



BANK FOR INTERNATIONAL SETTLEMENTS

How much do we really know about inflation?

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Themes and takeaways

- One Annual Report theme
 - Could an inflation flare-up bring the expansion to an end?
 - How much do we really know about the inflation process?
- Takeaways
 - We may be underestimating globalisation's influence on inflation
 - If so, a flare-up in inflation may not be that likely...
 - ...and refinements to monetary policy (MP) strategies may be desirable

Structure of the remarks

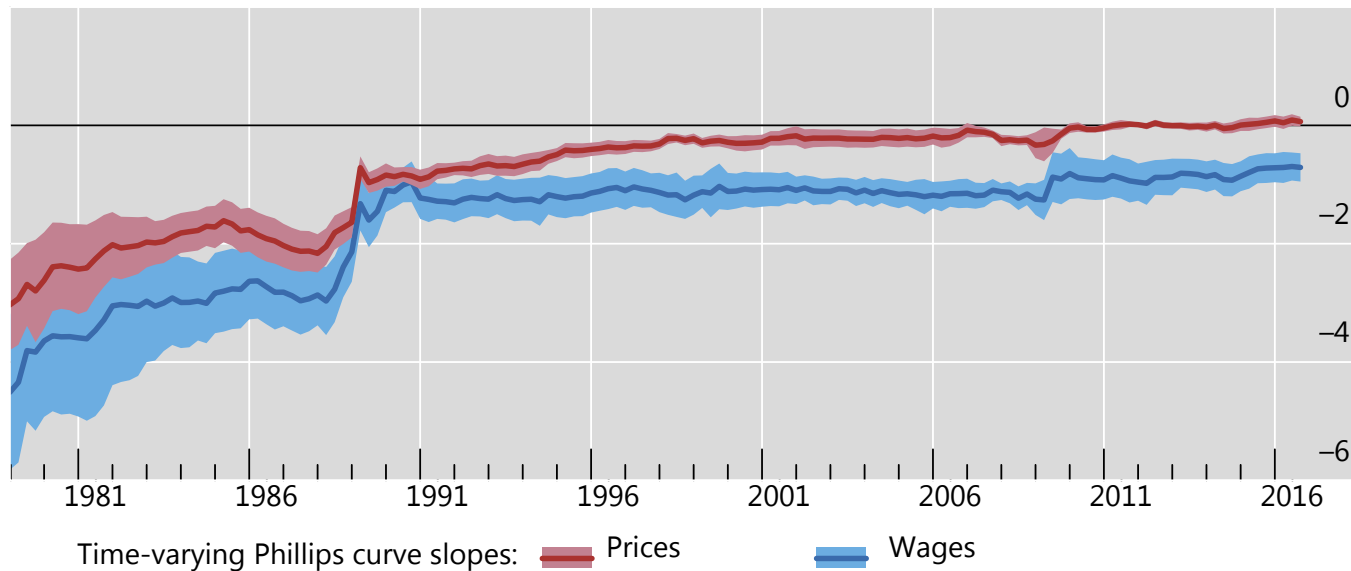
- Globalisation and inflation
 - A closer link than we think?
- Implications for the inflation outlook
 - Not the main risk to the expansion?
- Implications for monetary policy
 - A weaker link than we think?

I – Globalisation and inflation: an underappreciated link?

- The domestic slack/inflation link has proved weak and elusive
 - Especially for prices; a bit less for wages (Graph 1)
- Why? Possibly...
 - ...not just more credible monetary policy anchoring expectations...
 - Evidence they have been sticky around targets (Graph 2)
 - ...but also greater contestability from more integrated product, labour and capital markets...
 - ...alongside the huge increase in the effective labour force (Graph 3)
 - Eg delocation threat
- Two effects (Graph 4)
 - Symmetrical: greater sensitivity to global slack
 - Asymmetrical: secular downward pressure on inflation

