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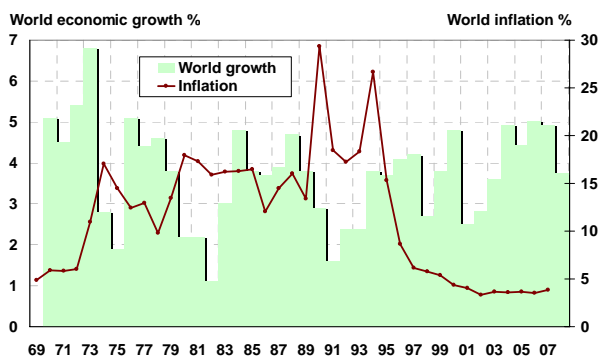
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IS INFLATION ALIVE AGAIN?

After a remarkable period of low inflation, the past year has seen inflation globally creeping upwards. The immediate causes are well known – rising food and fuel prices. However, opinion is divided about whether the current upswing in inflation will be temporary or whether inflation will revive more dramatically as it did in the late 1960s and early 1970s. This article will consider both sides of the debate.

Graph 1: Gdp growth and inflation



Source: IMF

The great moderation

Over the past 20 years or so the economies of most developed countries have experienced low inflation combined with relatively high and stable economic growth, a period that has been dubbed the ‘great moderation’. This was preceded by last century’s worst inflationary episode, where rampant inflation dogged many countries for over a decade. By the early 1980s, policymakers and politicians realised that, despite the short-term costs of raising interest rates, rising inflation posed a far greater threat to long-run economic stability. Between 1980 and 1983 central banks of developed countries began hiking interest rates aggressively to bring inflation back under control and restore credibility. The ensuing success helped to anchor inflation expectations, making the task of keeping inflation under control that much easier and creating a favourable environment for stronger economic activity. In the mid 1990s this success was extended to

developing countries, coinciding with the widespread introduction of inflation targeting as a monetary policy framework.

Low and stable inflation is a necessary ingredient for economic growth. It reduces interest rate volatility and helps firms to plan in a more stable environment, encouraging businesses to invest and therefore boosting economic potential. Low inflation also amplifies relative price movements, allowing the market system to work properly by sending clear signals. Lastly, low inflation is more desirable from an income and wealth distribution perspective, as high-inflation environments have more devastating impacts on the poor who are unable to protect themselves against falling real incomes.

The International Monetary Fund (IMF) noted in 2007 that the current global economic upswing has been one of the longest and most broadbased in the past century. In the past decade – post the 1997/98 emerging-market crisis – per capita gdp has grown at an annual rate of 7% in emerging market and developing countries. Low interest rates and a stable economic environment reduced risk aversion and fuelled an asset price boom, with equity and house prices rising by unprecedented amounts in real terms over the period.

Clearly, a more stable price environment has not been the only reason for the improvement in global fortunes. Liberalising economic regimes from Asia to Central and Eastern Europe and the massive opening up of economies to trade and capital flows were key ingredients.

However, the recent strong rise in inflation and the threat of recession in the world’s largest economy, the US, have raised concerns that the great moderation may be coming to an end. The fear is that we may return to a 1970s-style inflation or even stagflation, where inflation is high, but growth is weak.

The great inflation of the late 1960s and 1970s

The commodity price shocks of the 1970s are most commonly blamed for causing the ‘great inflation’. In early 1971 the Organisation of Petroleum Exporting Countries



