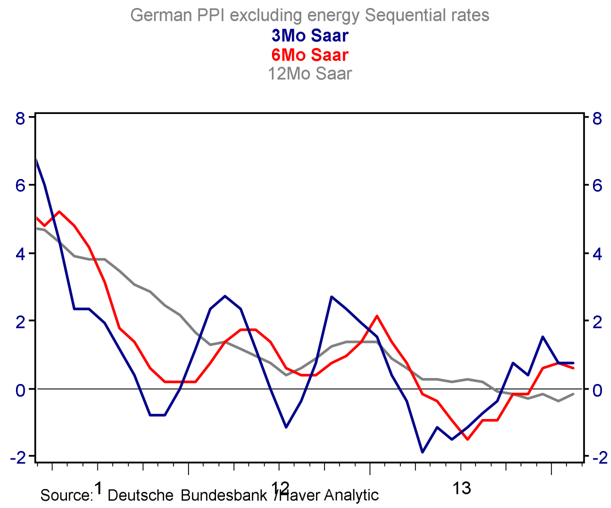
FACT AND OPINION-ECONOMICS O: 212-875-8637
TGIF from FAO-Economics Cell: 917-841-5225
INDEPENDENT ECONOMIC OPINION Robert A. Brusca, Ph.D.

THE GLOBAL INVESTMENT FACTS

Mar 20, 2014

Inflation: the bane of central banks…but not in the way you think



Germany PPI								
	%m/m			%-SAAR				
	Feb-14	Jan-14	Dec-13	3-mo	6-mo	12-mo	12-moY-Ago	IN Q1
Harmonized PPI	-0.1%	-0.5%	0.3%	-1.3%	-0.5%	-1.0%	-0.1%	-1.6%
CPI	0.1%	0.2%	0.0%	1.1%	0.8%	1.1%	2.8%	1.3%
Cpi Ex energy	0.1%	0.2%	0.1%	1.5%	1.3%	1.6%	3.0%	1.6%

It’s as though central banks have gone through the looking glass. In the days of yore we had central banks such as the Federal Reserve in the United States headed by Paul Volker and the Bundesbank in Germany headed by just about anybody (I really have to pause here and admit that when I typed this the first time, the software corrected my typo to Buddhist bank and there is something about that correction that rings true in the context of this article). If you had you grown up studying economics and central banks in those days you would’ve thought that the only job, the only thought, the only duty, of the central bank was to control inflation.

Many still cling to that belief. And certainly it’s true that when central banks deviate from that singular goal they do introduce other policy risks into the equation. However, when and if central banks completely ignore what’s going on in the real economy to make their policy, they clearly are ignoring an important part of reality. It may not be the central bank’s duty to spur growth; on the other hand, if there is no growth, no one is particularly interested in controlling inflation. Nine out of 10 times that there is no growth - or low growth - there will be no inflation unless the central bank had done something outrageously bad previously.

And so we live in one of these historically peculiar times. Central banks are controlling inflation – or it is being controlled for them... (There's a thought!) Inflation remains as their principal focus. Like being stationed at an outpost that is looking for the invasion from Mars; it's an important job. But at the same time some at central banks are looking for ways to deviate to try to spur growth because growth has been so very disappointing just about everywhere. This tension dominates the policy discussion inside the worlds' central banks today.

Today I present the inflation data from Germany whose central bank, the Bundesbank, operates under the auspices of the European Central Bank. Germany is the largest country in the European Monetary Union; for that reason its economic statistics carry the largest weight in contributing to statistics for that Monetary Union. Germany's PPI has declined in both January and February it is falling over 12 months over six months and over three months. Its three-month rate of decline is in excess of its six month and twelve-month rates of decline. And Germany's PPI has been falling for two consecutive twelve-month periods as the 12 month period one year ago saw the PPI fall by 0.1%. In the current quarter (to-date) the PPI is down at a 1.6% annual rate. That's not much pipeline pressure.

