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Global markets

Too hot or too cold?

Investors are caught between the desire for growth and the fear of inflation

POOR Goldilocks is suddenly out of sorts. After five years when economic conditions have been, like baby bear's porridge, "just right"—strong growth and low inflation-they are now spoiling fast. And as central banks begin to react vigorously, investors are taking fright.

When 2008 started, most investors assumed that the lingering effects of the credit crunch would allow interest rates to fall, or at worst be kept on hold. But over the past week markets have priced in a number of rate rises later in the year from the Federal Reserve, the European Central Bank (ECB) and the Bank of England. That has caused turmoil in short-term government-bond markets (see chart), as yields have been forced sharply higher.

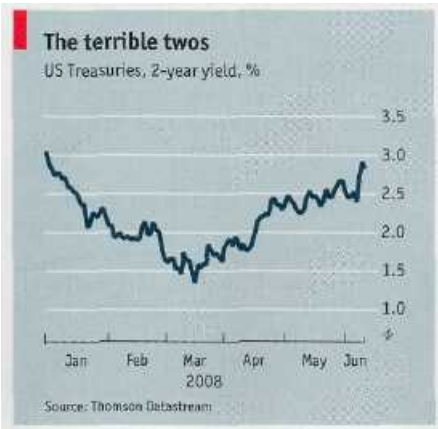
The problem is inflation. Central bankers may hope that soaring oil and food prices will prove to be just a blip, and will not result in secondary effects such as higher wages. But they know that higher inflation expectations, once entrenched, are difficult to eliminate. So they are sounding as tough as they can.

Tricky Trichet

This has not been well co-ordinated. On June 3rd Ben Bernanke, the chairman of the Fed, tried to talk up the dollar (a falling currency adds to inflationary pressures). But on June 5th Jean-Claude Trichet, the ECB president, gave a strong hint that euro-zone rates were soon to rise. That sent the euro sharply higher. As Albert Edwards, a strategist at Societe Generale, put it: "Only [two days] after Bernanke made his dollar-supportive comments and retreated to the sidelines, he received the studmarks from Trichet's boot in his chest."

If that central-banking snafu was not bad enough, June 6th saw both an unexpected rise in American unemployment and an $11 gain in the price of oil—a combination that points to higher inflation and slower growth. Small wonder that the Dow Jones Industrial Average tumbled nearly 400 points on the day.

Investors fear that central banks, in their zeal to prove their anti-inflationary credentials, may inflict some severe damage on economic growth. The problems of the financial sector are far from over, as the $2.8 billion second-quarter loss at Lehman Brothers illustrated. Its share price continued to take a hammering this week as investors worried about its balance sheet and business model.



There have been few bond defaults as yet, but Stephen Dulake, a credit strategist at JPMorgan, reckons investors may be looking in the wrong place for trouble; there have already been 26 defaults in the American corporate-loan market this year. Credit spreads (the excess rates paid by risky borrowers), having fallen sharply between mid-March and mid-May, have been edging higher again.

Meanwhile, house prices are falling in America and Britain. Consumers are struggling to cope with the impact of that on their wealth and with the effect of higher fuel and food prices on their wallets; a rise in interest rates may push them over the edge. In the global economy, more bad news came on June nth: Australian consumer confidence and New Zealand home sales fell to i6-year lows.

Nor is the task of balancing inflation and growth confined to the developed world. In China the central bank raised the amount of reserves banks must hold against their loans, in an effort to restrain inflation, and shares fell for seven days in a row up to June 12th. Inflationary fears led India's central bank to raise interest rates for the first time in more than a year.

In essence, the global economy has received two shocks in the past 12 months-the credit crunch and higher commodity prices. Those shocks have made the outlook more uncertain, not just for the economy but for monetary policy. And uncertainty makes investors nervous, not least because it comes after a long period when markets seem to have underpriced risk. "Recent years have seen the world get all the benefits of globalisation without the costs," says Peter Oppenheimer, a strategist at Goldman Sachs. "Emerging markets ▸▸

> got growth, developed countries kept the lid on inflation."

But higher commodity prices are a zero-sum game; for every winner, there is a loser. Many of those losers are likely to be companies. Profit margins have been at historic highs in some big countries, in large part because businesses have been successful in controlling labour costs. But higher raw-material prices present firms with a problem. Pass those costs on, and not only will consumer demand falter, but central banks may raise rates. So they may have to accept lower margins instead.

At the start of the year analysts were forecasting 15% profits growth for European companies in 2008. Revisions have brought that number down to 4%, largely because of problems in the finance industry. But Goldman Sachs thinks analysts are still too optimistic; it is predicting an earnings decline of 12% this year. A combination of higher interest rates and lower profits makes it difficult to see how stockmarkets could advance much during the rest of the year.

