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First Trust

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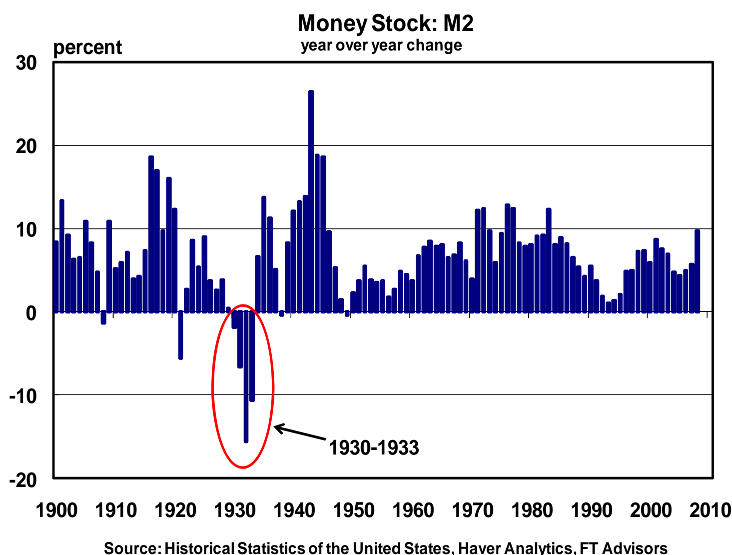
# Fed Balance Sheet Expansion Is Not Hyper-Inflationary

It is strange for fears of deflation and fears of hyper-inflation to exist at the exact same time, but that is the world we have created. Fears of deflation are being fanned by weak economic growth and deleveraging, while fears of hyper-inflation are being fed by a huge expansion in the Federal Reserve's balance sheet.

We believe both of these fears are unjustified. Although consumer and producer prices have been declining rapidly in recent months, this is due to an unprecedented drop in energy prices not a shift in underlying inflationary trends. Persistent 1930s-style deflation is unlikely to take hold because that kind of deflation is the result of a contraction in the money supply.

In the beginning of the depression, the M2 measure of the money supply contracted for four straight years – 1930, 1931, 1932, and 1933. In sharp contrast to that period, when the money supply shrank by roughly a third, the money supply is expanding today.




In fact, the Fed's balance sheet has expanded so rapidly that some analysts fear hyper-inflation. But the money supply is not expanding at anywhere near the same rate as that of the Fed's balance sheet.

While the Fed's balance sheet has expanded more than 500% at an annual rate in the past six months, the M2 measure of the money supply is up significantly less. M2 has grown 10% in 2008 over 2007, and is up at an annual rate of 14.5% in the past three months.

Not all increases in the Fed's balance sheet are created equal. There are two ways the Fed can expand the size of its balance sheet – printing money and borrowing money. Printing money does create inflation; borrowing money doesn't. And, recently, the Fed has been ramping up its balance sheet mostly through increases in borrowing, not printing money.

We use the euphemism of "printing money" to mean the creation of money by the Fed to buy bonds from the financial system, whether that is actual currency or just an electronic credit to a bank's reserve account at the Fed. Printing money not only expands the Fed's balance sheet but is also a direct increase in the money supply.

Borrowing money to increase the balance sheet does not increase the money supply. At the end of this piece are charts depicting the various components of the Fed's balance sheet – both assets and liabilities. Analyzing the detail of that data shows that 90.3% of the expansion in the Fed's balance sheet reflects borrowing from the Treasury, or from banks (now that the Fed pays interest on reserve deposits).

Why is the Fed boosting its balance sheet by borrowing? To temporarily fulfill the role of banks, who are much less willing to hold risky assets. Before the financial crisis, every night banks used to sweep funds from non-interest checking accounts into interest-bearing accounts. This reduced their need to hold reserves. The interest-bearing sweep accounts bought commercial paper, among other assets.

But, as economic problems spread, banks pulled back from this practice and the Fed stepped into the gap. Now, banks hold their reserves at the Fed, and the Fed buys the commercial paper and other assets.

At the same time the Treasury is lending money to the Federal Reserve, so that it can hold risky assets and relieve pressure on the banking system.

