

Retreating prices put rate hikes on back burner

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WashingtonOttawa — The pressure on central banks to start raising interest rates is fading as the threat of deflation creeps back into the global economy.

In the United States, prices fell 0.1 per cent in April, paced by cheaper gasoline, clothing, housing and cars.

Ben Bernanke and his U.S. Federal Reserve colleagues talk of “subdued” inflation. “Dead” might be a more apt description, freeing the central bank to keep its key interest rate near-zero and easy money flowing indefinitely, without overheating the recovering economy.

Many economists are now betting the Fed will leave its key rate unchanged until late 2011 or even 2012. And any move to sell off the piles of mortgage-backed securities accumulated during the credit crisis may be even farther off.

“The disinflationary pressure in the United States remains intense,” remarked Paul Ashworth, an economist at Capital Economics in Toronto. “Consumer prices are basically stagnant and deflation has never been a bigger threat.”

Even in Canada, an imminent rate hike is no longer a sure thing. Until recent weeks, the assumption was that the Bank of Canada would follow Australia’s lead and push up its key interest rate at the June 1 rate decision.

Bay Street traders are now putting the odds of a rate hike at just 50-50, noted a report by Bank of Montreal deputy chief economist Doug Porter.

The inflation dynamic in Canada is also less clear-cut. Friday’s April consumer price index report will be the Bank of Canada’s last chance to assess whether hotter-than-anticipated inflation readings earlier this year represent enough of a trend to start raising interest rates from record-low levels.

Central bank Governor Mark Carney recently scrapped a conditional commitment to stay on hold until July or later depending on inflation, in part because his preferred inflation gauge, which strips out volatile items, had breached the bank’s two per cent target much sooner than expected. But he has also said repeatedly that nothing is “pre-ordained.”

Inflation has since cooled. But the housing market is still strong and the economy has already recouped about two-thirds of the jobs lost in the recession.

“We continue to lean to the view that the Bank will indeed begin hiking rates at the start of June amid the powerful rebound in employment and housing,” BMO’s Mr. Porter wrote in an article he’s releasing Thursday morning. “However, the debate is by no means completely settled, with the Fed still in an extended holding pattern, core inflation fading again, and the very real possibility that European tremors could rumble louder.”

In the United States, the main driver of lower U.S. prices in April was relief at the gas pump. But even the core consumer price index, which excludes typically erratic moves in food and energy prices, was zero in April. And compared to a year ago, core prices fell 0.9 per cent – the weakest annual reading in 44 years.

Fed policy makers are convinced that both overall and core inflation will “remain subdued through 2012” and below the central bank’s informal target range, according to minutes of the bank’s April 27-28 meeting released Wednesday.

At the meeting, the Fed lowered “slightly” its near-term inflation forecast. The Fed, which tracks personal consumption expenditures (PCE) instead of the CPI, now expects PCE to rise between 1.2 to 1.5 per cent this year, 1.1 to 1.9 per cent in 2011, and 1.2 to 2 per cent in 2012.

Like Fed policy makers, economists don’t see much coming down the pipe that would spur inflation. Millions of Americans who lost their jobs during the recession are still looking for work, prices for key commodities are falling and stocks have tumbled in recent weeks on fears that several European countries may default on their debts.

The latest CPI numbers vindicate Mr. Bernanke’s reluctance to raise rates even as the recovery has strengthened in recent months, said CIBC World Markets economist Krishen Rangasamy.

“The Fed’s statement that inflation ‘is likely to be subdued for some time continues to be prophetic,” he said.

Within the Fed, Mr. Bernanke has faced pressure from at least one member – Kansas City Federal Reserve Bank president Thomas Hoenig – to start raising rates this summer.

At the April meeting, Mr. Hoenig voted against the decision to leave interest rates unchanged. Behind closed doors, he argued that the bank’s key lending should be raised to 1 per cent this summer, from its current level of zero to 0.25 per cent.