

Inflation Fears Running Amok, Again

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Inflation worries have come full circle. A year ago, when the commodities boom ran at full throttle, inflation made a cameo appearance. But the deep global downturn quickly put the inflation genie back in its bottle—only to unleash the spectre of deflation. Now, amid very tentative signs the economy is turning in response to massive monetary stimulus, some investors are starting to sweat inflation bullets again. How seriously should we take this threat?

Those fearing a return of rampant inflation foresee one or more of the following scenarios:

The economy recovers forcefully. A quick recovery isn't impossible, but at the moment the data suggest the downturn is merely slowing, not reversing. And when the recovery does begin, it will likely be subdued, as U.S. consumers are expected to rebuild savings (to pre-boom rates of 6% of disposable income from 4% currently) and pay down debts. The current degree of slack in the economy is already unrivalled in the past half century and quite possibly since the Depression. It might take half a decade before the economy returns to full capacity. Meantime, feeble wage-bargaining and pricing power will keep a tight grasp on inflation, a normal occurrence in the early years of recovery (*Chart 1*). Moreover, with most other economies in the dumps too, world-wide inflation and hence U.S. import prices should stay low for some time.

The Fed keeps policy loose for too long. It doesn't pay to bet against the Fed's commitment to price stability. Despite the economy's ups and downs in the past decade, and the commodity market's boom and bust, core inflation has stayed remarkably stable at just north of 2% (*Chart 2*). No doubt the task of unwinding the current stimulus will be more challenging than usual. Not only must policymakers return interest rates to more neutral levels (i.e., a fed funds rate of about 4%), they must also unwind the numerous lending programs put in place to deal with the credit crisis, such as the Term Asset-backed Loan Facility and Term Auction Facility. The Fed's assets will need to decline from possibly over \$4 trillion to pre-crisis levels of under \$1 trillion (*Chart 3*). Still, a couple of points are worth noting. First, barring a robust recovery, the Fed will have plenty of time to remove the stimulus because of the huge slack in the economy. Second, most of the Fed's lending facilities will unwind naturally when private

CHART 1
RECOVERIES DON'T SPARK INFLATION
United States

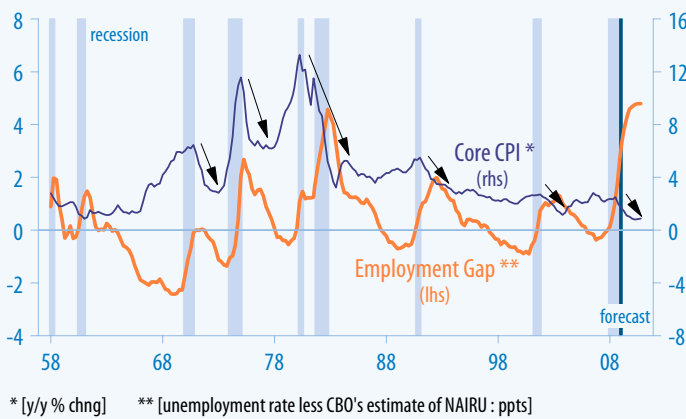


CHART 2
INFLATION IS VOLATILE, ITS TREND IS NOT
United States (y/y % chng)

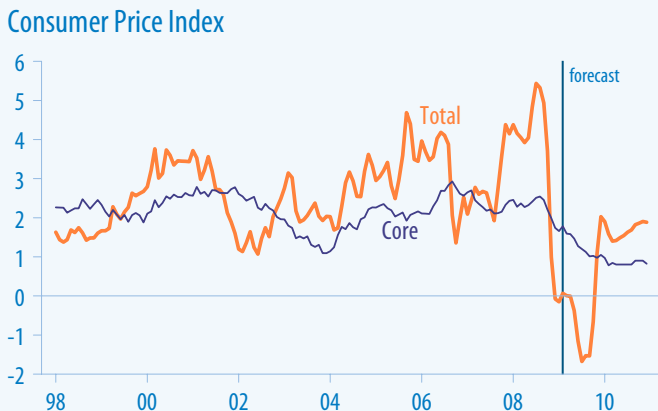


CHART 3
FED INFLATES ITS BALANCE SHEET
 United States (\$ trlns)
 Federal Reserve Balance Sheet: Assets

