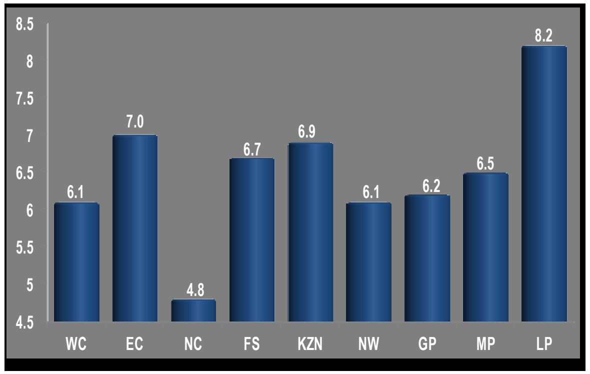
	Monthly (March to April)	Yearly (April 2015 to April 2016
Food	1.9	11.3
Non-Acoholic beverages	1.9	7.3
Alcoholic Beverages	1.2	6.6
Tobacco	0.2	4.3
Clothing and footwear	0.4	4.9
Housing and utilities	0.1	6.5
Household contents and Services	0.2	3.8
Health	0.2	6.2
Transport	2.6	2.7
Communication	0.0	0.1
Recreation and Culture	0.4	6.3
Education	0.0	4.6
Restaurants and Hotels	-0.5	5.7
Miscellaneous goods and services	0.6	7.1

Source: Stats SA (2016)

7. Inflation in KwaZulu-Natal (KZN)

Headline inflation in KZN accelerated moderately at 0.2 percentage points, from 6.7% in March to 6.9% in April this year (figure 2 and Stats SA, 2016). The slight increase ishowever greatly imposing pressure to consumers in the province in terms of purchasing power due to higher prices, particularly those of food.

Figure 2. Inflation by province year-on-year, April 2016



Source: Stats SA (2016)

This high inflation indicates that people, especially the poor will continue to live under extreme unbecoming conditions of higher poverty in the province. This situation is further exacerbated by the drought conditions which affecting KZN and other parts of the country.

Compared to others, Northern Cape (4.8%) is the only province with inflation rate within the targeted band. Limpopo (8.2%), Eastern Cape (7.0%) and the Free State (6.7%) are among provinces recorded the highest levels of inflation.

[10]Balance of payments records the difference in total value between exports and imports payments into and out of a country over a period.

[11]Purchasing power referes to the value of goods or services that can be purchased with a given amount of income.

[12] See effects of Inflation from http://www.economywatch.com/inflation/effects.html, accessed on 16/04/2016.

8. Monetary policy measures

The SARB plays a pivotal role in fighting against accelerating price levels in the country. It mainly utilizes repurchase rate (Repo rate)[13] as an instrument to lower inflation. This is despite the negative consequences that might be caused by higher interest rates to businesses, households and others.

The reserve bank has been hiking the rates since July 2015, following considerable rise in price levels perpetuated by depreciation of the Rand against other currencies. The repo rate is currently 7%, which probably have adverse effect to investments as it mostly financed through borrowings. This follows that higher interest rates tend to increase the cost of borrowing. Though it is good to tackle inflation, this is however, costly to the economy.This is cemented by the study by Jordaan (2014), which shows that every 1% increase in rates, results to 0.5% decline in economic growth.

9. Conclusion

The key problem with inflation is the fact that it results to lesser buying power of consumers. The adverse effects of inflation include among others an increase in the opportunity cost of holding money. It thus leads to uncertainty over future levels of prices which may discourage investment and savings.

The rapid increase in inflation inherently leads to the SARB to increase interest rates, which on its own is a burden to the already over indebted consumers. Evidence from the SARB indicates that an estimated 78% of households' income is spent on servicing debts. This as a result has direct impact on consumption and thus affecting the GDP of the country.

Furthermore, higher inflation has a tendency of negatively affecting the export industry of an economy. A rise in the costs of production adversely affects exports by making local goods more expensive, thus less competitive in the international market. This as a result leads to weaker balance of payments.

Circumstances like these normally force the central bank to use monetary tools to control high inflation rate by increasing interest rates. Once again, this leads to higher costs of borrowing - hence negatively effecting both consumption and investment and thus hampering economic growth.

References

Jordaan, J.C., 2014: Impact of interest rate changes on South African GDP and households: a combined macroeconomic and social accounting matrix modelling approach. Southern African Business Review, 17(3), pp.156-186.

IMF(April 2016): World Economic Outlook, *Too Slow for Too Long. World Economic and Financial Survey:* Available online: http://www.imf.org/external/pubs/ft/weo/2016/01/pdf/text.pdf, accessed on 20/04/2016.

SARB (2016): Quarterly Bulletin, June Report no. 272, accessed on the 22 April 2016, available from https://www.resbank.co.za/.

SARB (2016c): Monetary Policy Review, April 2016, available from http://www.resbank.co.za, accessed on 3/05/2016.

SARB (2016b): Statement of the Monetary Policy Committee, Press statement delivered by the Governor of the SARB. Available online: https://www.resbank.co.za,accessed on 19/05/2016.

Stats SA (2016): Consumer Price Index, April 2016, Statistical Release P0141, Embargoed until 18 May 2016, available online: http://www.statssa.gov.za/publications/P0141/P0141April2016.pdf, accessed on 30/04/2016.

Stats SA (2013): Consumer Price Index, the South African CPI Sources and Methods Manual, Release v .2, available online: http://www.statssa.gov.za/cpi/documents/The_South_African_CPI_sources_, accessed on 13/05/2016.

[13]The repo rate is the interest ratecharged by the SARB whenlending money to commercial banks in SA Seehttps://www.resbank.co.za/Research/Rates/Pages/CurrentMarketRates.aspx, accessed on 17/05/2016.

Province of KwaZulu-Natal

Spending your money wisely

KZN Provincial Treasury's Vision

"Be the centre of excellence in financial and fiscal management in the country"

KwaZulu-Natal Provincial Treasury
Treasury House
145 Chief Albert Luthuli Road
P O Box 3613
Pietermaritzburg
3201