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

Time-varying Phillips curve slopes:  
- Prices
- Wages

Inflation expectations remain well anchored

Graph 2

Sources: Consensus Economics; national data; BIS publications.
Globalisation greatly boosts the global effective labour force

Graph 3

Two types of effect of globalisation on inflation

**Symmetrical**
- Role of *domestic slack*
- Role of *global slack*

**Asymmetrical**
- Lower-cost producers +
- More and cheaper labour =
- *Persistent downward pressures*
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

Co-movement of inflation

<table>
<thead>
<tr>
<th>Period</th>
<th>Variance Explained by Global ULC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984–1999</td>
<td>0%</td>
</tr>
<tr>
<td>2000–2007</td>
<td>15%</td>
</tr>
<tr>
<td>2008–2016</td>
<td>45%</td>
</tr>
</tbody>
</table>

GVCs grow much more than final trade

Graph 6

% of world GDP

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.

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”