# Inflation surge to intensify financial turmoil

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The latest inflation figures from the US and the surge in prices around the world have blown apart the claim of central banks and government authorities that inflation was "transitory" and would pass once problems with the re-opening of the economy had passed.

On Wednesday it was announced that the US consumer price index (CPI) had risen by 6.2 percent in October compared to a year ago—the fastest annual rise since 1990 and a considerable jump from the 5.4 percent increase recorded in September.

So-called core inflation, after stripping out volatile items such as food and energy, rose by 4.6 percent, the highest level since 1991, and a clear indication that the price surge is spreading throughout the economy.

And the inflation surge is set to continue. As one financial analyst told the *Financial Times*: "Transitory is dead and buried. There is a good chance we will see core CPI close to 6 percent over the next few months."

The global character of the inflation surge is reflected in rising CPI figures elsewhere. The eurozone inflation rate was 3.4 percent in September, the highest level since before the global financial crisis, and well beyond the European Central Bank's target of 2 percent. In the UK the inflation rate is expected to reach 5 percent in the first months of next year.

Data coming out of China this week showed that factory gate prices rose by 13.5 percent in October, their highest increase in 26 years. The increase exceeded economists' forecast of a rise of 12.4 percent and was well above the level of 10.7 percent in September.

The price surge in China is the result of rising commodity prices, particularly in energy and other raw materials. At the same time, manufacturing activity has been declining, prompting fears of stagflation in the world's second largest economy.

The surge in inflation, particularly in the US, will add to the deepening turmoil in global financial markets, pushing up yields on Treasury bonds, especially at the short end of the markets and adding pressure on central banks to start tightening their monetary policies.

In response to Wednesday's figures the yield on two-year US Treasury bonds rose to 0.503 percent from 0.409 percent the day before. This was the biggest movement since the market turmoil since March 2020 at the start of the pandemic.

The yield on the 10-year Treasury rose to 1.558 percent from 1.431 percent as bonds were sold off and their prices fell. Yields, that is interest rates, and bond prices have an inverse relationship.

It remains to be seen what effect the rise in yields will have on the rest of Wall Street where the stock market has been powering to record highs over the past two months. It experienced a slight fall on Wednesday on the back of the inflation number and remained steady yesterday.

The stock market has been lifted to ever-greater heights by the flow of cheap money from the Fed and the expectations of higher earnings by the largest firms. Higher interest rates tend to depress stock values because they mean that the present value of future cash flows is discounted at a higher rate and is thereby lowered.

So far, the main financial impact of the higher inflation over the past months has been in the bond market where those investors, very often major hedge funds using billions of dollars of borrowed money, who bought into the Fed scenario of "transitory" inflation have lost large amounts of money.

The situation is being compounded by uncertainty about the direction of the policies of the Fed and other central banks. So far Fed chair Jerome Powell has insisted that there will be no increase in the Fed base interest rate at least until the process of tapering its purchases of Treasury bonds and mortgage-backed securities is completed in the middle of next year.

But there are fears that with inflation continuing to rise it may have to act before then and slam on the brakes. The problem of uncertainty was highlighted last week when the Bank of England decided not to lift its base rate after its governor, Andrew Bailey, had given clear indications that it would.

Uncertainty means large losses for hedge funds and other speculators who make bets based on forecasts that turn out to be wrong.

There are also clear indications the problems that beset the $22 trillion US Treasury market in March 2020 have not gone away. The market faced a profound liquidity crisis when, at one point, no buyers could be found for US government debt.

This was contrary to previous experience when, in times of turmoil, there is a rush for the "safe haven" of government debt. Instead, Treasury bonds were sold off in a dash for cash, requiring a massive intervention by the Fed, to the tune of $4 trillion, to stabilise the market.

This week, the FT reported that trading conditions in the Treasury market had become "less hospitable" in recent weeks and pointed to "choppy" movements in the prices of securities.

Liquidity, that is the ease with which an investor can buy or sell an asset, had deteriorated in recent weeks, it said.

A working group of US financial authorities set up to probe the events of March 2020 produced a report this week on top of those made in the past but added few insights and did not advance any proposals to prevent a recurrence.

In its report on the group's findings the FT cited critical comments by Yesha Yardav, a professor at Vanderbilt Law School who researches Treasury markets regulation.

"The report does not go far enough to support the plumbing of the Treasury market and to assure that liquidity providers will remain trading when conditions become stressed," he said.

The report, however, did contain one significant statistic which shows the extent of the problems with which regulators are now seeking to grapple.

At the end of 2007, just before the global financial crisis, US Treasury debt held by the public totalled $5.1 trillion, or 35 percent of gross domestic product (GDP). At the end of 2020, the debt had reached $21.6 trillion or 101 percent of GDP. The very increase in its size and the increasing complexity in financial transactions creates greater regulatory problems.

Furthermore, almost all trading is carried out electronically, most often using algorithms.

The report noted that because of electronic trading, firms "access multiple markets over ever-shorter time-frames" and markets have become increasingly interconnected, "resulting in significantly faster risk and information transmission."

This has two consequences. In "normal" times it means that greater profits can be made more rapidly. But it also means that in times of financial stress problems in one area are more rapidly transmitted to the rest of the market, creating the conditions for a generalised crisis.