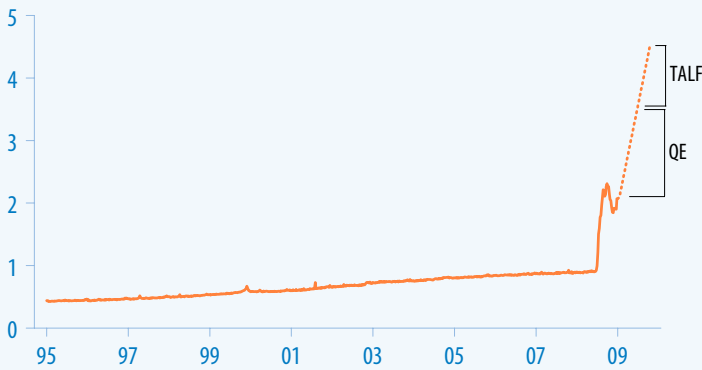
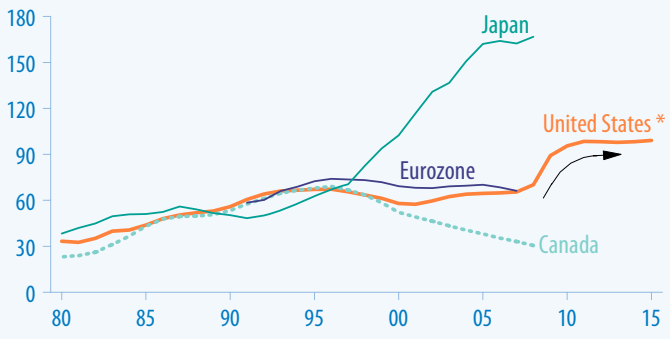


CHART 4
U.S. DEBT BURDEN TO JUMP BEFORE STABILIZING
 (% of GDP)
 Gross Federal Debt



* BMO forecast based on CBO deficit projection

lending recovers, though its longer-term holdings will take longer to wind down.

The Fed’s printing presses run overtime. Inflation increases when too much money chases too few goods, and decreases when not enough money chases too many goods. The central bank can always create more inflation by creating more money than is required to buy things. Currently, the Fed is aiming to create just enough money to ward off deflation and revive credit markets, without juicing inflation. If core inflation starts to move significantly above the Fed’s long-range “forecast” of 1.7%-to-2%, say in response to stronger growth, then the money supply would need to be cut back and the printing presses shut down.

The greenback plunges. Amid all the chatter about the U.S. dollar possibly losing its reserve status, the hidden secret is that almost nobody wants a weak dollar. For the U.S., while a weaker dollar would support trade, it would also boost inflation and long-term interest rates, thereby damaging the much larger domestic economy. Outside the U.S., exports would suffer further, and large holders of U.S. currency reserves (notably China with over \$1 trillion in U.S.-dollar reserves) would face a big haircut. Although the dollar would likely plunge if the Fed was the only swimmer at QE Beach, it has plenty of company these days.

The government monetizes the debt. The Fed’s recent decision to purchase \$300 billion of longer-term Treasuries (7% of outstanding) is a small step towards serious monetization but probably not the tip of the iceberg. Despite its challenges, the U.S. remains a highly productive and wealthy nation of 141

million working taxpayers. The recession would need to get far worse before there was any chance of the nation defaulting. Based on the CBO’s projections of a record \$1.8 trillion deficit this year (13% of GDP), and smaller though still sizeable deficits in subsequent years, the federal debt outstanding will jump from 75% of GDP currently to 96% within three years, before levelling off as the economy grows (Chart 4). While this is a massive run-up in the debt burden (the highest since WWII), it should be manageable (other countries, notably Japan, have pulled it off), provided that forceful action is taken to slash the deficit in subsequent years.

Bottom line: The Fed’s control of the money levers gives it a good grip on inflation (and deflation too). Barring a robust recovery, a plunge in the dollar or a worsening fiscal situation, inflation should stay dormant for some time due to excess supply. The longer-term picture, however, may become less sanguine if the Fed overstays its welcome and/or the government loses its fiscal compass.

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