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Jean-Paul Fitoussi

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Are We Experiencing a New (and Lasting) Upward Shift in Inflation?

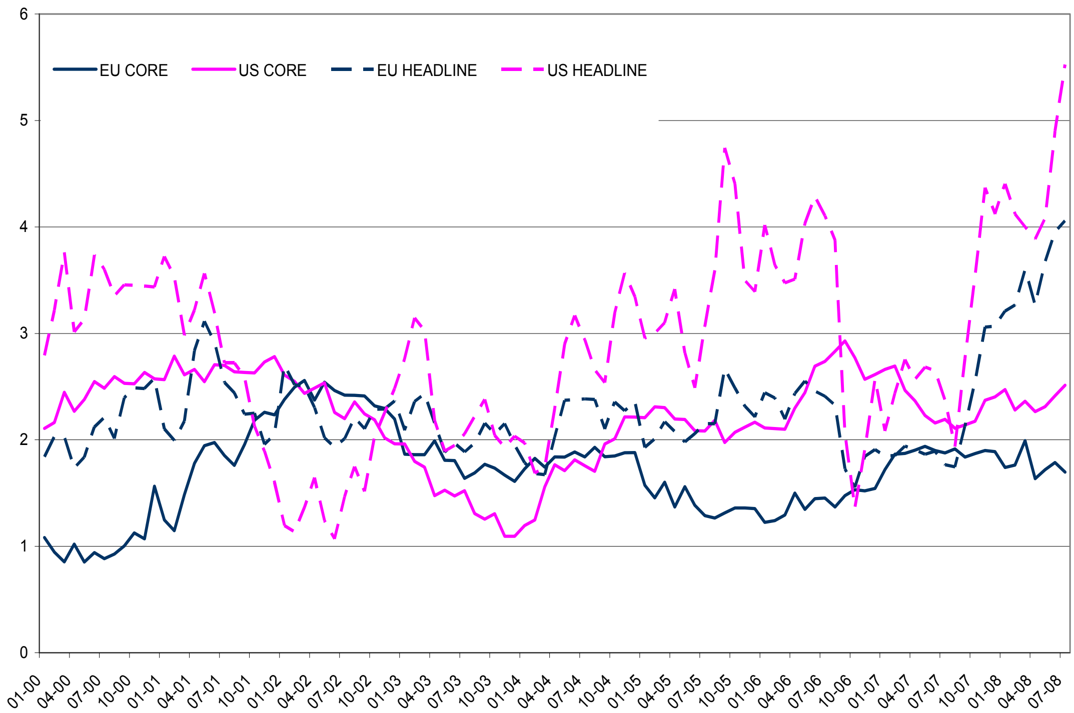
Jean-Paul Fitoussi

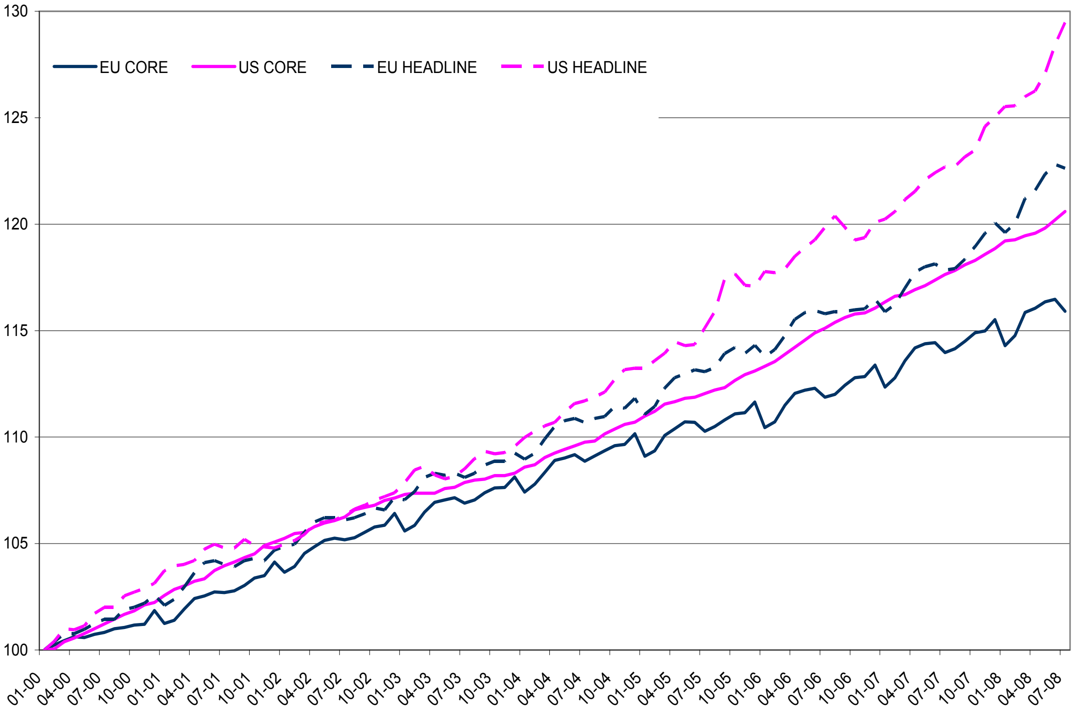
Executive Summary

The long wave of globalization will most probably lose part of its strength in the next few years. As a consequence inflation will not remain as low as it has been for the past three decades, where the growth strategy of emerging countries, especially China, has mainly relied on exports to the global market. The very success of this strategy implies that the western world would not still for long be able to pursue a growth strategy based on (excessively) cheap imports. A look at price indexes shows that inflation has been in the recent past on an upward trend and that it varies considerably across sectors. At the very least, the rate of inflation may become much more volatile in the decades to come. Besides the obvious consequence of actualizing its inflation target, the ECB should also rethink its policy (and its relationship with the other actors of economic policy in Europe) to put in place strategies aimed at accompanying the structural adjustment of the economy (that may be a cause of a slightly higher inflation). The increasing income inequality may also prove to be a problem for monetary policy, because it tends to generate stagflationary outcomes if it is not being taken care