OpinionAsia
Global Views on Asia

Inflation Woes: Is the Global Economy in need of Retooling?

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After a hiatus of decade or two, with inflation largely absent, this unwelcome phenomenon has reappeared to dominate the global economic policy debate. The US and European Central Banks, the FED and the ECB have been most vocal, not the least because their monetary policies, underpinned by inflation targeting have failed.

Now the International Monetary Fund and the Asian Development Bank have joined in the chorus. Some observers even speak about the dreaded combination of inflation and stagnation (stagflation). Central banks see this as a nightmare because lower interest rates may stimulate the economy but boost inflation, while higher interest rates may dampen inflation but also deepen the downturn.

The rise of inflation masks an even bigger problem that economic trends among main economic powers highlight - the lack of any genuine attempt to shape coordinated economic policies. With some justification, it can be said that the non-existence of global coordination viz. economic policies represents one of the villains pulling inflation out of the dark and into the limelight.

The world is now in a multilayered transition: the EURO has replaced national currencies, emerging market economies have acquired greater clout and confidence as compared to the US - the latter, continues to be harassed by the fall out from irresponsible economic policies coinciding with a forthcoming presidential election; An event which rules out new policy initiatives for the next six to nine months.

Demand pressure cannot explain the inflationary development because inflation has accelerated while global growth has dived. The culprit is likely to be found in the supply side and commodity prices are the first to catch the eye. The index of

19 major commodities jumped 29% over first half 2008 - the highest figure in almost 50 years.

While it is academically interesting to dissect the causes of the present inflationary wave, the rise in commodity prices has taken place and is behind us. It looks a safe bet that commodity prices will take a breather or fall over the next six to nine months. If so, the present supply generated inflation has run its course and economic policies should be designed, not to counteract what has happened over the last six to twelve months, but to prevent a new supply-generated inflation wave that strikes in a few years time. That makes it worthwhile to toss up a few ideas about how to extricate the global economy from the present trap and build in some mechanisms to achieve a better balance:

Firstly, although global demand is falling the prospect of global recession, albeit remote, cannot be ruled out if an erroneous policy mix is put on the table. Predictions for global growth in 2008 have steadily been lowered and hover around 3.7% - the final figure will probably be even lower. Admittedly, the danger of inflation calls for action, but decision makers should be ahead of the curve relative to timing and responses to counteract inflation now, without jeopardising future growth prospects.

Secondly, there is an urgent need to rebalance the global economy by bringing the large American deficit on balance of payments and public finance into line. This can only be done by reduced real income in the US. Such a prospect only seems palatable if combined with higher growth. Americans must produce more and consume less. This is going to happen. The question is when and how. If the US does not agree a policy mix with other major economic partners, the market, probably via a falling US dollar, will do it, and the ride may feel like jumping onto a roller coaster, not knowing when it stops.

Thirdly, the huge windfall profits accrued by the oil exporting countries must be recycled into the global economy. Purchasing power is removed from the global economy as long as these funds are sterilised.

Fourthly, the experience gained over a number of years point to adjustment imperfections in industrialised countries and probably also in some emerging market economies, explaining rising prices. Macroeconomic policy such as fiscal policy and/or monetary policy are simply not suitable instruments, while microeconomic or sectoral/structural policies have a much better record as corrective mechanisms. Examples include less rigid employment rules, a more effective and efficient capital market, measures to improve productivity and life-long learning.

Fifthly, steps to coordinate global economic policies have to be much more effective than is the case today. It is strange to see the International Monetary Fundcompletely out of the game instead of seeking to establish consistent policy

measures among the five or six major economic powers. The fundamental problem is that both international institutions and the major economic powers see national economic policy as an issue not to be influenced by other states. How they can take this line in the era of economic globalisation is hard to fathom.

Finally, the use of the US dollar as the denominator for global prices of commodities including oil, is a remnant of the past when the US economy was the undisputed leader and therefore market for these products. There is an alternative. It is a basket of currencies comprising the US dollar, EURO, Yen and perhaps the Yuan and Rupee.With such a basket, commodity prices would be more stable than now with one currency as the denominator. Since 2004, the US dollar has depreciated approximately 15-20% against all other currencies. It is possible, even likely, that at least some commodity exporting countries/companies have acted to counterbalance the fall in the $US, thus complicating an already difficult situation.

A basket would politically signal that we live in the era of globalisation and it would draw a number of countries into the picture as responsible for the global economy. Economically it would reflect the reality, which is that demand (and price) for commodities is not dependent upon one, but a number of countries and the risk of spill-over to commodity prices and economic (including exchange rate) policy would be reduced.

Often the argument is heard that the market is pushing prices up or down. That is only true as far as appearances are concerned. Free competition in the economic sense has long since given way to a situation where prices are set by a limited number of big suppliers without fear of newcomers as the initial cost of entering into global business constitutes an almost insurmountable barrier. Commodity prices including the price of oil is in general set by a few major suppliers. While these entities take demand and supply into consideration, they retain considerable scope for maneuver nonetheless.

What the world needs to do is to take a hard look at the realities to understand that the global economy is different from the picture defined by conventional wisdom. If the major players do not change track to adjust, the global economy will be driven in circles for some time yet.

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