Early birds will win the inflation game

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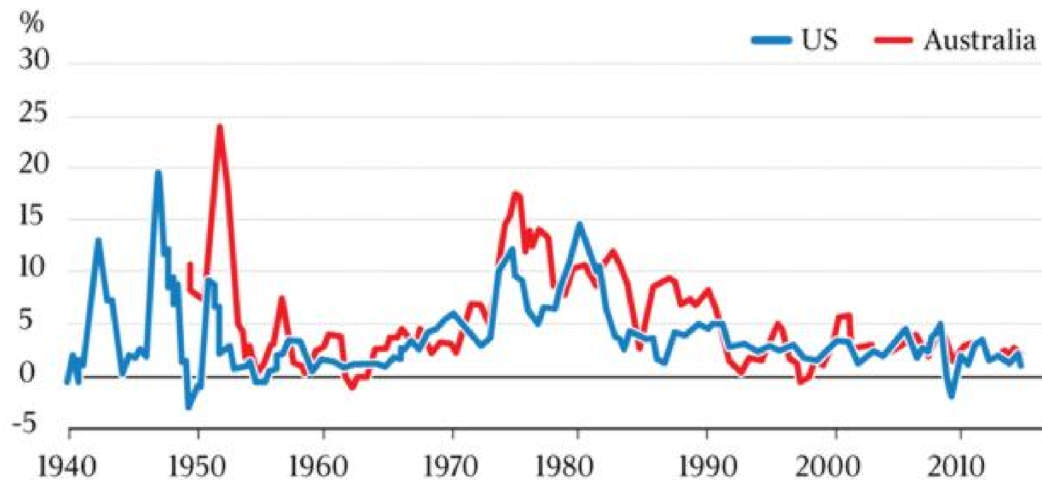

Consumer prices. *Source:* TheAustralian

I RECENTLY suggested that with bond yields as skinny as they are, even a whiff of inflation in the US is likely to lead to significant sell-off of bonds in the US and here — and this could happen in coming months.

This week, we look at the prospect of a cyclical increase in global inflation, not now but in three to five years. This thought, it must be said, is currently unfashionable. Most investors are unconcerned with inflation even over the coming decade; inflation hardly rates a mention even in retirement planning.

It's always tempting, but generally dangerous, to project ahead a recent experience — in this case, negligible inflation — and consider it a lasting trend.

Seventy years of inflation in the US and Australia are summarised in the chart.

The correlation of inflation in the two countries is surprisingly high — and that's despite different wage-fixing arrangements, economic cycles that are often out of synch, and big moves in the exchange rate.

Inflation surged in the early post-war years and again in the 1970s.

Both episodes followed, with lags, the massive increases in the global money supply associated, in turn, with the monetisation of government bonds issued in World War II and the creation of US dollars as the US engaged in the Vietnam War and spent on its "Great Society" program.

Special factors — the boom in wool prices caused by the Korean War and the “crash through” policies of the Whitlam government — also pushed our inflation higher.

The global money base is again rising rapidly as major central banks purchase assets, mainly government bonds, from the public. The combined balance sheet of the central banks of the US, Japan and Europe have expanded from $US3.5 trillion in early 2007 to $US10 trillion ($13 trillion) today — and there’s more coming.

After the past two bouts of rapid monetary expansion in the global monetary base, inflation took off. Will it happen again?

Philip Lowe, deputy governor at the Reserve Bank, commented recently that “the current environment is one in which there has been a very large monetary stimulus (globally) … (but) economic activity does not appear to have responded to the stimulatory monetary conditions in the way that occurred in the past and inflation rates have been very low … (However), global equity markets have been strong; property prices are again recording solid gains in some countries; and bond prices have increased substantially.”

Lowe offers two reasons why spending and inflation have responded only modestly to the global monetary stimulus. Many households and businesses are keen to reduce levels of debt to finance spending. And “it seems probable that both workers and firms perceive that their pricing power has declined … (because of) a combination of the scarring experience of the financial crisis and of the increasing globalisation of many markets.”

He says this is more than “a change in the normal lags”. Instead, “something deeper” is going on. “It still seems highly probable that a period of strong growth in the global economy would eventually see a generalised increase in pricing power. In the meantime, though, the inflation pressures in the global economy are quite muted.”

In my view, the money creation by the major central banks could well contribute to a cyclical rebound in global inflation in three to five years — as world growth picks up, memories fade of the debt overhang, and bank credit circulates again — and that’s a short period in the timescale of retirement planning.

The next cyclical upswing in inflation may well be milder than those of early post-war years and the 1970s, in part because central banks are more independent.

But we’re living longer, have higher expectations of what we want to do in retirement, and fewer retirees have defined-benefits superannuation (with pensions adjusted automatically for inflation). Even a mild cyclical pick-up in inflation, if it’s not been allowed for, is likely to complicate retirement planning in coming years.

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