

Inflation's Macro Myths

Is inflation one of those concepts you know when you see, much like the late Supreme Court Justice Potter Stewart's definition of obscenity? Let's hope not, because much of our instinctive reactions as traders and analysts depend on quick judgments whether the latest macroeconomic developments are likely to increase or decrease reported inflation. Worse, as all central banks have some measure of price stability as one of their stated objective functions, we live in a world where policy has to react to an absolute definition of inflation.

What, then, would transpire if it turned out we neither understood what inflation was, what causes it or how we should address it from a policy standpoint? Despite a widespread consensus emerging from the monetarist economists over the years and gradually accepted elsewhere that inflation is nothing more than too much money chasing too few goods and services, these questions are not farfetched at all.

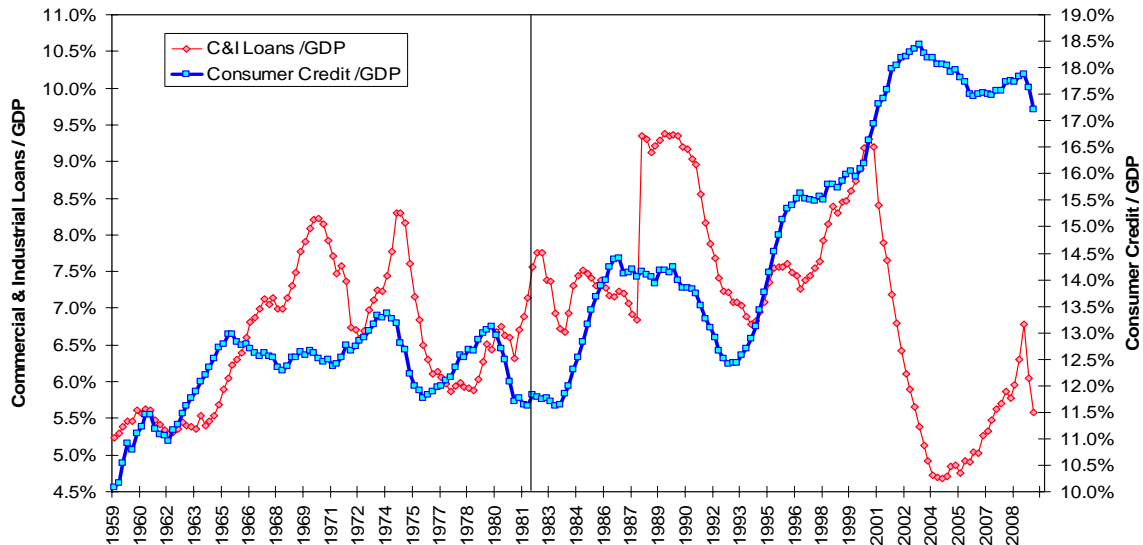
Breaking The Banks

The principal reason is stunningly simple; the textbook explanations of money and banking simply do not correspond to the real world as it has emerged since 1980 in a world of offshore banking, notional finance, securitized lending and global carry trades. The simplistic Keynesian multipliers we were taught way back in Economics 101, such as a 10% reserve requirement leading to a potential $1/(1-.1)$ or 9:1 monetary multiplier in a fractional reserve banking system require an equally simplistic banking system. In the world of the 1950s and 1960s, the Federal Reserve could affect the money supply by adding reserves to the banking system by buying Treasury securities on its own account or withdrawing reserves by selling Treasury securities from its own account. As the banking system was the source of credit to businesses and households, changes in free reserves led to a change in lendable funds; this had a direct effect on macroeconomic activity.

All of that broke during the 1980s. The elimination of Regulation Q interest rate ceilings on time deposits in the early 1980s meant banks and savings & loans could pay more for their funds and direct credit to willing borrowers. Combined with developments in financial engineering and the growth of the notional finance or swap market, this led to the explosion in securitized lending and the transformation of banks from vessels of lending to loan originators in the business of collecting fees. This model worked spectacularly well for a quarter-century – the U.S. had only two minor recessions between 1982 and 2007 – until it collapsed under the second bubble created by the Federal Reserve's ill-considered policy of addressing every economic hiccup with ever-lower short-term interest rates.

