Declaring Independence From Inflation Misconceptions

Here are a few truths to hold self-evident as the Fourth of July approaches. Everyone involved in financial markets has an institutional memory of the great inflation of the 1970s regardless of their age. Everyone thinks they understand the causes of inflation, how it forms, accelerates and spreads. And everyone who believes this is wrong.

Let's now begin a two-part look at the causes of inflation, how we can measure it and most important, how we can recognize its impact on the markets we trade. This first part will examine inflation top-down from the macroeconomic perspective. The second part, next month, will reverse the viewpoint and examine inflation bottoms-up from individual market perspectives..

The Broken Thermometer

First, let's mention the necessary but unpleasant issue as to why the government's Consumer Price index, Personal Consumption Expenditure deflator and indeed all other measures of inflation are widely regarded as suspect. Most of us today believe the CPI grossly understates the higher prices we know we are paying. How many of us recall an earlier Presidential commission, under George H.W. Bush, that concluded the CPI overstated experienced inflation? The move toward the good people at the Bureau of Labor Statistics adjusting prices to reflect technological improvements, the infamous "hedonic" adjustments, was a response to this commission.

Any good faith effort to measure inflation must account for economic realities such as substitution, price elasticity of demand, discounting and addition of services and increasingly the vagaries of Internet pricing. In addition, the CPI, which is classified as a Laspeyres index, one which traces the price of a fixed market basket over time, has to account for technological obsolescence. The quarterly GDP deflator, which is classified as a Paasche index, one which accounts for both content as well as price changes in the market basket, involves making educated guesses on the fly as to how the basket really changed.

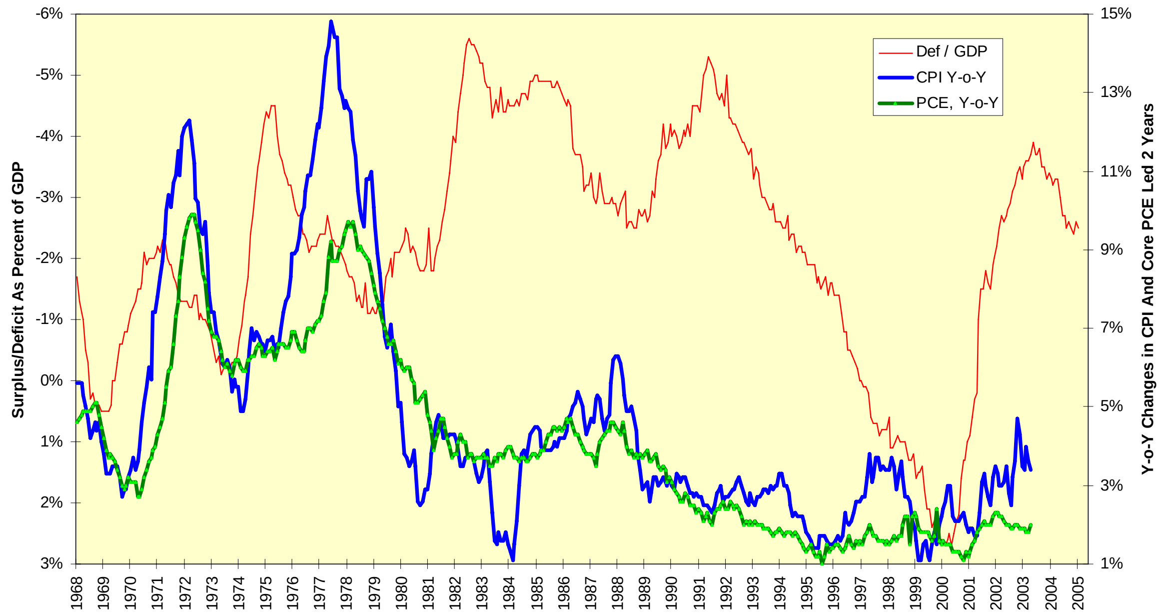
Finally, economic fashions come and go. Recent jumps in food and especially energy prices have induced policymakers to focus on "core" inflation; that is, the CPI without food and energy prices. This must be very useful to those who neither eat nor drive or heat their homes. In sum, inflation is far more than your personal price index multiplied by 300 million American citizens.