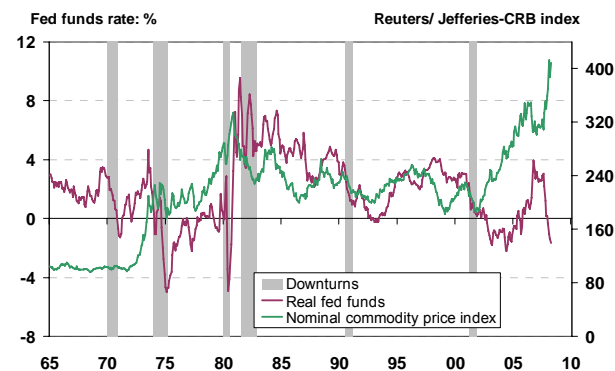
MAKE THINGS HAPPEN

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(OPEC) asserted its muscle for the first time and drove oil prices up by nearly 40%. This was followed by a series of further increases. By 1974 the price had risen by almost 500% from the start of the decade. The second oil shock occurred in 1978 and 1979, when prices rose by a further 190% over the two-year period. With other input costs increasing as well, inflation rose to unprecedented levels in the developed world, where there was still a strong manufacturing bias. Inflation in industrialised countries increased to an average of 14.3% in 1974 and to another peak of 13% in 1980.

A closer look suggests that a strong buildup of liquidity prior to the rise in commodity prices was more to blame for the significant rise in inflation, however. During the 1960s monetary policies in industrialised countries became more lax as memories of high inflation started to fade. It was also the era of the Philips curve and central bankers wrongly believed that there was a long-term tradeoff between inflation and growth, which made policymakers reluctant to tighten monetary policy. Finally – at least in the US – the Federal Reserve played an important role in financing the fiscal deficit, which had ballooned due to the spiralling costs of the Vietnam War, in the process boosting the supply of dollars in the global economy. This buildup of liquidity also helped fuel an economic boom that further fed into stronger demand conditions in commodity markets and therefore higher prices.

Graph 2: Commodity prices and interest rates



Sources: Reuters; US Federal Reserve

This suggests that higher commodity prices and inflation were caused – or at least accommodated – by excess money creation, which kept real interest rates low and boosted economic growth to above potential levels. In fact, inflation started rising in the late 1960s, well before the first oil price shock in January 1974. Even once economic growth started to slow, commodities may have provided investors with some alternative to other investments, given low interest rates and a depreciating dollar. Between 1970 and 1973 the number of commodity futures contracts increased from 14 million to 33 million.

When the oil price spiked in 1974, this added significantly to inflation that was already in the economy and set the

scene for the inflationary spiral that ensued. Over the next two decades inflation became entrenched, as rising inflation expectations quickly filtered into wage increases and the price-setting behaviour of retailers and manufacturers.

Is a repeat likely?

While a return to 1970s-style inflation may seem unlikely, there are some striking similarities between the early 1970s and the past few years. Surging commodity prices are again threatening to feed through into a more general increase in inflation. The oil price, in particular, has risen by 138% since early 2007 and has now increased by nearly 1 080% since its lows in early 1999. While impressive, this still does not measure up to the cumulative 2 180% increase seen over the 1970s up until the peak in late 1980. Put differently, the current price would still have to rise to around \$440 a barrel to represent a repeat of this earlier period. However, the real oil price (deflated by US inflation) has increased by a very similar amount, suggesting that the relative increase in the oil price has performed similarly over the two periods. It is also quite astounding that such a dramatic increase has had such a limited effect on inflation so far, at least in developed economies.

One reason for this may be that these economies are more services-oriented and therefore less dependent on oil than they were in the 1970s, but this was also the case in the early 1990s, when the Gulf War oil spike had an immediate effect on inflation. Another is that the prices of manufactured goods have been held in check by employment-maximising Asian countries (principally China) that have absorbed cost increases.