If we map both commercial and industrial loans and consumer credit as a percentage of GDP over time and mark the elimination of Regulation Q with a vertical line, we can see how the flow of credit to consumers expanded continually while the C&I loans trended irregularly lower. Businesses did not have to go to the banks for credit; they could go straight to the capital markets or to the commercial paper market for the credit they needed, while consumers suddenly found themselves living in an age of "yes."

Consumer Credit And Commercial Lending Diverged



The Wrong Thermometer

The various bubbles triggered by negative real interest rates transferred the inflationary impulse from price levels, the familiar consumer and producer price indices we all know and love, to asset prices. After all, if you could borrow huge quantities of money at negative real interest rates, another lesson from Economics 101 is those lower borrowing costs get capitalized in asset valuations. This mechanism was fueled further by global carry trades, such as borrowing the yen, Swiss franc or U.S. dollar at very low rates and lending them in riskier and presumably higher-returning assets such as emerging market stocks, real estate, physical commodities or high-yield bonds. The importation of goods and services from newly industrialized countries such as China financed by these carry trades held price indices down while asset valuations soared.

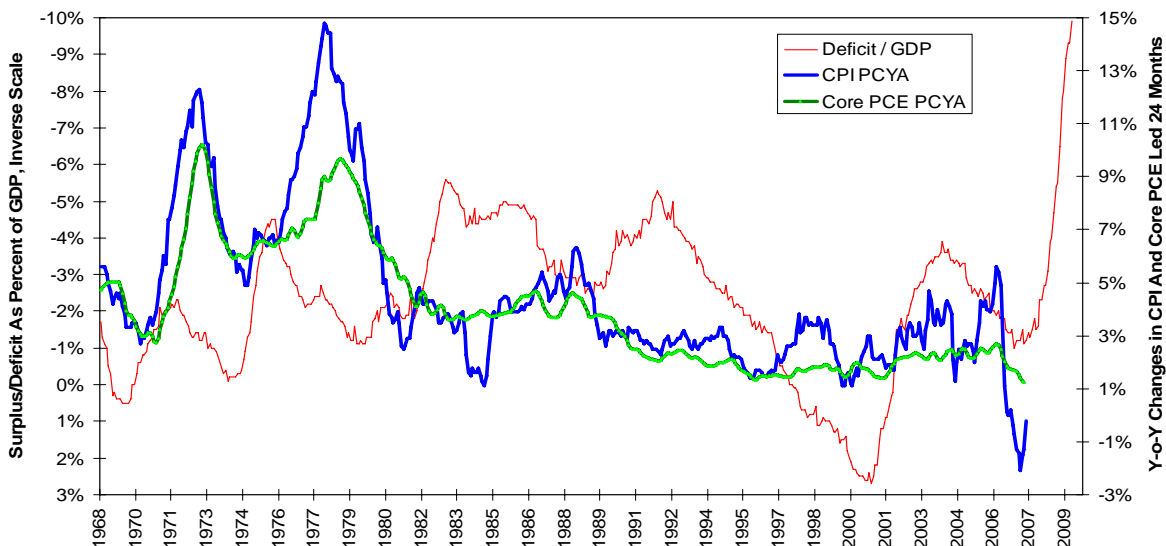
Restated, we had inflation in spades from all of the excess money. It just was in areas where we chose not to measure.

We have no measure of global prices plus global asset valuations, and as attractive the concept is as a goal, we probably will never achieve it. Consider all of the problems the Bureau of Labor Statistics has in constructing the Consumer Price index: It is criticized widely for such plug factors as owners' equivalent rent or for such statistical techniques as hedonic adjustments to account for productivity improvements and technological gains. And forget about normalizing asset valuations; simply ask yourself what the proper price/earnings ratio for a stock index is and whether the current level is excessive or not. Then multiply this across global markets. Still, the concept of inflation incorporating both prices and assets is one we should retain as a device for thought.

