36 South Views

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Central banks are dragging their feet like a recalcitrant child on the way to the dentist.

The primary drivers of deflation: internet intermediation, globalization and low cost labour have either been stopped in their tracks or are reversing. The primary drivers of inflation: demand inflations, supply shortage or cost inflation and money printing have arrived together like a synchronized tidal wave producing simply shocking numbers.

The response from central bank is to “keep calm and carry on”, “nothing much to see here, move along”, “it’ll be over soon folks – no need to panic”.

They steadfastly exclaim that they are earnest in the fight against inflation and so they should be, given that is their primary mandate! Yet in reality, they are bringing a knife to a gun fight.

25 or 50 basis point interest rate increases off a near zero base in the face of 7.5% and accelerating inflation is simply mind numbing. To do less than that (which is what Europe and Japan are doing) is outrageous.

But any more will risk cooling the economy, they say.

The economy has been on central bank liquidity steroids for years now, and it is nigh impossible to fight inflation (which they are primarily responsible for) without asset prices descending to earth, dragging the economy with it. The wealth effect goes into reverse as ordinary people realise their paper wealth is evaporating in real terms, so they pull in their horns in a major way dragging consumer spending down in the process.

It is a great pity that Covid and Ukraine have emerged as the perfect scapegoat to blame for this totally unforeseen price inflation, whereas central bank and government largess are the primary culprits. But blame the iceberg they will, not the full speed ahead order given at the bridge of this Titanic.

We will have to live in a financially repressed world with big negative interest rate. 6% negative interest rates will halve your real wealth in ten years pretty much. Add to that ad hoc taxes. Most people have been forced to the outer limits of their risk tolerance with property prices, so should mortgage rates rise along with food and energy, most people will be woefully unprepared.

Given the absence of any real resolve from central banks or governments (except maybe Hungary), the response will be muted or misguided: negative real rates as far as the eye can see, price controls, price caps funded by even more government spending.

If I had to guess, central banks will manufacture a recession by raising rates slowly but surely hoping to back off once underway. This will allow them an excuse to lower interest rates again citing lower unemployment as the primary goal now.

The assumption here will be that inflation and deflation are mutually exclusive, whereas I believe they can coexist. High inflation with a recession is where we will end up in the medium term in this pathway.

There is no high road left to travel – other pathways lead straight to much worse outcomes of extreme inflation or deflation à la 30’s and 70’s.

Add to this mix a society that has been raised on lattes and platitudes, with no resilience to life in the slow lane. It’s going to get interesting…

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