

1970s REDUX: INFLATION, BACK FROM THE DEAD

By Arthur B. Laffer

Summary

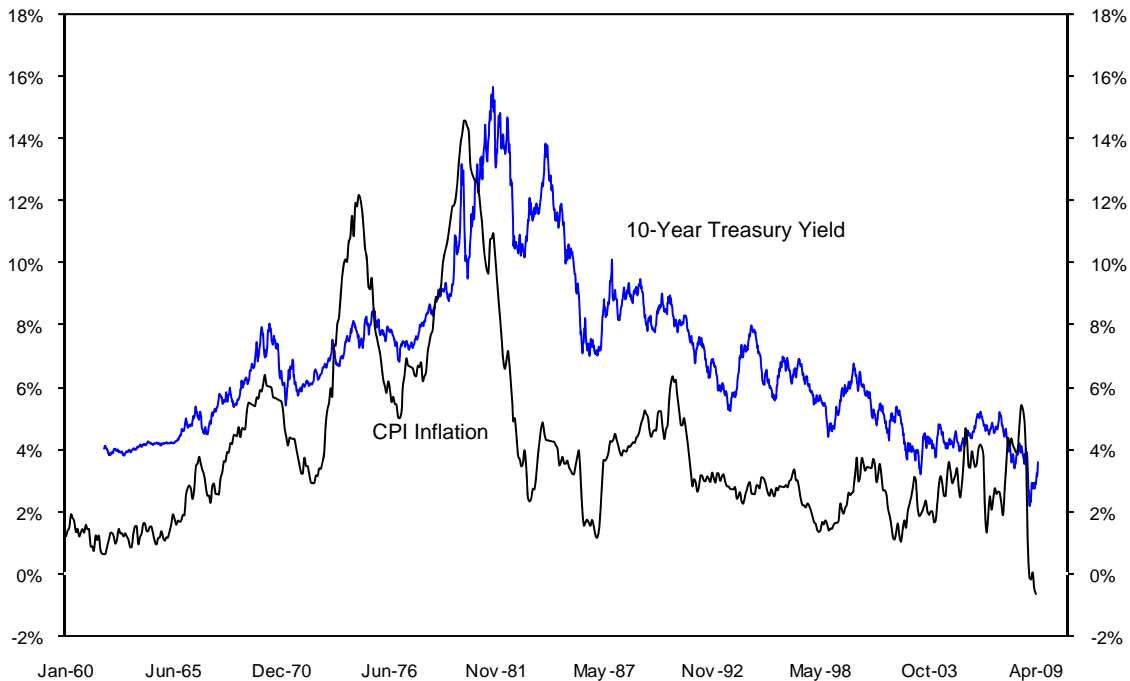
- The expansion of money, given an increase in the monetary base, is inevitable. Ultimately, the consequence of this expansion of money is higher inflation and interest rates.
- In shorter time frames, the expansion of money can also result in higher stock prices, a weaker currency, and increases in commodity prices such as gold and oil, as we are currently seeing.

For a politician, truer words are rarely found than those attributed to Rahm Emmanuel that a crisis should never be wasted. Crises give rise to vastly accelerated political agendas and initiatives scarcely conceivable under calmer circumstances. And this time, in mid-crisis America, it's no different. Here we stand more than a year into the crisis with a projected budget deficit of 13% of GDP, more than twice the size of the next largest deficit since World War II. And this projected deficit is the culmination of a year when the federal government, at taxpayers' expense, acquired enormous stakes in the banking, auto, mortgage, health care and insurance industries. The crisis, along with its ill-conceived government reactions, plus the ensuing economic downturn, have pushed unfunded liabilities of federal programs such as Social Security, Civil Service Retirement, Military Pensions and Benefits, Government Pension Benefit Guarantee Corporation, Medicare and Medicaid over the \$100 trillion mark.¹ With U.S. GDP and federal tax receipts at about \$14 trillion and \$2.4 trillion respectively, such a debt all but guarantees much higher interest rates, massive tax increases, and partial default on government promises.