If the Fed borrows money from the Treasury (with the Treasury issuing bonds to make that loan), the money is not "new money." It is just recycled through the system from one balance sheet to another. Or, if the Fed entices banks to hold more reserves (because it pays interest on those reserves), then the Fed is just using the systems' money, it is not creating new money.

If the Fed actually printed money to buy Treasury bonds or printed money to buy commercial paper, then the balance sheet expansion would be inflationary. But as long as the Fed is using other people's money to expand its balance sheet, the activity is not the equivalent to printing new money.

Having said all of this, it is also true that part of the Fed's balance sheet expansion represents the printing of new money. Currency has expanded at a 15.9% annual rate in the past three months. This is the most rapid expansion in currency since the months leading up to Y2K, when many feared the breakdown of our nation's computer system and wanted to hold cash.

The M1 and M2 measures of money are also expanding rapidly. In other words, the US will face an inflation problem if the Fed does not take its foot off the monetary accelerator at some point in the very near future – but it won't experience hyper-inflation.

So, there is some good news here and some bad. The good news is that fears of hyper-inflation and deflation are overblown. The bad news is that the Fed is printing money at a rapid rate and this will eventually lead to a return of inflationary pressures if the Fed does not suppress the money supply as downward pressure on velocity starts to relent in the months and quarters ahead.

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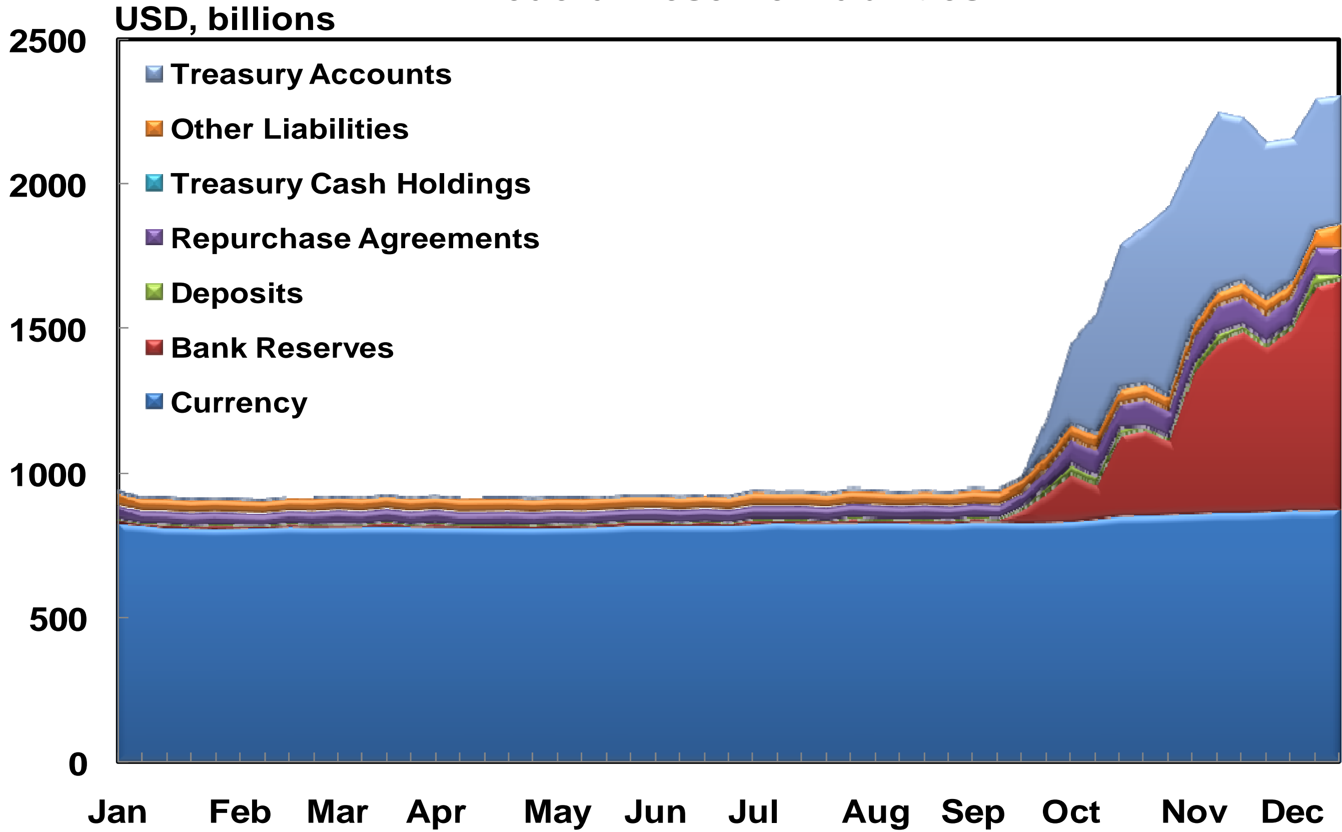


