Why isn't inflation higher?

One of the biggest enigmas of the current economic situation is the evolution of inflation in developed countries. In spite of implementing extraordinarily accommodative monetary policies, in a large part of the developed world prices have only grown very slightly and in some cases there have even been brief episodes of deflation. This seems to cast doubt on the validity of one of economics' most outstanding laws: namely, and to paraphrase Milton Friedman, that inflation is always and everywhere, at least in the long term, a monetary phenomenon.

The Dossier in this *Monthly Report* provides information and analyses this question, examining the key points in the debate. Firstly, measuring inflation and to what extent statistics are able to accurately capture improvements in the goods and services provided to citizens. In the digital era, more effort must be made to ensure official data reliably reflect a quickly changing reality. Without a good indicator for inflation we are unlikely to reach a correct diagnosis of the problems economic policy needs to tackle.

Secondly, evaluating inflation expectations, given that these help to determine the actual level of inflation observed. Here the Dossier urges a measure of caution when using expectations indicators based on the price of some financial products. As in other areas of the economy, the fact that a financial product is traded on an organised market does not necessarily mean it provides an accurate picture of the underlying value of certain economic variables.

Equipped with these basic tools, readers of the Dossier can then explore this issue further via a systematic examination of the different factors that may result in long-term low inflation. By way of a summary, here is a list of the main ones:

The first is the drop in commodity prices. The third article in the Dossier looks at the mechanisms through which this drop affects the rest of the price index components, pointing out that it is having a widespread and persistent impact on core inflation, in spite of being a temporary shock.

Second is the excess supply which, after the Great Recession, reached very high levels that are turning out to be difficult to eliminate. In some countries, such as the United States, the level of GDP is already close to its potential, but some analysts believe that the inflation of a specific country also depends on global excess capacity.

Third, the credibility of central banks, which has reduced price sensitivity to the cyclical situation of the economy. Throughout the crisis this factor has helped to avoid deflation but it also makes it difficult for the inflation rate to go up again once the economy starts to recover.

Four, the failed transmission mechanism of monetary policy due to the nature of the crisis we have just been through. After a debt crisis involving the bursting of asset bubbles and the deleveraging of many participants (financial and non-financial), expansionary monetary policies are passed on very slowly to final demand for goods and services, and only as economic agents manage to balance their books again.

In conclusion, the mystery of absent inflation can only be solved if we take into account the fact that many different factors determine inflation and that, consequently, there are many reasons why it remains so low. Given the unusual extent of the monetary policies developed by central banks to achieve their growth and inflation targets, the list of factors we have mentioned provide a useful guide to those issues that need to be examined to ensure future economic policy is flexible enough and therefore capable, when the time comes, of welcoming inflation, at the same time ensuring the problem of insufficient growth in prices does not become a different problem of excessive growth.

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