Gung-ho inflation fighters unwelcome

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Across the world, inflation is now uncomfortably high. After several decades in which inflation was dormant, memories of 1970s stagflation have been rekindled. The Bank for International Settlements has called for monetary policy to be tightened worldwide.

The one common factor is the sharp rise in world commodity prices. This is feeding into domestic headline inflation in many countries. Both demand and supply factors are pushing commodity prices up. World demand has been expanding quite strongly, thanks to good growth in developing countries, where higher living standards are increasing the demand for energy and foodstuffs. A sluggish supply response has made matters worse.

Whether commodity prices reflect demand or supply, it doesn't make sense for any single country to try to restrain domestic demand in response to global price rises. Should China slow its economy enough to keep petrol prices stable, or India slow enough to keep world food prices stable? Clearly not.

This common challenge plays out differently in different countries.

In the United States, despite a lethargic recovery from the global financial crisis and unemployment still above 9 per cent, headline inflation and inflationary expectations are running above the Federal Reserve's implicit target of 2 per cent. Fed chairman Ben Bernanke is under attack from critics who say that the continuing inflation reflects his zero policy rate setting or the much misunderstood "money printing" of QE2. His reply is that if petrol price rises are excluded, inflation was 1.2 per cent in the year to April.

While Bernanke need s to sound resolute enough to keep inflation expectations under tight control, he won't be tempted to crack down on inflation. The Fed retains a dual mandate -- to achieve price stability and low unemployment.

In the UK, global commodity price rises and a weak exchange rate have kept inflation above 3 per cent since 2009, well above the 2 per cent target. Moreover, a higher VAT will soon take inflation above 4.5 per cent. The Bank of England's credibility is under threat.

This credibility problem is largely self-inflicted. Over the years, governor Mervyn King has talked tough on inflation. Some members of the Bank of England monetary policy committee have a mechanical view of policy. They ask why the policy rate hasn't risen when inflation forecasts remain well above target.

But what can the Bank of England do? Higher UK interest rates won't have any effect on global commodity prices or offset the impact of the domestic VAT increase. What is the point of further restraint on an economy already suffering from feeble growth, negative credit expansion, stagnant employment, flat wages and harsh fiscal austerity?

Euro-zone inflation is above target but this certainly doesn't reflect strong demand. German gross domestic product has barely regained the pre-GFC level and unemployment is 7 per cent. At a stretch, it could be argued that Germany is recovering well enough to get interest rates back to more normal levels. This might justify the European Central Bank's plans to raise rates next month.

But this same monetary tightening flows automatically on to the rest of the euro zone. Crisis countries certainly don't need extra restraint on top of their existing painful austerity measures.

There is no easy reconciliation of these disparate underlying conditions in the euro area. But a doctrinal fixation with low inflation won't help.

Certainly, firm commitments from authorities to raise interest rates whenever headline inflation is above the target will act as an effective anchor for price expectations. But to stick to this commitment in the face of cost-push pressure is to risk being branded an "inflation nutter ".

What has changed to make life harder for central bankers? In the 1990s they enjoyed the benefit of China's emergence as a global supplier of cheap manufactures: a beneficial cost shock.

This was, however, a two-edged sword. China's fast growth soon bulked up enough to affect overall world growth. India, Brazil and a host of smaller countries joined the party. Before the early 2000s, the world grew around 3.5 per cent in a normal year. With these new fast-growing countries added, 4 to 5 per cent is the new normal.

This pace is not, of itself, inevitably inflationary: these new arrivals add just as much to supply as they do to demand. But the demand-supply balance is unevenly distributed. Commodities have low elasticity of demand and supply: higher prices lead to more production only slowly. In the meantime, the higher prices don't do much to crimp demand.

The solution is not to try to restrain the world to the old, slower growth rate. In a hypothetical world with one monetary authority, the optimal answer would not be to tighten until commodity prices stabilised. Instead, it would be to allow relative price shifts to take place, reflecting the changing balance of demand and supply.

But for this rebalancing to occur without triggering ongoing inflation, other prices have to stay stable. Some groups will be squeezed. The proper focus of monetary policy now should be to act as enforcer of these changes in relative prices. All that central banks can usefully do at present is discourage global price rises from triggering domestic inflation.

This is a much more subtle and difficult task than a simple gung- ho inflation-fighting rule. The delicate glue of price expectations which holds inflation in check might easily come apart. When central bankers try to explain why headline inflation is not the best guide to monetary policy, the public will remind them that headline inflation affects their spending power.

But, easy or not, this is the world we are now in. The key role of commodity prices is not going to disappear, even if prices stabilise or fall back.

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