

The New Inflation

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What the Consensus Doesn't Understand

(CPAI's suggested title)

We've learned a lot about inflation in the past 35 years. From the double-digit price increases of the 1970s to a close brush with deflation in 2003, the inflation saga has gone through a remarkable transformation. The interplay between globalization and new IT-enabled technologies changes the very context of the inflation debate. Financial markets and central banks need to update their perceptions of the New Inflation.

Unlike physics, there are no mathematical constants that lie at the core of our understanding of inflation. In fact, the inflationary timeline of the past 35 years reveals striking shifts in the forces that shape the price determination process. The decade of the 1970s was a world of "closed" economy models. As the two energy shocks of the 1970s demonstrated, supply disruptions mattered, especially when domestic operating rates were high. Labor market rigidities also mattered, especially for workers that were shielded from global competition and "protected" by wage indexation. The Great Inflation came from the interplay between costs and prices and the self-reinforcing culture of inflationary expectations. Lax monetary policy was an important enabler of what became known as the "inflationary spiral." Central banks had yet to understand the message of Milton Friedman, that "Inflation is always and everywhere a monetary phenomenon."

The 1980s were a backlash to the 1970s, in effect, dominated by disinflation and by the ascendancy of monetary policy as the change agent. Paul Volcker led the charge, embracing an eclectic monetarist framework in late 1970 when America's CPI inflation rate was surging at a 13% annual rate. He pushed the federal funds rate all the way up to 19% in 1981 in an effort to wring inflation out of the system. The experiment worked. The US went into its worst recession since the Great Depression, and a deeply ingrained inflationary mentality cracked. Along the way, the resistance of US labor crumbled -- collective bargaining contracts were re-opened, wage indexation clauses were abandoned, and the insidious expectational spiral started to unwind. The cure -- however painful -- was a decisive victory for Milton Friedman and the monetarist doctrine he espoused.

The rules changed in the 1990s. Trade liberalization led to globalization, and closed-economy models gave way increasingly to the new realities of open economies. At the same time, IT-enabled technological change led to the birth of the Internet -- the virtual glue that cemented cross-border connectivity in goods and services, alike. Central banks were unprepared for these developments. Fixated on closed-economy perceptions of price stability, they were surprised by the disinflationary consequences of the interplay between globalization and the Internet. At the same time, central banks came under the influence of the IT-enabled productivity boom -- convinced that a new strain of productivity-led inflation immunity was emerging that could justify unusual monetary accommodation. This powerful combination -- disinflation in

conventional CPI-based prices plus monetary accommodation -- provided an entirely different context for the inflation debate. It gave rise to the Asset Economy.

The 2000s began with a breakdown of monetary discipline in a post-asset-bubble world. Three months into the millennium, the equity bubble burst. Central banks dusted off the script of the 1930s and eased aggressively, injecting more and more liquidity into disinflationary economies. Real interest rates dipped back into negative territory, and the developed world lurched from one asset bubble to the next -- from equities, to bonds, to property. The metaphor of the water balloon suddenly didn't seem so far-fetched: In a world awash in excess liquidity, the inflation had to go somewhere. As globalization and technological change continued to squeeze pricing in goods and services, the surplus liquidity went to the other end of the balloon -- the Asset Economy. Now, of course, central banks are attempting to reclaim the high ground. That's especially the case for America's Federal Reserve, which has belatedly recognized the linkages between monetary accommodation, asset bubbles, low saving, current-account deficits, debt overhangs, and global imbalances (see Alan Greenspan's October 12 speech, "Economic Flexibility").

This, of course, is an over-simplification of 35 years of experience on the inflation front. And it is one person's point of view. But as policy makers and financial markets now come to grips with another inflation scare, this history raises critical questions about what we have learned along the way. As I see it, three powerful forces emerge from this saga -- globalization, technology, and monetary policy. The first two are holding down inflation and, barring an outbreak of protectionism, are likely to do so for the foreseeable future. The third force -- monetary policy -- has the potential to be an important swing factor. However, it is not clear what type of inflation -- CPI or asset-based -- will arise from excess monetary accommodation. Here, as well, context, is key. It may well be that liquidity injections are not powerful enough to outweigh the secular disinflationary forces of globalization and IT-enabled technological change. In a low nominal interest rate climate, that could well mean that the transmission of monetary stimulus gets directed more at asset markets than at goods and services. After years of denying this possibility, Alan Greenspan now appears to have conceded this critical point (see my 30 October dispatch, "Batonless").

