



Daily Note: 18 June 2008

Central banks and the return of inflation

WE SUGGEST: Expect higher interest rates in medium term

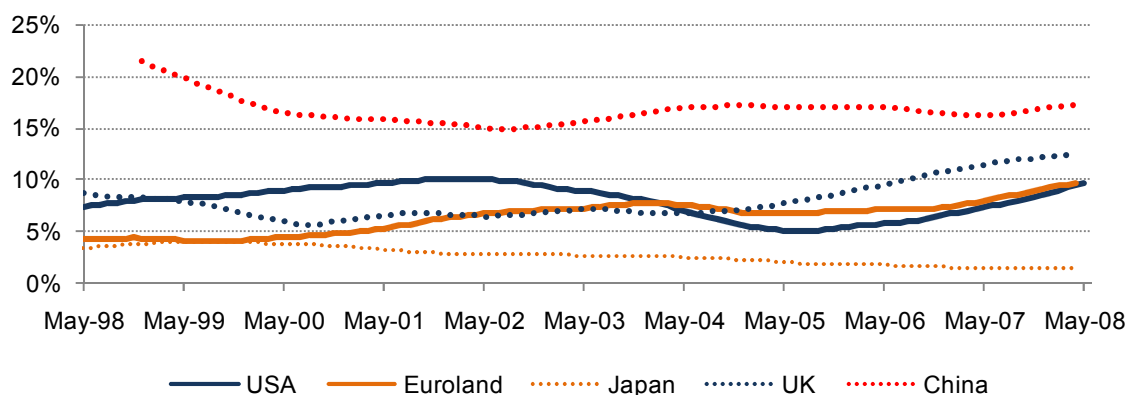
SUMMARY: With the significant exception of the ECB, no major central bank has related recent inflation to broad money developments. Yesterday's letter from Governor Mervyn King to the Chancellor mentioned money but only in passing. But inflation is ultimately a monetary phenomenon. Unless broad money and credit growth is brought down, inflation will not ease.

Yesterday the Bank of England was the latest central bank to have to comment on higher consumer prices. The Governor was once again forced to write a letter to the Chancellor of the Exchequer, explaining why inflation had risen above its permissible target and what the Bank intended to do to bring it down again. Significantly, the Governor's letter held out the prospect of further letters in the autumn, as the rate of inflation is expected to remain above 3% for some months to come.

But it was not so much what the letter contained, as what it did not contain that was peculiar. In a *Daily Note* yesterday, Diana Choyleva pointed out that there was no mention of China, ie how the rest of the world is affected by Chinese overheating. However, in fairness to the Bank, the letter did refer to the impact on British consumer prices of the global balance of demand and supply for food and energy, which is at least part of this story. More curiously, however, the letter only referred to broad money in passing. Given that under Mervyn King, there has been a distinct impression that the Bank is attaching more importance to broad money developments than under previous Governors, the referral to money was strangely brief.

To quote Milton Friedman: "Inflation over any protracted period of time is always and everywhere a monetary phenomenon." Inflationary pressures may be external or internal – but it is up to central banks to negate or to validate them and whether they do so or not will be reflected in the growth rate of broad money and credit.

