Inflation elusive, but central bankers getting twitchy

By Ross Finley
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A significant pickup in inflation still remains tantalisingly out of reach in most developed economies – aside from asset prices – yet several central banks are leaning toward launching or stepping up efforts that could slow it down.

What has shifted in recent months is an acceptance that fiscal policy, touted around the turn of the year as the essential comeback kid after the shock election of Donald Trump as U.S. president, has not yet come back.

Much of this is because of a lack of progress on Trump's tax cut agenda, dimming down what was called the "Trumpflation" trade in financial markets and now even calling into question a multi-year rally in the U.S. dollar.

But what this does is thrust central bankers – who only six months ago were said to be waning in influence – back into the spotlight.

Many seasoned central bank watchers say past experience shows that until inflation really accelerates convincingly, and for a sustained period for reasons other than a rise in the price of oil, the best monetary policy is to be doing nothing.

The latest minutes from the Federal Open Market Committee's policy discussions show a split over inflation, which is sure to cast unusually sharp focus on Fed Chair Janet Yellen's testimony to both houses of Congress in the coming week.

Indeed, with the exception of persistent four-decade-low first-time claims for jobless benefits, U.S. economic data has been undercutting relatively modest expectations for the past several months, particularly on measures of inflation.

Wage inflation across most of the developed world, widely viewed by economists as the most compelling and potent driver of sustained overall price inflation, hasn't picked up the way central bankers have predicted it would either.

The Fed, however, remains set on further interest rate rises, and is now contemplating how and when to start reducing its $4.5-trillion balance sheet, bloated by years of mass asset purchases as stimulus once it had no interest rate left to cut.

"Of course the evolution of the economic data over the next few months remains of critical importance," notes Investec's chief economist Philip Shaw.

"In particular, will the momentum of the economy be maintained and is the recent run of soft inflation idiosyncratic, as most senior Fed officials seem to believe?"

It's not only Yellen who might set the mood in the coming week. The Bank of Canada meets to set policy on July 12 following a run-up in the Canadian dollar, with markets leaning toward expecting the first rate rise in nearly seven years.

The domestic debate is partly over whether a rate rise is now warranted in part to tamp down rampant urban housing markets – particularly in Vancouver and Toronto – as soaring real estate prices have pushed Canada's household debt to income ratio to near the highest in the world.

Like in other similar economies, Canada's consumer price inflation on its own does not point convincingly to a need for the Bank of Canada to deliver higher interest rates.

"Its decision one way or the other could have an effect on markets beyond its shores as it will be seen as a proxy for policy normalisation over a wider jurisdiction," notes Shaw.

For some, discussion of “normalisation” appears eerily similar to 2011, when the European Central Bank, faced with a similarly shaky-looking inflation outlook, raised interest rates in what is now regarded as a mistake, arguing higher rates would be supportive of business confidence.

A punishing sovereign debt crisis followed and a period of eye-wateringly high unemployment, ushering in an expansion of the central bank’s balance sheet by well over a trillion euros and counting, along with negative interest rate policy.

For now, the ECB appears to be moving very gingerly toward unveiling how and when it will trim back its tens of billions worth of monthly bond purchases, but that date is approaching.

Some of the Bank of England’s Monetary Policy Committee also now think that now is the time to raise rates – despite the uncertainty of Britain starting to negotiate its way out of the European Union. They are prompted by a surge in inflation caused in large part from a plunge in sterling after the Brexit vote.

For now, they remain in a minority, but the possibility has supported the pound and markets have been put on notice.

But a change of mood appears to have taken place at the Bank of Japan, however, which is backing off initial attempts to signal an imminent shift away from its ultra-easy monetary policy. On Friday it launched a bond-buying bonanza, offering to snap up unlimited quantities in order to calm markets.