Figure 1

United States Inflation and Interest Rates

(CPI Inflation: Monthly, Yr/yr, SA, through Apr-09; 10-Year Constant Maturity Rate: Weekly, through 5/29/09)

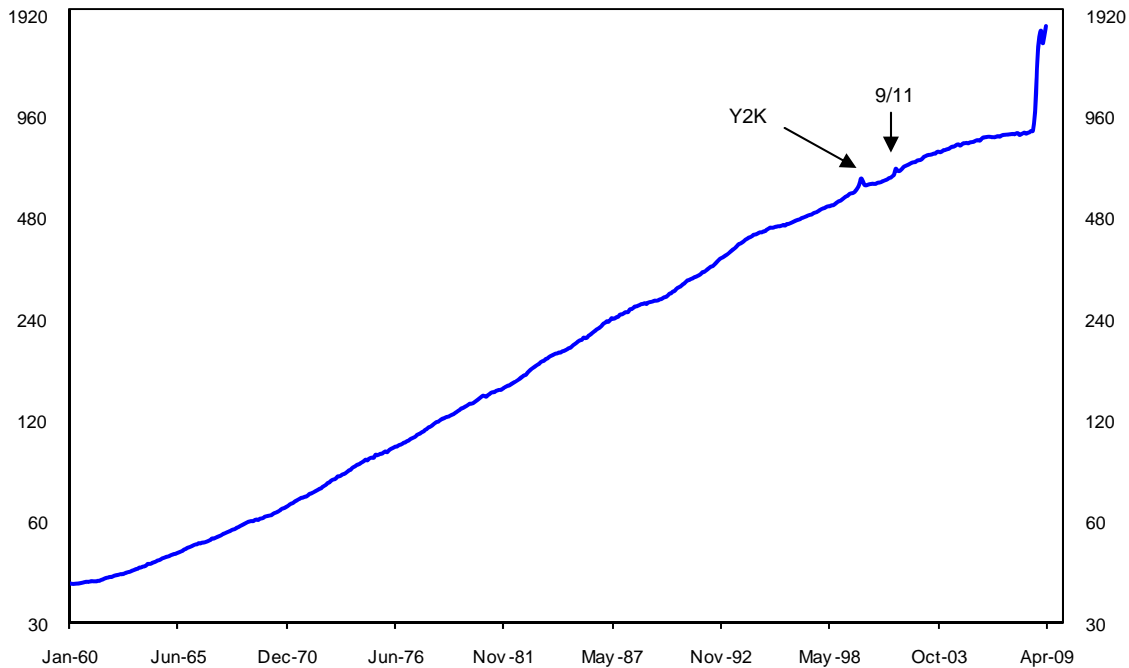


¹ 2009 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds; 2009 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Trust Funds; 2008 Annual Report of the Government Pension Benefit Guarantee Corporation.

But as bad as the fiscal picture is, panic-driven monetary policies portend even more dire consequences. We can expect rapidly rising prices and much, much higher interest rates over the next four or five years (Figure 1), and a concomitant deleterious impact on output and employment not unlike the late 1970s.

About eight months ago, starting in early September 2008, the Bernanke Fed did an about face and radically increased the monetary base—which is comprised of currency in circulation, member bank reserves held at the Fed, and vault cash—by a little less than \$1 trillion (Figure 2). The Fed controls the monetary base 100% and does so by purchasing and selling assets net in the open market and by lending to banks. By such a radical move, the Fed signaled a 180° shift in its focus from an anti-inflation position to an anti-deflation position.

Figure 2
Monetary Base
(Monthly, Billions of \$, Semi-log, SA, through Apr-09)



