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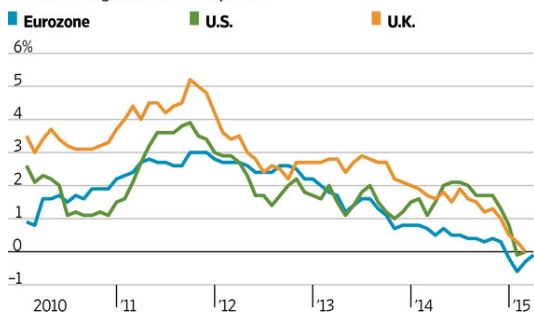
HEARD ON THE STREET

## Zero Hour for Global Inflation

Persistently low inflation is making ultralow interest rates an abnormally normal situation

### Vanishing Point

Annual change in consumer prices



Sources: Eurostat, U.S. Bureau of Labor Statistics, U.K. Office for National Statistics; Associated Press (photo) THE WALL STREET JOURNAL.



European Central Bank headquarters in Frankfurt

By RICHARD BARLEY

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First it was interest rates. Now it is inflation.

Zero is becoming an uncomfortably familiar number. Unpicking the puzzle of ultralow inflation is vital for both policy makers and investors.

Even factoring in lower oil prices, the current readings are remarkable. Annual headline inflation in the U.S. was zero in February. Before its dip into negative territory during the global financial crisis, it had been positive since 1955. In the U.K., where even in 2009 inflation never fell below 1%, consumer prices were flat in February, year over year, for the first time since 1960. In Japan, inflation in February excluding food and taxes was zero. And in the eurozone, the flash reading for March shows consumer prices down 0.1% from a year earlier.

Inflation has fallen despite unprecedented monetary policy. Rates are close to zero and trillions of dollars' worth of quantitative easing has been unleashed. Ultralow inflation also stands at odds with falling unemployment. In Germany, for example, joblessness is at a record low since reunification, yet inflation stands at just 0.1%. Wage inflation has shifted into a lower gear from precrisis levels.

So far, however, markets and central bankers seem more worried than consumers. Extraordinarily low long-term bond yields paint a grim picture of the future; falling market measures of medium-term inflation have flustered central bankers, in particular at the European Central Bank. Even in the U.S., the five-year/five-year forward measure of inflation has fallen.

That is puzzling. The ECB might have a credibility problem in terms of its willingness to push inflation higher, given its Bundesbank heritage and rate increases in 2008 and 2011. But the Federal Reserve should have fewer problems: Indeed, there have been hints that inflation running above target for a while would be no problem. Still, markets appear worried.

Consumers seem less fazed. Surveys of European and U.S. consumers show stable inflation expectations over the medium term, even though they often extrapolate from current levels. Markets seem more guilty of that at present: The puzzling decline in U.S. inflation expectations is highly correlated with the fall in oil prices.

Markets may in fact be fretting more about central banks. With interest rates trapped close to zero, policy makers have little room left to maneuver against falling inflation; Japan's experience is a nagging reminder of that.

There may be a historical bias at work. Many view central banks such as the Fed as essentially institutions for fighting inflation rather than forces for stoking it. And a lot of current policy seems to be aimed at redistributing inflation through currency shifts. Central banks may also be facing pressures that are less amenable to domestic monetary-policy solutions, such as globalization and demographic shifts.

An important indicator now will be wage inflation, particularly in the U.S. and U.K. Job gains have put the so-called nonaccelerating inflation rate of unemployment, or NAIRU, in focus. This may be lower than in the past, due to structural changes in the labor market. But if unemployment falls further and wages remain subdued, central banks will face an even bigger inflation puzzle. In such an unusual situation, their reliance on extraordinary measures may become ever more ordinary.

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