Macro Myths

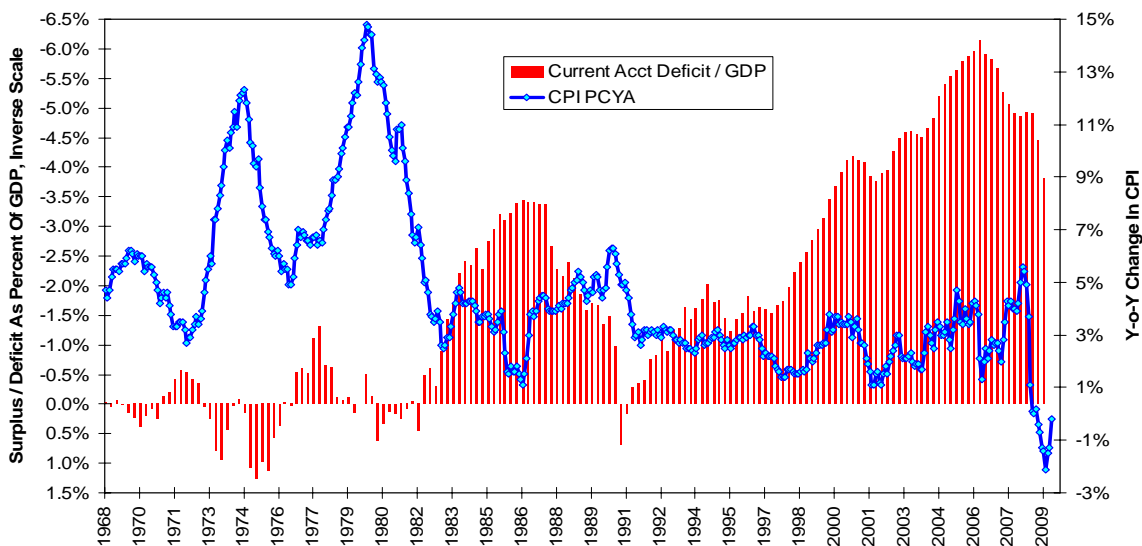
The less people understand about a concept, the more causes are proffered therefor. Let's take the role of federal deficits in causing inflation. The deficit as a percentage of GDP has moved to a new and frightening plateau after shrinking during the Clinton years. Many skeptics assume this gives the federal government an enormous incentive to create inflation as a way of repudiating its own debts. Does the deficit correlate to either year-over-year changes in the CPI or in what was one of the Greenspan Federal Reserve's favorite measures (at least when it suited his immediate need to bamboozle somebody), the core personal consumption expenditure deflator. Not at all: As the normalized deficit has increased, the CPI has declined and core PCE has been flat for fifteen years.

Federal Deficits And Inflation



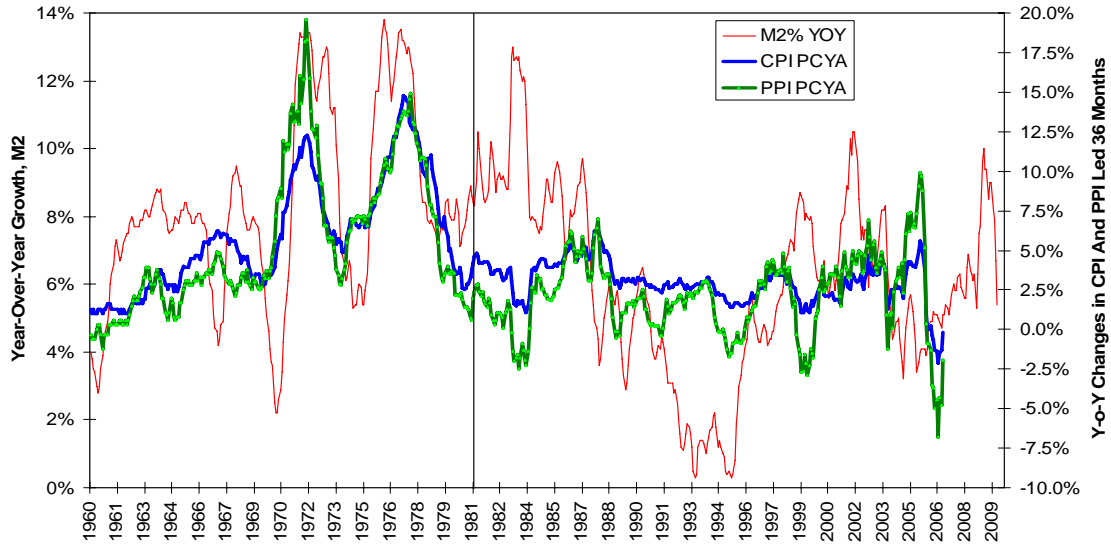
What about the other “twin” deficit, the current account deficit as a percentage of GDP? Once again, the logic is simple; the U.S. has an incentive to pay back its debts with inflated dollars. The only problem here is the trend in CPI has been lower while the trend in the current account deficit has been higher. It is a shame so many theories get destroyed upon their first encounter with the data.