of. If the short term prospect is for the rate of inflation to decrease, the longer term prospect is that it may well decrease towards a new equilibrium rate higher that the preceding one which is reflected in the present objective of the ECB.

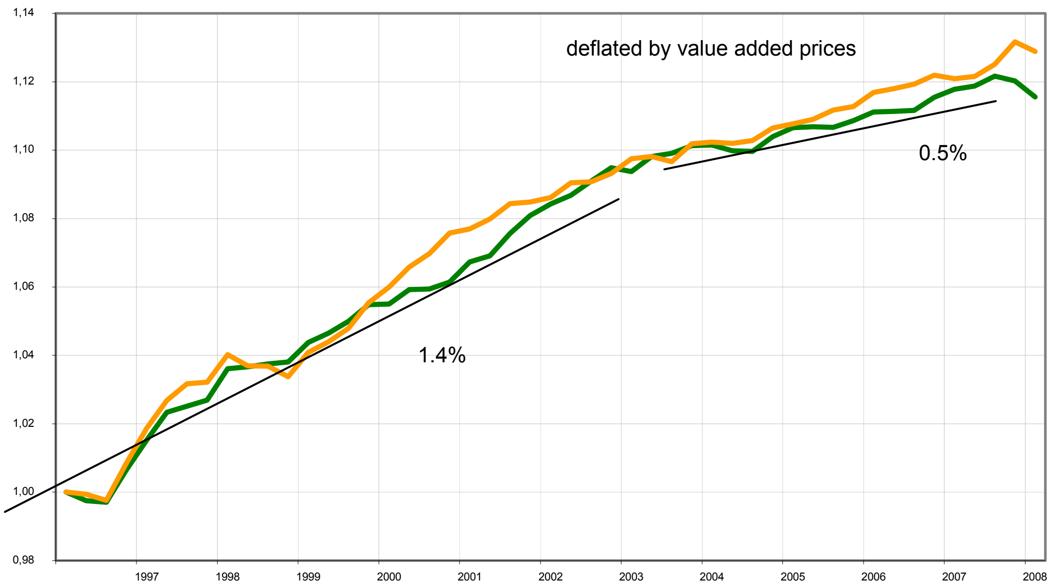
The recent evolution of commodity prices has raised a number of questions that are relevant for policy making in general, and for monetary policy in particular. The public debate has focused on the decreasing purchasing power of household – especially the poorest ones – and on the action economic policy makers should take in order to contrast this trend. This briefing paper will try to give elements to answer two questions. The first is whether we are heading towards the end of the era of (abnormally) low inflation that we experienced since the middle of the 1980s. The answer to this first question will be yes, as the structural factors that kept inflation lower in the past are fading, and hence it is realistic to expect an increase of say one point in the equilibrium inflation rate. The second and related question is whether this should imply a different attitude of central banks, notably the ECB. I will argue that, besides the obvious implication that the target inflation rate should be raised for credibility reasons, the structural factors behind the increase of inflation, and the consequences in terms of aggregate welfare and income distribution should be addressed by monetary policy and fiscal policy alike.

