



International Economic Conditions



Will International Excess Capacity Restrain U.S. Inflation?

Recent increases in the U.S. federal funds rate have fostered concerns about accelerating U.S. inflation. Many analysts reject that view, stressing that excess capacity abroad will restrain any acceleration in U.S. inflation. The argument that foreign excess capacity can restrain domestic inflation is questionable, however, and the U.S. evidence fails to support it.

Advocates of a foreign excess capacity effect suggest that inflation results from firms trying to produce more goods and services than their capacity will bear. Firms bid up wages, prices of capital goods and raw materials in an effort to produce more output. As costs of production rise, firms attempt to raise the price of their output. Excess capacity abroad, however, permits production to satisfy U.S. demand to be shifted abroad without generating U.S. cost pressures. With foreign capacity utilization now at relatively low levels, these analysts claim that inflation will remain contained.

Will international excess capacity restrain U.S. inflation? At best, international capacity related price restraint is temporary—and small. As excess capacity is eliminated by production growth, this effect disappears. The foreign excess capacity effect is likely to be small because many goods are not internationally traded. Furthermore, increased purchases of foreign-produced goods tend to reduce the international value of the dollar, boosting domestic prices of imports and reducing the competitive pressures on domestically produced alternatives.

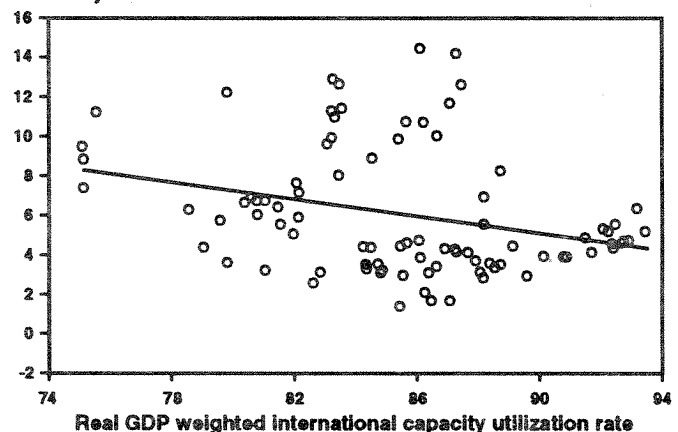
If excess capacity abroad has held down U.S. inflation temporarily, there would be a positive relation between inflation and foreign capacity utilization rates. The chart shows a slight negative rather than a positive relation between U.S. inflation and a measure of the rate of total foreign capacity utilization. The total foreign capacity utilization rate is measured by the sum of several of our major trading partners' (Canada, Germany, Italy and Japan) quarterly capacity utilization rates weighted by their real output levels from 1971 to 1993.

The arguments and evidence fail to support the view that foreign excess capacity can restrain U.S. inflation. Since inflation is caused by excessive growth of the money supply, slowing domestic money growth is the only certain way to reduce inflation.

— Christopher J. Neely

International Capacity vs. Inflation

Quarterly rates of U.S. Inflation



Views expressed do not necessarily reflect official positions of the Federal Reserve System.