A flatter Phillips curve for prices and (less so) for wages

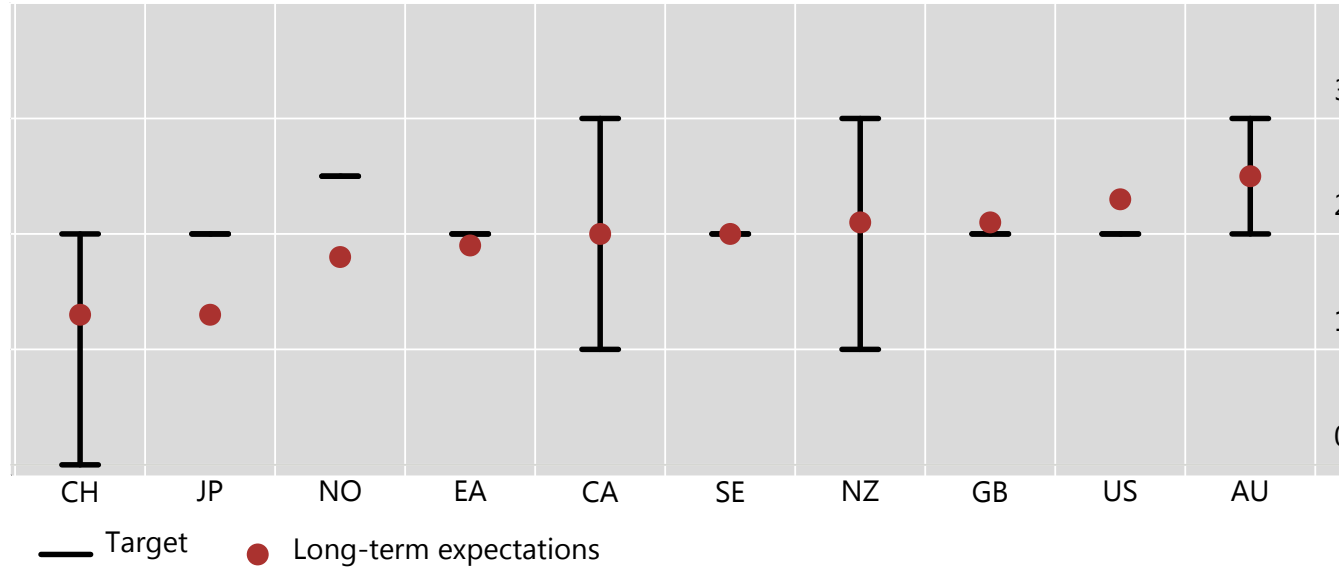
Graph 1



Source: 87th Annual Report.

