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Economic News

DEFLATION, INFLATION, INTEREST RATES

Stimulus programmes, low interest rates and liquidity glut – just how big is the danger of inflation?

There has recently been mounting speculation that inflation could return in the wake of the liquidity glut induced by the central banks and the state's debt-funded bailouts for the banks and the economy. Our opinion: 1. In a few years time there *could* be a return to seventies-style inflation; but given wise economic policy this is not inevitable. 2. Worries about tomorrow's inflation may not be allowed to lead to a disregard for the far more acute risks of deflation. The prime concern must be to do everything possible to fend off deflation and prevent the downwards spiral in the economy and the employment market that it would bring with it. Once this has been achieved, it will be possible – and necessary – to tackle inflation.

When German inflation shot up to its highest level for 14½ years in summer 2008 there was a heated debate about the return of inflation. In the meantime, the inflation rate has fallen below 1% and customers and the spook of inflation is looming large again in our talks with customers and in the media. To many it appears that the combination of debt-funded economic stimulus programmes, bank-bailout packages and the ultra-loose monetary policy pursued by several central banks must inevitably lead sooner or later to (high) inflation. Is this a probable or merely a possible scenario? Or is it perhaps simply the reflection of a peculiar German sensitivity to inflationary risks?

Inflation is unlikely to be back any time soon, but deflation is quite possible. The economic slump means that demand is increasingly lagging behind supply in many economies, including Germany's. In an environment of rising unemployment the pace of wage increases will slow and companies' pricing power will decline. Although given time economic stimulus programmes may lead to capacity bottlenecks and price increases in isolated sectors – especially in the construction industry – they do not lead to a general inflation process. Indeed, Germany's year-on-year inflation rate will presumably slow to below zero percent for several months. In the USA, consumer prices averaged out over the year will probably even fall. On its own, this does not yet spell true deflation and is mainly the result of cheaper crude oil and other commodities, which is a welcome economic stimulus for importing countries. During a period of genuine deflation, credit and incomes contract, ultimately leading to lower prices across a broad front due to slacker demand, as in the global economic crisis.

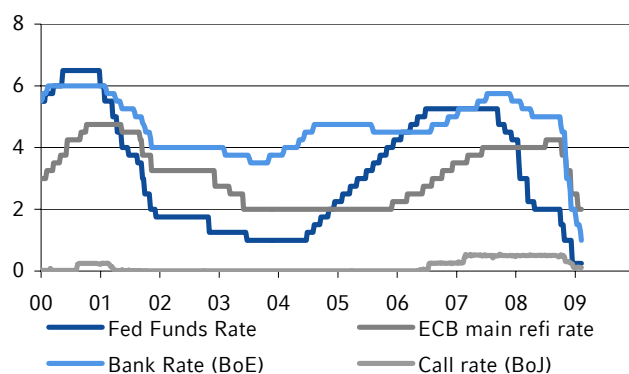
Holger Sandte
+49 211 826-7398
holger.sandte@westlb.de

The statistical evidence that the volume of lending is contracting is an alarming signal for the euro-zone. The deeper the downturn in the employment market, the more likely incomes are to shrink. And in Germany at least the economic stimulus package will not bite before the second half of this year.

Strong economic policy stimuli are needed to ward off the threat of deflation

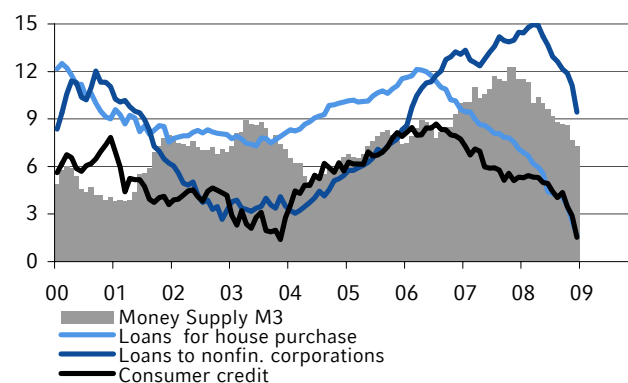
If there is anything to be learnt from the Great Depression in the thirties and the recession in Japan in the nineties it is this: monetary and fiscal policy should provide fast and massive expansionary stimuli, and the phase during which the financial sector fails to function fully must to be kept as short as possible – otherwise deflation and a deep recession, if not a downright depression, are just around the corner. The best way to repair the financial sector is still being sought feverishly on either side of the Atlantic. As regards monetary and fiscal policy, the USA has done more to stimulate the economy than has Continental Europe, but they are following roughly the same line. Measures should be dosed according to the motto “better too much than too little” as – in our opinion – at least – too little would appear to be riskier than too much. And if (moderately) expansionary monetary policy stokes inflation expectations, then this is not work of the devil, but is in fact the very object of the exercise when deflation is imminent, even though central bankers are usually loath to say so.

