Back to the 1970s? Why inflation is again a spectre

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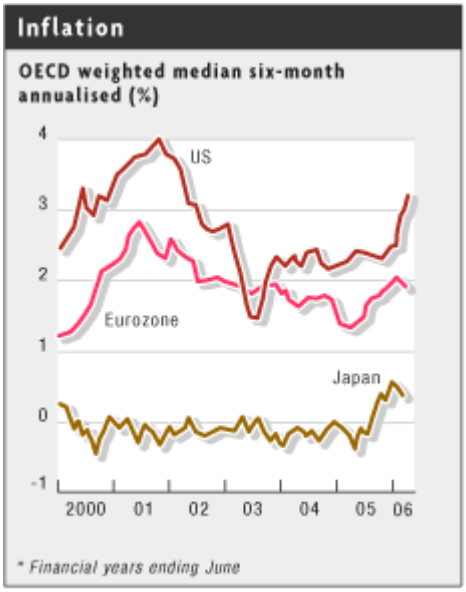
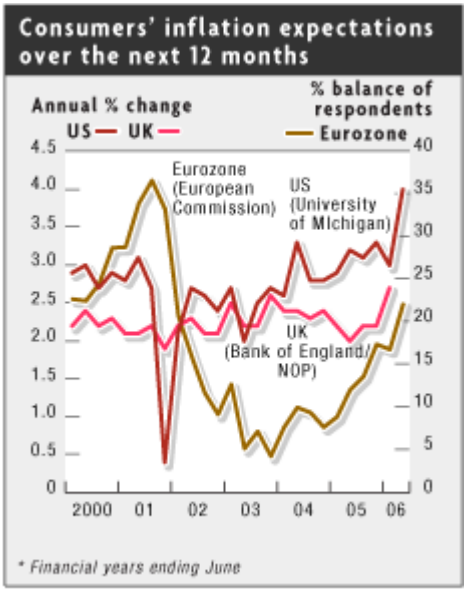
The threat of inflation once more hangs heavy over the global economy. Anxiety about rising prices may be cloaked in decorous central banker-speak. But there is no mistaking the swelling chorus of concern from monetary policymakers, financial markets and many of the world's most respected international financial institutions.

Readers of the runes do not have to look far for signs of jitters. When Ben Bernanke, the Federal Reserve chairman, warned on Monday that sharp recent rises in consumer prices had been "unwelcome developments", the financial markets tumbled, fearing further US interest rate increases. The European Central Bank has lost patience with inflation that has remained persistently higher than its 2 per cent definition of price stability. It is almost certain to raise the cost of borrowing on Thursday, perhaps by 0.5 percentage points. Even the Bank of Japan – so long the land of falling prices – now worries more about the dangers of inflation than the "economy falling into a deflationary spiral".

No one is expecting a sudden return to the bad old days of the 1970s. Inflation as a global phenomenon was gradually squeezed from advanced economies in the decade from 1985. This "great disinflation" is expected to endure. But the concern is that the world's pivotal central banks may have to work harder than they have done for many years to ensure continued price stability.

In the past six months underlying inflation has been on the rise across the world's three big economic areas. Since the increase in inflation has broadly manifested itself in goods and services without direct links to energy prices (see chart), five new concerns are emerging.





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First, the rapid economic growth over the past four years has eliminated spare capacity in the US and Japan, reducing the scope for expansion to continue apace without boosting inflation.

Second, there is a serious risk that high and, more important, rising energy prices will be a permanent feature of the global economy in a world characterised by surging energy demand and relatively fixed supply.

Third, the benign forces of deflation emanating from China as a result of the low prices of goods it exports to other countries might be waning, as its endless appetite for oil to sustain industrial expansion continues to drive energy prices higher. Calculating that the direct impact of cheap imports from Asia was to lower inflation by only 0.1 percentage points a year in the US and 0.3 percentage points in Europe over the past five years, Jean-Philippe Cotis, chief economist of the Organisation for Economic Co-operation and Development, argued that "experience over the past three years suggests commodity price pressures may significantly outweigh the disinflationary influence of low-cost manufacturing imports".

Fourth, monetary indicators, including personal borrowing, have been glowing red-hot in recent years, indicating there has been too much money sloshing around in the system even if the visible effects have been largely limited to surging asset markets, particularly property prices.

Fifth, the public's expectations of future inflation are strengthening, increasing the likelihood that today's inflation will lead to tomorrow's wage demands.

Against a backdrop of all these forces that may propel inflation upwards, central bankers rightly remind the public that higher interest rates cannot reduce inflation today but that they will never lose sight of future price stability.

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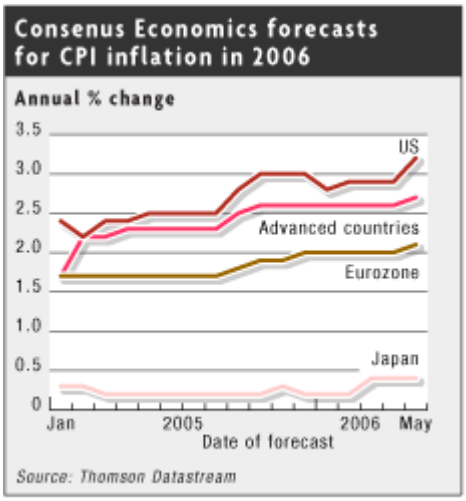

Their forecasts, they add, show demand is likely to moderate and inflation will remain under control a year and more into the future. Private sector forecasters agree.

So central bankers' real dilemma is whether they should trust their own forward-looking forecasting models and relax a little – or respond to the immediate signs of rising inflation.

Normally the solution would be easy: trust the model. It incorporates the latest figures and gives the best indication of whether rising inflation is a temporary phenomenon. But there is a new problem with this approach: it has been rendered less relevant by the dramatic globalisation of the world economy.

Forecasting models tend to suggest inflation will rise if demand is likely to exceed potential supply in the economy and vice versa. But the links between estimates of output gaps and recorded inflation have become fainter as the world's economies have become more integrated.

Even if the Fed, ECB and BoJ are confident their models remain valid and they do not need to be panicked into tighter monetary policy, they will have to weigh up the incontrovertible evidence of rising inflation now against uncertainties surrounding the more benign outlook.

Faced with the possibility of having to explain considerably higher inflation, the last excuse cautious central bankers would want to resort to is "our models suggested prices should not have risen as they have".

If businesses and consumers around the world were forced once more to confront a dragon they had thought slain 20 years ago, they might give that explanation short shrift.