Christian Noyer: Is inflation set for a comeback?

Speech by Mr Christian Noyer, Governor of the Bank of France, at Deutsche Bank, Paris, 19 March 2008.

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With inflation surging everywhere, it is quite natural to wonder if we could have reached the end of this worldwide era of “great moderation” in both output and price volatility which has characterized Alan Greenspan’s tenure of office.

True, one could argue that we are just experiencing one-off shocks in commodity and food prices whose inflationary consequences will wane rapidly thanks to the increased flexibility of our economies.

But other possible scenarios are more worrying. Second-round effects could, after years of relatively well contained wages, be triggered by shifts in inflation expectations; through the catching-up of developing economy, the globalisation process could have become inflationary; the ageing of our developed European economy, the necessary fight against global warming could structurally add inflationary pressures,.... and the room for monetary policy decisions could be restricted by the state of the financial and banking system and by the risks of slowdown of growth.

I would like to review these issues. In order to avoid any misunderstanding let me immediately make my point. Even if it is clear that inflationary pressures have both increased and changed in their nature, I firmly believe that monetary policy can still ensure price stability, over the medium term.

My central scenario for the short term is a scenario where after a couple of months inflation will recede in the euro area and come back “below but close to 2%” in accordance with our definition of price stability.

It is not unusual to witness commodity and consumer prices acceleration in the initial phase of an economic slowdown, as there is some inertia in employment and commodity prices dynamics with respect to activity. This has happened previously at the end of the 1990s, with a subsequent moderation in inflation.

In the short run, recent inflationary shocks are likely to maintain inflation at a high level for most of 2008 as we may expect a significant degree of persistence in energy, industrial commodity or some food price increases (such as meat). In the euro area, HICP inflation has reached 3.3% in February. It might remain well above 2% in the coming months but ebbs later this year according to ECB staff forecasts. These projections rely on a scenario of global economic slowdown and moderation in commodity prices, which would contain pressures on capacity utilisation in the labour and product markets. They are all the more credible than we do not see at this juncture a major diffusion of price increases: less than 30% of the consumption basket (energy and food) are responsible for more than 60% of the overall increase.

There are nevertheless some upside risks to these projections.

First, further shocks on food and commodity prices cannot be ruled out. On the demand side, should emerging countries decouple to a large extend from the United States, their contributions would then be sufficient to maintain a significant pace of commodity prices growth. On the supply side, unexpected climate or geopolitical disruptions may lead to shocks on production, as in the past few years. On top of both factors, in the current context of raising inflation and troubled financial markets, commodities attract a growing part of investment, speeding up sometimes rather artificially their price increases.

Second, the triggering of possible second round effects is a well known source of concern for the Governing Council of the ECB. The common desire of firms and households to offset profit margin and purchasing power losses stemming from inflationary shocks may lead to a wage-inflation spiral, ending in deteriorated output prospects and welfare losses to all parties. One should however note that nothing significant has materialised at this juncture. On the contrary, remunerations have remained well in line with productivity gains with, to take an example, reference wages increasing by 0.3% in France during the fourth quarter of last year.

From this point of view, protracted shocks to food and commodity prices put the anchoring of inflation expectations and the credibility of monetary policy to the test. The recent upward trend in European household and market expectations may be of some concern. However, as emphasised in a forthcoming issue of the Banque de France monthly Bulletin[1], which is entirely devoted to various inflation related issues, currently available measures of inflation expectations appear crude and limited in terms of information content to explain short run wage formation or consumption dynamics. In practice, the Eurosystem has a prudent and comprehensive approach when considering private agents' inflation expectations. While taking into account a large range of expectations indicators, the Governing Council does not react to them mechanistically.

A firm anchoring of inflation expectations is nevertheless crucial in order to take up the challenges coming from the new inflationary environment.

Among the long-run evolutions that can be expected with a high degree of certainty, the changing impact of globalisation on inflation, population ageing and climate change constitute threats to price stability and major new challenges for monetary policy.

First, globalisation may turn out to be more inflationary in the future than in its early phase.

This was one of the issues addressed in the recent international symposium of the Banque de France.

For over ten years, with the growing integration of our economies, powerful forces, throughout the world, have been acting to enhance price stability. Each year, the integration of millions of people into the world labour market has increased global production capacity, in particular for tradable goods. For monetary policy in developed countries, this process has been equivalent to a sequence of positive supply shocks that took the form of a spontaneous decline in the import price of manufactured goods. All other things being equal, this terms-of-trade gain has allowed for a lower inflation rate for a given capacity utilisation rate. More fundamentally, and although things seem to be less straightforward in this area, it is possible that the increasing openness of our economies have structurally changed the wage and cost formation process in a manner that favours price stability. It is clear that heightened competition triggered by imports reduces the market power of firms at the national level. But, other more indirect effects are also detectable. According to studies carried out at the Banque de France, to be published in our next Monthly Bulletin[2], the disinflationary impact of imports appears to be relatively independent of import volumes: the mere existence of potential competition renders the markets, in the words of experts, more "contestable" and influences behavioural patterns.

