A foreign affair
Oct 20th 2005
From The Economist print edition

Inflation is increasingly determined by global rather than local economic forces

The average inflation rate in the G7 economies rose to an estimated 3.2% in September, its highest for 13 years. The main reason for the return of inflation is that oil has become a lot more expensive; “core” inflation rates, which exclude oil and food, remain much lower in all countries. But fears are mounting that higher oil prices will feed into other prices throughout the economy, pushing inflation higher still.

This is particularly worrying for America. On top of soaring oil prices, companies’ unit labour costs rose by 4.2% in the year to the second quarter, mainly thanks to slower productivity growth. The rate of growth of these costs increased by more over the year than at any time for two decades. With energy and labour becoming conspicuously dearer, any inflation model based on a mark-up of prices over costs should be flashing red. Yet in the past year core inflation has not budged. How come?

Stephen Roach, chief economist of Morgan Stanley, suggests that thanks to globalisation, the inflation process has changed over the past three decades in a way that has significantly weakened the link between domestic cost pressures and inflation. He draws on an analysis in the latest annual report of the Bank for International Settlements (BIS), which suggests that global forces have become more important relative to domestic factors in determining inflation in individual countries.
According to the BIS, the correlation between core inflation and the growth in unit labour costs in America fell to only 0.3 in 1991-2004, from nearly 0.8 in 1965-79. The link between inflation and labour costs also faded in other developed economies (see chart). This probably reflects two things. First, the integration into the world economy of China and other emerging economies with vast supplies of cheap labour has curbed the bargaining power of workers in developed economies. These workers therefore find it harder to secure higher wages when inflation picks up. And second, fiercer global competition has made it more difficult for firms to pass increases in wages through to prices. Instead they must absorb them in their profit margins.

As further evidence that firms are less able than they were to hand cost increases on to their customers, the BIS found that fluctuations in import prices also have much less impact on core inflation than they once did. Similarly, the link between movements in exchange rates and import prices has sharply diminished. Standard economic theory has it that a fall in the dollar against the euro should push up the dollar prices of European exports to America, raising America’s inflation rate. But the proportion of exchange-rate changes passed through to import prices has fallen everywhere; in America, it has been 60% lower since 1990 than it was in the previous 20 years. Today, exporters set their prices for a local market and then either hedge their currency risk or absorb currency changes in their margins.

Increased global competition has thus limited the room for firms to pass on higher costs. This makes a nonsense of traditional economic models of inflation, which virtually ignore globalisation and assume that companies set prices by adding a mark-up over unit costs, with the size of the margin depending largely on the amount of slack in the economy. In reality, when setting prices firms are increasingly likely to be constrained by global competition. Given the price the market will bear, they design and make their products as profitably as they can. As a result, domestic cost pressures, whether in labour or energy, no longer lead automatically to higher inflation, but are more likely to show up as swings in profit margins.

This suggests that in forecasting inflation central banks now need to pay less attention to domestic shifts in unemployment and capacity utilisation and much more to the global balance between supply and demand. The BIS’s research shows that since 1990 the core rate of inflation has become less responsive than it used to be to changes in the output gap (a measure of economic slack) in all the main developed economies except Britain. The ups and downs of inflation increasingly reflect the global balance between supply and demand.

A premature obituary

The nature of inflation has thus changed. But it has not died, although the forces of globalisation have helped to combat it. Policy blunders by central bankers could still allow it to break out again. Indeed Don Kohn, a governor of the Federal Reserve (and one of several potential successors to Alan Greenspan as chairman), reckons that the impact of China and other newly industrialising economies on inflation is often exaggerated. In a speech last week, he drew on a Fed study which concluded that the direct impact of cheaper Chinese imports on American inflation was modest. However, this study ignored the indirect effects of China on wages and the fact that cheaper Chinese goods do not just reduce the price of imports from China but, through competition, the price of all goods sold worldwide.

Mr Kohn may well have underestimated the extent to which globalisation has borne down on inflation in past years. However, more important for policymakers today is its future effect. As Mr Kohn argued, the emergence of new industrial giants has increased not only global supply but also demand, particularly for oil and other raw materials. By running large current-account surpluses these economies are currently adding more to supply than to demand, so their net effect is disinflationary. But this could change. If their exchange rates rose and their domestic demand increased, said Mr Kohn, downward pressure on prices would ease, and might one day be reversed.

Even though globalisation has helped to hold down inflation so far, capacity constraints will eventually appear in the global economy, just as they always have at the national level. Globalisation does not relieve central bankers of their responsibility for maintaining price stability. But it may require them to steer policy by a different compass: one that takes much more account of developments abroad.