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High-wire act by the central banks

To prevent a slide into a depression, monetary and fiscal policies must currently take an extremely expansionary course. However, they must do so only until the money markets return to functioning normally and the demand of the overall economy can stand on its own again. The risk now is that the central banks will miss the point after which a flooding of the banking system with liquidity is no longer appropriate. No easy task, more like a high-wire act.

Global recession

At this time there is little doubt that the global economy is in the worst recession of the postwar period. Thus even we, who are among the biggest optimists, are assuming that German GDP will shrink by just over 4% this year. Numbers deeply in the red are also expected for other industrialized countries. And even where growth rates are still positive, as in China, for example, the growth potential is by no means exhausted – which means nothing other than that unemployment will also rise significantly in those countries.

Central banks are trying to counter

For that reason, monetary and fiscal policy makers around the world are blasting out of all their barrels. Key interest rates are hitting historical lows, and central banks are at the same time launching massive liquidity programs, and a few, like the Fed or the Bank of England, are even resorting to so-called quantitative easing – which means nothing other than that the money press is being fired up.

Inflation heading our way?

It therefore comes as no surprise that inflation has now become the topic of cocktail conversations. But how likely is it that monetary depreciation is already at the gates?

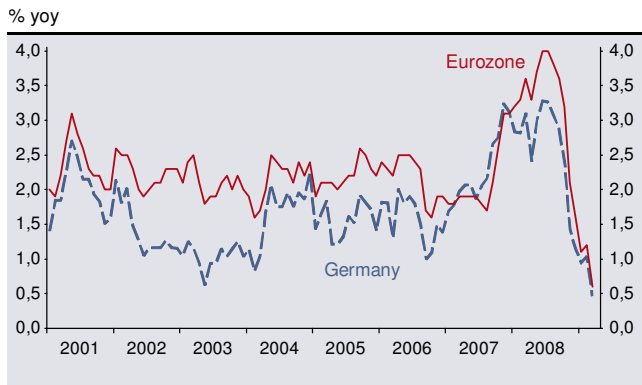
Declining inflation for the time being

For now, the economic weakness will lead to declining rates of inflation and in some countries even to a temporary decline in the price level. In the US, for example, the inflation rate marches more strongly in tandem with the economic cycle than is the case in the Euro zone. Prices and wages adjust more rapidly. In an environment of considerable excess capacities in businesses and rising unemployment, it is fairly unlikely that the expansion of the central bank money supply will directly stoke inflation.

Basis effects from energy prices

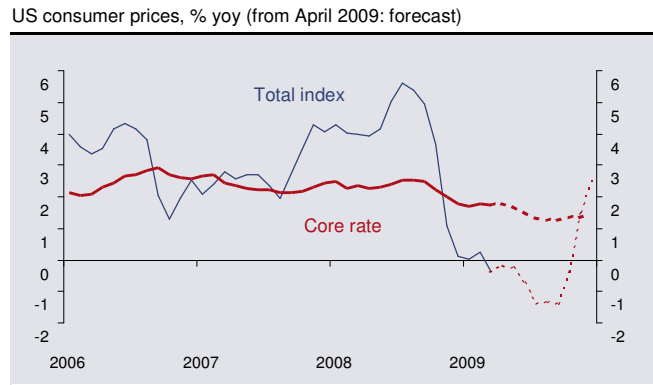
Against this backdrop, inflation will not be a problem in coming months – especially also because of the sharp drop in energy prices since the middle of 2008. It is more difficult, however, to assess the long-term development. What will happen when the economy revives in response to the extensive global stimulus programs?

Inflation rates still in retreat



Sources: EcoWin, Helaba Research

Recession and the price of oil depress inflation in the US



Sources: EcoWin, Helaba Research

What will happen when the economy revives?

At the moment it is difficult for many to imagine that this could actually happen. However, the first indications of a recovery in the economy are already multiplying, which means that slightly positive rates of growth next year are becoming more likely again even in Germany. But even then, inflation, a typical late-cycle phenomenon, should not yet rage out of control. Still, the theme of deflation will be off the table – but only because both monetary and fiscal policy are currently being deployed on such a massive scale against the economic downward spiral.

First extremely expansionary ...

And this is where the difficult task for monetary as well as fiscal policy begins: to prevent a slide into depression, both of these macroeconomic policies must be extremely expansionary at the right time. But they must be kept that way only until the money markets return to functioning normally and demand in the overall economy can once again stand on its own.

... and then restrictive again at the right moment

The risk is that the central banks will miss the moment when flooding the banking system with liquidity is no longer appropriate. This poses two potential dangers: the central banks could at some point realize belatedly that they have made a mistake by being too expansionary and then drive up interest rates so rapidly that the national economies once again slide into recession. Or the central banks do in fact wait too long, and inflation accelerates noticeably.

Fiscal policy with a time lag

Since fiscal policy measures will unfold their effects in many countries only with a pronounced time lag, and a reversal will be extremely difficult given the workings of parliamentary processes in a still relatively weak economic environment, I believe that the second scenario is the more likely one over the medium term.

Timing is everything

In the end, everything will depend on whether the large central banks of the world, including the European Central Bank, will remain expansionary for exactly as long as necessary to prevent a deflationary spiral, and then reverse direction at the right moment to avoid triggering an inflationary avalanche: no easy undertaking, but a veritable high-wire act.

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