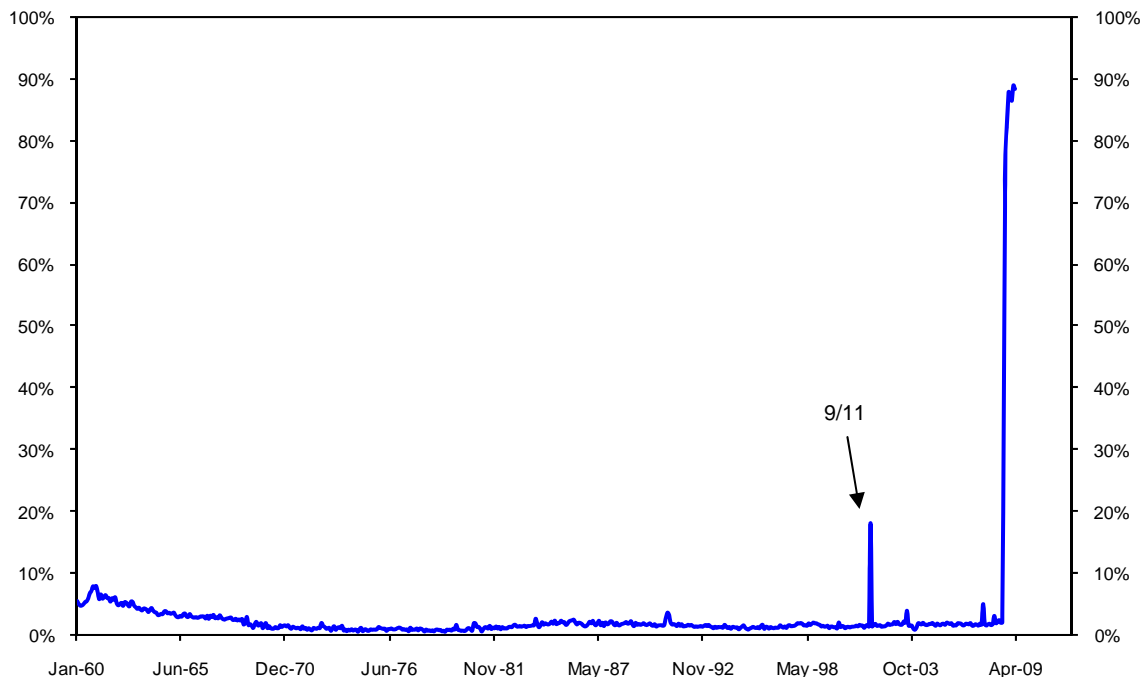
The percentage increase in the monetary base is the largest increase in the past 50 years by a factor of 10. It is so far outside the realm of our prior experiential base that historical comparisons are rendered difficult if not meaningless. The currency in circulation component of the monetary base, which prior to the expansion had comprised 95% of the monetary base, has risen by a little less than 10%, while bank reserves have increased almost 20-fold. Now the currency in circulation component of the monetary base is a smidgeon less than 50% of the monetary base. Yikes!

Bank reserves are crucially important because they are the foundation upon which banks are able to expand their liabilities and thereby increase the quantity of money.

Banks are required to hold a certain fraction of their liabilities (demand deposits and other checkable deposits) in reserves held at the Fed or in vault cash. Prior to the huge increase in bank reserves, banks had been constrained from expanding deposits by their reserve positions. They weren't able to increase overall liquidity in the economy, which had been so desperately needed in response to the liquidity crisis. But since September of 2008, all of that has changed. Banks now have huge amounts of excess reserves, enabling them to make lots of net new loans (see Figure 3).

Figure 3 is at first glance rather bizarre, with excess reserves as a percentage of total reserves being at near zero for almost 50 years and then bouncing up in the blink of an eye to almost 90% (\$824 billion of excess reserves versus total reserves of \$933 billion). The next largest period of excess reserves over the past half century was in September of 2001 when then Fed-Chairman Alan Greenspan judiciously expanded excess reserves to ward off a financial collapse following the attack on America. Figure 3 should visually illustrate the extreme nature of the Fed's actions of late. These are the types of numbers Bill Safire of the New York Times and former speechwriter for President Nixon referred to as MEGO numbers, where MEGO stood for "My Eyes Glaze Over."