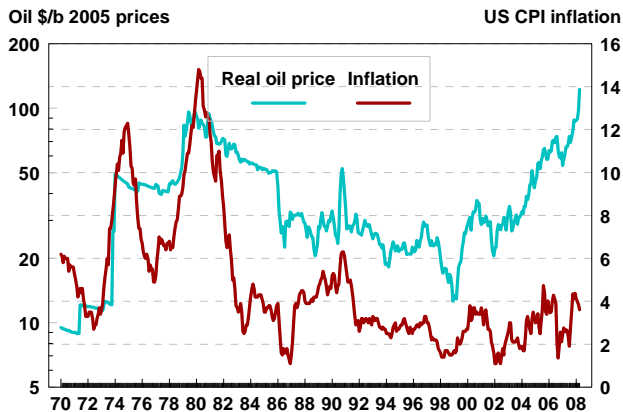
General inflation has also been held in check by structural changes since the 1970s. Globalisation has increased competition and the productivity benefits of large-scale production. Escalating technological improvements have meant that new products have become less resource-intensive and also less costly to produce. The decline of trade union power following the turbulent 1970s also meant more flexible labour markets.

Finally, central banks are quick to take much of the credit, suggesting that the credibility established over the past two decades of keeping inflation low continues to pay dividends by keeping expectations and pricing behaviour under control.

Some suggest that that credibility may be wearing thin, however. A number of studies, including those by Stephen Cecchetti et al (2007) and Jeffrey Frankel (2006), suggest that overly loose monetary policy over the past few years has much in common with the late 1960s period, when it facilitated a buildup in liquidity and above-trend economic growth, at various points pushed asset and commodity prices higher and, ultimately, was the

source of the great inflation. Frankel argues that low real interest rates and easy money make investing in commodities an attractive option, rather than low-yielding treasury bills. In addition to this, low real interest rates decrease the incentive to extract resources and increase the incentive to hold inventories. All these factors put upward pressure on commodity prices.

Graph 3: The real oil price and US inflation



Disturbingly, the ‘great inflation’ period shows that many commodity prices took considerable time to adjust to slower economic conditions and that, once the inflation genie was out of the bottle, it took massive effort and draconian monetary policies to get the cork back on [see for example, Agénor and Montiel (1999) and Ben Bernanke (2004), the chairman of the US Federal Reserve].

The current episode may eventually turn out to be similar as commodity prices are showing little tendency to correct despite their elevated levels. Certain commodities have attracted considerable investment or speculative interest, a fact highlighted in the IMF’s April World Economic Outlook, whose authors argue that low interest rates and rising inflation will keep financial demand for commodities high, as investors look to hedge against inflation and seek alternatives to equities and low-yielding treasuries.

What is different to the 1970s, however, is that the emergence of China and other emerging economies has fundamentally increased demand for both agricultural and non-agricultural commodities. There is unlikely to be a sufficient supply or demand response to higher prices in the short to medium term to change this. There are also other complications, with protectionist tendencies surfacing in response to shortages, particularly of food, where some agriculture-exporting countries have already constrained exports. If these practices escalate, prices are more likely to continue rising than fall as the necessary

supply responses will not be forthcoming.

The danger is that the longer basic prices continue to rise the more likely it is that it will spill over into general inflation. Core inflation in most developed countries has so far also remained relatively subdued in comparison with the 1970s, despite the fact that headline inflation has been on an upward trend over the past year. This is less the case in emerging economies, where core inflation has been drifting higher, although not nearly as fast as headline inflation. However, there are signs that second-round inflation is starting to emerge, with companies globally suggesting that increased costs will have to be passed on to consumers despite weaker demand conditions. Inflation expectations are also starting to rise, ticking up in both the UK and Europe and heading steadily upwards in most emerging economies.

Conclusion

Many central banks are betting that the current surge in commodity prices will be temporary rather than permanent. Central banks, particularly in emerging economies, have been reluctant to raise interest rates (see article below), despite rising inflation and robust domestic demand. If they are correct and the current inflation shocks are temporary, then they are preventing unnecessary economic discomfort. The danger is that, if they are not, and commodity prices continue to rise as some are now predicting, central banks will see significantly higher inflation in the future. Should this spill over into heightened inflation expectations, as was the case in the 1970s, they will instead face an even tougher challenge of restraining the inflation genie over the medium term, with negative consequences for economic growth and asset prices.

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