

Fire and ice

Jean Pisani-Ferry

‘Some say the world will end in fire, some say in ice’. It is with this quote from the poet Robert Frost that Kenneth Rogoff, the Harvard professor, summed up the current economic uncertainty. The image is well chosen. On the one hand inflation is on the up almost everywhere, at 3.5% in the euro area, 4% in the US and 8.7% in China. On the other hand the International Monetary Fund, whom only decency prevents from speaking of a recession in the US, is once again reducing its global growth forecast to 3.7% for 2008, as against about 5% for 2007. Central banks are caught between the devil and the deep blue sea: should they increase rates in order to fight the fire, or decrease them to avoid ice-over?

Contrary to appearances the latest data gives the lie to this dilemma. Simple inertia may explain that prices continue to accelerate while growth is slowing. If anything, it is surprising how restrained prices have been so far. Since the start of the global recovery six years ago the price of energy (in dollars) has multiplied by three and that of other commodities by two, in other words a shock almost on a parallel with 1973-75. But rather than taking off, global inflation has this time merely flickered, rising by only one to two points, very close to the mechanical effect of the rise in commodities.

The real question relates to the future. Are the factors underlying the price restraint in the process of changing? This will determine the line to take: stifle inflation before it is too late, or first cushion the effects of the financial shock.

In the case of commodities the change is clear. We experienced a situation of plenty and low prices for twenty years. Inadequate investment, geopolitical tensions and emerging-country demand have shaken us out of it. In part the phenomenon will be self-correcting: the increase in prices will trigger a rise in investment which will in turn work through into a rise in supply. But only in part, because the more that global growth switches towards emerging economies the more it will push up demand for commodities. Americans may well be big consumers of energy and food but an increase in their incomes converts primarily into a demand for services. Things are different for the Chinese and Indians, for whom more income means a car and animal-based food products. Energy and arable land being finite, we are now entering a new economy of scarcity.

Faced with this lasting tension on the price of resources the first restraining factor is the capacity of central banks to convince people that they do not intend to allow long-term inflationary slippage. It is remarkable that in those countries where they are measured, expectations of price increases remain stable and low. This is perhaps the chief asset of the independent central bank model which has now become the norm worldwide. The greater the credibility of monetary institutions the more – paradoxically - they are able to ride temporary inflationary jolts with impunity. We are today harvesting the benefit of the institutional investments of the 1990s.

The second factor is globalization itself. Since the 1990s one of the reasons for lasting price restraint has been the sharpening of international competition. Economic opening has brought hundreds of millions of

Chinese, Indian and Polish workers into world trade. As will be obvious to anyone observing supermarket shelves, this surge (as the economist Richard Freeman called the doubling of the global workforce) has exerted strong downward pressure on the price of manufactures. It has even influenced the price of services in countries which are open to immigration such as the UK.

Some allege that this pressure is about to slacken. The strike of the Romanian workers of Dacia or the social legislation of European inspiration adopted by China at the end of 2007 apparently signal the end of an era. Having anchored disinflation, will globalization now stoke inflation? This argument is overdone. For a start it fails to take into account that most wage claims are counterpart to productivity gains. And it also loses sight of the fact that China alone will have to create ten million jobs annually for years to come in order to absorb the workforce arriving from rural areas. Even if occasional tensions do arise, it should not be forgotten that hundreds of millions of workers, better and better trained, are still waiting in the wings to obtain access to the capital and technology which will allow them to boost their productivity. Absorbing them will be a matter of a generation, not a matter of a few years.

So it is most likely that commodities will remain expensive and labour cheap in the years to come. It will not be yesterday's world of plenty but it will not be an inflationist hell either. This prospect merits the watchfulness of central banks, but it does not prevent them from acting against recessionary risks either.

Jean Pisani-Ferry is director of Bruegel, the Brussels economic think tank.