

Wealth Manager

Ian Williams: why the Fed and BoE are both wrong on inflation

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Recent pronouncements from the US Federal Reserve and the Bank of England point to the current high rates of inflation as being transitory and capable of falling back to an assumed core rate of around 1% to 2%.

The rationale behind the argument is that inflation is a year-on-year phenomenon and if a spike in, say, oil prices pushes up inflation to above target levels, then in 13 months' time that rise will drop out of the respective index and inflation returns to 'normal'.

The problem with this analysis is that we have been hearing this message for some time now and as yet there is no sign of the rate of inflation dropping back to desired levels. Indeed BoE Governor Mervyn King has had to write a great number of letters to the UK Chancellor trying to explain away the UK's persistently high inflation rate and why so called 'special factors' have consistently failed to disappear on a net basis, after the requisite 13 month index calculation. This is because the main cause of the inflation is imported inflation that the Bank of England or the Fed cannot do much about. Therefore, if inflationary pressures are outside of their control, why do they continue to claim that it is within their capabilities to bring it down?

As the Western G7 nations have de-industrialised, the bulk of global manufacturing has switched to South East Asia, particularly China. When this first occurred the effect was that the West experienced imported deflation across a whole range of consumer goods as Chinese products were much cheaper than the Western products they replaced. The problem now is that China is suffering rapid ongoing rates of inflation and as they produce 90% imported consumer goods of the Western economies, China's inflation is now our inflation.

So why is the cost of Chinese goods rising so fast? The Chinese economy has been growing at breakneck speed for over a decade, so inflationary pressure is hardly a surprise. Wages in China are rising rapidly alongside food and real estate prices. Secondly, the entire Asian region is growing at similar rates and this accounts for a substantial proportion of the global population. This growth is the main driver behind the ongoing bull market in raw material prices. The third reason is that Chinese monetary policy has been expansionary in order to accommodate economic growth. And finally, the Chinese Yuan is rising against sterling and the dollar, while the cost of shipping is also going up due to higher oil prices,.

It is unlikely that any of these factors will reverse any time soon. China's growth may slow from 11% per annum to around 8%, which is not enough to subdue any resilient inflationary pressure. Commodity prices, contrary to Mervyn King's predictions, are far more likely to continue to rise, while the yuan is virtually a one-way bet against sterling and the dollar.

Inflation looks more likely to continue around its present levels rather than fall back to lower levels. Having stated that the Fed and the BoE are pretty powerless in bringing inflation down, this does not mean that they cannot create some of their own 'domestically generated' inflation.

While the BoE is unlikely to instigate any more QE, the Fed is mid-way through QE2 and voices within the Fed state that if oil rises to \$170 a barrel levels (due to events in the Middle East) then QE3 could be rushed out to prevent the US economy suffering the recessionary impact that higher oil prices would cause. This would be an identical policy error to that of Edward Heath's administration in the 1970s when the first oil shock occurred, causing hyper-inflation.

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