The surge in oil prices, accompanied by a surge in food prices, has had the expected effect of increasing headline inflation all over the world. But since already some decades, the message of the analysis of Michael Bruno and Jeffrey Sachs has well been understood: an oil shock would lead to an episode of stagflation in a context where wage indexation is pervasive. So almost everywhere in advanced countries wage indexation has disappeared from the economic scene, as both the stability of core inflation and the stagnation of real wages seems to indicate.

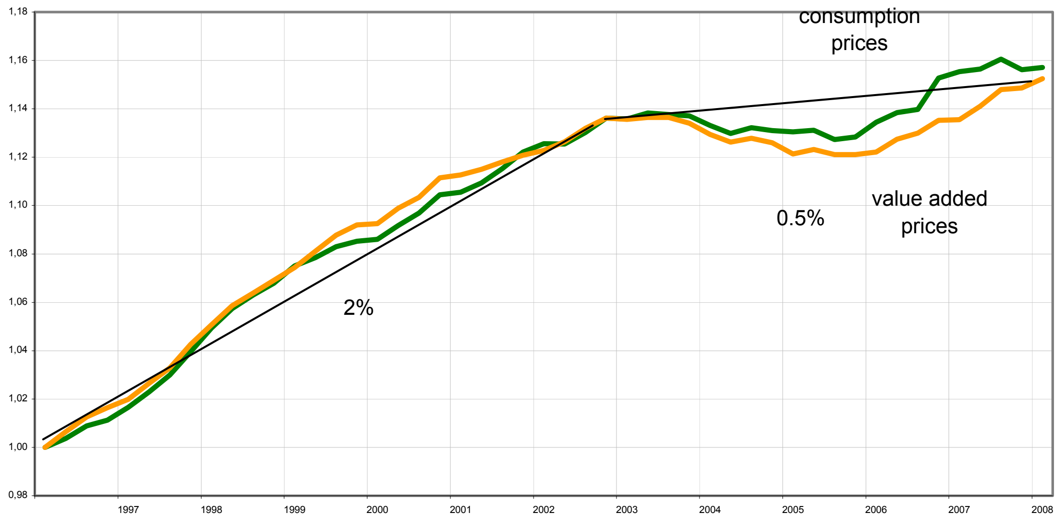




Real wage per capita: Euro area



Real wage per capita: US



Hence this time the oil tax has mainly fallen on the shoulders of the wage earners. In the language of the ECB it seems, at least until now, not to have had second rank effects. But this type of adaptation to a supply shock has necessarily a growth effect: the slowing down of consumption and its subsequent effect on investment is reducing the rate of growth almost everywhere. This is a first "disinflation" factor characterizing the present situation. A second factor has to be found in the reversal of oil prices (at least their levelling off) and the reversal of food prices whose surge was in part due to specific factors not likely to replicate in the future.