I know that the first consideration of someone reading this is to note that, ECB does not target the producer price index. And that's true. It does not. But the PPI is one of those pipeline inflation gauges. The CPI in Germany is up in those two consecutive months and is rising over 12 months, six months and three months, unlike the PPI. In the quarter to date Germany's CPI is rising at a 1.3% annual rate with the CPI ex-energy up at a 1.6% annual rate. For Germany these are quite tolerable rates of inflation. But as I documented in earlier writings, countries within the European Monetary Union that are trying to regain their competitiveness with Germany have to run even lower inflation rates than Germany to catch up on lost competitiveness. Inflation rates this low for Germany, create great problems for other European nations particular those trying to recover from a period of extended austerity.

The biggest problem in Europe as well as the biggest problem in the United States is getting growth started, not controlling inflation. And I'll admit that the most logical place to start talking about this does not seem to be in a piece about inflation and central banks. But in the case of Europe, there is no European wide fiscal authority and in the case of the US, the monetary authorities are just about tapped-out in terms of stimulative policy options. And in both cases the central banks seem braced for a wall of inflation that is just not going to come.

In the Federal Reserve there's concern that the large that balance sheet may still do inflation damage down the road. In the European Union concern's stem from the traditionally hardest-money members that ECB outright monetary transactions might occur on a scale and in a way that's inappropriate that could reignite inflation.

Info FACT: A central banker is someone who lives in a brick house and still worries about termites.

In Fed Chair, Janet Yellen's testimony yesterday, there was precious little concern expressed that the weather-afflicted weakness in the US economy could remain when the bad weather goes away. There was no mention of the risk of geopolitics impacting growth until the question was asked as the press conference. Europe's dependence on energy out of Russia puts it in a situation that should give Mario Draghi, the head of the European central bank, unending nightmares.

But central bankers are supposed to worry about inflation the same way that firemen worry about fires: always and everywhere.

The state of global competition is such that in recent years the bulk of the increase to productive capacity went to countries that featured export-led growth as a strategy. These not only were countries looking to build out their industrial sectors and create a strong export base using the most modern technology and coupling it with extremely low wages, but these were countries uninterested in developing their own domestic demand. In China, for example, the ratio of domestic consumption to GDP plummeted. These are countries with low savings rates. These are countries that ultimately ran persistent current account surpluses. These are countries that ultimately led to the problems we have in the real world now that finds us with an excess of supply and a deficit of demand.

In this situation the macroeconomic reality is that there is enormous global slack in the economy regardless of local domestic circumstances. Inflation is only slightly more likely than an extinct dodo bird to appear. Still, central bankers continue to fight the good fight.

But where do they think the demand will come from? Not from I said the (ungrammatical) little red hen. What about the ability to raise prices? From which well will that spring? Or will it born out of Zeus's head? That raises the question of whether the risk is all mythological…

I worry about the situation in Europe because it puts the so-called peripheral countries (even though not all of them are on the periphery) in difficult circumstances when the traditional low-inflation center countries continue to hue to their historic line of very low inflation. I worry about the US because inflation is historically lower relative to its history than it is in Germany. Still, the US economy is having jagged economic performance. The Fed has already used its most credible weapons to stimulate the economy without the best of effects, and yet the central bank seems the most worried about the potential for inflation to rise from the ashes of low-growth.

I don't think that central bankers need a new portfolio of responsibility. But I do think when they look at their job to control inflation they need to look more broadly at the real environment that surrounds them rather than at their worst fears that seem to be completely decoupled from that surrounding environment. It's not just what central bankers can do, it's also the kind of direction and leadership they can provide. Germany's tight adherence to low inflation goals is destabilizing for the European Monetary Union. Similarly, in the U.S., the Fed's language which suggests that it's willing to be very tolerant by keeping interest rates low as long as inflation stays below 2% is belied by its own forecasts which show it raising rates persistently in its own members' forecasts of its key policy rate even though those same forecasts show inflation is not rising significantly out to 2016: The PCE rate doesn't even get up to 2% by end 2016. But the Fed funds rate is rising. So what does the Fed's verbiage mean?

O: 212-875-8637
Cell: 917-841-5225
Robert A. Brusca, Ph.D.

At some point central bankers have to wake up and look at the landscape that really surrounds them. They need to look at the language that they use to communicate to the public and at the policy path that they are really setting out in front of them. They need to ask if those two things really go together. In the case of the Monetary Union and in the case of the Federal Reserve there is still more policy disconnect than there are workable policy connections. And if you're not aware that you just not paying attention.

Signed:
Central bank cynic