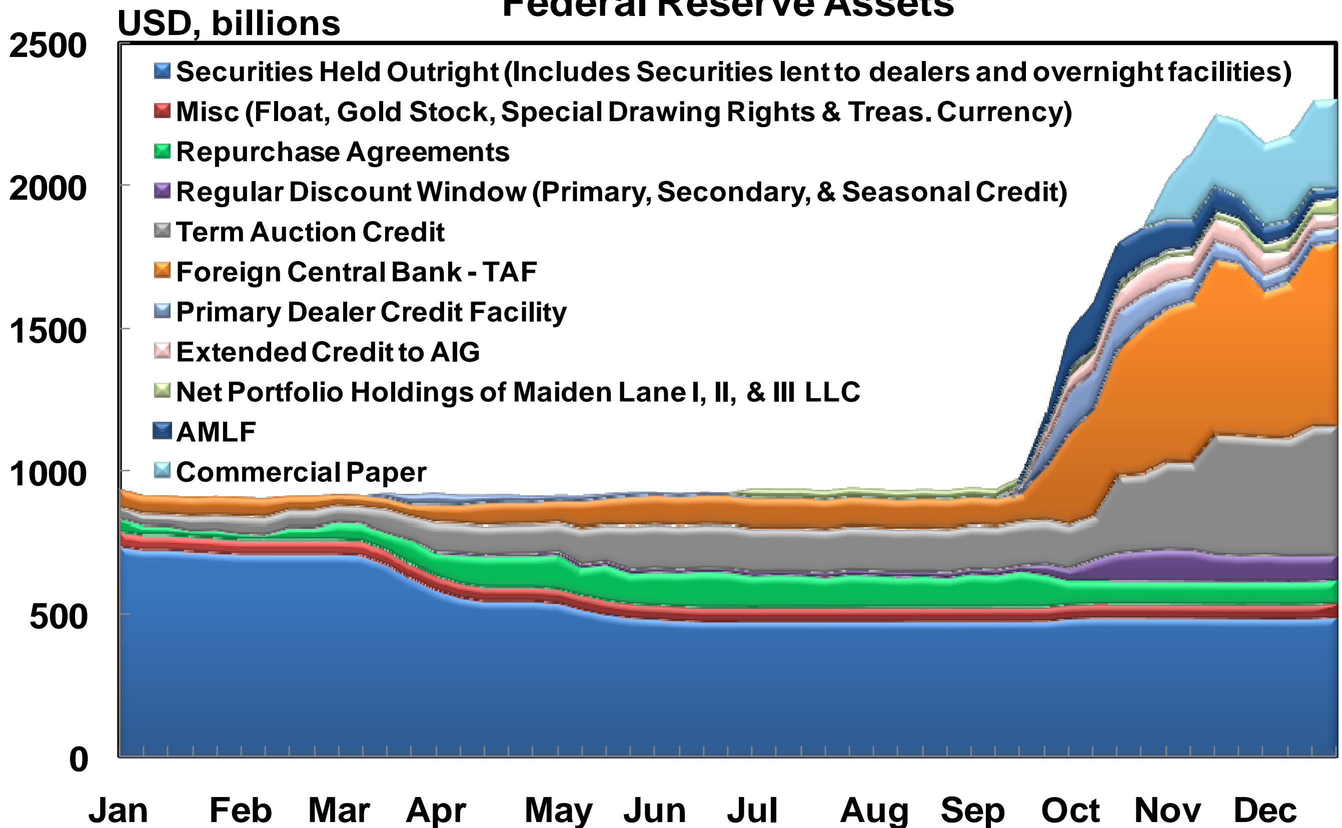


**Source: Federal Reserve H.4.1, FT Advisors**

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