The Macroeconomic View

As we shall see below, conventional macroeconomic measures are not providing us significant cause for concern. Inflation is a monetary phenomenon, and one with a major moral hazard attached. The U.S. government is the world's largest single debtor, the U.S. current account deficit exceeds 7% of GDP and the U.S. dollar is the world's reserve currency until further notice. This gives the U.S. and its government the means, opportunity and motive to repudiate its debts by inflating the currency.

Here we encounter our first misconception. Do we have a strong historic basis for relating the federal budget deficit as a percentage of GDP to annualized changes in either the CPI or the core PCE deflator at a lag of two years? Not really; the surpluses of the Clinton administration followed a drop in inflation, and while the expanding deficits of the Bush administration have led higher inflation, current year-over-year growth rates of the inflation measures are well below where they were the last time federal budget deficits claimed this share of GDP.

Chart 1: Federal Deficits And Inflation



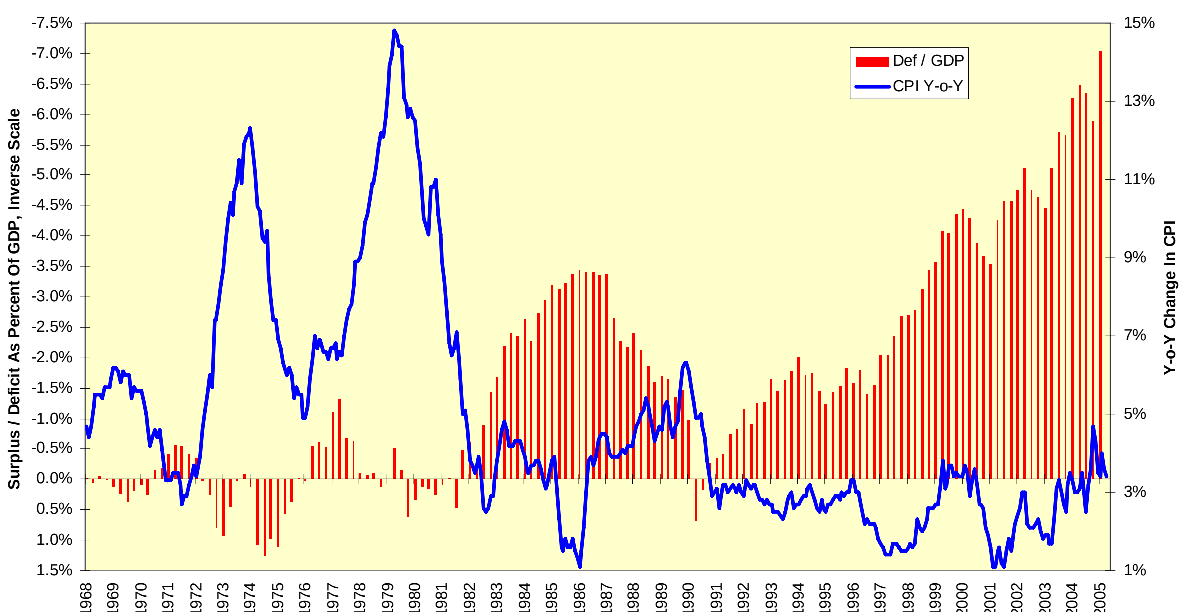
Keeping Current

Now let's move on to the second misconception, that surrounding the second of the twin American deficits, the current account. The logic for this deficit, which combines merchandise trade with services and financial flows, contributing to inflation is impeccable. The dollars sent overseas to purchase foreign goods and services often are bought by foreign central banks with freshly created money and held in official accounts. Money created by the stroke of a pen should be worthless and therefore inflationary.

As is often the case, theory and reality collide. Year-over-year changes in the CPI were far higher from the late 1960s to the early 1980s, a period wherein the U.S. ran a mix of current account surpluses and small deficits. The continuously expanding deficits from 1991 onwards only recently have seen annualized changes in the CPI over 4%.

Yes, we have enjoyed the benefits of growing exports from Mexico and China, but these cannot account for all of downward pressure on consumer price growth. As always, the simplest answer is the best: The connection between the current account deficit and inflation existed only in the heads of people who did not bother to check their facts.

