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The search for missing inflation

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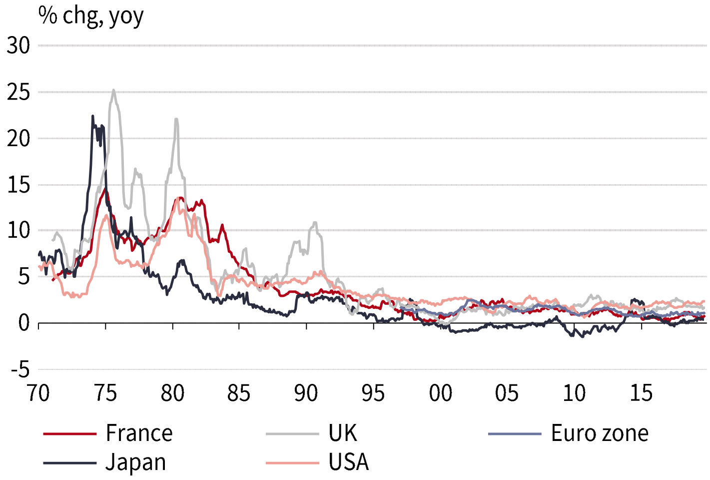
For fifty years, the obsession for combating inflation has dominated OECD economies. Today, inflation has virtually disappeared; central banks are struggling to increase it towards their 2% target. There are multiple causes and they are often linked: globalisation, technological innovations, weakening influence of trade unions, lacklustre global demand, weak inflation expectations… The spectre of "Japanisation" now hovers over the developed economies.

We have moved into a new world. A world where inflation remains sluggish despite enormous monetary creation since 2008. A world where prices no longer rise notwithstanding the decline in unemployment. In the eurozone, underlying inflation (which excludes the most volatile components such as oil and food) came to 1% year-on-year in October, far from the European Central Bank's (ECB) 2% target. In Japan, it is close to zero. In the US, core PCE (personal consumption expenditures) inflation – the Fed's preferred measure of inflation – is now below 2%, whereas the economy is at full employment.

Core inflation



Despite the wealth of imaginative ideas that they have implemented since the 2008 crisis (quantitative easing, close to zero or even negative interest rates), **central bankers have failed to achieve their long-term 2% inflation target**. What a reversal! Whereas since 1945, inflation has been the bearer of many evils, today the developed world is incapable of increasing it to 2%!

Why does inflation remain so obstinately low?

Deflationary pressures are not new: they date back to the 1980s; **several phenomena played a role**:

- First and foremost, there was the priority given by central bankers to **combating inflation** from the early 1980s; the anti-inflationary credibility that this conferred on them enabled inflation expectations to be anchored at a low level.

- Secondly, **globalisation** was a powerful deflationary force. Globalisation meant that there was an influx of cheap products and services from China and other emerging countries into the developed world, lowering the prices of imported products and increasing the competition for local companies.

- **Technological innovations** also increased deflationary pressures through three main channels: 1) e-commerce led to additional competition by enabling customers to compare prices online before purchasing; 2) automation in virtually all sectors resulted in lower productions costs and, in turn, lower prices in the shops; 3) the decline in the price of technological components, coupled with the extension of the digital offering, resulted in a constant fall in the prices of products with a high technological component for consumers.

- Finally, the **weakening influence of trade unions** in the developed world moderated inflation by blocking the "price-wage" loop. The increase in labour supply (first and foremost Chinese) on a global scale and fears of factory relocation to low-cost countries, combined with the increased flexibility of the labour market, with a higher proportion of precarious contracts (short-term contracts, "zero-hour" contracts, etc.), has, in recent decades, profoundly changed the balance of power between employers and employees to the detriment of the latter, which has eroded the power of trade unions and limited the rise in wages.

The 2007-2008 financial crisis marked a new turning point. When the developed economies sank into recession **there was a sharp decline in inflation** due to a powerful **negative demand shock**. However, since 2012, the global economy has returned to a moderate growth path. And yet, despite the recovery in demand, underlying inflation has remained sluggish – a phenomenon whose explanation continues to be discussed.

However, there is no doubt that **weak inflation expectations, largely due to the long-term decline in inflation, are helping maintain inflation at a low level**. Economic agents largely use past inflation to predict future inflation. And as they take into account their inflation expectations to set prices and wages, these expectations directly affect current inflation. In Japan, inflation has on average been zero since the 1980s.

The spectre of "Japanisation" – or "secular stagnation" as referred to by former US Treasury Secretary Larry Summers – **is hovering over the developed world**.

Japanisation is the expression used by economists to describe **Japan's more than 30-year battle against more or less latent deflation and anaemic growth**, by resorting to extraordinary but relatively ineffective or non-effective monetary stimulants, that have caused interest rates to decline to zero, while the public debt has soared to record levels, all against the backdrop of an ageing population.

Durably low inflation is a major challenge: it increases the weight of real debt; it makes it more difficult to adjust real wages in the event of an economic shock; and more importantly, it reduces the leeway of monetary policy when interest rates are already at levels close to zero.

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