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Global inflation

A delicate condition

HONG KONG AND WASHINGTON, DC

Global inflation is rising even as the world economy is slowing. How much should policymakers worry?

HAVING a little bit of inflation is like being a little bit pregnant. Is that old adage worth bearing in mind as consumer prices across the globe accelerate? Even as America flirts with recession, figures released on January 16th showed that consumer prices were 4.1% higher in December than a year earlier, up from 2.5% in 2006. In the euro area, inflation is running at 3.1%, the fastest pace since the euro notes and coins began circulating. China's inflation rate, at 6.9%, is the highest in 11 years.

According to an index produced by Goldman Sachs, global inflation was 4.8% in the year to November, two percentage points up from the previous year (see chart on this page). Prices accelerated in 80% of the countries that Goldman tracks.

By historical standards, this is all small beer. An inflation rate of 5% hardly marks a return to the double-digit price increases that haunted rich countries in the 1970s and emerging economies for far longer. (For much of the 1990s, the average inflation rate in poor countries was 50%.)

Nonetheless, the upswing is broad enough to pose awkward questions. With ever more signals, from weak retail sales to rising joblessness, pointing to an American recession, is the world headed for a bout of stagflation-lite? And will stubborn price pressures constrain the marked easing of monetary policy that America's central bankers now promise?

The answers depend on what has been driving inflation up and whether those pressures persist even as economies slow. Ultimately, inflation is a monetary phenomenon, so responsibility lies with central bankers. Pessimists point out that monetary conditions have been loose in recent years, with real interest rates low and credit growth rapid, particularly in emerging economies.

Others worry that the task of central bankers has become harder as globalisation has shifted from being a disinflationary phenomenon to an inflationary one. The downward price pressure from cheap Chinese goods may be abating while the developing world's rampant demand for

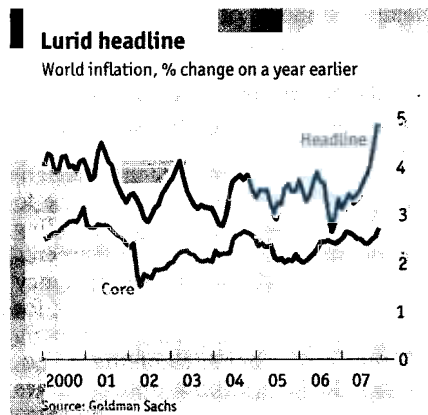
resources may continually drive commodity prices higher.

There is some truth to these arguments, but none offers a complete explanation of recent price trends. In some emerging economies monetary laxness is clearly fuelling inflation—in the Gulf states, for instance, as the direct consequence of their dollar pegs.

But elsewhere the picture is less clear. Take China, where fears of social unrest have made inflation one of the government's top concerns and have led it to impose various price controls over the past week. The accumulation of vast foreign-exchange reserves has fuelled domestic money growth and the inflation rate has tripled in the past year. But that rise is almost entirely due to a jump in food prices, particularly of pork. Core inflation (excluding food, but including oil) is running at only 1.4%. Pig disease deserves more blame for China's recent inflation than loose policy. What's more, China's monetary conditions are tightening fast.

Nor is China's deflationary effect on global tradable-goods prices about to end. To be sure, Chinese wages are accelerating, up by 19% in the year to September, the fastest pace for five years. But those official figures, which include only state-sector workers, almost certainly exaggerate overall wage increases. More important, China's productivity is growing faster, by 20% a year, according to America's Conference Board, a research organisation. That means overall unit costs are still falling.

It is true that the prices of American imports from China are rising after several years of decline. But that has more to do with the weakness of the dollar than with increasing Chinese production costs. And even if the prices of Chinese goods rise, they could still dampen inflation in richer



economies, because they are much cheaper than domestically produced equivalents and are gaining market share. As China produces higher value items, it will push down prices of domestically produced goods in ever more industries.

A more direct link between developing countries such as China and inflationary pressure comes through commodity prices. The prices of many raw materials have surged in the past 12 months. The Economist's dollar-based commodity-price index is up by 26% from a year ago. The food index is up by almost 50%. The price of oil has risen almost 80%. These jumps are the main cause of higher inflation across the globe. They are also related, at least in part, to structural changes in the global economy.

The world economy is increasingly powered by countries, such as China and India, whose growth is far more energy- and commodity-intensive than that of rich countries. Since 2001, China has accounted for about half of the increase in the world's demand for metals and almost two-fifths of the increase in oil demand.

This shift means that the usual relationship between America's business cycle and commodity prices may change. Past American recessions have sent the prices of oil and other resources down. That may no longer be so. Economists at HSBC say that the correlations between industrial output and commodity prices began to fall apart a few years ago.

