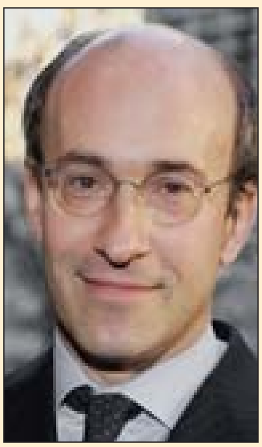
STRAIGHT TALK

Disinflation: An Unsung Benefit of Globalization?

If the trend toward greater globalization were to reverse, inflation might return

Kenneth S. Rogoff



Kenneth S. Rogoff was IMF Economic Counsellor and Director of the IMF's Research Department until October 2003 and is now Professor of Economics and Director of the Center for International Development at Harvard University.

GLOBAL INFLATION has dropped from around 30 percent a year in the early 1990s to under 4 percent today (see chart). No wonder so many central bankers are riding high. Inflation-therapy gurus claim to have found the magic elixir that solves the classic dilemma of central banks: how to stabilize output growth at high-employment levels without drifting into high inflation. Perhaps. Certainly, the practice of central banking has improved enormously over the past 20 years. We now have greater central bank independence, greater public appreciation of the costs of inflation, better monetary policy techniques, and a larger number of "conservative" anti-inflation central bankers. Then, too, more central bankers appreciate that surprise inflation can, at best, have only temporary positive effects on output and employment, and, at worst, can lock an economy into a spiral of ever-higher inflation and broader macroeconomic instability. One can't help but draw an analogy between a stock market boom—when everyone is an investment genius—and a global disinflation—when every central banker is an inflation-slayer.

But I'd like to register a note of caution about attributing *all* of the improvement in inflation to better policy and institutions. What gives me pause is the fact that, even in many countries where institutions are relatively weak, central banks have limited technical expertise, and political cohesiveness is sometimes tenuous, inflation rates have also plummeted. From 1990 to 1994, annual inflation averaged over 40 percent in Africa, over 230 percent in Latin America, and over 360 percent in the transition economies. Today, inflation rates in all three regions border on single digits. Even in countries like Brazil and the Democratic Republic of the Congo—countries whose cumulative price increases since 1970 have exceeded 1,000 trillion percent—inflation for 2003 is likely to be at or near zero. What do the inflation gurus have to say about that?

Globalization helps fight inflation

Is it possible that other favorable factors have been helping to drive down global inflation? I would like to advance the hypothesis that globalization—interacting with deregulation and privatization—has played a strong supporting role in the past decade's disinflation. Why, exactly, might this occur? The answer is that globalization (together with deregulation and privatization) increases competition, driving down inflation both directly and indirectly. Directly, simply because monopolists tend to charge higher prices when competition is absent. Indirectly, by relieving political pressures on the central bank to inflate. After all, greater competition raises overall output while making prices more flexible (making unanticipated inflation less potent as a means of raising output and employment). As a result, the central bank can more credibly commit to reduced inflation. Thus, not only does increased competition have a one-off effect on prices, but it can also lead to a permanent reduction of inflation. Another helpful channel of influence from globalization to lower inflation is that as people acquire more options for holding their savings—for example, in dollar-denominated assets rather than in assets denominated in a local currency—governments have less ability to inflate the savings away.

I am not saying that globalization has been the only tailwind helping central banks fight inflation. Certainly, fiscal policy has played a supportive role in many countries and regions over the past 10 years—take, for example, the notable improvements in a number of African and Latin American countries. But fiscal policy can hardly be the main explanation, given the many countries in which government debt has been climbing rapidly, while inflation has continued to fall.

Nor is productivity growth very convincing as a universal explanation for global disinflation, although many people seem to think it is. Yes, U.S. productivity growth jumped noticeably starting in 1995, but disinflation had begun by the early 1980s. Yet, even by the late 1980s, when U.S. inflation had already dropped sharply, leading economists like Robert Solow and Paul Krugman were questioning whether the technology boom would ever show up in the productivity numbers. And, more important, there are many regions (such as Europe) where productivity growth has fallen or been stagnant over the past 20 years, but where inflation has also been sharply reduced.

