



The Prospects for Inflation Ahead

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The Great Recession of 2007-2009 is now over and the U.S. economy is expanding nicely as are most economies. The recovery from the recession reflects the operation of normal market forces and expansionary monetary policy by the Federal Reserve and other central banks. Many observers argue that the recovery in the U.S. is still anemic because the unemployment rate is still close to 9% and there is considerable economic slack. They argue that the Fed should continue on its expansionary track to insure that the recovery will be durable and strong.

The problem is that expansionary monetary policy by the Fed and by central banks around the world is creating incipient inflationary pressure which is already manifest in rising commodity prices and in headline inflation in both emerging and some advanced countries. See Figure 1 which shows for the U.S. for the past decade the headline and core CPI and also the Commodity Research Bureau's spot index of commodity prices. As can be seen the CRB index is very volatile and it is correlated with movements in the headline inflation rate. Recently it has been rising and this is starting to appear in headline inflation but it is still very modest. Also see Figure 2 which shows the MIT BPP index and the headline inflation rate for the very recent past. This index which is daily comes from scraped data from U.S. supermarkets and other retail establishments. It provides real-time information on major inflation trends and is a complement to traditional measures of inflation. As can be seen this index is now trending above the headline CPI. For other advanced countries like the UK headline inflation is close to 5%. In addition oil prices have risen considerably very recently reflecting the turmoil in the Middle East. Whether that will add to inflationary pressure depends on how long the crisis lasts.

Both the record of economic history and recent empirical work suggests that we may be in for a significant run up of global and U.S. inflation in the not too distant future.

The history of the Great Inflation (1965 to 1983) reveals that sustained expansionary monetary policy manifested in the growth rate of M2 in the U.S. and virtually all countries (with the principal exceptions of Germany and Switzerland) led to a rapid and sustained run-up in headline and core inflation which peaked in 1980. There is considerable debate over the causes of the Great Inflation (see Bordo and Orphanides forthcoming) but the general consensus among monetary economists is that it reflected the failure of the Federal Reserve and other central banks in not tightening monetary policy sufficiently to prevent inflationary expectations from rising and becoming persistent. An alternative explanation for the Great Inflation emphasizes the role of the two big OPEC oil shocks in 1973 and 1978 which were accommodated by loose monetary policy (Blinder and Rudd 2010). Although evidence by Barsky and Killian (2001) suggests that OPEC, which prices oil in terms of US dollars, was only reacting to a previous run-up in US inflation when it engineered its dramatic oil price hikes.

The Great Inflation was first manifested in a rise in commodity prices and later appeared in overall inflation. This reflected the basic distinction first pointed out by Okun (1975) between goods that are traded in auction markets and whose prices react quickly to both nominal and real shocks and goods traded in customer markets (manufactured goods and services) whose prices are relatively sticky. In the long-run, the paths of prices for both types of goods are determined by the long run growth of the money supply (reflecting monetary neutrality). What happens in episodes of expansionary monetary policy characterized by falling real interest rates is that real

commodity prices rise much more quickly than the prices of other goods and according to Frankel (2008) they overshoot the long-run equilibrium price level. At the same time the prices of other goods react slowly to the monetary pressure. Frankel (2008) finds that commodity prices are a good predictor of future inflation. See figure 3 which shows M2 growth, the real short-term interest rate, an index of commodity prices and the CPI. In a similar vein Browne and Cronin (2007) use time series techniques for the US (1959 to 2005) to show that the growth of M2 and commodity prices as well as the growth of M2 and headline CPI are cointegrated (tied together in a long-run equilibrium relationship) but that the adjustment mechanism to the long-run equilibrium (the error correction mechanism) involves considerable overshooting by commodity prices. They also find that the deviation of commodity prices from their long-run equilibrium values well explains the subsequent path of the CPI.

In addition global inflation is important because many countries follow similar expansionary monetary policies and the world is becoming increasingly more integrated. Recent work by Ciccarelli and Mojon (2010) for the period 1960 to 2007 shows that global inflation based on OECD data is a good predictor of future national inflation rates for many countries including the U.S. See figure 4 which shows OECD aggregate inflation and the US CPI.

