End of "The Great Moderation"

Gabriel Stein says the recent low inflation period is different from previous ones.

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Gabriel Stein, Director of Lombard Street Research, an economic research and forecasting firm based in London, was in Israel earlier this week warning that inflationary pressures worldwide could bring an end to the era of the 'Great Moderation'.

According to Stein, "The past fifteen years have been characterized by what some commentators call 'The Great Moderation.' The salient points of the Great Moderation are low and stable inflation and low business cycle volatility. In this, it differs not only from previous decades, but also from previous low-inflation decades, which were characterized by substantial volatility on both counts (prices and output)."

The Great Moderation was the result of a number of coinciding factors, explained Stein. The most important of these are the shift to independent inflation-targeting central banks and the downward pressure on prices of traded goods resulting from globalization, notably the entry into the world economy of a large low-cost workforce - primarily from China and India.

However we may now be past the benign phase of globalization and entering what for prices is a malign phase, Stein argues. Increased demand for resources and rising wages in the low-cost countries will push up global inflation. Until recently, China exported net deflation; the inflationary impact of China's booming oil demand was more than offset by the deflationary effect of cheap Chinese goods. But now China is itself grappling with growing inflation and export prices are also rising. Chinese manufacturers are battling not only with higher oil energy costs but rising wage inflation. The increased demand for skilled labor, still in short supply in China, led to an increase of nearly twenty percent in wages in the first quarter of this year. Spiraling prices may not be just a passing phase. As Asians get higher paychecks, they consume more and demand higher quality products, placing inflationary pressures on many products.

"China is only in the early stages of a rapid industrialization so its commodity demand will become even more inflationary over time," said Stein. "And now the deflationary benefits of cheap Chinese labor are receding as well, as the country tries to move up the value chain."

A key question is how central banks will react, explains Stein. Taking their cue from the 1970s, they are likely at first to negate inflation, rather than validate it. This means that - over the next decade - we are likely to see higher nominal and real interest rates than we have seen during the Great Moderation. The next question is whether this is a sustainable situation.

Stein noted that the Bank of Israel has so far chosen the correct cautionary road of fighting inflationary pressures, holding back the demands of the financial markets and manufacturing associations. In contrast, the US Federal Reserve appears to be adopting the path of lower interest rates to encourage consumption and investment, hoping to also reduce financial market turmoil. Stein supports the current stance of the Bank of Israel and disagrees with the decisions of the Fed. "Market turmoil is not a reason to cut interest rates, central banks are emphatically not in the business of rescuing investors from failed investments," he said. Stein quotes the philosopher-insect Jiminy Cricket: "You've buttered your bread, now sleep in it!"

Stein maintains that inflation may be a far more pernicious economic force that needs a tough and independent Central Bank to combat it. Stein's insights on the likely end of the era of the Great Moderation should certainly make those supporting a new Bank of Israel Law pause for second thought.

Gabriel Stein worked for the International Relations Department of the Israeli Ministry of Finance. He is now a director of London's Lombard Street Research and co-founder of the World Service.

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