Inflation expectations remain well anchored

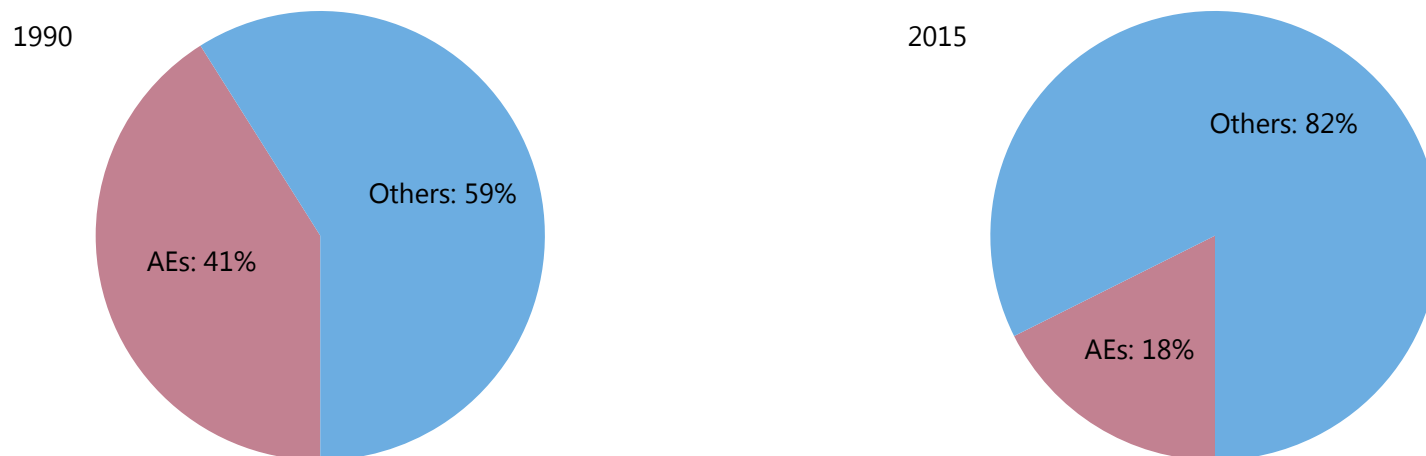
Graph 2



Sources: Consensus Economics; national data; BIS publications.

Globalisation greatly boosts the global effective labour force

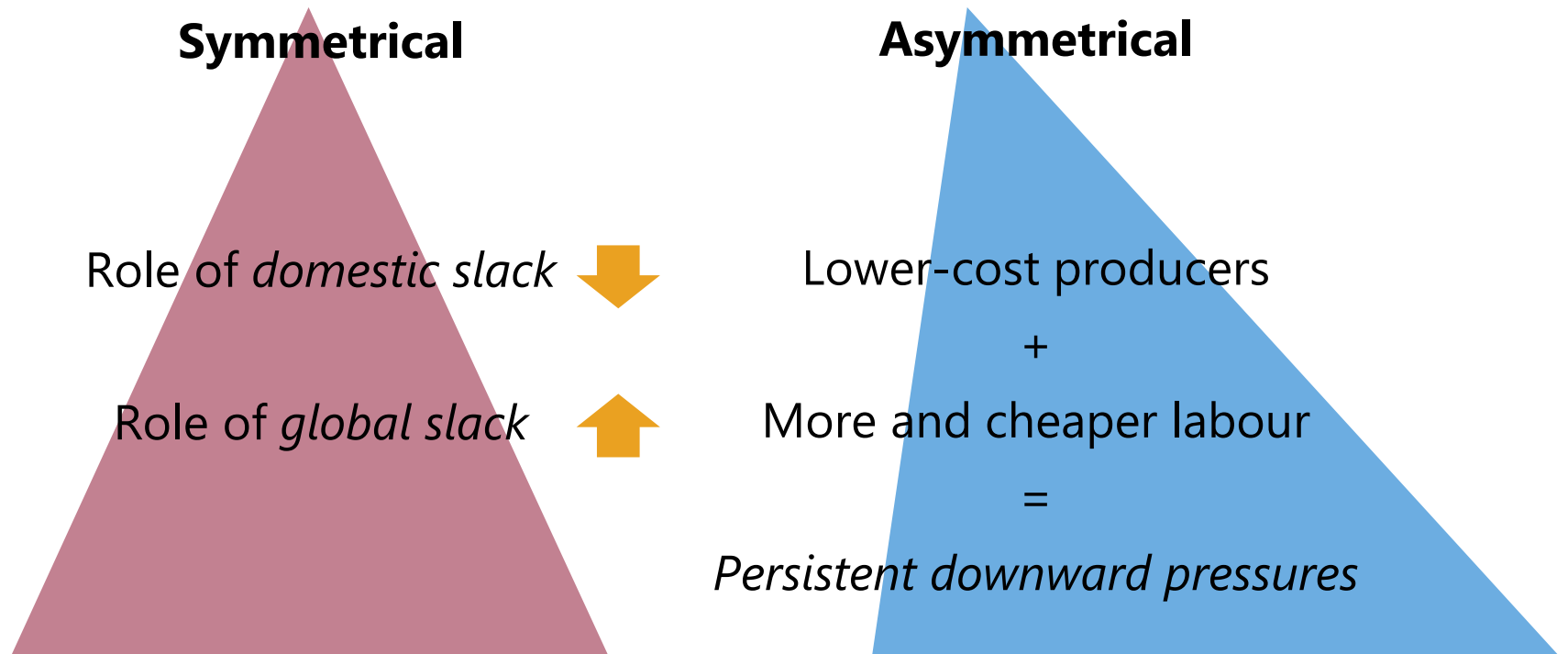
Graph 3



Sources: World Bank, *World Development Indicators: Population ages 15–64*; BIS calculations.