Policy Implications

The Fed and other central banks focus on core CPI excluding food and energy because these components are highly volatile. Core CPI inflation according to conventional theory is determined by the degree of slack in the real economy and by inflationary expectations. Most observers today argue that since core inflation is considerably below the implicit inflation target of 2%, and unemployment and the output gap are still too high, that inflation is not an important worry for policy makers. Yet commodity prices are rising and headline inflation is also rising. It will likely take a long time for headline inflation to feed into core inflation through the conventional mark up channels but once it does it will be hard to dislodge as the experience of the Great Inflation taught us. Also rising commodity prices feeding into headline inflation risks precipitating a run up in inflationary expectations manifest in bond and other asset prices. In such a scenario the Fed risks losing its credibility for low inflation and may have to tighten quickly. Such an inflation scare can have significant and unintended consequences for the real economy and for emerging markets dependent on capital flows from the U.S. (as occurred in the last inflation scare of 1994). In addition another possible channel for future inflation is imported inflation from emerging countries. Many emerging countries are now following expansionary monetary policies which are too loose relative to their underlying growth potential. Through international trade this will feed back into the advanced economies, with support from dollar depreciation.

These issues suggest that the Fed should pay more attention to what is going on in the global commodity markets and in the emerging countries as indications of the consequences of its and other central banks expansionary policies in the last two years. For these reasons the Fed should consider tightening its policy stance sooner rather than later when it is too late.

References

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Figure 1 - CPI Headline, CPI Core, CBR spot index