Figure 3
Excess Reserves of Depository Institutions as a Percentage of Total Reserves
 (Monthly, Percent, NSA, through Apr-09)



The way a bank or the banking system makes new loans is conceptually pretty simple. They find an entity that they believe to be credit-worthy that also wants a loan, and in exchange for the new customer's IOU (loan), the bank opens up a checking account for the customer. For the bank's sake, the hope is that the interest paid by the borrower more than makes up for the cost and risk of the loan. The recently ballyhooed "stress tests" on banks are nothing more than checking how well a bank can weather differing levels of default risk.²

What's important for the overall economy, however, is how fast these loans are made and how rapidly the quantity of money increases. For our purposes, money is the sum total of currency in circulation, bank demand deposits, other checkable deposits, and traveler's checks (economists call this M1). When reserve constraints on banks are removed, it does take the banks time to make new loans. But, given sufficient time, banks will make enough new loans until they are once again reserve constrained. The expansion of money, given an increase in the monetary base, is inevitable, and it is the consequence of the expansion of money that will ultimately result in higher inflation and interest rates. In shorter time frames, the expansion of money can also result in higher stock prices, a weaker currency, and increases in commodity prices such as oil and gold.

While I'm not keen in general on debunking red herrings, in the current discussion of Fed actions, the short-term maturity of the reserve instruments are pointed to as a reason why this time excess reserves are not inflationary. The reasoning is simply that these excess reserves are self-liquidating in 28 or 84 days and therefore don't constitute an inflation risk. They'll be gone before they can do damage and excess reserves can return to more appropriate levels.

Unfortunately this argument doesn't hold. Short maturity instruments can be renewed by the Fed forever, and long-maturity instruments held by the Fed can be sold by the Fed at will. The length of maturity of the instruments the Fed chooses to use has no bearing whatsoever on the degree of permanence of the excess reserve position.

The Fed describes the Term Auction Facility (TAF), to which we are referring, as follows:

The TAF is a credit facility that allows a depository institution to place a bid for an advance from its local Federal Reserve Bank at an interest rate that is determined as the result of an auction. By allowing the Federal Reserve to inject term funds through a broader range of counterparties and against a broader

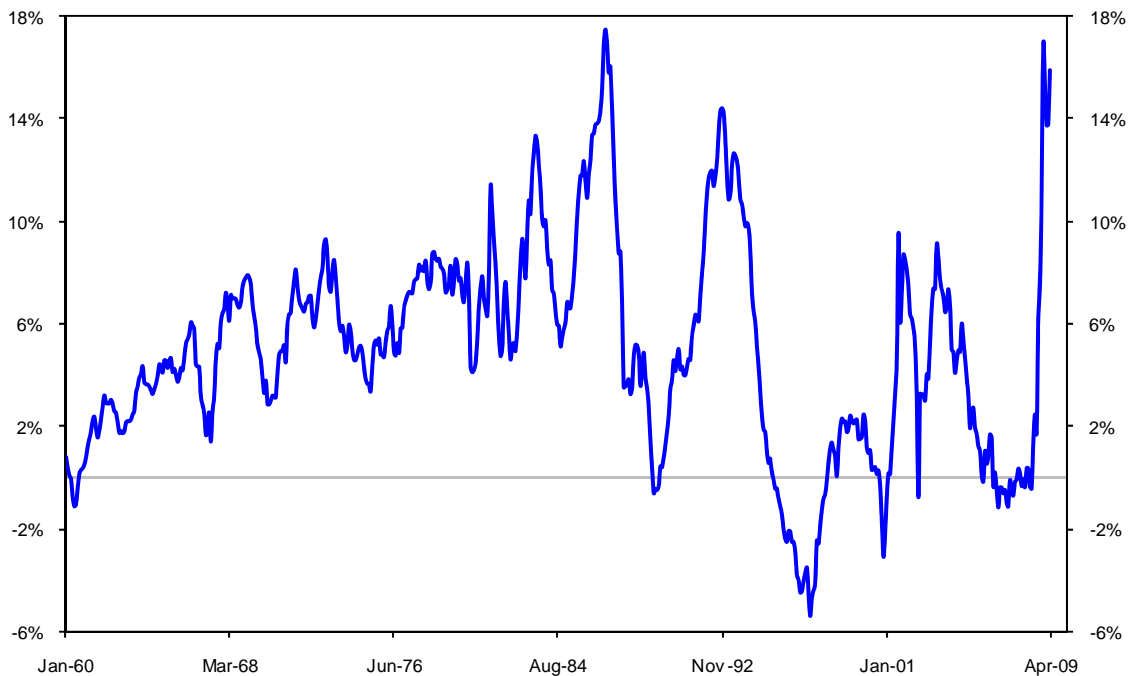
² We will follow in the upcoming weeks with a more in-depth discussion of the stress tests and the state of the banking industry in a paper by Kenneth Petersen, Ph.D.

range of collateral than open market operations, this facility could help ensure that liquidity provisions can be disseminated efficiently even when the unsecured interbank markets are under stress....