Currency markets are also likely to be volatile. The Fed would like to engineer a rise in the dollar against the euro and the yen and a fall against the developing Asian currencies. But that will be hard to pull off as central banks around the world grapple with the inflation/growth trade-off. The dollar's yield will continue to look unattractive, since American interest rates are likely to remain lower than most (bar Japan's). The Bank of Canada, which was widely expected to cut rates this week, decided to keep them steady.

And government-bond markets may also be set for turmoil. Analysts have been scratching their heads at some of the recent moves. "If we told you that the Dow fell by 400 points one Friday after the largest rise in the unemployment rate in nearly ▸▸

Buttonwood | Let them heat coke

How green taxes hurt the poor

AS SPANISH hauliers and French fishermen have shouted out for all the world to hear, higher fuel prices are not popular. This is uncomfortable for those—including this newspaper—who see increased taxation as a way of fighting global warming. Green taxes tend to fall hardest on the poor.

You could see the rise in the oil price over the past five years as a gigantic carbon tax. It is, at last, succeeding in cutting demand in the developed world (although not yet in the developing one). But it has been extremely painful for some parts of society.

There may be worse to come. Many climate experts favour the ambitious target of cutting carbon emissions by 80% before 2050. Technological change will help. But encouraging those new technologies may well call for higher energy taxes.

In America the Congressional Budget Office has estimated that a cap-and-trade system, designed to cut emissions by 15%, would reduce the average income of the lowest quintile of the population by 3.3% and the richest quintile by just 1.7%.

The effect on the poor is not uniform; fewer drive cars, for example. But those that do spend a big part of their income on petrol. In 2007 Britain's Institute for Fiscal Studies (IFS) estimated that a 5% rise in fuel duty would cut the income of the poorest decile of Britons by 0.27%; the richest decile would lose only 0.11%.

And although the poor may not all drive, they must all heat their houses in winter. According to an IFS paper* last year by Don Fullerton, Andrew Leicester and Stephen Smith, the poorest decile of British households spent 12% of their income on fuel in 2004, compared with just 4% for the richest decile. (It is a safe bet that the share has since risen.) In addition, the wealthy have more money to spend on

products that improve energy efficiency, such as insulation and hybrid cars.

The link between fuel and food prices only worsens the burden on the poor. This has caught people's attention because corn is being used as a biofuel. But oil is also a constituent of many fertilisers and the growth of emerging markets is affecting demand for both. Once again, the poor devote more of their budget to food than the wealthy do.

The answer might seem simple. Let the green taxes rip and then compensate low earners by making more benefits available to them. A similar answer has been proposed for the adverse affects of globalisation; rather than restricting trade, governments should instead seek to cushion globalisation's impact on those members of the population that lose.

A report** by the Joseph Rowntree Foundation in 2004 suggested several ways to do this, for example by using a lower energy tariff for those on benefits or granting a free water allowance to some households. But the report came up against one difficulty. You could devise compensation packages that made the average poorer person better off. But widely differing uses of energy meant that around 20% of the poorest households would still lose out. In a way, governments would be faced with a similar problem to the one that bedevilled Gordon Brown, the British prime minister, earlier this year when he sought to abolish the country's lowest rate of income tax. The change produced some losers, and their grievance counted for more than the gratitude of the numerous winners.

There would be other drawbacks with a tax-and-compensate system. If such an approach were means-tested, the effect would be to increase marginal tax rates for the poor (since benefits will be withdrawn as incomes rise). That will reduce incentives to work.

Even if the benefits are not means-tested, they may counteract the effect of higher taxes on energy demand. In Britain, for example, all pensioners are given a winter-fuel allowance. But it seems odd to try to prevent energy use with higher taxes on the one hand and then to subsidise it on the other.

The fundamental problem is difficult to get round. If governments desire people to use less energy, they have to ration supply by price. They can limit frivolous use (gas-guzzling cars, televisions on standby and the like). But there may be a core demand for energy (heat, light, commuting) where consumers will resist cuts. For that part, the rich will always be able to outbid the poor (not to mention the politically powerful middle class). And that will plague green campaigners.

* www.ifs.org.uk/mirrleesreview/reports/conference_drafts/environment.pdf

**Green taxes and charges: Reducing their impact on low-income households. www.jrf.org.uk/knowledge/findings/housing/074.asp

three decades, would you buy or sell two-year Treasury notes?" asks William O'Donnell, a strategist at UBS. The usual response would be to buy, but investors sold. Expectations of higher short-term interest rates trumped the safe-haven appeal of the bonds.

At the ten-year level, it may seem odd that investors are willing to receive a Treasury-bond yield of just 4.1% when headline inflation is 3.9%. But if the American economy slips into recession, ten-year yields could fall a lot lower than that; they were 3.1% in June 2003.

So, a world without Goldilocks would be a harsh one for investors. It is not a place where bears eat porridge and go for strolls in the wood. It is one where bears eat ingenues for breakfast. •

Fonte: The Economist, n. 8584, p. 85-87, 14 June. 2008.