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First Trust

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Monday Morning Outlook

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Where Does Inflation Come From?

In his final warning before hiking interest rates last week, European Central Bank (ECB) president Jean Claude Trichet said, "If we are not resolute, there is a risk that inflation will explode." With this he lifted the overnight lending rate to 4.25%.

We are not sure of the exact numerical definition of "exploding inflation," but the ECB is clearly worried that 3.7% growth in the European CPI over the past year is fueled by more than just energy and food.

This leads us to ask a rhetorical question: where does inflation come from? Sometimes an answer can be found at the extreme and today's extreme on the inflation front is Zimbabwe, where prices are doubling every month.

So why is this happening? Is it due to rising commodity prices? Or, rising wages? No. Zimbabwe is experiencing hyperinflation because the government is printing money to meet its payroll. They have printed so much money that it has become virtually worthless.

As Milton Friedman taught, inflation is everywhere and always a monetary phenomenon. The only way inflation can exist, let alone "explode," is if a central bank or government prints more money than an economy needs. What determines the need for money is the increase in goods and services. If the money supply grows faster than the growth rate in goods and services, the value of money will decline. Inflation is too much money chasing too few goods.

Imagine an economy with 10 apples and $10, each apple will cost $1. If the money supply is increased to $20, then the price of apples will increase to $2. If the apple supply increased to 20, and the money supply doubled to $20, then apples would still cost $1.

This is why rising oil and food prices by themselves are not inflation. As long as the money supply does not increase, any increase in spending on oil or food would be offset by a decline in demand for other goods. Other goods prices would be forced to fall; and the overall price level (inflation) would remain unchanged.

Milton Friedman won the Nobel Prize for explaining this mechanism. And despite the fact that many people want to relegate monetarism to the ash heap of intellectual history, it remains the only true and correct explanation of inflation.

What's interesting is that the ECB understands this, and has institutionalized Friedman's monetary thinking. By law, the ECB has a "single mandate" for monetary policy – price stability.

On the other hand, the Federal Reserve has a "dual mandate." Congress says the Fed must promote "maximum employment" _and_ "price stability." This dual mandate is conflicting. In fact, the more the Fed focuses on employment and economic growth, the higher the probability that commodity prices and inflation will rise, the dollar will fall, and the economy will suffer.

In fact, if all we knew about the ECB and the Fed were that the former had a single mandate and the latter had a dual mandate, we could easily make a forecast for the direction of exchange rates. Think of it in terms of football. If one team had a single mandate from management to win, but the other team had a dual mandate to keep it uniforms clean _and_ win, the first team would win a huge percentage of the time.

In other words, the longer it takes the Federal Reserve to hike rates and tighten monetary policy, the weaker the dollar will become and the higher inflation will climb. We do not believe inflation will "explode" in the US, but elevated readings in the 3% to 5% range are clearly on tap for the next few years.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-8 / 2:00 pm	Consumer Credit – May	$7.3 Bil	**$6.7 Bil**		$8.9 Bil
7-10 / 7:30 am	Initial Claims – Jul 5	395K	**399K**		404K
7-11 / 7:30 am	Int'l Trade Balance – May	-$62.5 Bil	**-$62.1 Bil**		-$60.9 Bil
7:30 am	Import Prices – Jun	+1.9%	**+1.8%**		+2.3%
7:30 am	Export Prices – Jun	+0.5%	**+0.5%**		+0.3%
8:45 am	U. Mich. Consumer Sentiment	55.5	**56.0**		56.4
1:00 pm	Treasury Budget – Jul	$30.0 Bil	**+$23.7 Bil**		-$165.9 Bil