

Inflation Is a Clear and Present Danger

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The most painful and frustrating economic policy blunder of the past 50 years was the Great Inflation of the 1970s. Painful, because it was the catalyst for three damaging recessions (1973-75, 1980, 1981-82), all the while eroding living standards and seriously undermining confidence in America.

It was also deeply frustrating. Despite the teaching of Milton Friedman -- which clearly explained that inflation was caused by too much money chasing too few goods -- a combination of bad economic models, denial and political expediency allowed it to happen.

One would think that the odds of a repeat were low, and for 20 years, after Ronald Reagan and his Fed Chairman Paul Volcker had the courage to get inflation under control with tight money and tax cuts, this was true. Unfortunately, the lessons seem to be fading. Today, the U.S. (and through it the world) faces its greatest threat from inflation in 30 years. And as in the past, this threat is being met with denial and political expediency.

Today's problems began seven years ago in 2001, when the Federal Reserve overreacted to the deflationary mistake it made in the late 1990s. The Fed vigorously pumped money into the economy in order to drive interest rates down rapidly.

As is so often the case, after the Fed has acted, but before the typical lag in monetary policy has

fully played out, conventional wisdom argues that the Fed has become impotent. Back in 2002 and 2003, the logic was that the Fed was powerless over globalization, and low-cost labor would continue to feed deflation. In addition, because long-term rates were rising as the Fed cut short-term rates, many thought that markets were undermining Fed intentions.

But, as always, when the Fed injects excess liquidity into the system, inflation begins to rise. As early as 2002, soaring commodity prices and a falling dollar became the canaries in the coal mine of excessively loose



President Reagan meets with Paul Volcker, chairman of the Federal Reserve Board, 1981.

monetary policy.

In their wake, almost every measure of inflation in the U.S. has moved significantly higher. In the past year, producer prices have increased 9.2%, while consumer prices are up 5.6%. Yet, because there are so many measures of inflation it is possible to focus on some, for instance consumer prices excluding food and energy (aka, "core" CPI), which remain benign. This allows many to say there is no inflation.

But oil and food are absorbing a large part of excess Fed liquidity. When consumers spend more on energy, they have less to spend in other arenas. This reduces demand for other goods, keeping prices lower than they would be otherwise. This helps explain the divergence between overall and core measures of inflation.

This divergence is now coming to an end. If the recent decline in energy and food prices continues, that money will be released and other prices will start to rise more quickly. The July jump of 0.3% in "core" CPI inflation is likely one of the first signs.

Some argue that the recent drop in commodity prices indicates lessening inflationary pressures. But nothing could be further from the truth. Commodity prices had reached levels that were not justified by current monetary policy. As a result, their pullback is just a correction, not the beginning of a new trend. If this pullback had occurred as the Fed was lifting the federal-funds rate, like back in 1999, it would be a different story. Excluding food and energy from the CPI is sometimes justified because their price movements are often volatile and short-lived. But the five-year average annual growth rate of the CPI, which should smooth out any short run issues, is now 3.6% -- its highest level since 1994. Moreover, the Cleveland Fed's trimmed mean CPI, which excludes the 8% of prices growing the fastest and the

8% growing the slowest, is also up 3.6% in the past year -- its fastest growth since 1991.

When investors hear comparisons of today with the 1970s, they immediately think double-digit inflation. But, it's not that bad -- yet. It took 20 years of accommodative monetary policy in the 1960s and '70s to create the Great Inflation. A more accurate comparison on the inflation front would be the late 1960s, when consumer price inflation accelerated to 6% from about 1%. This period was the precursor of the 1970s. Except for catch-up after the wage and price controls of 1971, the actual move into double-digit inflation did not occur until the late '70s.

With the real (or inflation-adjusted) federal-funds rate now negative, the signals are clear. The Fed is still adding more money to the system than is demanded, and this suggests that the general increase in inflationary pressures will continue. The only question is whether policy makers will get the courage to fight inflation before it gets out of control.

And this is the rub. Much like the 1970s, there is a widespread denial that inflation is a problem today. Some argue that Fed policy is not easy, either because the money supply is not growing, or that banks are deleveraging, which counteracts any attempt by the Fed to inject money.

The first argument hits at the root of Friedman's monetary theory. If money is not growing, then how

can inflation be a problem? But money *is* growing. No measure of money is declining, despite bank deleveraging, and Reserve Bank Credit (the Fed's balance sheet) has expanded at a 14.4% annual rate in the past three months.

Another sign of easy money is that every country that pegs to the dollar, including China and the United Arab Emirates, is experiencing a rapid acceleration in its inflation rates as it imports inflationary U.S. monetary policy.

The second argument is belied by history. Between 1983 and 1994, exactly 2,747 U.S. banks and S&L's failed, representing total assets of \$894 billion. During that period of deleveraging, real GDP in the U.S. expanded at an annual average of 3.5%. The Great Depression is the only period of sharp economic contraction in the U.S. correlated with bank failures. But that was clearly related to a deflationary mistake in Fed policy. Real interest rates were outrageously high in the late 1920s, and much of the '30s, which is not true today.

One of the reasons that monetary policy is so loose today is that our economy is addicted once again to easy money and low interest rates. We hear over and over that the Fed cannot tighten because the housing market and the economy are vulnerable. This was the same argument made in the pre-Volcker 1970s, when the U.S. bounced from one economic crisis to the next.

But a look back at the past 40 years clearly shows that the economy was much healthier in the 1980s and

'90s, when real interest rates were high, rather than low as they were in the 1960s and '70s.

The Fed's "dual mandate" -- to keep the economy strong and prices stable -- serves to support this mistake. In contrast, the European Central Bank has a single mandate: price stability. No wonder the dollar has been so weak relative to the euro. Imagine two football teams. One with a single mandate: win. The other with a dual mandate: win and keep your uniforms clean. It's clear that the one with the single mandate will have more success in achieving its goals over time.

It is this combination of denial of actual inflation, bad economic models and the political expediency of keeping interest rates low that makes a repeat of past policy mistakes likely. In the end, inflation can be controlled -- the Volcker-Reagan strategy of tight monetary policy and tax cuts still holds the key -- but only if policy makers find the courage.

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