Broad money, 3-year moving average of 12-month change, %

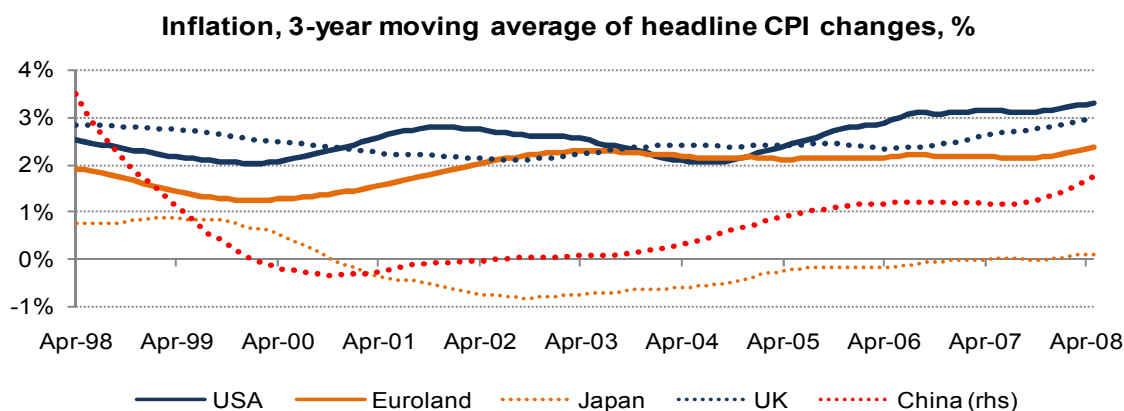


And broad money growth has certainly been buoyant. On a three-year moving average (to smooth out minor fluctuations), nominal broad money growth has almost doubled in the United States over the past two years (from 5.1% to 9.8%), accelerated sharply in the euro-zone (from 7.1% to 9.7%) and in the UK (from 9.5% to 12.4%) and picked up from an already strong pace in China (from 16.9% to 17.4%). Only in Japan has broad money growth continued to ease – but the Japanese situation is already known to be *sui generis*; and even in Japan, as we will see, the rate of inflation is picking up.

It is true that recent broad money growth rates have been somewhat more subdued, although this varies very much from country to country. Not so in the US, where broad money (our recreated M3-like measure) is actually growing at a 37-year high of 14.5% in the year to both April and May. But euro-zone M3 growth peaked at 12.6% in the year to November 2007 and has since come off somewhat, although the latest figure was a small rise to 11.4%; in the UK, M4 growth has slowed to 11.1% in April from a peak at 14.3% in October 2006; while in China there was a recent peak at 18.5% in Q3 2007, easing to 16.1% in the year to May. Moreover, in the advanced economies broad money has probably been artificially boosted in recent months by the reappearance on banks' balance sheets of previously off-balance sheet items.

However, the relationship between nominal broad money growth and output growth in most advanced economies tends to average out with broad money over longer periods of time growing some 1-3 percentage points faster than GDP. At the same time, real trend growth tends to be in the 1½-3½% range, varying from country to country. This means that if acceptable inflation is around 2%, nominal broad money growth should ideally not exceed a 6-8% range, again varying from country to country. If broad money growth remains above this rate for any significant period of time, the result will almost inevitably be inflationary. The case of China is somewhat different, as the country's trend growth rate is considerably higher than that of advanced economies, most likely in the 8-10% range; while a primitive financial system means that the broad money growth probably needs to be higher relative to GDP than in a more advanced economy. However, even in China, broad money growth in the 15-20% range will over a longer period of time be inflationary.

Hence, it is disconcerting to find that over the past ten years, nominal broad money growth in the largest world economies has tended to be on the high side. Over the whole period, the average has been 8.5% in the US, 8.6% in the UK and 16.4% in China, in other words in all three somewhat above what most likely would be compatible with eventual trend output growth. Only in the euro-zone, where the 10-year average is 7.3% is the number in the 'safe zone' – although the profile is skewed, with accelerating growth in the second half of the period.



It should therefore come as no surprise to find that inflation rates in all these countries (and even in Japan) have accelerated over the past three years and is now above explicit or implicit targets in most of them (Japan excluded). Ultimately, inflation will only slow down if broad money and credit growth not only slow down to ranges more compatible with trend rate output growth, but, in the near term undershoot so that long-term averages begin to come down. To put it another way, in order for the world positive output gap to close and a negative output gap to open, world growth needs to go from above-trend, not to trend but to below-trend for some time. But for this, weaker broad money growth is also necessary.

What to do, what to do?

A key reason for the rise of inflation is that we are now in the malign phase of globalisation – malign only in the sense that there is upward pressure on the prices of traded goods and services and also will be on wages. Moreover, much of the developing world is also overheating – not only China, but also other countries in the Far East, the Persian Gulf countries and central and eastern Europe.