According to this appraisal, the causes behind inflation have had their maximum effect in 2008. It has to be recalled that from July 2007 and July 2008, oil prices have more than doubled and since the July peak, they are decreasing (with some fluctuations). The same is true for the bulk of commodity prices. Inflation is thus expected to recede in the year to come in advanced economies. Some economists are also arguing that there is another factor behind the increase in commodity prices, namely the financial crisis: when financial assets prices would have decreased enough, the expectation of their return to normal will add a further deflationary effect on commodity prices.

For all these reasons the fear of stagflation – the synchronous increase of the rates of inflation and unemployment – seems to be grossly exaggerated.

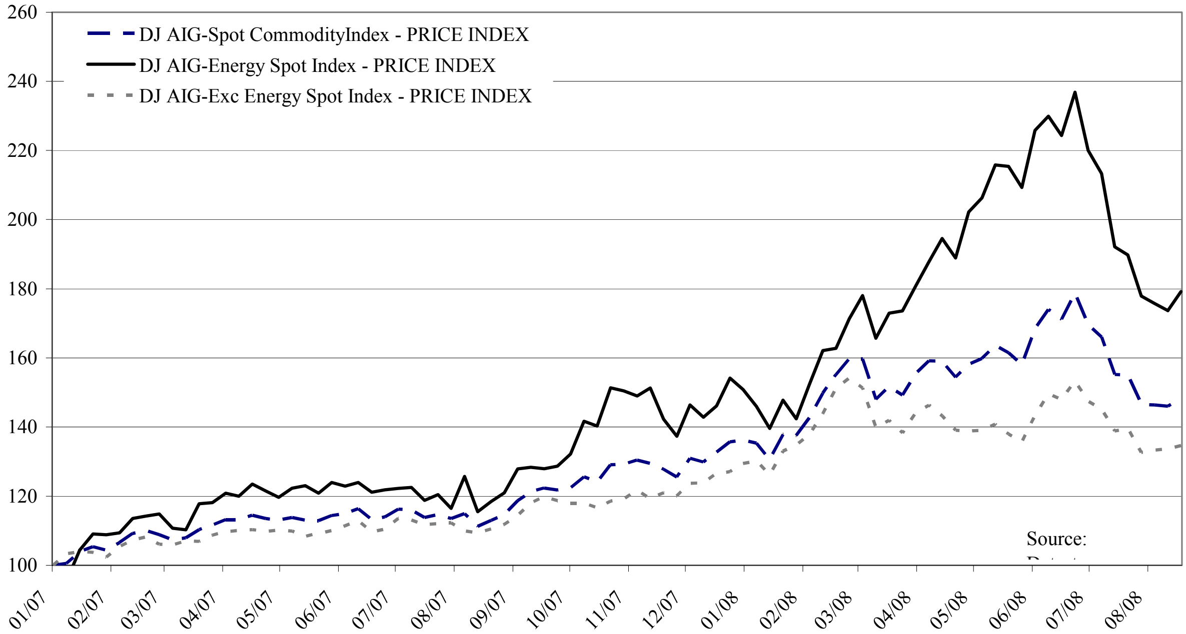
But this does not amount to saying that monetary policy is not confronted with a problem. It is certainly in emerging and developing economies where oil, food and other commodities account for a much larger fraction of the Consumer price index. But it is also in advanced economies because the global context is exhibiting a noticeable and foreseeable change. Globalization has had and continues to have the expected beneficial effect in favouring growth in the developing countries which have chosen a growth strategy based on openness to trade. As a consequence, the world is becoming more balanced, and the period of abnormally cheap exports which has helped to lower the equilibrium rate of inflation in the western world is progressively coming to an end .That process will take still some more decades to be accomplished, but already the discrepancy between the terms of trade of the advanced economies and the emerging countries is slowly reducing. Moreover, the process is already sufficiently advanced, that absent radical technological progress, the pressure on the price of exhaustible resources will continue to increase.

1. Are We Experiencing an Increase in the Equilibrium Inflation Rate?

Figures 1 and 2 report the evolution of global commodity indexes from the Dow Jones and the Economist respectively, together with selected subcategories.

