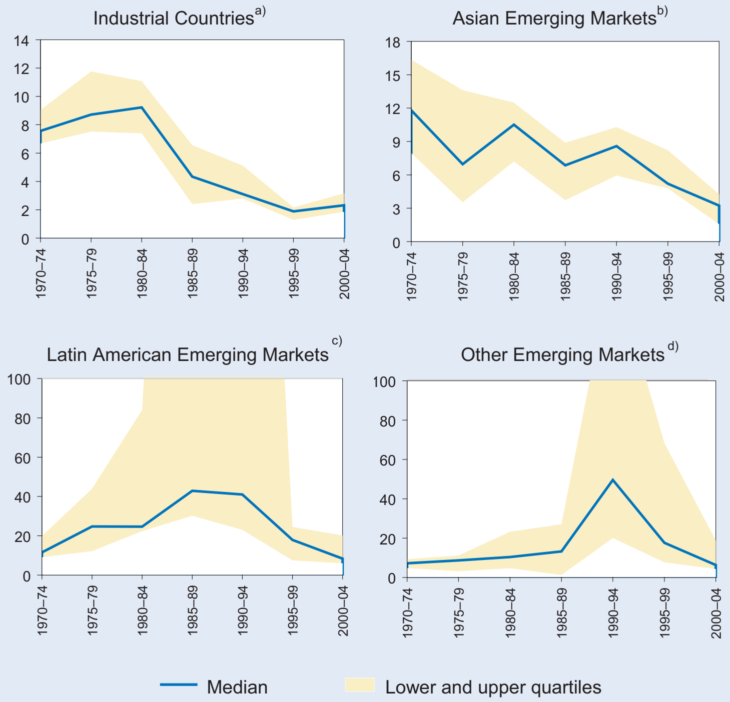
Globalisation and Inflation

In its latest World Economic Outlook, the International Monetary Fund looked at the relationship between globalisation and inflation.[1] It arrived at the following conclusions:

- Over the medium term, inflation is determined by the objectives of central banks' monetary policy, such as inflation targeting. The impact of globalisation on inflation will, therefore, be temporary unless it changes the overarching objectives of monetary policy. This is unlikely in industrialised countries, given their already low inflation targets. In emerging market and developing countries, however, greater openness may have been an important factor in lowering inflation.
- The direct effect of globalisation on inflation via import prices has generally been small in industrialised countries, although import price declines due to global increases in spare capacity have had sizable effects over one- to two-year periods.
- Globalisation has helped reduce the sensitivity of inflation to domestic capacity constraints in advanced economies, for example, through the impact on labour markets and wages.
- Globalisation has had a significant effect on relative prices in industrialised countries with the largest declines in relative prices in sectors that are most exposed to foreign competition, particularly in low-tech and low-skill sectors. In the high-tech manufacturing and services sectors, productivity growth has also contributed to changes in relative prices.

Inflation

Distribution of five-year averages of year-on-year CPI inflation across countries



a) Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States.
b) China, India, Indonesia, Korea, Malaysia, Philippines, Thailand
c) Argentinia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Venezuela
d) Czech Republic, Egypt, Hungary, Poland, Romania, Russia, South Africa, Turkey.

Source: IMF staff calculations.

To summarise: Globalisation has certainly had a dampening effect on inflation in the industrialised countries in recent years and has allowed for a "more measured monetary policy tightening" to date.

How will globalisation affect inflation in the future?
According to the IMF, ongoing trade integration will continue to put downward pressure on prices in many industries, as China's share in world trade, for example, may double over the next decade. Moreover, international trade in services will also accelerate, leading to declining relative prices in certain sectors.

On the other hand, strong global growth and declining economic slack have reduced the restraining impact of import prices on inflation. With strong global growth expected to continue, a further upturn in import prices may result in stronger inflationary pressures going forward. The possibility of further commodity price increases adds to these upside risks.

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[1] International Monetary Fund, World Economic Outlook, April 2006, Washington, DC, Ch. 3.