

Box A

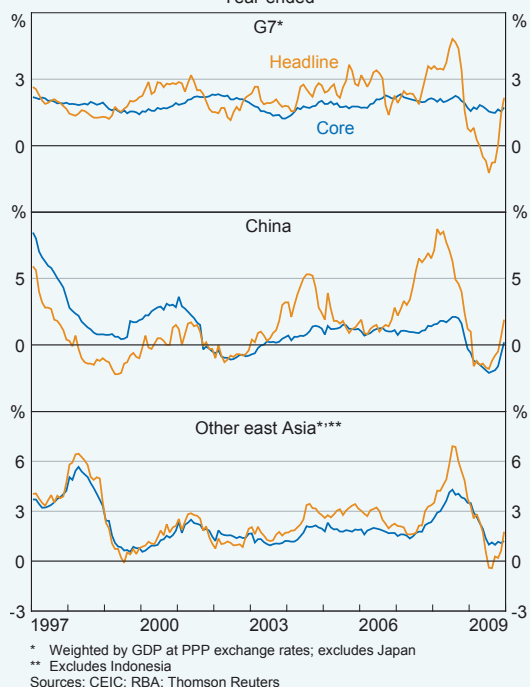
Global Developments in Inflation

Consumer price inflation has slowed considerably across the world through 2009. After peaking around September 2008, annual inflation turned negative in many countries around mid 2009 (Graph A1). In most cases, this was the first occasion that annual inflation has been negative in the post-war period. This sharp decline was driven by the global recession, and particularly its effects on oil and other commodity prices. While oil prices have since recovered – and headline inflation is again positive in most countries – they remain well below the levels seen prior to the onset of the global recession (Graph A2).

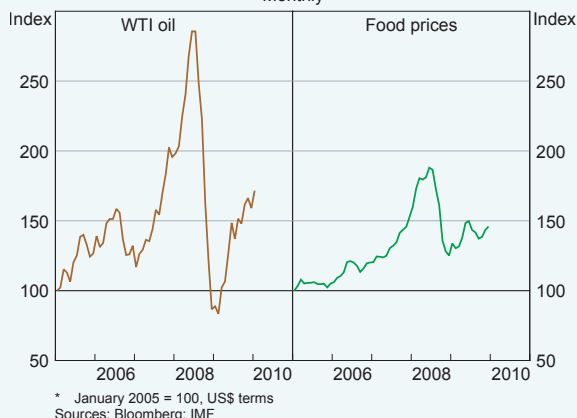
The effects of the global recession and the significant expansion of spare capacity in most economies can also be seen in measures of ‘core’ inflation, which typically exclude the effect of changes in oil and some food prices. Core inflation has declined across a wide range of countries since September 2008 (Graph A3). The extent of the decline has been most pronounced among the Asian economies, which had earlier experienced significant run-ups in core inflation; the median fall among a broad sample of emerging Asian economies has been around 2½ percentage points. The size of these declines reflects the higher responsiveness of inflation to output developments in many Asian economies. Price and wage setting arrangements in these economies are more flexible given the greater degree of informality in employment contracts and pricing.

The extent of the moderation in core inflation among developed nations has been smaller, with a median decline of just over 1 percentage point. Some advanced economies that have had particularly large falls in output – for example, Ireland and

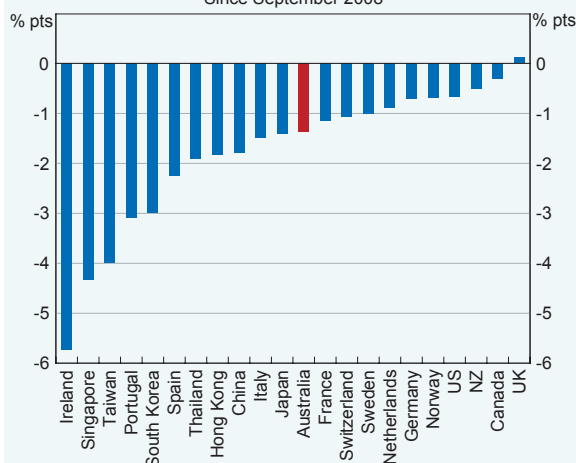
Graph A1
Consumer Price Inflation
Year-ended



Graph A2
Global Oil and Food Prices*
Monthly



Graph A3
Change in Year-ended Core Inflation
 Since September 2008



Sources: ABS; Central Statistics Office Ireland; RBA; Thomson Reuters

Spain – have also had larger-than-average declines in core inflation. However, other advanced economies have had relatively small declines in year-ended core inflation. This, in part, reflects lags in the response of inflation to changes in output, with the maximum effect typically estimated to occur after around one year;¹ hence there is stronger evidence of disinflation in rates calculated using only data for the past three or six months.

The relatively small moderation in inflation in some countries is also partly explained by significant currency depreciations in the early stages of the crisis. For example, the United Kingdom, Canada and New Zealand all saw trade-weighted depreciations of more than 15 per cent in late 2008 and early 2009. The effect of this on the prices of imported goods is most evident in the United Kingdom, whose currency has depreciated by around 25 per cent in trade-weighted terms since September 2008; the year-ended rate of change in core tradables prices

is estimated to have risen to around 3 per cent recently, compared with an annual average of minus 1½ per cent during the past decade.

Traditional measures of core inflation have also been affected by special factors or government decisions in some countries. For example, in the United States a one-off rise in the price of tobacco (which increased by 30 per cent due to a 250 per cent rise in federal excise last April) has boosted the standard core inflation measure. Reflecting this, alternative measures of underlying inflation such as the trimmed mean and weighted median produced by the Federal Reserve Bank of Cleveland have declined more sharply than the standard core measure (falling by a little over 2 percentage points). In Canada and New Zealand, statistical measures of inflation have also fallen by more than the standard core measures.

As these temporary impacts fade, core inflation rates are likely to fall back further. Consistent with this, bond market prices suggest an expectation that inflation will ease further over the next two years in the United States, United Kingdom and Europe. Beyond that, however, there is considerable uncertainty about the medium-term outlook for inflation. More than 15 per cent of financial market participants recently surveyed by J.P. Morgan expect annual inflation to exceed 4 to 4½ per cent in the United States and United Kingdom over the medium term, with around three-quarters of these respondents citing large government deficits as the reason, while 10 per cent expect inflation to remain around 1 per cent or less, due to persistent economic weakness. ❖

¹ See, for example, Smets F and R Wouters (2004), 'Comparing Shocks and Frictions in US and Euro Area Business Cycles: A Bayesian DSGE Approach', European Central Bank Working Paper No 391.