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Inflation

Bobbing back up?

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Concerns about inflation are growing around the world

Reuters

PERHAPS it is time to feel uneasy. Though not very powerful now in much of the world, inflation is an uncomfortable force that may be getting stronger. Last week, the Bank of England startled markets by raising interest rates unexpectedly. This week, it became clear why. The Bank's governors had been given a sneak peek at the latest consumer-inflation figures for the country, which are a full percentage point higher than the Bank's 2% target. If you include mortgage-interest payments, the cost of living is substantially higher.

This is a bit surprising considering that energy costs, which had been putting a great deal of pressure on the cost of living, have started to decline. New figures from the International Energy Agency indicate that in 2006, oil consumption in the 30 member nations of the Organisation for Economic Co-operation and Development (OECD) fell by 0.6%, the first drop in more than 20 years. After peaking in July at nearly $80, the price of a barrel of oil has declined precipitously; on Thursday January 18th, it briefly dropped below $50 in intraday trading.

This has been showing up in inflation figures recently. According to numbers released in December, OECD countries experienced average consumer price inflation of just 1.7% in the year to October 2006. But the November figures show a substantial uptick, to 2.1%. And in America this week, new data indicated unexpectedly high producer prices, which have fairly well squashed any hopes of an interest-rate cut in the near future. Though American consumer-price inflation fell in 2006, core inflation, which excludes volatile food and energy costs and is closely watched by the Fed, was up compared with 2005. Some now think that America will have to raise rates in the second half of the year to fight off resurgent price pressure.

Others argue that the leaps forward are more a result of statistical flukes than real threats. But this argument is hard to sustain. The more that those volatile, “non-representative” figures are excluded from a price index, the less the index reflects the real experiences of consumers—a criticism frequently levelled at the use of core inflation as an indicator.

The most worrying possibility was raised by Mervyn King, the head of the Bank of England, last year: that China, India, and other rapidly growing Asian nations may have been behind the low inflation experienced by much of the world in the past decade or so. The arrival of this huge pool of labour into global markets resulted in lower prices for consumer goods ranging from clothes to television sets. This has increased real disposable incomes for Western consumers while holding back inflationary pressures in these categories. At the same time, outsourcing has limited inflation even in previously non-tradeable sectors, such as help-desk support.

But if import prices stop falling, Mr King warned, inflationary pressures may creep back up. And for various reasons, that channel for checking inflation is looking weaker. Protectionist pressures are growing in Europe and America, threatening to limit imports. America, in particular, is leaning hard on China to allow its currency to float more freely, making its exports more costly for American consumers. Though China’s government has been extremely reluctant to be seen to give in to American influence, it may want to do so for its own reasons. The massive purchases of American dollars required to keep its currency artificially weak have left its central bank with a huge inventory of dollar-denominated securities, and its currency market operations increase the inflationary pressures in its already overheating economy.

There is one central bank not haunted by fears of inflation, however. The Bank of Japan would welcome a brisk increase in its rate of consumer-price inflation, which until the middle of last year hovered between nothing, and a tenth of one percent. Yet even there, the central bank is preparing to lift interest rates (to a whopping 0.5%), though it refrained from doing so this week. Toshihiko Fukui, the bank's governor, is concerned about a surge in capital spending, caused in part by rising property prices. Memories of the speculative property bubble in Japanese that preceded its disastrous decade of stagnation are still fresh. He is also hoping to slow a brisk carry trade in the yen, as investors borrow at ultra-low Japanese rates and sink their borrowings into higher yielding assets in other developed countries, where interest rates are much higher.