April 2011

Will Rising Interest Rates Accelerate Inflation?

Inflation appears to be a major worry worldwide. China has raised interest rates and banking reserve levels to fight inflation. Other central banks such as Australia and Canada had previously acted. Now one of the world's major economic blocks, the Euro Zone's Central Bank has increased rates a ¼ point to 1.25% to fight inflation. It appears that Fed Chair Bernanke has no intention of following Europe's lead.

All of this raises the question, will rising interest rates accelerate inflation? The commonly accepted concept among consensus economists is that raising interest rates fights inflation. But is this true? **Like so many economic questions the answer is, "it depends."**

In a conventional economic cycle, inflation occurs because increasing demand in relation to supply causes prices to rise. Wages rise to meet the change in prices of basic items and a wage/price spiral begins. The conventional response is to raise interest rates causing a reduction in borrowing and spending with a concomitant reduction in demand and, thus, lower prices. For this to be the result, demand must be elastic and capable of being reduced.

Inflation does not always occur as a result of an increasing wage/price spiral. Monopoly power can cause prices to rise. OPEC, for example, had sufficient power to cause oil prices to rise in the late 1970s.

In an advanced industrial economy, oil is a major raw material used in every aspect of the economy. Petrochemicals are used in plastics, paints, gasoline, dies, lubricants,

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power generation, etc. When oil prices rise, it affects such a broad section of the economy that inflation is inevitable.

Today, we are experiencing an inflation threat propelled by a sudden dramatic rise in oil prices. This is being driven by three factors. Increasing demand for oil as the worldwide recovery progresses, unrest in the Middle East and North Africa, and devaluing of the dollar.

The inflation potential in Europe and the U. S. is driven by increased costs of oil, food, and clothing. These costs are inter-related.

Oil is the raw material of fuel and fertilizers. Its cost affects the production and transportation cost of food. Whether vegetables for consumers or grain and feed for animals or breakfast cereals, as oil rises, so do costs.

Can you fight a non-wage/price spiral inflation caused by increasing raw material costs, such as oil, with higher interest rates? In an advanced industrial economy, the answer normally appears to be no.

While demand can in part fall for things like gasoline, at the bottom of a recession, the demand for many of these products is inelastic. We cannot stop eating.

Higher interest rates don't reduce Middle East or North Africa tension and won't affect an oil price rise based on it. The problems in the Middle East or North Africa won't be solved by the European Central Bank or the Fed raising rates.

In an advanced economy the situation is even more complex. Most businesses today are financed through borrowing rather than raising investment capital. Congress has begun to discuss whether eliminating the deduction for business borrowing would reduce the risks to the economy in future downturns by forcing business to raise capital rather than borrow.

In a weak recovery, eliminating the interest deduction for business borrowing merely increases costs and forces business to compete for needed funds with government borrowing, driving up capital costs and interest rates. The effect would be a material reduction in economic activity.

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When the Fed raises interest rates to attack inflation caused by higher oil prices at this stage of a recovery, it normally adds to inflationary pressures. ***Why?*** Higher interest rates increase the cost of goods sold for every business that uses borrowed capital.

Under such circumstances, increasing interest rates by raising the cost of goods sold, in fact, accelerates rather than retards inflation. Higher rates reduce business liquidity and buying power in the economy causing a negative long term impact.

So is the Fed right to keep rates low to stimulate the economy? Remember we said the answer is, it depends. The mix shift of multiple factors will determine which way higher rates cut.

Fed Chair Ben Bernanke has consistently played down the inflation threat. Recently he said the rise in oil, grain, and other global commodities are likely temporary and won't translate into a broader inflation problem. The Fed Chair said "I think the increase in inflation will be transitory." Over the next two years, Bernanke said, people expect inflation will be subdued, a sign that prices will remain in check.

The Fed seems to be oblivious to the advice that most American businesses are getting. Like us, many trusted advisors are recommending that, where possible, businesses begin raising their prices incrementally to relieve rising raw material costs.

It is at this stage of an economic cycle that having a government coordinated, long-term plan for fostering a recovery becomes so important. Higher interest rates as part of a broader, coordinated approach could have a quite different effect depending on the circumstances.

One of the main causes of higher oil prices is the devaluation of the dollar caused by the Fed's quantitative easing. It has caused far higher inflation in oil prices than Middle East or North African unrest. When the Euro Zone raises interest rates at this point, it strengthens the Euro.