These disinflationary forces are still present. However, there are now other more powerful forces that have the opposite effect.

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[1] V.Chauvin, D.Irac, N.Maggiar et H.Poncet, « L'information apportée par les anticipations d'inflation sur les salaires et la consommation dans la zone euro » ; J.Coffinet et S.Frappa, « Anticipations d'inflation dans la zone euro : que nous disent les marchés financiers ? » ; J.Coffinet et J.S.Mesonnier, « Anticipations d'inflation du secteur privé et conduite de la politique monétaire »

[2] S.Guilloux et E.Kharroubi, « L'impact des prix d'importations sur l'inflation domestique. Le rôle de la structure des échanges ».

First, a natural process of real appreciation of currencies in catching-up economies is taking place, leading to upward pressures on the prices of their imports. Along with the catching-up in terms of standard of living, the level of prices in emerging countries tends to converge to the level of advanced countries through a combination of appreciating currency and higher inflation. Although somewhat hampered by exchange rate policies in the past decade, it seems to gather speed now with, as an example, the most needed faster appreciation of the Renmibi and at the same time accelerating inflation in China. This process will affect import prices of manufactured goods in developed economies.

Second, the growth of emerging market economies and the rise in the living standards of their populations are also leading to a surge in the demand for natural resources, food and energy, which logically has a strong and permanent impact on inflation.

Furthermore, by strengthening the magnitude of global shocks in relation to more specifically domestic shocks and favouring the international transmission of the latter, globalisation introduces a much greater synchronisation of inflationary cycles between countries, with the ensuing risks of amplification.

Overall, the effects of globalisation have ceased – probably in the long term – to be spontaneously disinflationary.

Other factors will add to the inflationary pressures in the medium to long run. Without elaborating too long on them today, I want to mention in particular population ageing and climate change.

The ageing of the population will lead to a significant increase in public spending, for retirement pensions and health expenditure. At the same time, the growth in public indebtedness during the past twenty years will require an adjustment at some point. Both issues will lead to a mix of economic policy decisions and there may be a conflict between firms and employees about the final burden sharing, with risks of a wage-inflation spiral.

Climate change could also have both a direct impact on prices, through disruptions in production, and an indirect impact, through policy measures to curb down carbon dioxide emissions.

Climate change, through unusual weather outcome – temperature, rain or unusual seasonality – or disasters, would disturb climate sensitive productions such as food products or electricity (e.g. hydroelectric energy). Scarcity of these products would then lead to temporary overshooting in their prices.

Measures to curb down carbon dioxide emissions will have a direct impact on prices through increases of indirect taxes and an indirect impact through the necessary adjustment of the production process. This adjustment will involve heightened tensions on production capacities, as part of the equipment stock will have to be discarded due to changing regulations or due to increases in its operating costs with higher taxes. Some temporary impact on inflation may therefore be expected during this process.

However, in the medium run, the challenge of climate change may lead to a significant improvement in technological progress, which will lead *a minima* to reduce energy consumption and carbon dioxide emissions for a given level of output but could also stimulate productivity growth. This inflationary impact highlighted before would then be offset both by downward pressures on energy prices and by productivity acceleration.

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As we can see from this rapid review of risks factors to inflation in the short to the long run, there is a clear upward bias to risks regarding inflation, which has to be taken into account by economic policy.

It is thus all the more necessary to insure a proper degree of competition on product markets and a well-functioning price system, inducing changes in consumption or production patterns according to the relative scarcity of products. There are large margins of improvement with respect to product market competition both in emerging and advanced countries.

In the euro area, the fulfilment of the Lisbon agenda objectives could have a significant offsetting impact. Higher employment rates and acceleration in productivity would lead to both less inflation and higher growth. The low current employment rates of the younger and older workers provide a wide acceleration margin for European growth. The potential catching-up of information technology use in the Euro area would lead to a substantial increase in productivity growth. Both evolutions would significantly reduce the inflation content of growth and help contain inflationary pressures.

However, most of the burden lies on central banks, as "inflation is always and everywhere a monetary phenomenon". The current "two pillar" approach of the Governing Council with a crosschecking between the economic and the monetary analysis has, I believe, permitted us to deliver a stance of monetary policy which has been totally appropriate to the situation of the euro zone. The anchoring of inflation expectations at a level consistent with price stability, which is currently observed in the financial market, is therefore completely justified. The years to come will give to the central bankers the opportunity to demonstrate that these years of "great moderation" are not just the result of lucky circumstances but are largely due to an improved monetary policy framework.