By the way, I can't resist noting that the success in lowering inflation has been extremely successful as a pro-growth, pro-poor policy. As former IMF First Deputy Managing Director Stanley Fischer has often noted, many studies suggest that the costs of inflation are borne most heavily by the poor—because they lack the wealth that would enable them to diversify into inflation-proof assets. Thus, inflation is one of the cruelest and most regressive of all taxes. Followers of the antiglobalization movement, for whom increased trade and competition are anathema, should take note: here is an example of the consequences of globalization that are clearly not adverse for the poor. Indeed, lower inflation rates have helped poor people throughout the world.

What could bring inflation back?

Absent a dismantling of improved central bank institutions, can inflation ever come back? The answer, of course, is yes. If the trend toward greater globalization were to reverse—say, if heightened conflict made international shipping much more difficult and expensive—the benefits of increased trade and competition could be reversed, leading to a sharp increase in inflation. Indeed, that is exactly how the last great era of globalization (1870–1910) came to an end. The outbreak of World War I led to a breakdown of the gold standard, but it also led to a sharp fall in trade, a fall that was exacerbated further still in the 1930s by the Great Depression. Global trade did not really recover until after World War II. Mind you, the model underlying my discussion is a supply-side one and, therefore, appropriate for thinking about medium-term inflation trends. Short-run inflation also depends heavily on demand factors; negative demand shocks can easily lead to a reduction in both trade and inflation, but only temporarily.

Although I have argued that one cannot possibly attribute global disinflation solely to better fiscal policy (because in many countries it has not been better), let's understand that fiscal policy will always be an Achilles' heel. Persistent large budget deficits can overwhelm even the strongest central banking institutions and even the most determined anti-inflation central banker. With fiscal positions much weakened after the recent global downturn, and with many countries facing demographic time bombs, some countries may ultimately see a return to inflation as the only option. True, Japan, with a debt-to-GDP ratio already approaching 160 percent and one of the world's worst demographic profiles, has the OECD's lowest interest rates. Evidently, Japanese citizens—who hold more than 95 percent of Japanese government debt—still have relatively few concerns about a resurgence in inflation. Looking ahead, especially as the onslaught of retirees leads to a sharply lower savings rate over the next 10 years, it is easy to imagine they might be proved very wrong.

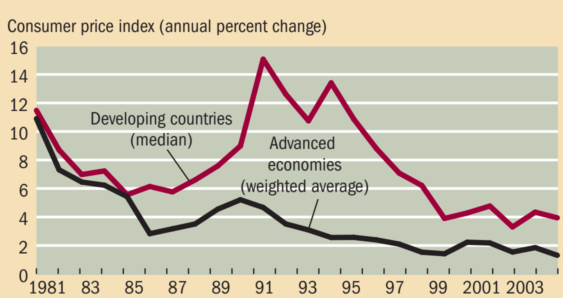
How to keep inflation vanquished

Can any measures be taken now to protect against a future resurgence of inflation? The only real defense is to rely on continuing improvements in central bank institutions. Central banks must recognize that an adverse supply shock may temporarily lead to deflation but be alert to the threat that, over the medium term, it can lead instead to inflation.

What does all this imply for IMF policy advice? Certainly, it reinforces the case for advocating greater central bank autonomy and for remaining alert to the risk of inflation, even in the present very low inflation environment. Someday, the technological and political forces that have been leading to greater economic competition will almost surely run in reverse for a period. When this happens, markets will quickly separate the wheat from the chaff. Those countries that have taken advantage of the present benign inflation environment to strengthen their institutions will be well poised to ride out the storm. Countries that have done no more than let the winds of globalization bring down their inflation rates may be seriously vulnerable to a reversal. I am not suggesting that inflation be immediately elevated to public enemy number one, but critics are wrong to dismiss the inflation issue entirely. Like many tropical diseases that have supposedly been eradicated, inflation may once again rear its ugly head, and central banks need to remain alert, including to developments that roll back globalization. ■

Falling prices

Global inflation has dropped sharply since the early 1980s.



Source: IMF, World Economic Outlook database.