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Stable Prices, But at What Cost?

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Last week's troubling news on inflation (as detailed in the November reports for [consumer](#) and [wholesale prices](#)) should come as no shock to readers of this blog (assuming, of course, you've agreed with our thesis). For some time now, we've been expecting that pricing pressures were set to rise. The only question was, when? We can answer that question with a confident "now," allowing us to move on to the next batch of questions: how long will it last, and how high will it go?

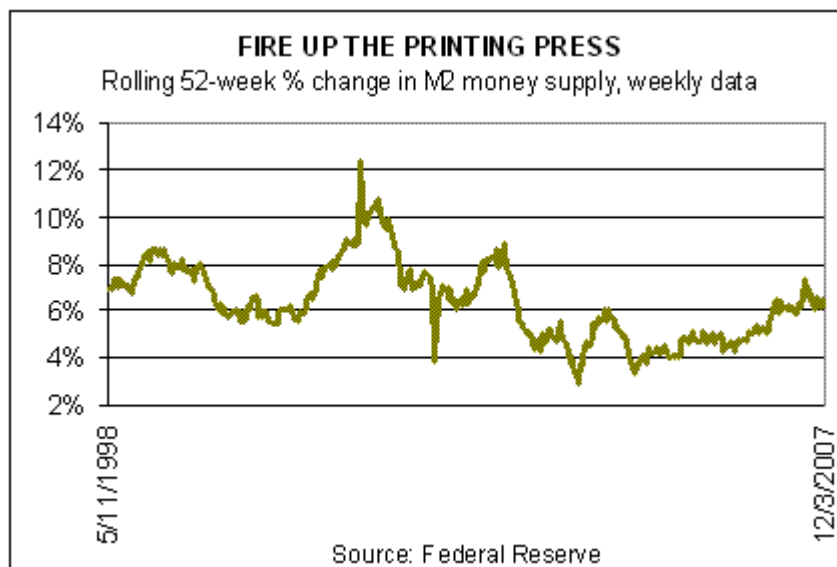
Those answers are yet to be determined. While we wait to see how the central bank reacts, we can review the lessons that the past imparts. That begins with the recognition that inflation never dies, although it does go into long stretches of hibernation. Even then, it's always waiting to pounce, looking to exploit any temporary lapse in central banking judgment or the occasional exogenous event, such as oil running higher.

For much of the 1990s, and deep into the 21st century, prices have been relatively contained. But your editor has a deep and abiding respect for cycles, and so one might wonder if the great disinflationary cycle has finally turned, or at least ended? Twenty years or so, after all, is a long time, and nothing lasts forever in economics.

Certainly it's getting easier to make a persuasive case that the risk outlook for inflation has notched higher. Indeed, with producer prices rising in November at the highest annual rate since the 1970s, and consumer prices also bubbling strongly last month, the numbers speak for themselves.

We don't know what's coming, of course, but this much is clear: inflation remains a monetary phenomenon, as Milton Friedman preached long ago. To the extent that prices rise or fall far out of line with what shifting demand and supply trends imply, the effect is almost certainly due to decisions by central bankers. So it goes in a world of fiat currencies, where printing presses eventually determine the value of dollars, euros, yen and so forth.

With that in mind, we turn to those printing presses overlooked by the Federal Reserve. As our chart below reveals, the annual pace of M2 money supply (the broadest measure of printing press activity published by the Fed) has been steadily climbing in recent years. For the 52 weeks through this past December 3, M2 is up 6.2% in nominal terms. That's almost certainly higher (perhaps much higher) than the pace of growth for GDP this quarter.



Why is the Fed creating what some might say is excess liquidity? The usual suspects come to mind, starting with efforts to juice the economy to circumvent sluggish growth or recession. There are also some liquidity problems in the credit markets, spawned by housing correction and the ills associated with subprime mortgages. In fact, it's never hard to rationalize a little extra liquidity to tide the economy over until the outlook is brighter. The challenge is keep a little nip every now and then from turning into a drunken binge.

Yes, the Fed has reasons for being aggressive in the matter of printing money above and beyond what economic growth require. Perhaps those reasons are compelling, perhaps not. But there's a price to be paid in using liquidity as a tool for repairing damage wrought by imprudent financial decisions made elsewhere.

We can remain agnostic on whether the Fed's doing the right thing or not and still recognize that there will be a cost to the use of liquidity as a treatment for financial sector's problems. The cost, of course, is inflation.

Granted, it's unclear how high inflation will go or whether it'll endure as a long-term proposition. That said, history suggests that letting the inflationary cat out of the bag is asking for trouble. Indeed, containing inflation before it gains a head of steam is much easier than trying to beat it down once it's bubbling.

The good news is that there's still time to battle the beast. Inflation is higher, and the warning signs are clear, but we're still in the early innings of what may be a long game. Alas, the opportunity to keep prices under control won't last forever, nor will the choice be politically easy.

If the inflationary winds are blowing once again, and the Fed resolves to lean into the bluster to slow the pricing momentum, the cost will likely be an economy that's slower growing, and more prone to recession in the short term. In the long run, however, the dividends will be obvious, as they were for years in the wake of Paul Volcker's heroic but initially under-appreciated efforts to stem inflation's tide in the early 1980s.

Students of financial history will recognize that it's much easier to sacrifice long-term price stability on the altar of short-term growth. Politicians and the average consumer inevitably favor good times today. Inflation, by contrast, is a slow-moving monster, and its bite is typically mild and easily overlooked at any short stretch of time. As the years drift by, however, inflation slowly, and persistently eats away at wealth like termites feasting on unprotected wood. One morning you wake up and find that bread costs \$5 a loaf, and your bank account totals \$3.50.

The conceit is that inflation can be fought tomorrow. Sometimes it can, as Volcker proved. But sometimes tomorrow never comes. Meanwhile, one shouldn't assume there'll always be a Paul Volcker waiting in the wings.

This article has 1 comment:

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(1) "In the long run, however, the dividends will be obvious, as they were for years in the wake of Paul Volcker's heroic but initially under-appreciated efforts to stem inflation's tide in the early 1980s."

(2) "Meanwhile, one shouldn't assume there'll always be a Paul Volcker waiting in the wings."

Paul Volcker is dumb as a rock. He created the inflation that you said he eradicated. He targeted non-borrowed reserves instead of total reserves. At times 10% of all reserves were borrowed. \$1 dollar of borrowed reserves creates the same legal-economic base as \$1 of non-borrowed reserves. He was the worst Chairman to hold the post.