WILL ECONOMIC STAGNATION LEAD TO STAGFLATION?

Stock markets around the world advanced during the third quarter of 2012 despite decelerating global economic activity as investor expectations of continued excess liquidity creation by the major central banks fueled the equity rally.

These are extraordinary and unprecedented times for central bankers around the world. Their official mandates and missions are to 1) regulate the country's banks, 2) manage the money supply and provide for a stable currency foundation, 3) control inflation and 4) create a monetary environment that can support full employment. The fourth goal is expected to be accomplished in partnership with fiscal policy. However, the U.S., Europe and Japan are saddled with high levels of sovereign debt and must reduce their government deficit spending and raise taxes to avoid further credit rating downgrades such as the loss of AAA government bond ratings by the U.S., France and Japan. Fiscal policies in the developed countries can no longer engage in ever increasing debt-financed spending programs to stimulate their respective economies. Central bankers have found themselves playing doubles tennis or bridge without a partner.

The entire weight and fate of the global economy rests squarely on the shoulders of the central bankers in our interconnected capitalistic world. Fortunately, the U.S. Federal Reserve Bank (FRB), European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England (BOE) understand the grave responsibilities cast upon them and they have all engaged in aggressive monetary easing policies. Initially, conventional low interest rate policies were instituted but they proved to be only partially effective as the countries fell into a liquidity trap where monetary theory in the current stagnant economic environment prescribes an interest rate lower than zero to generate optimal economic stimulation.

The solution to the sub-zero interest rate conundrum facing the four major central banks was to engage in various forms of unconventional monetary easing policies called Quantitative Easing (QE). The standard version of QE adopted by the FRB, BOJ and BOE involved making massive financial asset purchases and paying for them with newly created bank credit or newly issued paper currency. The ECB engaged in massive low cost bank lending programs to rescue the ailing European banks.

In September the FRB and ECB announced aggressive new open-ended QE programs with no predetermined magnitudes or termination dates. This opens the possibility of unlimited credit creation or money printing with the objective of substantially reducing unemployment in the U.S and lowering financing costs for troubled European governments and banks.

The management of inflation risk by the central banks is being significantly reduced in importance as they have directed their priorities towards reducing unemployment and preserving the integrity of the Eurozone, Euro and European banks. The FRB's inflation target of 2% has become a long-term average goal rather than a fixed short-term ceiling and this opens the possibility that U.S inflation could potentially rise to 3-4% before the FRB reverses course and tightens its policy. The ECB and BOE also have inflation targets of 2% but that number could also be breached on the upside with further massive QE.

The world has benefited substantially from three decades of declining inflation which reduced costs and stimulated economic growth. However, synchronized credit creation and money printing by the major central banks may ignite inflationary forces similar to the 1960's and 1970's. Stagnant subpar global economic growth of 3-3.5% in an environment of rising inflation expectations could breed stagflation. The central banks would almost certainly not permit inflation to rise above 4-5% for a sustained period of time but an inflation advance from 2% to 3% is a 50% increase which could motivate investors to seek out inflation-hedging assets such as equities and WHV's energy and materials investments for potential protection against purchasing power degradation and paper money devaluation.

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