Figure 1 shows an impressive increase of energy prices since the beginning of 2008 to

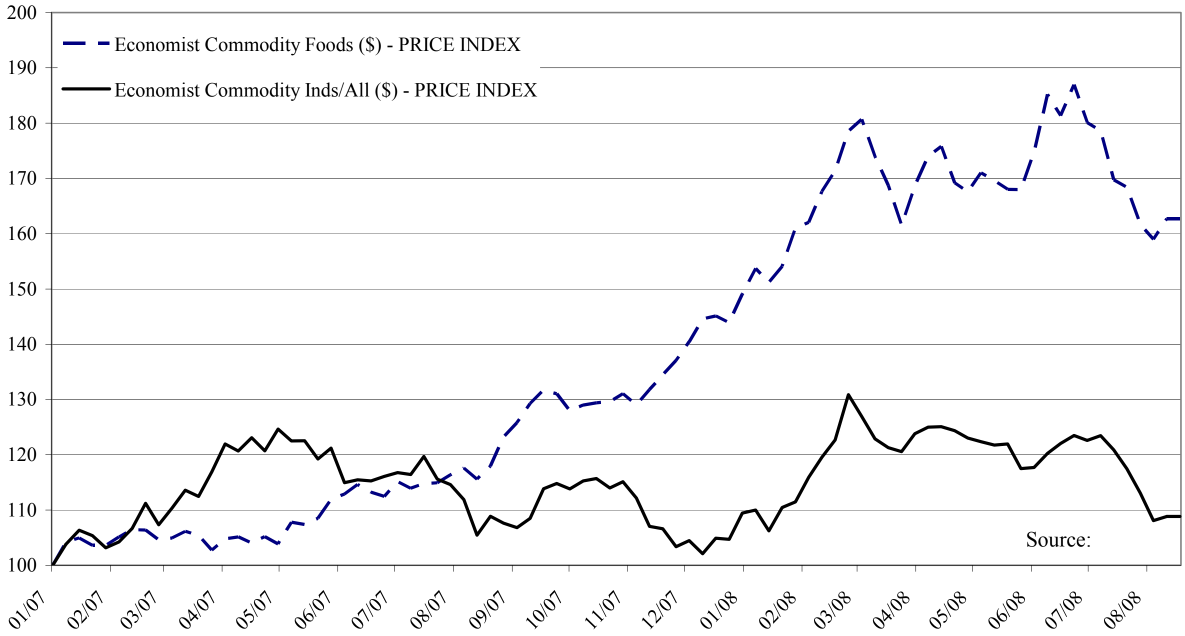
Fig 1 - Dow Jones Price Index (2007=100)



the peak of July (more than 70%), but also an equally impressive decrease (almost 30%) during the month of August. These fluctuations drove the average index as well.

Similarly, figure 2 shows that without food, the price index increase was not dramatic, while food prices almost doubled from January 2007 to the peak of last July.

Fig 2 - Economist Price Index (2007=100)



Thus, we can observe three major stylized facts. The first is an upward trend of the price level. The second is an increasing variability, with fluctuations easily above 10% from one month to the other. And the third is a very unequal distribution across commodities and sectors, with commonly used commodities (food, energy) increasing significantly more than the average.

In Fitoussi and Gergescu-Roegen (1980), we linked the equilibrium level of inflation to the structure of the economy. That paper noticed how asymmetric price behaviour may be a natural consequence of uncertainty, that pushes prudent entrepreneurs to prefer price adjustments to quantity adjustments (i.e., new capacity building) when observing increases in demand. The degree of asymmetry increase with uncertainty, and there is little doubt that in a period of financial crisis uncertainty becomes pervasive. In sectors experiencing excess supply, price adjustments are much more difficult to achieve as they are constrained by institutions in general, and social ones in particular. This asymmetry on the price dimension is mirrored by a converse asymmetry in the quantity dimension, i.e., quantity adjustments are stronger in sectors characterized by excess supplies. Price behaviour asymmetry determines a positive inflation rate in equilibrium (i.e. when aggregate demand and supply are equal) because prices increase in sectors with excess demands more than they decrease in sectors with excess supply. An important consequence of this definition of equilibrium inflation is that for a given average excess demand (say zero), increased variance at the sector level implies an increase in the equilibrium inflation rate. The data below show clearly than something of this kind (increased dispersion) is a characteristic of the present period. Another mechanism by which sector heterogeneity brings about a positive equilibrium inflation rate is the tendency for wages to move together, while productivity growth is very different between sectors (lower for example in the services sector).