It is important to view the current inflation debate in this historical context. For the US, there can be no mistaking the inflationary impacts of the energy shock of 2005 -- a 35% increase in energy prices over the past year boosted overall CPI headline inflation to a 14-year high of 4.7% in September 2005. At the same time, there are literally no signs of inflationary pressures elsewhere in the economy. The notorious "core" CPI -- which can be helpful in understanding the spillovers from energy and food prices to other segments of the pricing structure -- actually ticked down to 2.0% in the 12 months ending September 2005 and is off 0.3 percentage point from this year's peak rate of 2.4% hit in February. For months, various surveys have been warning of a broadening out of pricing leverage, as soaring energy prices are passed through into quotes of other goods and services. That's true of tallies from the Institute for Supply Management as well as from Morgan Stanley's own collection of industry experts. Yet over that same period, there has been no validation of those concerns in the form of a pickup in core inflation. In terms of the broad gauges of US prices, inflationary pressures remain narrow and generally well contained.

This raises a fundamental question about the inflationary impacts of supply shocks in a globalized world economy. In the closed-economy models of yesteryear, it seemed reasonable to worry about the pass-through effects of an energy shock -- especially if labor and product markets were tightening. In the open-economy models of today, however, it may well be that an increasingly powerful global price arbitrage has contained the spillover effects that might have occurred in the past. That's certainly what the statistical evidence shows: Over the past 15 years, there has been a sharp reduction of the correlations between labor costs and the CPI, as well as the import-price elasticity of the CPI (see my 14 October dispatch, "Déjà vu 1994"). These are the telltale signs of a very powerful strain of globalization at work. If the linkage between aggregate pricing and two of its major determinants -- labor costs and import prices -- has been loosened, the transmission of a supply shock to other segments of the price structure may well be diminished. That's what seems to be the case in the US -- at least for the moment.

Thirty-five years of inflationary experience also teaches us about the importance of expectations in shaping major changes on the price front. The latest consumer survey tally from the University of Michigan underscores an important dichotomy that has opened up with respect to the time horizon of inflationary expectations in the US. Near term, US consumers are quite concerned about the inflation outlook -- 12-month ahead CPI-based inflationary expectations surged to 4.6% in early October -- a 16-year high and a dramatic deterioration from the 3.1% reading as recently as August. But there has been no discernible deterioration in longer-term inflationary expectations over the next five years -- they held steady at 3.1% in early October, slightly above the 2.75% average of the past 3 1/2 years. Consequently, the expectations sampling of the Michigan survey portrays the energy shock of 2005 as largely a transitory disturbance on the inflation front, with short-term spillovers into energy-dependent goods and services -- transportation and home utilities -- but no lasting impacts on perceptions of secular inflation trends. This is a major difference from the far more lethal interplay between supply shocks and underlying inflation in the 1970s and 1980s.

The New Inflation is first and foremost a global phenomenon. Closed economy price models have broken down for a reason over the past 15 years -- namely, because of IT-enabled globalization. This has had a profound impact on the dispersion of inflationary trends around the world. The convergence between inflation in the developed and the developing world is particularly noteworthy in that regard. As recently as 1994, inflation in the developing world was still running at around 80% -- literally 30 times the 2.6% aggregate inflation rate for advanced economies. In 2005, the IMF reckons that inflation will slow to just 5.9% in the developing world -- only about 2.6 times the 2.2% inflation rate estimated for the developed world. The power of this convergence cannot be minimized. It has pulled down inflation in some of the most inflation-prone segments of the world. For example, in 2005, our estimates place Latin American inflation at just 5.5% -- less than half the 13% pace of 2002. The pass-through of supply shocks into domestic pricing structures must meet this stiff global headwind head-on.

The New Inflation should not be confused with the end of inflation. There are very plausible conditions that could lead to a meaningful and sustained reacceleration of price increases. Policy blunders by central banks would be especially worrisome for inflation. A protectionist-led breakdown of globalization would only compound the problem. An outbreak of sharp wage increases would undermine the all-important expectational mindset that has become central to

the inflationary dynamic. In the end, however, I do not believe that commodity-specific supply shocks are enough in and of themselves to trigger a broad-based outbreak of inflation -- even in economies such as the US, where slack in labor and product markets is dwindling. The New Inflation is dominated by a powerful inertia that is exceedingly difficult to dislodge.

We may have inflation scares in the year ahead, but I suspect they will turn out to be false alarms. Stock and bond markets could be whipsawed if they discount mounting inflation. Central banks are at risk of going too far if they tighten in fear of the ghosts of inflation past.