Two types of effect of globalisation on inflation

Graph 4

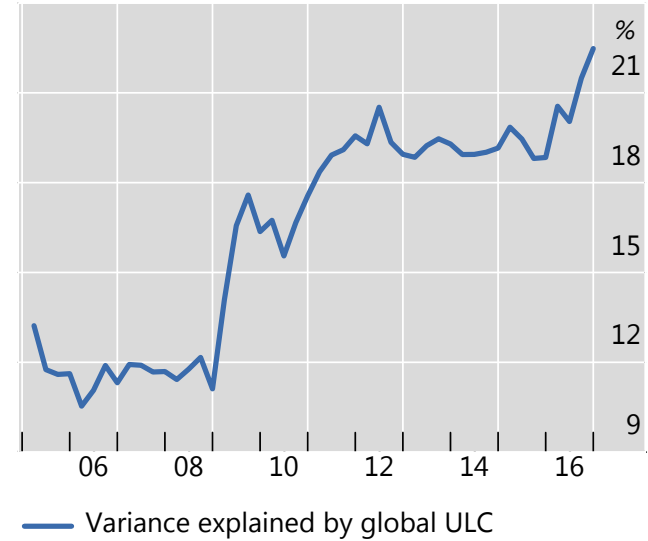
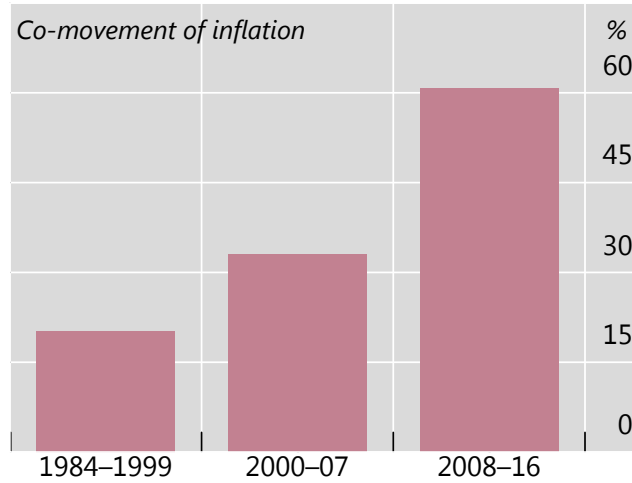


I – Globalisation and inflation: an underappreciated link?

- Evidence 1: higher global component of domestic inflation
 - Eg for unit labour costs (ULCs) (Graph 5)
 - But this does not pinpoint underlying forces
- Evidence 2: growing relevance of global relative to domestic slack
 - But evidence is ambiguous
- Evidence 3: global value chains (GVCs) help explain relative importance of global slack
 - Both across countries and over time (Graphs 6 and 7)
- Evidence 4: measures of secular decline in labour's "pricing" power help explain the flattening of domestic Phillips curves
 - Surely globalisation has influenced that pricing power