The crucial question is therefore how central banks will react to rising inflation. Last week, I was travelling around the United States. At one meeting, I was asked what the worst possible (economic) future I could foresee was. My immediate answer was ‘a return to protectionism and the erosion of the mandates of inflation-targeting central banks’. The debate is certainly already there; in Australia, there have been calls for a change in the RBA’s target, while in the euro-zone, the entire history of EMU has been one of politicians attempting to influence the ECB in non-inflation targeting directions. However, low and stable inflation is a good thing *per se*. Anyone who has lived through the 1970s and 1980s will more than agree. It would therefore be extremely worrying if inflation-targeting were to be abandoned at the first whiff of grapeshot. Moreover, the higher inflation is, the higher inflation expectations are and the more difficult it is to keep the rate stable. A rate of 4% is inherently less stable than one of 2%; and if we are unhappy with 2% and want 4%, what is wrong with 7%? 10%? Or even 12%? Except, of course, that once we begin to hit those rates, households and companies find much of their time diverted as they attempt to ensure that the value of their assets is safeguarded, at the expense of productive activity.

The current situation, with surging commodity prices, in many ways resembles that of the 1970s, with the two oil shocks in 1973/74 and 1979/80. A likely initial reaction from central banks will therefore be to look at those episodes and note that countries whose central banks negated inflation in the first oil crisis (eg, Germany) emerged rather better from the second one; conversely, countries whose central banks validated inflation (eg, Britain), did rather worse. The logical conclusion of that is therefore to tighten monetary policy – as is already happening or imminent in most advanced and emerging economies. The two significant exceptions are the US and the UK. As for the US, I refer to my *Daily Note* last Monday, which discusses the likelihood of the Fed actually raising interest rates, as well as the limited impact this is likely to have, given the possible size of hikes. Suffice it to say that while the Fed is not the cause of current inflation problems, its actions have certainly contributed to them to a not insignificant degree. As for the UK, Diana Choyleva’s *Daily Note* yesterday notes that the Bank of England may not have to tighten monetary policy – not least because monetary conditions in the UK are tighter than in the US – but that not doing so is certainly a gamble and depends on the rest of the world doing the Bank’s job for it.

But it could be foolish to rely on that. The globalised economy almost certainly means that the world output gap is more important relative to the national one than was previously the case.¹ This does not mean that central banks are losing their control over broad money and credit and ultimately over inflation (although their control may never have been quite as strong as they – and we – fondly like to think). But, to again repeat a point made in my *Daily Note* last Monday, it does mean that their relative power is diminished. In order to achieve the same effect, they may have to do more, ie change interest rates in larger steps than the 25bps we have gotten used to of late. Alternatively, there may be a greater need for global co-operation between central banks in time of inflationary stress. From this point of view, the fact that the Fed and the Bank of England are to some extent shirking their responsibilities, is deplorable.

Moreover, keep in mind that inflation currently not only is unusually high but also accelerating in a cyclical downturn; the world output gap may be shrinking, but it is still positive. Unless the coming world slowdown is long and deep enough to bring inflation down below the generally acceptable 2% level, it means that the future upturn will occur with inflation already somewhat elevated by historical standards for the same point in the cycle. The inflation-driving aspects of globalisation will remain, meaning that inflation over the next cycle is likely to be higher than in the past few ones. In order to negate that, central banks are likely to have to keep monetary policy tighter than hitherto. The long-term historical average for real policy rates in the United States and in Euroland (with Germany as Euroland predecessor) is around 1%. Over the next cycle, this could therefore quite likely be 2%; with long-term real interest rates somewhat higher than that.

Gabriel Stein

gabriel.stein@lombardstreetresearch.com

¹ The BIS has published a study (Globalisation and the determinants of domestic inflation, William R White, March 2008) arguing the case for the increased importance of the global output gap. However, it must be noted that an ECB study (Globalisation, domestic inflation and global output gaps: evidence from the euro area, Alessandro Calza, April 2008) disputes these findings, at least as far as Euroland is concerned.