Whatever its origin, this link between average inflation and the structural differences across sectors becomes important in light of the stylized facts analyzed above.

For reasons already developed, we should not observe further increases in the rate of inflation, quite the contrary. The consensus for the Euro area is for example of an inflation rate that should stabilize around 3% by the end of 2008.

Nevertheless, a detailed analysis of the factors that determined the path of inflation in the past pushes to believe that the abnormally low inflation levels of the past will not be easily found again. At minimum the rate of inflation could exhibit in the future much more volatility.

At the basis of the era of low (and relatively stable) inflation that we experienced since at least two decades is the globalization process that had its more visible aspects in the fast integration of emerging economies (notably China and India) in the world economy. This led to what Freeman (2005) called the "great doubling" of the global labour force, that had strong deflationary effects. In the Briefing paper that I prepared for the EP in December 2007, I mentioned a number of factors that at different levels explained the tendency of global inflation to decrease. I report them here for the reader's convenience:

1. The more straightforward is the direct effect of cheap imports, which reduces the overall price level. This effect is larger for countries that have a higher share of imports in domestic consumption.
2. Related to the former, there is the substitution effect of cheaper imports for domestic goods. According to the ECB monthly bulletin, of August 2006, China and new member states have seen their exports to old member countries of the EU double from 1995 to 2004.
3. Trade openness has also an effect on domestic prices, through the downward pressure that it exerts on wages of sectors more exposed to foreign competition. The threat of delocalization and of outsourcing has been used to moderate wage growth and to keep labour costs low.
4. A global economy also tends to reduce bottlenecks and capacity constraints, thus reducing the sensitivity of inflation to domestic supply problems. Supply and demand are increasingly determined at a global scale.
5. Increased competition implies a process of selection in the domestic market, with less efficient firms that will be driven out of business. This implies an increase in overall productivity and a decrease of prices.
6. Finally, even when the share of imports is low, and hence the direct effect plays a limited role in affecting inflation, the simple threat coming from potential competitors will force domestic producers to keep prices low. The notion of market contestability, introduced by Will Baumol in oligopoly theory, fully

applies to international trade, and explains why the reduction of inflation also appeared in relatively closed economies (like the US for example).

The briefing paper of December 2007 considered also the two apparently opposed views of Lawrence Ball (2006) and Kenneth Rogoff (2004). The first argues that most of the effects of globalization on inflation are temporary, in the sense that they are linked to the current transition towards a more integrated world, which pushes prices downwards. Once the transition accomplished, concludes Ball, inflation will go back to more reasonable levels. Rogoff argues that Globalization has modified so deeply the economic environment that inflationary pressures are today permanently lower than in the past (notably through the increased competition that makes prices and wages more flexible). Both opinions seem to be correct but they are referring to two distinct mechanisms. Ball refers mainly to the effect of globalization on income – and the end of the terms of "trade's rent" – Rogoff to the effect of the dismantling of the barriers to trade on competition.