Inflation and ULCs become more global

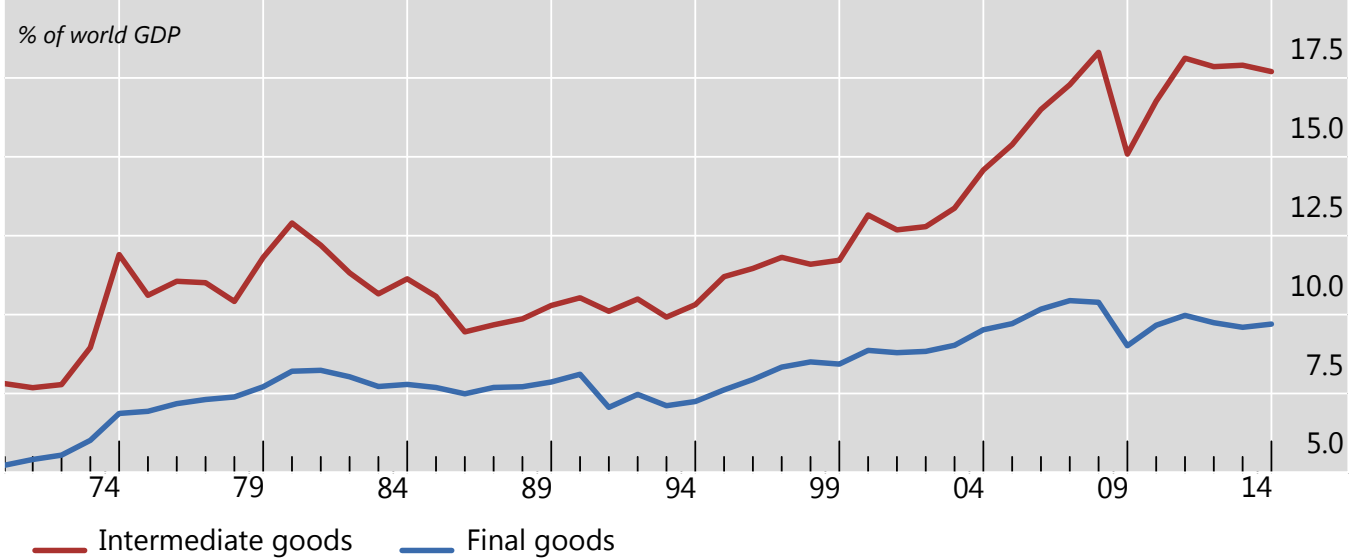
Graph 5



Source: 87th Annual Report.

GVCs grow much more than final trade

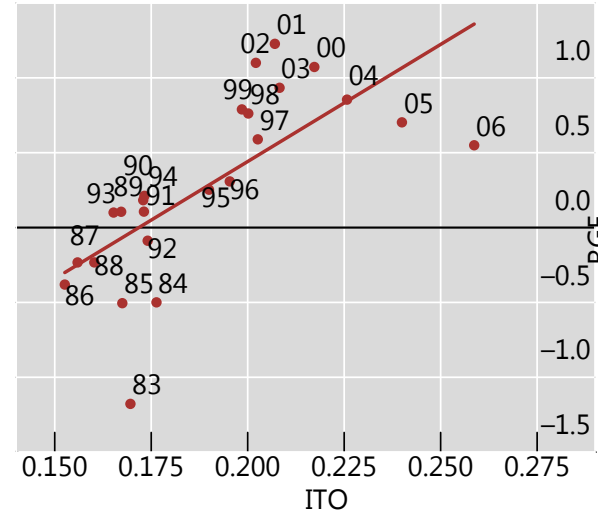
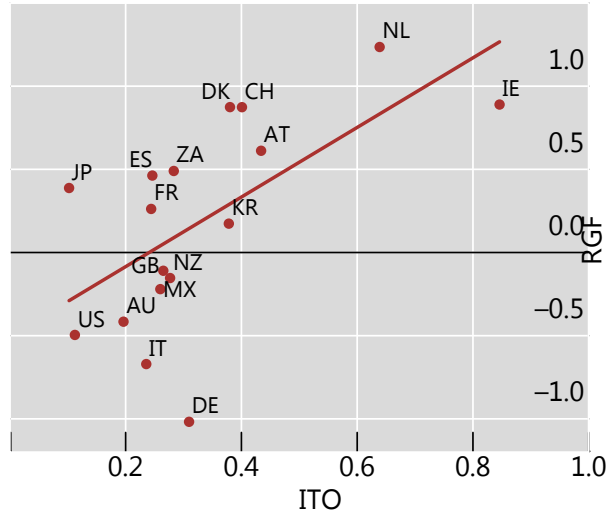
Graph 6



Source: 87th Annual Report.

