Foreword

During the 1990s, a number of countries successfully achieved low and stable inflation. Part of the decline reflects the large and negative output gaps in the early 1990s and favourable supply shocks later in the decade. However, inflation has remained relatively subdued as economic conditions have strengthened and some of the supply shocks have reversed. Moreover, actual inflation has remained well below the rates forecast by models based on historical data. This raises the issue of whether the inflation process has undergone structural changes and, if so, which have been the principal forces.

There are several plausible reasons why such changes could have occurred.

First, due to globalisation and increasing competition in both domestic and international markets, firms' pricing power may have been eroded. Put another way, prices have become more sticky or the inflation process has become more persistent. One result of such changes is that the pass-through of cost increases (including exchange rate changes) into prices has fallen. Moreover, when relative prices evolve more slowly, firms that are subject to menu costs will set prices for longer periods.

Second, with inflation in the 1-3% range for some time, inflation expectations may have become more firmly anchored, particularly if the public believes that the monetary authorities will successfully resist any persistent movements of inflation away from this level. This is likely to be the case as many countries have explicitly adopted price stability as the overriding target for monetary policy.

Third, increases in productivity growth may have raised the rates at which economies can grow without encountering inflationary pressures. To some extent, this change may appear as a decline in the sensitivity of inflation to measures of the output gap, which tends to be overestimated in such conditions. Another measurement or estimation problem is that higher productivity growth may be an endogenous response to increasing competition and firms' loss of pricing power.

To explore these issues further, economists from nine central banks were invited to a workshop, chaired by Lars Heikensten, First Deputy Governor of Sveriges Riksbank, and held at the BIS on 31 October 2000. The papers presented at the workshop and reproduced on the following pages covered various approaches to the issues raised above. While there was a consensus that most of the structural changes involved technological progress and productivity growth, the empirical evidence is not yet firm enough to draw clear lessons for monetary policy.