U.S. Inflation and the International Economy

MUCH IS BEING made of the apparently contradictory signals being sent by various U.S. economic indicators. The nation's falling unemployment rate and rising industrial capacity utilization rate would seem to indicate inflationary pressures. But even with the lowest unemployment rate in decades, prices haven't moved much, and the producer price index has actually fallen this year (*Chart 1*).

A number of explanations have been offered for the apparent contradiction of an economy growing despite capacity constraints and without inflation. Many of these explanations involve domestic factors. For example, some analysts argue that falling domestic computer prices and increasing computational capacity explain at least some of the decline in overall prices and increases in overall output. Similarly, growth in the domestic labor force may explain why the low unemployment rate has not set off wage pressures that led to price increases.

Some explanations for the contradiction between what look like strains on U.S. productive capacity and the absence of substantive inflationary pressure are international. One candidate involves exchange rates. Chart 2 shows the Federal Reserve Bank of Dallas' real trade-weighted value of the dollar index. This chart indicates that, after adjustments for differentials between inflation in the United States and its trading partners, the purchasing power of the dollar in 1997 has been markedly higher than at any time during the 1990s. That a dollar buys more foreign products now than a year ago might mean that foreign competition is disciplining U.S. producers more now than a year ago. Domestic producers that consider raising prices risk losing market share to foreign producers.

Chart 1
The U.S. Producer Price Index, 1990–97

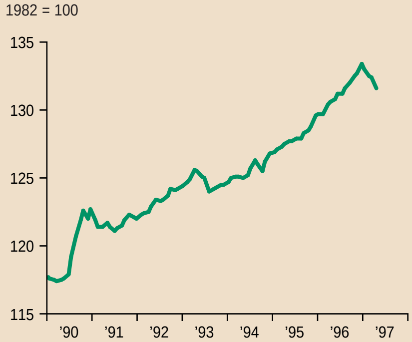
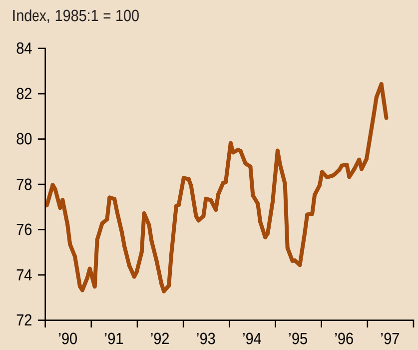


Chart 2
Real Trade-Weighted Value of the U.S. Dollar



Another possible reason U.S. inflation is low despite strains on domestic capacity is that capacity utilization is relatively low in other developed countries. Consequently, increasing U.S. demand can be easily shifted abroad without putting upward pressure on imported goods prices. Chart 3 offers a perspective on this factor by showing manufacturing capacity utilization relative to its 10-year average for each of six countries, including the United States. Indexing capacity utilization to its long-run average is important because differences in countries' methods for calculating capacity utilization make cross-country comparisons misleading.

Chart 3 shows that capacity utilization in most of the United States' principal trading partners is lower than their 10-year averages. With the exception of Canada, all the U.S. trading partners' capacity utilization is below their 10-year average. Not surprisingly, considering the allegations that the United States faces capacity constraints, the U.S. capacity utilization is above its 10-year average.

Even if U.S. buyers do not purchase products abroad, the availability of excess capacity in other countries creates competitive pressures against price increases in the United States. The opportunity for U.S. purchasers to buy abroad from sellers with excess capacity implies that, if U.S. producers raise prices, they may not have domestic customers for long. The very existence of larger excess capacity can dampen upward price pressures.

But despite the presence of this apparent safety valve for U.S. inflation, there is reason to suspect that the pressure release might have only a limited life. Chart 3 shows, that in most countries with capacity utilization below their long-run averages, the indexes are edging up. While a continued strong dollar may permit domestic price pressures to be let off internationally, world capacity constraints may catch up and no longer serve as a release for domestic demand.

—William C. Gruben

Chart 3
U.S. Manufacturing Capacity Utilization