GVCs make inflation more global across countries and over time

Graph 7



ITO = (exports & imports of intermediate goods and services)/GDP.

Relative global factor (RGF) = the impact of the difference between global and domestic slack on domestic inflation.

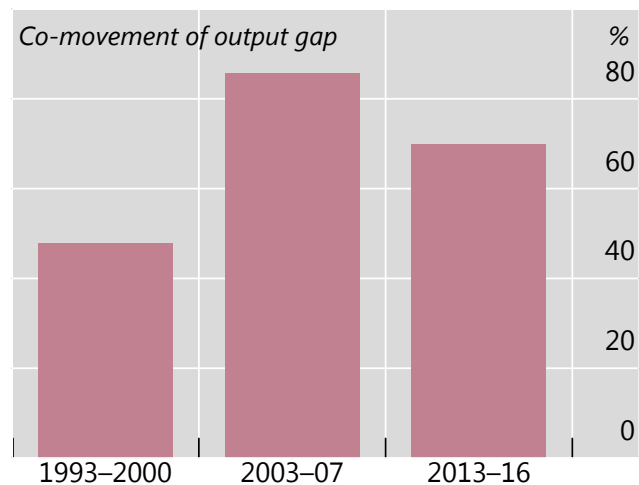
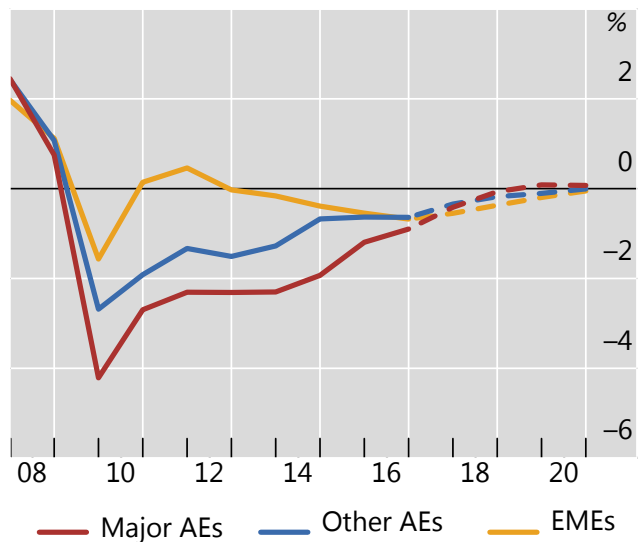
Source: R Auer, C Borio and A Filardo, "The globalisation of inflation: the growing importance of global value chains", *BIS Working Papers*, no 602, January 2017.

II – Implications for inflation risks

- In principle, ambiguous
 - Higher: slack is simultaneously vanishing in many economies (Graph 8)
 - Lower: persistent globalisation headwinds
- On balance, the second effect may well dominate
 - Expansion synchronisation is not unusually high (Graph 8)
 - Wage pressures still appear remarkably low

Output gaps are closing but are not unusually synchronous

Graph 8



Sources: IMF, *World Economic Outlook*; national data; BIS calculations.

III – Implications for monetary policy

- I 1: “Inflation is always and everywhere a monetary phenomenon”?
 - Dictum needs to be nuanced
 - Inflation requires MP accommodation
 - MP can bring inflation down
 - But real-sector forces may have persistent effects
- I 2: Should not overestimate central banks’ ability to fine-tune inflation
 - Raising inflation against powerful headwinds may prove hard
 - Recent experience confirms this?
- I 3: This puts a premium on understanding inflation drivers
 - If supported by globalisation or technology, disinflation is benign
 - Longer horizon and more tolerance for inflation shortfalls?
- If globalisation were rolled back, what would happen to inflation?
 - Probably higher: back to the future...
 - ...but the “solution” would be worse than the “problem”