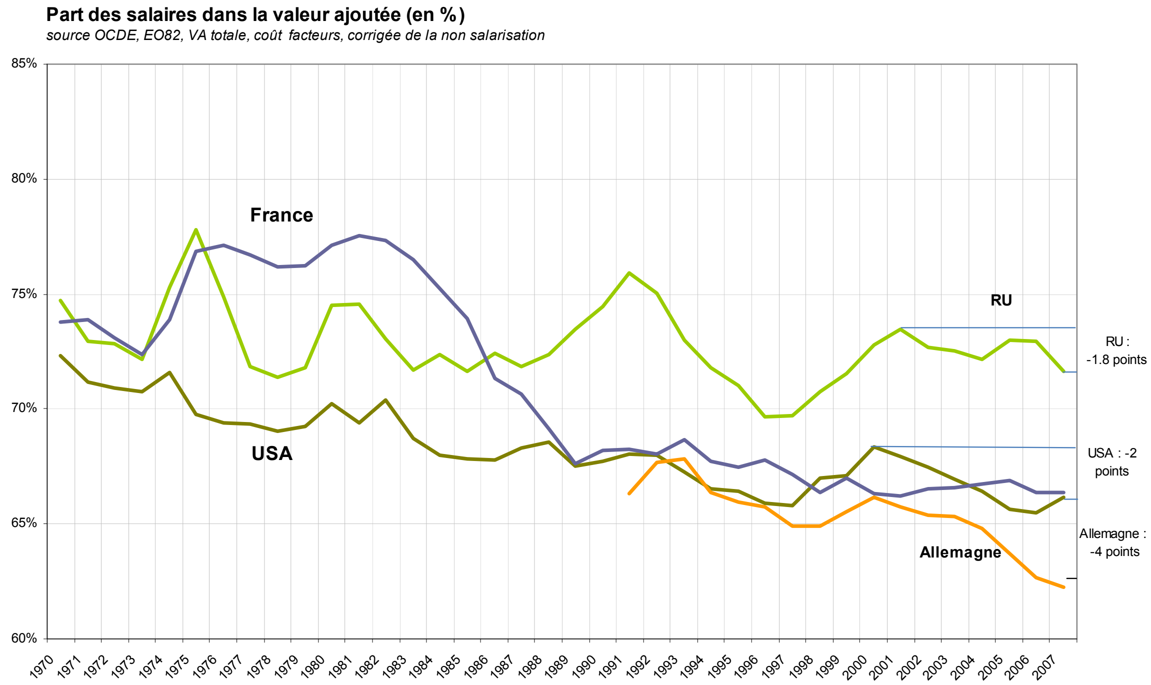
It is my opinion that we have already seen most of the second effect, and that the first (the Ball effect) will dominate in the future. The consequences of the huge structural shock represented by the big doubling are inevitably beginning to fade, as the generalized wage increases in China's urban areas witness. The balance between satisfying external and internal demand will certainly progressively change in china. In the next few years the deflationary effects of emerging economies' participation to the global trade system will be reduced. Furthermore, the delocalization of production to low wage countries in the past has created an excess capacity, that on one side helped to keep prices low, and on the other induced firms to close production units in rich countries. Now that emerging economies are growing richer and increase their demand, we are heading towards less excess capacity.

A second important factor is that the increasing wealth of emerging economies increases demand (both for consumption and for production) of scarce and exhaustible resources like energy and food. This effect is for the moment weak and there is some debate among economists about its responsibility in the increase in the prices of commodities. Some for example would argue that the increase in the Chinese demand for oil between 2005 and 2008 represents 1% of total oil demand (and less than half of this amount for India) and can't thus explain the huge increase of oil prices. But in an oligopoly market where supply is controlled by producers, a marginal increase of demand may have huge effect on prices. And whatever the past this effect will certainly gain momentum in the future, and will contribute to a large increase of the rent of the owners of these goods.

A distinct argument is that the attempts of advanced countries to weaken their dependency on exhaustible resources and to respond to the increased demand of clean environment by their population may contribute to increase inflation pressures: climate change policies may in effect impose higher prices in energy and energy-intensive goods and services. So what? Should we in order to avoid transitory increase in the equilibrium inflation rate, or in its volatility, renounce to invest in the future and especially in new technologies of environment and energy? If these investments prove profitable their effects on energy productivity will in the medium to long run decrease the pressure on prices. Moreover, there may be here a measurement problem: the increase in headline inflation consecutive to these policies may well reflect a quality effect because it affects positively the welfare of the people.

Finally, a sometimes ignored feature of globalization is the restructuring of the economy, which implies the reallocation across sectors of demand and productive capacity. During this process the variance of excess demands and supplies increases and the equilibrium inflation rate with it. This effect will of course become less important as the restructuring comes to an end, but it is likely to play an important role in the next years.