A stronger Euro means that the Euro buys more dollars under current circumstances than before. Since oil is traded in dollars, this lowers the cost of oil for the Euro zone. For Europe, this will reduce inflation. It will help to stabilize their recovery.

The question is, given a weak recovery, will higher interest rates in the U. S. slow the economic recovery more than would reduced oil prices help the recovery?

If you don't eat, drive, or buy clothes, then there is no long term inflation, yet. But we do, and the recovery is not at a stage where demand for these items can fall enough to offset inflation.

Higher interest rates would strengthen the dollar. This would reduce raw material costs, including oil. It would also help to stop the flow of dollars overseas that is draining much needed capital from our recovery.

Higher interest rates would strengthen our recovery at this stage, not only by stabilizing raw material costs, but by lowering inflation and by adding to the buying power of consumers on fixed incomes.

Contrary to what the Fed Chair has expressed, the current inflationary pressures are not short lived. The failure to stop quantitative easing and raise rates now will not only increase short run inflation (higher oil prices), it will build pressure for major problems two years from now, when the Fed will not have the tool of lowering rates to stabilize the economy as needed. The failure of the Fed to act now is but one more example of it failing to take into account all of the facts and circumstances in setting monetary policy.

How Will The State Of The World Economy Effect 2011?

Manufacturing has driven our recovery. Current data indicates our economy will expand thought 2011, with 2012 being even stronger.

Certain sectors of our economy will not share in this growing recovery. Construction is particularly weak.

Housing Starts in the Midwest are running below 2010. Nationally, housing declined over each of the last

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three months and is forecast to continue declining through 2011, with starts below the 2010 level.

On the plus side, retail sales are improving. For the economy to continue growing, manufacturing and retail sales must continue to carry a greater share of the expansion. A key to this is growing exports which depend upon the world economy.

Key Latin American economies like Brazil and Argentina are growing at over 8%, while Columbia and Chile are growing at 4 to 6% a year. Mexico's industrial production is rising at the steepest rate in four years and is 6.1% above 2010.

Canada is growing at the fastest pace in 10 years. Canadian mining is up over 10% in the first quarter of 2011. Canada is forecast to continue its recovery.

China's economy while continuing to grow is slowing in some sectors. Minimum wages in 30 provinces have increased 22% with inflation rising 4.9%, including a 10.3% jump in food prices.

With the dollar declining in value, direct foreign investment in China was up 23.4% year over year! China experienced its first quarterly trade deficit in 7 years, over $1 billion. You should expect to see the cost of imports from China rising over the next year adding to our inflationary pressures.

India has a 30% growth in auto manufacturing with expansion of its economy continuing. Europe, lead by Germany, has continued to expand and should see growth through 2011.

Japan was 18% above its recessionary lows, but now its recovery is in question. Japan's need for imports to restore its post earthquake economy may help U. S. exports. The other Southeast Asian economies grew 14.1% in the first quarter and are in a rising trend that should last through at least the next two years.

With continuing worldwide recovery, we should expect our exports, especially of food and machinery products, to continue to grow through 2012. This is a key factor in our strengthening recovery over the next two years.

Newsletter

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Recent Cartoon

Housing Starts hit 65 year low.

New Office Building construction lowest level in 11 years.

The decline in commercial building projects continues for the 34th consecutive month.

THE WISE OLD OWL

You need to re-examine your foreign supply situation. Growing inflation will cause your foreign costs to rise and reliability may soon re-emerge as a problem just as our expansion heats up. Economic data indicates slower grow for several months accelerating by the 4th quarter. Growth will continue to accelerate in 2012 coupled with increasing inflation.

Our strategic partner, the Institute For Trend Research, has warned, "We see the issues of future higher interest rates; higher taxes; federal, state, and local government deficits; unfunded pension liabilities and inflation (including energy and food) as contributing factors to what we think will be a recession that begins in late 2013 and encompasses all of 2014." You need to plan how you will take advantage of the growing economic opportunities during 2011-2012, while preparing for the very different economic cycle coming in 2013. We have helped our clients increase efficiency, improve branding, add revenue streams, and increase market penetration, while coping with each new cycle. We can help you do the same.

Put Our Experience To Work For You

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