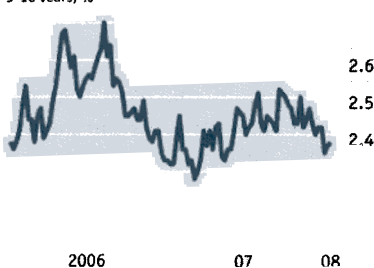
But that does not mean commodity prices will continue to surge. Emerging economies may be more resilient to an American recession than hitherto, but they are unlikely to grow faster. At the margin, therefore, the demand for commodities will slow. And in the longer term, higher commodity prices will eventually lead to greater supply. Much of the surge in raw-material prices in recent years reflects the fact that few foresaw the pace of emerging-market growth. All of which suggests that, even if commodity prices don't fall, their rate of increase will ease, and the biggest driver of recent global price pressure will weaken.

The weight of expectation

So is it time to stop fretting about inflation? Not quite. For a start, a pick-up in underlying inflation suggests that price pressure has seeped beyond commodities. According to Goldman's index, core consumer prices, which exclude the volatile categories of food and fuel, are rising in some 70% of countries. Second, economic weakness does not immediately suppress underlying price pressure. Goldman's economists point out that during the 2000-02 global downturn, core inflation in G7 countries peaked more than a year after growth started to weaken. The rich world could easily face a prolonged period of weaker

Not expecting

Inflation expectations, spread between US Treasury bonds and inflation-protected securities 5-10 years, %



Source: Capital Economics

growth and persistent price pressure.

How much to worry depends on whether this combination affects people's expectations of future inflation. Academic evidence suggests that low, stable inflation expectations are the main difference between today and the 1970s. Because central banks have earned a reputation as inflation fighters and people expect long-term inflation to remain low, price shocks—even on the scale of the recent commodity-price surge—need not translate into persistently higher inflation. Were workers and firms to expect higher inflation, and set wages and prices accordingly, central bankers would face a big problem.

That concern is haunting the European Central Bank (ECB). Judging by its survey of professional forecasters, long-run inflation expectations remain stable: the seers predict 1.9% in five years time. But consumers' expectations of price rises over the next year have risen quite sharply. What is more, unemployment is low and, judging by the unions' opening bids in pay negotiations from Germany to Italy, workers are demanding hefty wage increases. The risk of a wage-price spiral, albeit a modest one, is not negligible. The ECB's hawkishness—including threats that interest rates might have to rise—is designed to stamp it out.

The Fed has more leeway, though inflation has picked up faster in America than in the euro zone. Judging by the spread between American Treasury bonds and Treasury Inflation-Protected Securities, investors' expectations of inflation between five and ten years hence have been falling (see chart above).

Given the American backdrop, the Fed's recent decision to step up the pace of interest-rate cuts is understandable. The weak economy poses a bigger danger than inflation. But there are risks. Even if commodity-price inflation wanes, the falling dollar means America faces other inflationary threats. And if overall price pressure remains stubbornly elevated, inflation expectations may yet rise. If that happens, the Fed will face the unenviable task of curtailing its easing or even raising rates while the economy is weak. ■

A Citi situation

LONDON AND NEW YORK

The mother of all write-downs is unlikely to mark a turning-point

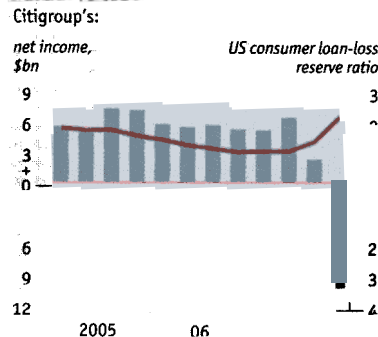
IT HAS a fearful symmetry to it. A year ago Wall Street banks were taking turns to chalk up record profits. Now they are sheepishly making history writing down curdled mortgage investments. Citigroup, the world's biggest bank by assets, is no longer by market value, plumbed new depths this week, reporting a \$9.8 billion fourth-quarter loss (see chart). It cut the value of collateralised-debt obligations (CDOs) and other nasties, already marked down heavily, by a further \$18.1 billion.

Citi's newish boss, Vikram Pandit, has a plan: a \$14.5 billion capital infusion from sovereign-wealth funds and others (including Citi's *éminence grise*, Sandy Weill), a dividend cut, and the jettisoning of "non-core" businesses and people. Bold stuff, but it was not enough to reverse the recent decline of bank shares or the overall stock market, which is growing increasingly alarmed about the prospect of a recession.

The good news is that fresh equity is available for capital-strapped banks. (Merrill Lynch, which was expected to announce a big write-down after *The Economist* went to press, also secured a large dollop this week.) They have also been cheered by the return of interbank lending rates to more normal levels, thanks to liquidity injections by central banks.

The first piece of bad news is that banks' prospects are just as murky as they were in August. Perhaps the most depressing aspect of Citi's results was the tone of remarks by its chief financial officer, Gary Crittenden. Valuing CDOs and the like "all gets extremely complex", he told analysts, and "it is very difficult to forecast exactly where all this is going." It does not help that there is no uniformity of valuation methods across the industry. Some banks

Paradise lost



Source: Company reports