Thus, pressure for inflation to increase so as to reach a new equilibrium level (albeit still low) will come from rents, from price adjustment asymmetries, from climate change policies and from the reduction of excess capacity and excess supply of labour. This effect will be mitigated by a probable reduction in profit margins – which are at a very high level today as a consequence of the "great doubling"– as it is normal when the labour market is exhibiting a tendency towards a vanishing excess supply of labour. It has to be reminded as shown in the following graph that the share of wages in value added has decreased since the middle of the eighties, and has still decreased in the more recent period. That means it exists some room of manoeuvre for this share to rise in the future without creating inflationary pressures.



2. What Implications for Monetary Policy?

If the analysis above were correct, the most immediate and obvious consequence would be the necessity of an upwards revision of the ECB target. I already argued in the past (Fitoussi (2002)) that the 2% objective had been chosen in a period of abnormally low inflation, and that we risked experiencing excessively restrictive monetary policy because of that. This argument is even stronger today: last July the ECB raised its rates of a quarter of a point, while the Euro zone was experiencing the first period of negative (quarter to quarter) growth. A too low inflation target may lead to a backward looking monetary policy!

More generally, in a situation in which some goods exhibit important price increases due to structural factors, the only hope to avoid an increase in the general price level lies in the capacity for policy to be able to reduce the price level in other sectors, in order to compensate. I see two different ways to obtain this objective.
The first is a policy mix (low interest rates and targeted fiscal measures) able to facilitate investment and productivity growth in some sectors, thus lowering unit labour costs and prices.

The second is a policy mix aimed at reducing inflationary pressures through brakes on aggregate demand. The current policies carried out today in Europe are leading to a contractionary policy mix. The fear of second round effects, that I discussed at length in my briefing paper of December 2007, pushes the ECB to keep interest rates high in order to avoid wage increases, even when most of today's inflation is imported. This has the consequence of compressing real wages, a phenomenon that all European countries experienced, albeit with different intensities.

This strategy has undesirable contractionary consequences, and makes the burden of adjustment fall disproportionately on the shoulders of low and middle income households, as I will highlight below. But more importantly, it is not necessarily effective. The asymmetric behaviour of prices implies that, the generalized decrease in demand will call for an adjustment on quantities rather than on prices, and hence will be unable to compensate fully the increase of prices in the energy sector. This mechanism is the core of the increasing risk of entering a stagflation phase. But as said below the likely reversal of commodity prices increases make this risk more remote.

Thus, a policy of high rates and exclusive focus on inflation targeting do not seem to be the appropriate response to the current transition towards a slightly higher equilibrium rate of inflation, because they are likely to depress the economy while being ineffective to fight inflation.

If the above diagnosis is correct, what we need is a policy aimed at facilitating the restructuring of the economy, and at addressing the increasing variance of sector disequilibria. Monetary policy alone could not accomplish this task, and coordination with other policy tools (fiscal policy, competition policy, industrial policy) becomes necessary.

The situation is further complicated by the increasing income inequality that makes average inflation less and less significant. The dispute on perceived inflation may be partly explained along these lines. The unequal price increase impacts the different income brackets differently. More specifically, energy and food enter in a disproportionately large share in the consumption basket of lower income brackets, which as a consequence experience a larger loss of purchasing power. Nobody recognizes himself in an average figure in a context of growing inequalities. As a consequence the statistical apparatus that we currently use may become too abstract to correspond to perceptions.

Thus income inequality should also be targeted by policy, because for a given average rate of inflation, the negative effects are larger when income is more dispersed.
Furthermore; an important consequence of increasing inequality is the accumulation of large liquidities in the hands of a few households. This inevitably has an impact on speculative movements, asset price inflation etc., which may be a major cause of concern for monetary policy. Hence the argument according to which the excessively high growth of monetary aggregates may be finally translating into consumer prices may be misleading. As argued in a former briefing paper excess liquidity may well be the symptom of excess saving due to a set of reasons: increasing inequalities, increased rents (high commodities prices), huge current account surplus in emerging countries etc… Thus "excess liquidity" is likely to affect much more asset prices than consumer prices.

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