Current Account Deficit And Inflation



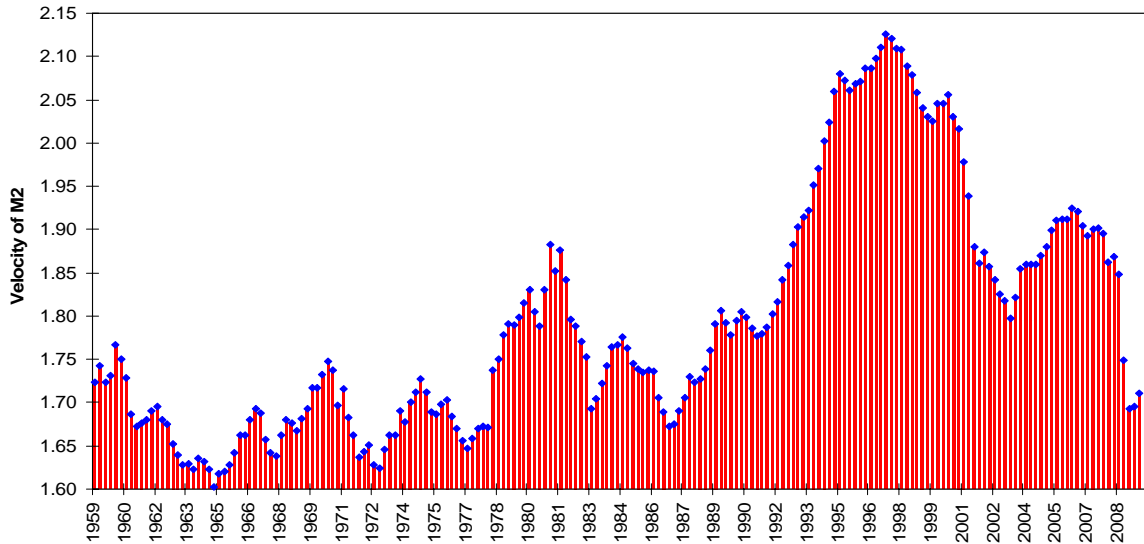
Well, if deficits do not produce inflation, what about the money supply itself? As monetary policy is alleged to work with long and variable lags, a fancy way of saying we do not know what will happen or when for a given change in policy, let’s map the year-over-year changes in M2 against those for the CPI and PPI led by 36 months. Once again, a vertical line is imposed at the removal of those Regulation Q interest rate ceilings. Whatever leading relationship existed between money and price indices before the early 1980s does not exist now. And yet this relationship is accepted as gospel truth by most economists.

Money Supply Growth And Inflation



One of the problems with the monetarist model, $MV = PT$, or the money supply times velocity equals the price level times the volume of transactions, is it presumes stable velocity, or the ratio of GDP to the money supply. This ratio is anything but stable; it climbed for a decade between the late 1980s and late 1990s and then went into an equally long downtrend. Velocity collapsed with the 2007-2009 financial crisis and recession. How anyone could look at this chart and presume an expansion of the money supply is one and the same as an expansion of GDP is inexplicable.

Velocity Is Not A Constant



Back To The Markets

A rational person would review the above and conclude many of the macro factors commonly linked to inflation are not causes at all, at least not in the world that has existed since the first Reagan administration (as an aside, the Depository Institution Deregulation Act of 1980 was enacted during the Carter administration; the hapless Georgian never gets nor never seeks credit for deregulatory impulses commonly credited to Reagan). If these are not causes, then the odds are very high any purported cures addressing them will fail.

Can we get a better read on inflation and its causes from financial market variables? That issue will be addressed next month.