In short, the TAF will typically auction term funds of 28-day or 84-day maturity, depending on the Auction. All depository institutions that are judged to be in generally sound financial condition by their local Reserve Bank and that are expected to remain so over the terms of TAF loans are eligible to participate in TAF auctions. All TAF credit must be fully collateralized; loans for which the remaining term to maturity is more than 28 days are subject to additional collateralization requirements.... Depositories may pledge the broad range of collateral that is accepted for other Federal Reserve lending programs to secure TAF credit. The same collateral values and margins applicable for other Federal Reserve lending programs will also apply for the TAF.³

At present, banks are doing just what we would expect them to do. They are making new loans and increasing overall bank liabilities (money). The 12 month rate of growth of money is now in the 15% range, and close to its highest level in the past half century (Figure 4).

Figure 4
12 Month Growth in Money: M1
(Monthly, SA, through Apr-09)



With an increased trust in the overall banking system, the panic demand for money has begun to and should continue to recede. The dramatic drop in output and employment in the U.S. economy will also reduce the demand for money. Reduced demand for money combined with this type of rapid growth in money is a surefire recipe for inflation and higher interest rates. The higher interest rates themselves will also further reduce the demand for money, thereby exacerbating inflationary pressures. It's a catch 22.

It's difficult to range the magnitude of the inflationary and interest rate consequences of the Fed's actions because, frankly, we haven't ever seen anything like this in the United States. To date what's happened is potentially far more inflationary than were the monetary policies of the 1970s when the prime interest rate peaked at 21.5% and inflation peaked in the low double digits. Gold prices went from \$35 per ounce to \$850 per ounce, and the dollar collapsed in the foreign exchanges. It wasn't a pretty picture.

All of this discussion of the monetary base, money and inflation is not just some theoretical possibility that may or may not happen at some future date; it is happening right now. The dollar has begun to fall rather precipitously in the foreign exchanges against all the major currencies (Figure 5). Expected inflation as measured by the difference in the nominal yield

³ Board of Governors of the Federal Reserve System, <http://www.federalreserve.gov/monetarypolicy/taffaq.htm>.

on the 10-year T-bond and the 10-year TIPS (Treasury Inflation-Protected Security) yield has spiked (Figure 6), and commodity prices such as oil and gold have made a major upward move in the last few months (Figure 7). It's all happening right on schedule with no sign of stopping. Actual measures of inflation such as changes in the consumer price index and producers' price index take a while before they register the inflation, but believe me, they are coming.

Figure 5
DXY Dollar Index
(Daily, through 6/04/09)