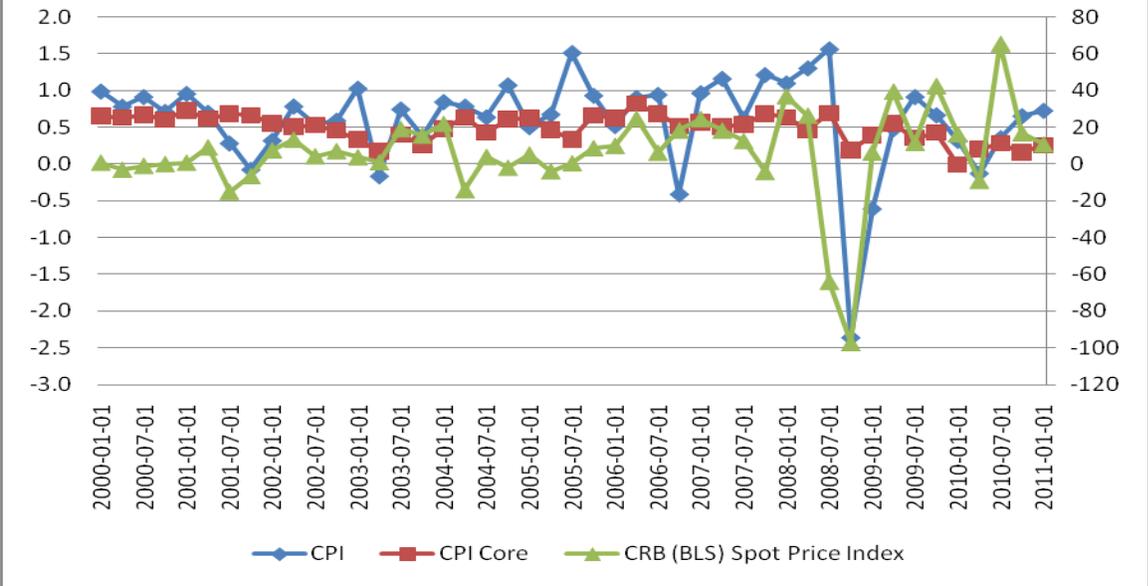


Figure 2 - BPP supermarket index, US CPI

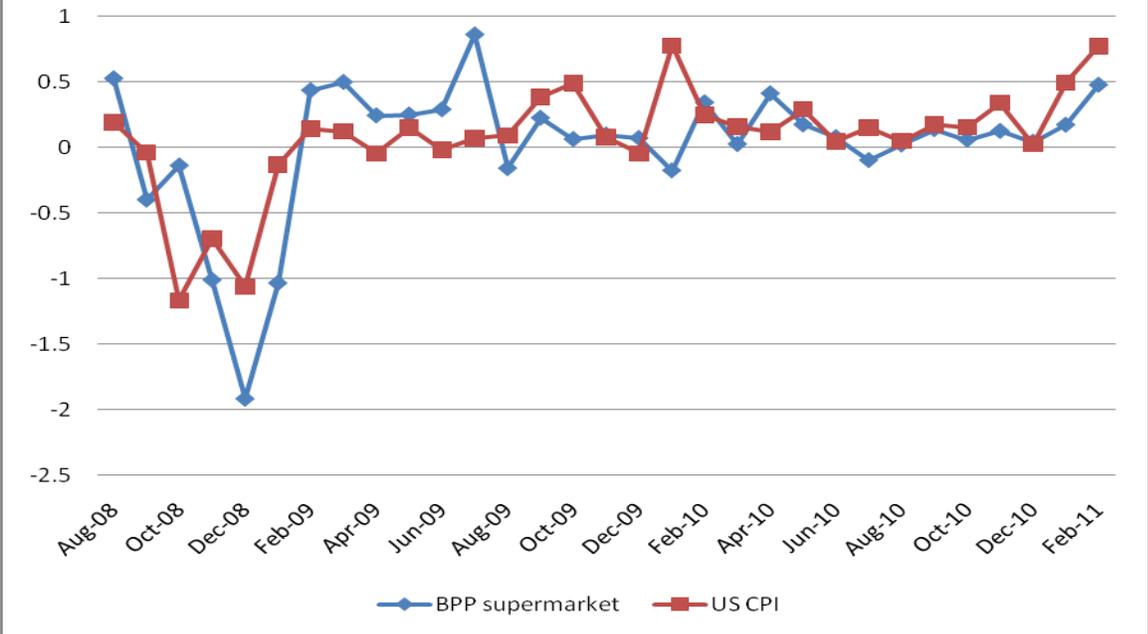


Figure 3 - M2 growth, Real interest rate, CRB spot index

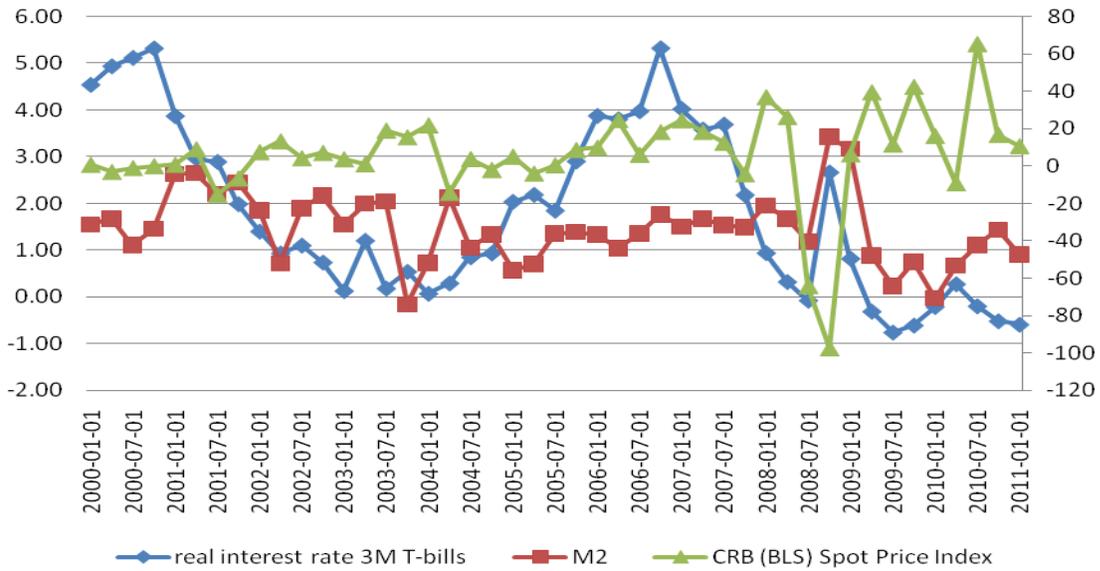


Figure 4 - OECD average CPI, US CPI

