Bill Gary's

Price Perceptions

Technical Update

Issue #1364A • July 5, 2008

Inflation Genie Out of Bottle!

Global inflation is running rampant. Russia's inflation rate is 15%, Vietnam 25%, China 8%, India 8%, Argentina 9%, Egypt 20%, Saudi Arabia 11% and the US near 5%. A common denominator between these nations and others is... *Central banks are holding interest rates well below the inflation rate.*

When inflation rates exceed interest rates, it has always been a clear sign that monetary policy is too easy. Globalization raised living standards throughout the world and governments became committed to *perpetual economic growth*. Politicians and central bankers now view economic retrenchment as a policy failure... Therefore, the only way to maintain growth is to continue excessive monetary expansion or devalue currencies.

However, global growth has expanded to a point that production of food, energy and other commodities are unable to keep up with demand. Central bankers have traditionally viewed inflation as a domestic problem of supply and demand. When the domestic economy slows, they ease interest rates and when it reaches a point of overheating, they raise interest rates. However, *it is becoming obvious they must begin using global measures of supply and demand if inflation is to be controlled*.

One nation's central bank, acting alone, cannot control world inflation. A global central bank does not exist to impose restraint on nations that excessively expand money supply. The Bank for International Settlements (BIS) is the organization that oversees central banks and banking regulators throughout the world. However, they have no power to force individual banks to restrain credit and slow monetary growth. But, they can issue reports that warn of dangerous economic situations.

This week, the BIS said: "Global inflation is a clear and present threat to a world economy that needs higher interest rates and a new framework to deal with future credit and asset bubbles." The Federal Reserve has traditionally held that identifying a "bubble" was too difficult. They have assumed it was better to clean up the mess after it bursts. However, many economists are beginning to view US monetary policy as much too expansive and believe an economic downturn with higher interest rates is needed.

The "inflation genie" has been out of the bottle too long. It is the function of commodity markets to send strong price signals to central bankers and governments to curb excessive monetary expansion. However, it is not politically popular in the US to slow economic growth, especially during an election year. Therefore, the burden of slowing global growth is being shifted to foreign nations. Commodity traders should be watching economic policies in China and India for clues of a slowing global economy.

Bill Gary