on the UP

Western economies are likely to see the return of inflation in 2017, and with it the risk of too steep an increase in prices

After two years of low inflation in both Europe and the US, financial markets are welcoming rising inflation as a sign that economic prospects are improving. In a way, they are right. Economic fundamentals in the developed world are probably in their best shape in a decade. Despite serious political risks linked to populism on both sides of the Atlantic, the growth outlook looks very promising indeed. But, just as deflation concerns in 2015 and 2016 were overblown, markets are now at risk of overlooking the potential risks associated with the ongoing reflation.

The lesson of history is clear. While some historical periods of deflation were driven by strong improvements in productivity, you would be hard pressed to find a period of high inflation associated with a general improvement in economic conditions. Hyperinflation during the 1920s in the Weimar Republic and the West's stagflation of the 1970s serve as prime examples of the deleterious effects of high inflation on wealth and prosperity.

Inflation erodes the value of money and distorts the price signals that tell economic participants how best to allocate effort and resources. That Western economies achieved impressive economic growth from the 1980s until the recent global financial crisis as central banks sought to target a low and stable rate of inflation, is no coincidence.

The disinflationary effects of cheap oil since 2014 have supported solid gains in real incomes. Households have enjoyed a tax cut without the budget deficits. Unless wages begin to accelerate in line with the inflation pick-up – unlikely, but not impossible – households will see real incomes squeezed this year. Households could turn to credit and begin to draw down on savings to maintain their preferred level of consumption. This has already started to happen in the UK, with households again gearing up to support spending as rising import costs sap real income growth.

Financial markets benefit from low inflation, too. Low interest rates and large central bank balance sheets support asset prices. After hiking in December 2015, the Fed did not follow up shortly thereafter – as was expected at the time – because of the market turbulence at the start of 2016.

Responding to the same risk in the eurozone, the European Central Bank (ECB) stepped up its monthly asset purchases. In the UK, following the Brexit vote, the Bank of England easily justified cutting rates and increasing quantitative easing (QE), thanks to the low inflation at the time. As inflation rises towards central banks' targets, monetary policy makers will find it harder to justify their ultra-easy monetary policies.

Economic fundamentals are probably in their best shape in a decade

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If the US and European economies avoid the political pitfalls, rising inflation will tilt central banks towards tighter monetary policies. The rise in government bond yields since late 2016 reflects rising market expectations of higher central bank interest rates. While the Fed will probably hike three times this year, the Bank of England could hike for the first time in the second half of 2017. In the eurozone, where the recovery is less advanced than in the US and UK, later this year, the ECB may signal when it intends to complete its QE programme – likely by mid-2018 – with markets taking that as a sign that interest rate hikes may follow soon after.

Although global economic prospects are improving and the post-Lehman caution is fading, the necessary repair to public- and private-sector balance sheets is not yet complete. The Western world is thus still highly vulnerable to downside risks. If a confidence crisis hits, we may need central banks to resume their erstwhile role as guardians of the recovery. But, if such risks materialise and central banks are forced to hesitate because inflation is rising above their targets, the real price of inflation could be much higher.

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