Key rates, in %



Source EcoWin, WestLB Research

Eurozone: lending to the private sector % y/y change



Source EcoWin, WestLB Research

Ample liquidity supply, but tight lending

Risk of inflation due to liquidity glut? The toothpaste problem

There would be a risk of inflation if the excess liquidity that is being pumped into the banking system by the central banks at extremely low interest rates were to encourage banks to lend generously for consumption or investment purposes. At the moment, however, the opposite is the case: many banks are reluctant to lend. In addition, the credit they are prepared to supply is meeting with slackening demand. As a result, liquidity is not filtering down from the central bank via the commercial banks to companies and consumers for investment and consumption. Although central banks are lengthening their balance sheets they are not doing so to the same extent that many commercial banks are shortening theirs.

But as soon as the economy finds its feet again *on a sustained basis* – we estimate that this will not be the case before next year – monetary and fiscal policy will have to be more restrictive otherwise there will be inflation in the markets for goods and services and/or another bubble will form in the financial markets.

Economic policy will have to be tightened

Governments will have to reduce their budget deficits by raising taxes or cutting spending. The ECB will have to increase interest rates appreciably and throttle back the liquidity supply. It has the instruments needed to drain off liquidity. On the one hand, however, liquidity may be drained off too slowly and too much of it could find its way into the real economy – it is easier to get toothpaste out of the tube than back into it. On the other hand, the ECB could come under pressure to pursue an excessively lax course on the way towards lower interest rates as otherwise governments' interest expenses could get out of control. Heavily-indebted governments could be tempted – as has often been the case in the past – to lighten their debt burden by allowing inflation. However, as governments are notorious for not providing that much-prized commodity “price stability,” independent central banks have been set up around the world, and ultimately they are in a position to halt the inflation process by raising interest rates – albeit at the expense of growth.

The ECB has proven its independence as regards containing inflation

In the past the ECB has proven its independence. However, the zeitgeist could conceivably change and the social consensus in favour of a high degree of price stability could disintegrate. It is possible that inflation “doves” will take over the helm at the ECB and other major central banks in the next few years and will not take such a narrow view of price stability. This is not something that can be forecast seriously, however, which also means it is impossible to rule it out entirely. Such a regression is, however, unlikely in our view. But it still needs to be monitored.

Japan—many years of a zero rate policy and still no inflation

The example of Japan also leaves a small question mark hanging over the apparent inevitability of the inflationary processes. The property bubble burst there at the end of the eighties and during the “lost decade” from 1990 to 2000 the country amassed a national debt of 180% of GDP, from which all other big industrialised countries are a long way off today. The Japanese central bank has been pursuing a zero rate policy for years. Nonetheless, to this day Japan is still not suffering from inflation or high interest rates at the “long end” of the curve.

Conclusion: the dangers of inflation are manageable, bond yield increase relatively moderate

Inflationary risks lead to rising risk premium in long-term bond yields

It would be naïve if one were also to rule out the risk that inflation could rise steeply in the medium to longer term. During the past 18 months much has happened that no-one had previously believed possible. However, once the financial and economic crisis is over we expect the big central banks will increase interest rates fast and steeply so that – while inflation rates may perhaps overshoot in the short term—they will not go beyond what is necessary in the long term. Achieving this will not be easy as it will probably involve conflict with governments. But it is easier to combat inflation than deflation with economic policy. To this extent, we should be glad to exchange our fears of near-term deflation for worries about more distant inflation. The markets are likely to be uncertain for some time to come about how far inflation will rise. This suggests increasing inflation premiums in interest rates. Perhaps this also explains the recent slight increase in inflation expectations that can be inferred from inflation-linked bonds. Since we believe that the danger of inflation is ultimately manageable, we expect that the yield on 10-year Bunds is more likely to rise to around 5% during the next upturn rather than as far as 8% or 10%.

WestLB AG
Herzogstraße 15
D-40217 Düsseldorf

WestLB AG
London Branch
Woolgate Exchange
25 Basinghall Street
London EC2V 5HA
United Kingdom

T: +49 (0)211 826 71841
F: +49 (0)211 826 6154

T: +44 (0)20 7020 2000
F: +44 (0)20 7020 4209

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