The myth of central banks and inflation

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Central banks' near universal success in bringing down inflation over the past two decades has led many policymakers to conclude that they have pretty much solved the problem of high inflation, once and for all. Market participants have bought into this story, as evinced by a host of quantitative and survey measures. Outside a few developing countries, nobody seems to worry much about a sustained bout of 5 per cent or 6 per cent inflation, much less the double-digit levels of the 1970s. But have central bankers truly slain the hydra of inflation?

The advent of modern independent and anti-inflation-oriented central banks is one of the great success stories of modern economic science. But this story has been exaggerated. We should consider the possibility that the unprecedented pace of modern globalisation, recently emphasised by Ben Bernanke, the Federal Reserve chairman, might also have played a role. If so, what will happen if the winds of globalisation ever reverse course?

Why should globalisation matter for inflation? A very popular but wrong-headed view is that "China exports deflation", so that more rapid growth in China automatically translates into lower inflation everywhere. This is nonsense. As long as a central bank has monopoly control over its currency, as most do, it can set medium and longer term inflation trends at any level it likes. If the central bank really wants to stabilise the country's overall inflation rate, it will respond to lower import prices by allowing an offsetting rise in the prices of domestic goods. In this sense, it would be more accurate to say that China exports inflation rather than deflation.

Instead, one should think of the modern era of rapidly expanding trade and technology progress as providing a spectacularly favourable milieu for monetary policy. With hugely positive underlying trends, central banks have been able to establish and maintain low inflation while delivering growth results that have often outperformed expectations. Rather than face the usual historical trade-off, central banks have let citizens have their cake and eat it. No wonder central bankers have become so popular.

But precisely because globalisation has produced such a steady stream of upward surprises, there is an element of illusion to central banks' success, as most people have only sluggishly adjusted their expectations to the faster growth trends. Consider the performance of Alan Greenspan, the recently retired Fed chairman. Mr Greenspan famously got a number of big calls right, including his early recognition of the productivity boom in the 1990s, as well as his aggressive proactive responses to the tragedy of September 11 2001, the 1998 Russian debt crisis and the 1987 stock market crash. In each of these cases, Mr Greenspan's big call was to slash interest rates and pour liquidity into the system, leading markets to believe that the Fed would always insure the downside of the economy without taking away any of the upside.

But life cannot always be this good for a central bank. If big Fed interest rate surprises are always cuts, markets will eventually catch on, ratcheting up inflationary expectations. Economists Milton Friedman and Ned Phelps elegantly illustrated this point way back in the 1960s. So how was Mr Greenspan able to pull off his long sequence of one-way surprises? Because he did it in an era when continuing upside surprises to underlying growth helped absorb liquidity.

Although not every country has benefited from globalisation as much as the US has, the dynamic has tended to be similar. For example, most of the rich countries have seen spectacular terms-of-trade gains; that is, a fall in the price of imports relative to exports. (Italy and Japan are possible exceptions, as both countries had export niches that were particularly vulnerable to the rise of China and the rest of emerging Asia.) Even in the developing world, which did not necessarily enjoy the same terms-of-trade gains, the move to more market-based economies has brought such efficiency gains that they have still experienced a sharp increase in trend growth. No wonder that central bankers, who are often given credit or blame for long-term growth trends over which they have little impact, have become such big rock stars. What more can one ask for than low inflation and high growth?

There are other more subtle and long-lasting impacts of globalisation on inflation.* These include the impact of greater competition, as well as greater wage and price flexibility, all of which operate to make central banks' commitment to low inflation more credible. But the main story of consistently high underlying real growth explains, more than anything, why globalisation has helped central banks so much. Central bankers deserve credit for taking advantage of these good times to establish and enhance their credibility. I also admit to underplaying the role that better central bank policy has played in creating greater macroeconomic certainty, thereby directly enhancing growth. But central bankers did not create the computer chip, nor did they liberalise China.

So the question is: what happens if the winds of globalisation turn? What if a combination of economic and political problems leads to a sharp slowdown in China? What if security checks in the wake of a terrorist attack lead to a sustained pause in the expansion of global trade? What if a slowdown in trend growth exacerbates the fiscal problems that most countries are already going to face as their populations age? Or, more immediately, what if there is a disorderly unwinding of the oversized US current account deficit? Having built up public expectations about their ability to deliver high growth and low inflation simultaneously, central bankers might have a hard time explaining what went wrong.

Perhaps central banks will get lucky and not have to face any severe problems for another couple of decades but, unfortunately, that is not likely. Thus, there is some urgency in the need for central banks to take greater pains to avoid taking too much credit for upside performance.

Already today, central banks face steeply higher oil prices combined with a pause in falling import prices from developing Asia. But the current conjuncture is just a small test compared with what might happen if globalisation hits a really large bump in the road. Then, at least in a few big countries, inflation will end up being far higher than policymakers or market participants now seem to think possible. Market convictions that inflation is forever dead will be shattered.

** Impact of Globalization on Monetary Policy, by Kenneth Rogoff, August 2006 Jackson Hole Symposium, www.kc.frb.org*

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