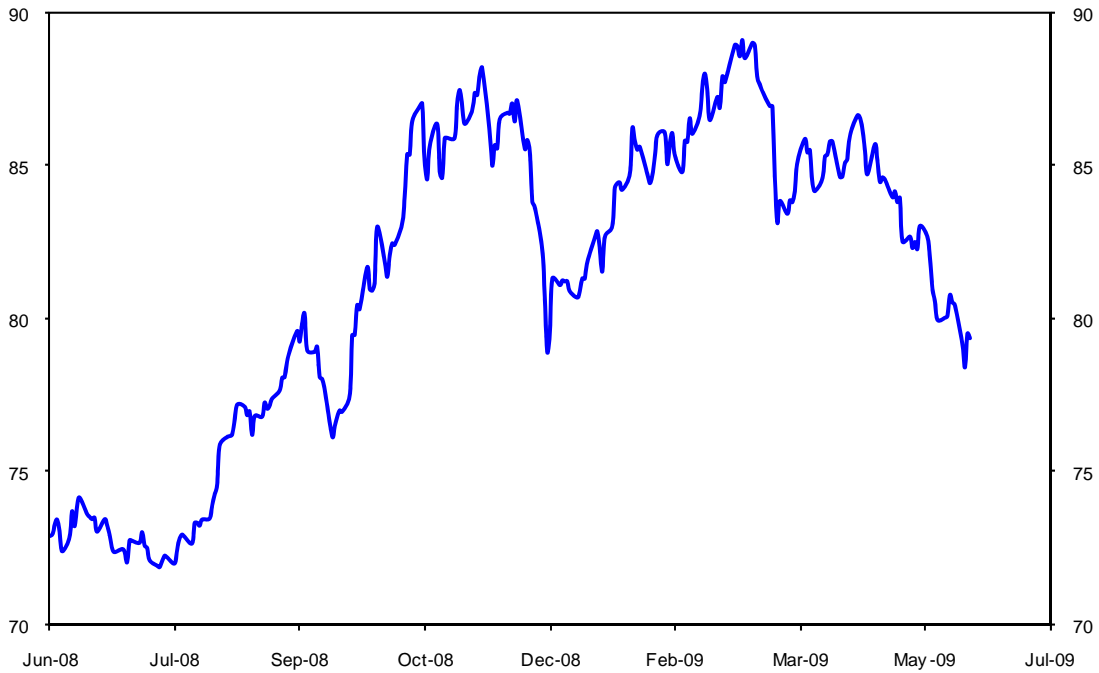


Figure 6
Expected Inflation
(Daily, Percent, through 6/04/09)

