

‘Inflation’ inflation

Climbing prices back on the radar

April 8, 2011 – Have you noticed? The word “inflation” has made a comeback. Call it “inflation inflation” if you like. But it seems to be everywhere. Not too long ago, “deflation” was the economic buzzkill word of the day. But this past week, the spectre of generally falling prices faded into a dim memory, and the new bogeyman of rising prices finally lurched out of the closet.

Citing price stability as its mandate, the European Central Bank hiked its key interest rate 25 basis points, to 1.25%. Inflation in the 17-country eurozone was running at an annual rate of 2.6% in March, already irritatingly above the ECB’s 2% target. Incidentally, that 2% target is a benchmark that most developed Western central banks, including Canada’s, have adopted as an acceptable rate of inflation.

The ECB’s rate hike was the cause of much punditry and general gum-flapping in the econo-sphere, mostly because of what appears to be the coincidental timing of Portugal’s turn at the eurozone’s cash cage last week. Portugal, you may recall, is one of the eurozone’s fiscal basket cases, which, having lived way beyond its means during the fat years, is now facing insolvency. And until two weeks ago, the country resisted an EU bailout and attempted to raise cash and cut spending to finance its deficits on its own. To no avail. Two weeks ago, the government fell as the opposition resisted attempts to cut spending (!), and elections were called. The caretaker administration had no alternative but to ask for the EU bailout – and the conditions that come with it.

The difference between Portugal’s rescue and that of Greece and Ireland is that most everyone saw it coming. No shock. And hence, no impact on markets. Markets will now begin to focus on Spain, a much larger economy than the other three, and potentially much more problematic for the EU.

Granted, Spain has moved quickly to head off the kind of implosion seen in Greece and Ireland. Government spending has been slashed (with the obligatory demonstrations and burning of things by miffed public employees), and even more importantly, the savings bank sector has been restructured. Yet risks remain. Unemployment stands stubbornly at 20%. The residential real estate market resembles the worst parts of Florida. Consumer spending declined by 4.5% in February, the eighth consecutive month that Spaniards stayed away from the shops. Spain’s local inflation, meanwhile, is running at an annual rate of 3.6%. No, a turnaround is not imminent. And the eurozone quite possibly has yet to face its stiffest test.

Given the de facto bankruptcy of some of the eurozone's peripheral economies, it's little wonder that the ECB's move to hike rates was met with more than just a little criticism. A rate hike, after all, will raise interest costs all around, increasing the burden on the debtor nations, squeezing the margins of already-shaky banks even more.

Meanwhile, China, the world's second largest economy let us not forget, last week also raised its benchmark rate a quarter-percentage-point, to 3.25%. It was the fourth rate hike in six months, and speaks to the central bank's concern that March inflation figures, to be released next week, may exceed the 4.9% annual rate posted in both January and February. China isn't alone in battling inflation. Throughout Asia, developing nations are battling steadily rising prices, most visibly food and energy. India's inflation rate, for example, sits at something north of 9%, as the Reserve Bank of India hiked its key interest rate to 6.75% last month.

And, strangely enough, the inflation bandwagon has rolled up to the corner of 20th Street and Constitution Avenue NW in Washington, DC. That's where the Federal Reserve Board of Governors hangs out. The minutes of last month's Fed policy meeting revealed growing divisions among governors over when to pull the plug on the Fed's massive money-printing operations in effect these past two years. To sink QE2 or not? That is the question.

Assorted Fed bigwigs are starting to raise caution flags over continuing the liquidity-providing stimulus programs. Most recently, Dallas Fed President Richard Fisher opined that the Fed is "near a tipping point" in the stimulus business and went on to say, "I see many risks to the Fed overstaying its welcome." And with commodity prices rising and inflation rearing its ugly head elsewhere in the world, Mr. Fisher said, "my gut tells me that this will result in some unpleasant general price inflation numbers in the next few reporting periods." His warning: that there's a risk the Fed will breach its duty to hold inflation at bay. We've been warning in these notes of this eventuality for some time. Though the dovish faction – those plumping for continuing accommodative policy – still hold sway inside the Fed building, the inflation bandwagon is already waiting at the front door. And that raises the probability of a Fed rate hike later this year.

Will the bandwagon reach Ottawa? You could argue that there's already enough carney noise there, given the current electioneering. But a recent Bank of Canada survey indicated that 73% of businesses surveyed thought inflation would be above 2% over the next two years. In fact, Canada's core inflation rate in February slipped to 0.9%, even as the headline rate stood at 2.2%. The slide in the core rate is seen as anomalous. Higher prices are on the way. And so is a higher Bank of Canada policy rate.

Stock markets pretty much fought a holding pattern last week, neither advancing nor retreating markedly on the week. Rising crude oil prices helped keep Toronto's S&P/TSX Composite Index marginally on the black side of the ledge, with a 0.05% week-over-week gain.

South of the border, though, the uncertainty about of the outcome of the US federal budget impasse weighed on Friday's trading, keeping markets subdued. The Dow Jones Industrial Average closed with a hairline week-over-week gain of only 0.03%, while the S&P 500 Composite Index retreated 0.3% on the week.■

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