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Global Trends May Hinder Effort to Curb U.S. Inflation

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JACKSON HOLE, Wyo., Aug. 27 — As the Federal Reserve fiercely debates how to reduce inflation within the United States, economists are warning that trends outside the country may soon make the Fed's job much harder.

In recent years, global integration has made things easier for the Fed in two ways. An explosion in low-cost exports from China and other countries helped keep prices of many products low even as Americans spent heavily and loaded up on debt.

At the same time, China and other relatively poor nations reversed the normal patterns of global investment by becoming net lenders to the United States and Europe. Analysts estimate that this "uphill'' flow of money from poor nations to rich ones may have reduced long-term interest rates in the United States by 1.5 percentage points in recent years — a big difference when home mortgage rates are about 6 percent.

But as Fed officials held their annual retreat this weekend here in the Grand Tetons, a growing number of economists warned that those benign international trends could abate or even reverse.

For one thing, they said, China's explosive rise as a low-cost manufacturer does not mean that prices will fall year after year. Indeed, China's voracious appetite for oil and raw materials has aggravated inflation by driving up global prices for oil and many commodities.

Beyond that, new research presented this weekend suggested that the United States could not count on a continuation of cheap money from poor countries. Those flows could stop as soon as countries find ways to spend their excess savings at home.

"Medium- and long-term interest rates are set outside of the country,'' said Kenneth S.

Rogoff, a professor of economics at Harvard University and a former director of research at the International Monetary Fund. “It’s very important to think about what to do if the winds of globalization change.’’

The warnings come as the Fed’s new chairman, Ben S. Bernanke, faces widespread skepticism among economists about his forecast for a “soft landing” — a mild slowdown that will tame inflation without costing many jobs.

Inflation is already running above Mr. Bernanke’s unofficial target — 2 percent a year, excluding energy and food prices — and few analysts here say they believe the Fed will raise rates and slow growth enough to bring inflation down to its target anytime soon.

“They are in a box, and they know it,” said John H. Makin, an economist at the American Enterprise Institute and a hedge fund manger. “It’s an awkward position for them to be in.”

Economists presenting papers at the Fed retreat said that the central bank may be hindered as global trends that have kept inflation and interest rates lower than they would otherwise be turn less favorable.

The biggest change could be an increased reluctance by foreign investors to finance the United States’ huge trade gap, now more than $700 billion a year.

“What happens if foreign investors decide they don’t want to accumulate American assets any more?” asked Martin S. Feldstein, economics professor at Harvard and president of the National Bureau of Economic Research.

“Something has to change to make the debt more attractive — an increase in interest rates in the U.S. or a decline in the exchange rate of the dollar,’’ he continued. “In the short term, the Fed will face slowing output growth, possible with higher inflation.”

For the moment, bond investors appear to accept the Fed’s view that inflation will remain low. Long-term interest rates have actually edged down slightly since the Fed decided on Aug. 8 not to raise overnight rates.

But economists, including some leading bond investors, predict that inflation will creep higher even if oil prices stop climbing.

“The consensus among people here is that the Fed’s real target is not 2 percent but about 2.5 percent,’’ said David Hale, an economic forecaster in Chicago. Looking ahead 12 months, if Fed members do not make progress bringing inflation down, “it’s going to call into question their credibility,’’ he said.

Members of the Federal Open Market Committee, which sets monetary policy, appear torn. In a sign of uncertainty this weekend, Mr. Bernanke and all other senior Fed policymakers were unusually tight-lipped about any of the issues — wage trends, the ability of companies to pass higher costs on to customers, or the plunge in home sales — that are at top of their agenda.

Mr. Bernanke has been arguing that inflation will cool as annual economic growth slows to 2.5 percent, from about 3.5 percent.

But some Fed officials, worried that inflation pressures are becoming more entrenched, want to take tougher action. Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, voted against the pause in rate increases.

Michael H. Moskow, president of the Chicago Fed, strongly suggested last week that he favored higher rates and declared that the risks of higher inflation were greater than the risks of an unexpectedly sharp slowdown. Mr. Moskow is not currently a voting member of the policy committee, which rotates the regional bank presidents, but he participated in the debates.

Ethan S. Harris, chief United States economist at Lehman Brothers, said the Fed’s focus on core inflation understated the challenges posed by international shifts. The focus, he said, includes the price-lowering impact of China’s expansion but excludes the impact of higher oil prices. “They’ve included the part that makes things look better and thrown out the part that makes things look worse,” he said.

Officially, the Federal Reserve does not set explicit targets for inflation. But Mr. Bernanke, a longtime champion of inflation targets, has said that his own definition of price stability is to keep core inflation between 1 percent and 2 percent a year.

The Fed’s job is not made any easier by the upcoming midterm elections, in which Republicans are struggling to keep from losing control of both the House and Senate.

The Fed has two policy meetings, in late September and late October, before the November elections. The central bank often likes to avoid any interest rate changes immediately before an election, for fear that it will be accused of interfering on behalf of one party or another.

Regardless of what Mr. Bernanke does in the next few months, economists at the conference here said that globalization and the United States' growing foreign debt could make his job more difficult.

Raghuram G. Rajan, the International Monetary Fund's current head of research, presented new research to explain why many poorer countries are now net lenders to rich countries — and why they might change course. He argued that fast-growing poor countries relied less on foreign capital than many nations, and that they saved much more than they invested.

One example is Chile, the most prosperous country in Latin America. Thanks to soaring copper prices in recent years, Chile has paid off its government debt and is running a budget surplus equal to about 7 percent of its gross domestic product. Chilean leaders are putting the surplus into a long-term stability fund, part of which is invested in foreign securities, that will be used to maintain full government operations if copper prices plummet.

Mr. Rajan said many countries might not have a way to channel their excess savings because their banking systems were too underdeveloped. If so, the savings rates of those countries may decline as people become more accustomed to rising incomes and as banks find ways to rechannel savings into consumer and business loans.

Even though capital is flowing uphill to rich countries like the United States right now, Mr. Rajan said, "it doesn't mean these flows are optimal, safe or permanent."