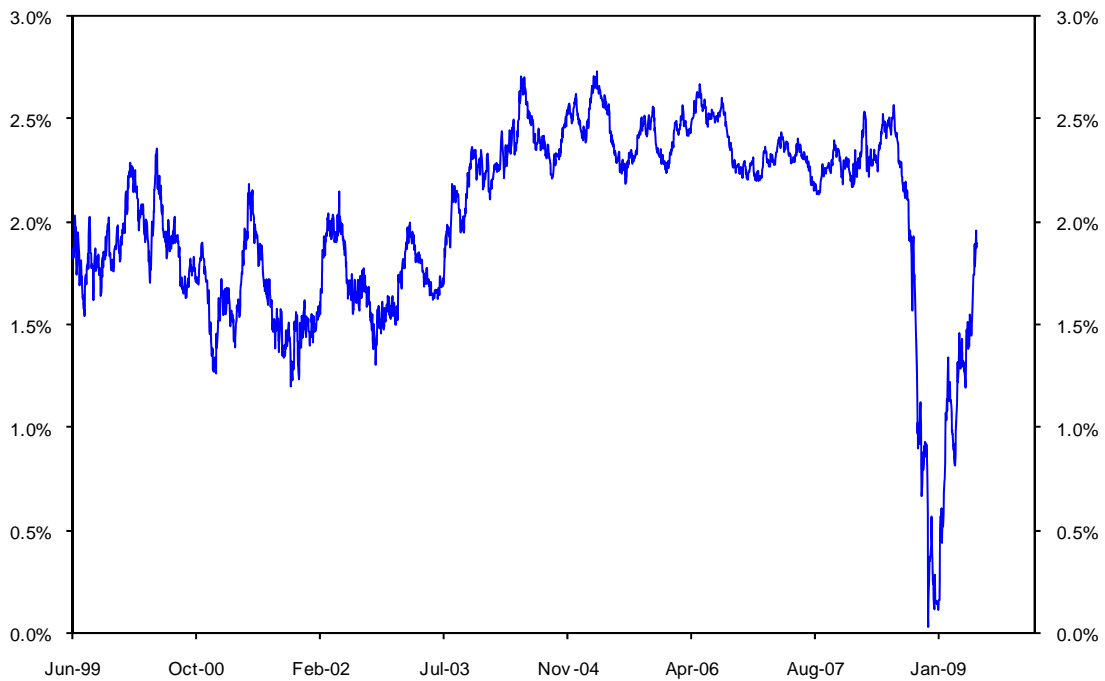
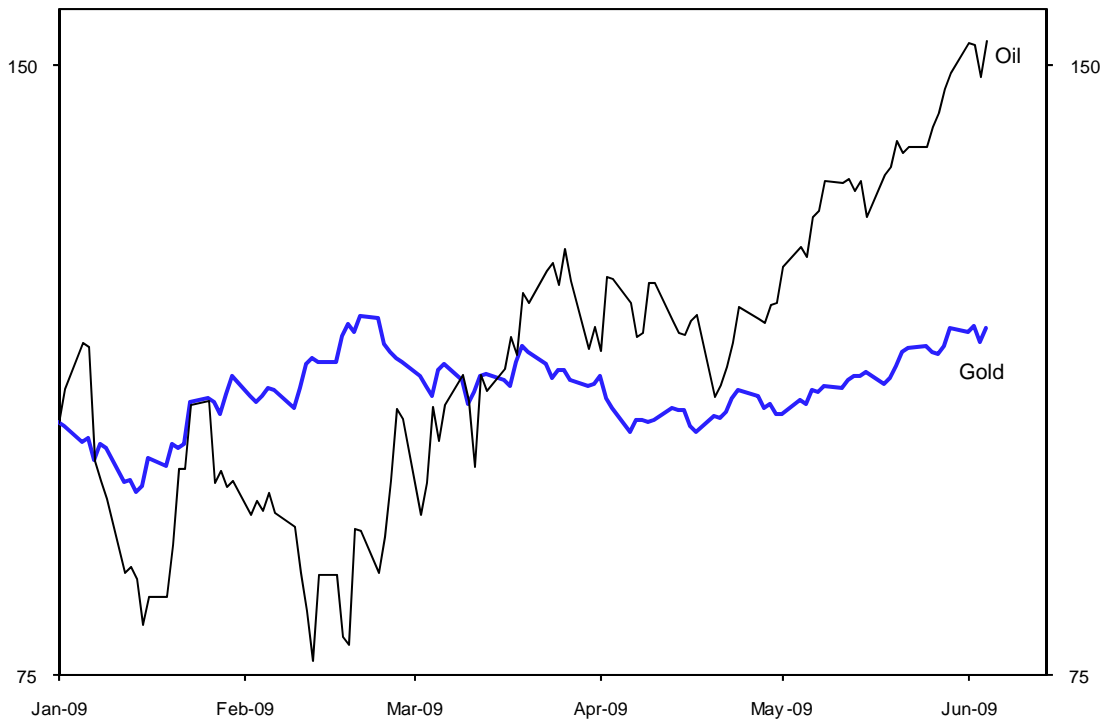


Figure 7
Gold and Oil Prices
 (Daily, Semi-Log, 1/1/09=100, through 6/04/09)



Now, the Fed can, and I believe should, do what it must to mitigate the inevitable consequences of their unwarranted increase in the monetary base. They should contract the monetary base back to where it otherwise would have been, plus a slight increase geared toward economic expansion. Absent this major contraction in the monetary base, the Fed should increase reserve requirements on member banks to absorb the excess reserves. Given that banks are now paid interest on their reserves and short-term rates are very low, raising reserve requirements should not exact too much of a penalty on the banking system, and the long-term gains of the lessened inflation would many times over warrant whatever short-term costs there might be.

Alas, I doubt very much that the Fed will do what is necessary to guard against future inflation and higher interest rates. If the Fed were to reduce the monetary base by \$1 trillion, they would put themselves in direct competition with the U.S. Treasury's planned issuance of about \$2 trillion worth of bonds over the coming twelve months. Failed auctions would become the norm and bond prices would tumble, reflecting a massive over-supply of government bonds. In addition, a rapid contraction of the monetary base as I propose would also cause a contraction in bank lending, or at best limited expansion. This is exactly what happened in 2000 and 2001 when the Fed contracted the monetary base the last time—the economy quickly dipped into recession. While the short-term pain of a deepened recession is quite sharp, the long-term consequences of double-digit inflation are devastating. For Ben Bernanke it's a Hobson's choice. For me it's how to protect my assets for my grandchildren.

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