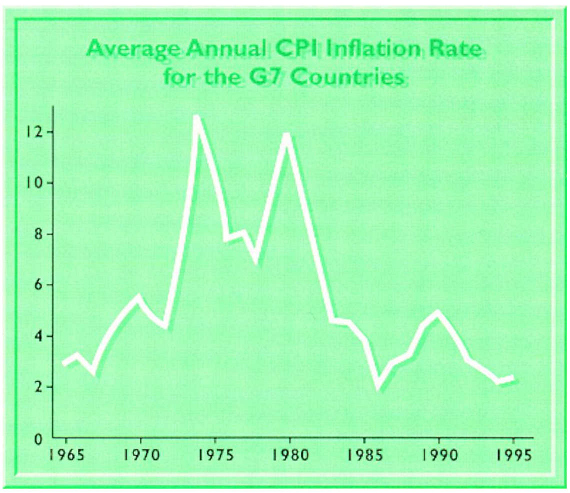
From the Editor

Christopher Ragan

INFLATION HAS BEEN A PART OF OUR LIVES FOR SO long that it is hard to believe that some people are now—finally—debating whether in fact inflation is yesterday's issue. The debate is not about whether the current low rate of inflation is a problem, but whether the cause of inflation's recent demise implies that it will no longer be a problem in the future. In this debate, there seems to be the puzzling belief that the sustained inflation we experienced for over 20 years "just happened", that it had nothing to do with policy decisions, especially those of central banks.

Through the Twin Peaks to the Valley

The path of inflation in the G7 countries for the past 30 years has traced out a mountain with twin peaks. For the decade following the early 1960s, inflation varied between 3% and 5% per year. Then the first OPEC oil shock in 1973, together with substantial price increases in lumber, grain and livestock, led to a more-than-doubling in the rate of inflation. For the next few years, inflation fell; but it rose sharply again with the second OPEC shock in 1979. The inflation, initially unexpected, redistributed income in arbitrary ways: away from creditors and toward debtors; away from fixed-income pensioners; and away from workers on fixed-wage contracts. As inflation persisted, consumers, workers, firms, and governments were forced to rethink the way they made decisions. Cost-of-living clauses became pervasive, indexed bonds were introduced, inflation hedges of various sorts made their appearance; in short, considerable resources were diverted away from producing "useful" things and toward "dealing" with inflation.



Source: Bank of Canada

By 1980, enough was enough; high and volatile inflation was costly. With nearly 10 years of high inflation behind them, central bankers around the world were finally prepared to inflict the necessary pain to reduce it. Paul Volcker, as Chairman of the US Federal Reserve, engineered a significant monetary contraction in the US. And central bankers in other countries closely followed suit. Not surprisingly, the world entered into what was then the largest recession since the Great Depression. But inflation did come down, and fast. By 1985, the average inflation rate in the G7 was about 2%, down 10 percentage points from its (second) peak in 1980. The strong economic recovery that followed brought with it another increase in inflation so that by 1990 inflation was about 5%.

Despite the fact that inflation in 1990 was only slightly higher than the levels of the mid-1960s, central bankers were not prepared to call it quits. The words "price stability"—zero inflation if taken literally—appeared more frequently in their formal policy statements. From 1990 to today, inflation in the G7 has fallen from about 5% to just over 2%. Though there is some variation across the countries—just over 0% in Japan; at or below 1.5% in France, Germany and Canada; just over 2% in the UK; and 3% or more in the US and Italy—the overall picture is certainly one of low inflation.

The Death of Inflation?

It is in this setting that the debate over the death of inflation has made its appearance. And its importance has led *World Economic Affairs* to devote the *Forum* in this issue to explore both sides of the debate. Roger Bootle, Chief Economist at the HSBC Group in London, is arguably the lead proponent of the "inflation is dead" school. His article, which draws on his recent book, *The Death of Inflation*, argues that the rapid pace of technological change, the increase in competition due to globalisation, and the weakening of union power have all combined to make inflation an all-but-dead phenomenon. Bootle suggests that central bankers have only a limited influence on the path of inflation.

Arguing that inflation is down but not necessarily out is John Crow, the former Governor of the Bank of Canada. It was under the leadership of Crow, from 1987 to 1994, that the Bank of Canada established "price stability" as its ultimate objective and also established a formal set of inflation-control targets. Crow quickly established his inflation-fighting credentials within the group of central bankers. Not surprisingly, Crow argues that the future path of inflation depends crucially on central-bank policy, and that there is no reason to be sanguine about the threat of future inflation.

The path from the twin peaks to the valley took 15 years and was by no means an easy or painless descent. But what lies ahead? Does the valley go on indefinitely, or is there another peak to climb? I hope that after reading this issue of *World Economic Affairs* you will have a better idea at least of what footwear to choose. ◆

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