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## Can the Federal Reserve control inflation in a global marketplace?

**Can the Federal Reserve control inflation in a global marketplace?** Yes, it can. The growing integration of world markets has by no means diminished the Federal Reserve's ability to control inflation. If anything, the more intense competition associated with global openness complements the FOMC's efforts to achieve price stability. Since 1980, as trade and competition between nations has progressed, the rate of inflation in the United States has fallen precipitously. Even as commodity prices are rising here and internationally, domestic inflation remains firmly under the Federal Reserve's control.

One of the bedrock principles of economics is that trade is mutually beneficial. When one nation profits from trade, it does not necessarily mean the other loses—it is not a zero-sum game. The concept holds when applied to prices. Cross-border competition generally has a favorable impact on the level of consumer prices, whether for steel or software.

Globalization provides firms with access to lower-cost inputs while it reduces firms' ability to mark up prices beyond what is necessary to cover their costs and provide a competitive rate of return. Separately, openness fosters specialization and cross-border technological transfers, both of which reduce prices through productivity gains. International trade also tends to keep wage rates at competitive levels. Moreover, prices and wages that evolve in such competitive environments tend to adjust more flexibly to changes in underlying market conditions than prices and wages that arise in less-competitive situations.

Still, with world commodity prices now on a sharp upward path, and with inflation rising in some developing countries, notably China, many observers wonder if higher import prices will serve as the conduit to growing inflation in the United States. A sharp rise in import prices—particularly in goods like oil that are used in the production of other U.S. goods—can put upward pressure on a broad swath of consumer prices.

These price strains will always prove transitory, provided that the Federal Reserve System does not accommodate them through a monetary expansion.

Increases in the prices of imports and in the prices of domestic goods made with imports have two general impacts on the economy. First, they cause consumers and businesses to switch to cheaper alternatives whenever possible. This substitution effect can cause the prices of the alternative goods to rise, of course, but competition tends to limit their size. Second, the rise in import and related prices reduces the purchasing power of consumers' income, much like a tax. This income effect ultimately limits the scope of price increases—prices can rise only so far before consumers completely stop buying those products, given income constraints—unless, of course, income somehow expands along with the price pressures.

The only way that can happen is for the Federal Reserve to ease monetary policy. In fact, the FOMC often did so in the 1970s, fearing that the income effect from sharply higher imported oil prices would otherwise lower output and employment. The results were disastrous, ushering in the unintended effect of upward spiraling inflation and stagnant growth. Easing monetary policy in an attempt to minimize output losses can convert a broad-based relative price hike into inflation with—at best—uncertain, temporary gains to employment and output. Ultimately, the economy still must adjust to elevated import prices, but having to adjust to a higher rate of inflation on top of relative price increases is a recipe for recession.

Keeping the focus of monetary policy on a low and stable inflation objective, in contrast, allows the economy to adjust to higher relative import prices without the added uncertainty about how and when the central bank will wrench it back out of an inflationary environment. Commodity prices may grab the headlines, but remember: The conduit of inflation is always monetary policy. ♦