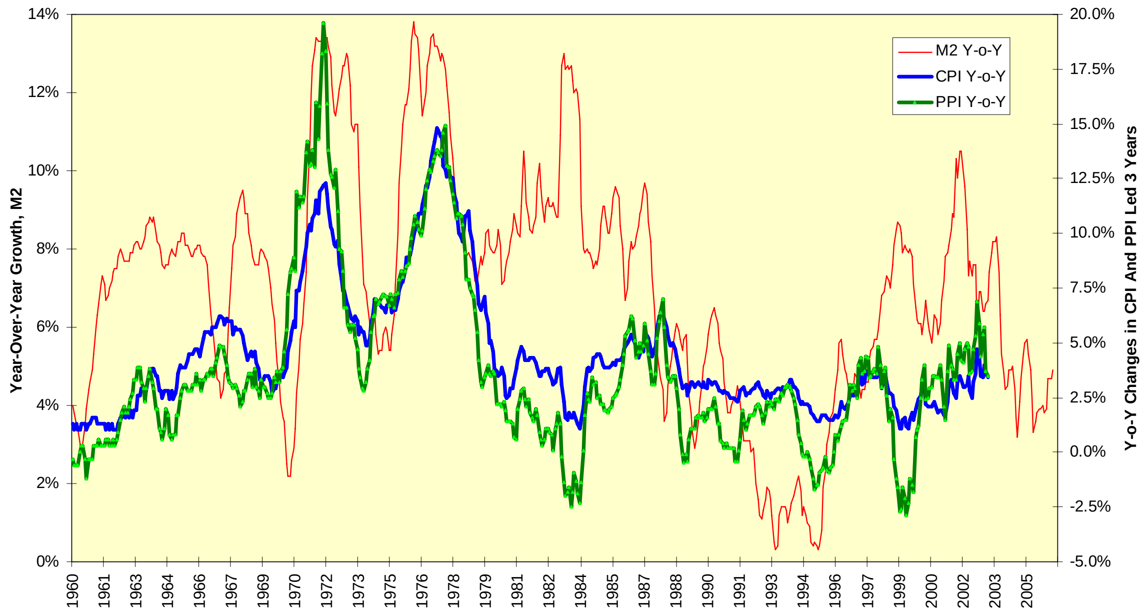
Chart 2: Current Account Deficit And Inflation



Money Supply

If you enjoyed the first two misconceptions, you are going to love the third one. If inflation is at its most basic too many dollars chasing too few goods and services, then a rising money supply should precede rising inflation, right? Moreover, this view allows those who wish to blame the Federal Reserve and its sister central banks for all manner of economic ills to do so. And the collective memory of the 1970s inflation is the central banks allowed the money supply as measured by M2 to grow out of control. This fueled inflation as measured by both the CPI and the PPI with a 3-year lag.

Chart 3: Money Supply Growth And Inflation



However, economic relationships must hold true in all markets and under all conditions or be overwhelmed by another factor to be more than just anecdotal. What was true in the 1970s should have continued to be true during later periods of rapid money supply growth, such as 1983 and 2001. We can discern small increases in the price indices after these bursts in money, but "small" is the operative word. Moreover, the relationship appears asymmetric; lower rates of M2 growth between 1985 and 1996 at best led to stable rates of inflation. We cannot look at the declining rate of M2 growth after 2002 and say with any measure of confidence it will exert a stabilizing influence on future inflation.

Don't Bet On Debt

Now it is time to take on a fourth misconception, the one that the Great American Debt Machine is leading us down the path to perdition. Like Presidents, the Federal Reserve receives both more blame and more credit – pun intended fully - than it deserves for its actions. They can affect the level of free reserves amongst member banks, but they cannot control the other sources of corporate financing such as the corporate bond market, commercial paper and non-U.S. borrowing by subsidiaries.

This affects the execution of monetary policy. Commercial lending expands the money supply by virtue of fractional reserve lending in a way other financing sources cannot; remember those "multipliers" from your long-ago economics classes. And while commercial and industrial loans have ceased falling as a percentage of GDP, they remain at very low levels historically.

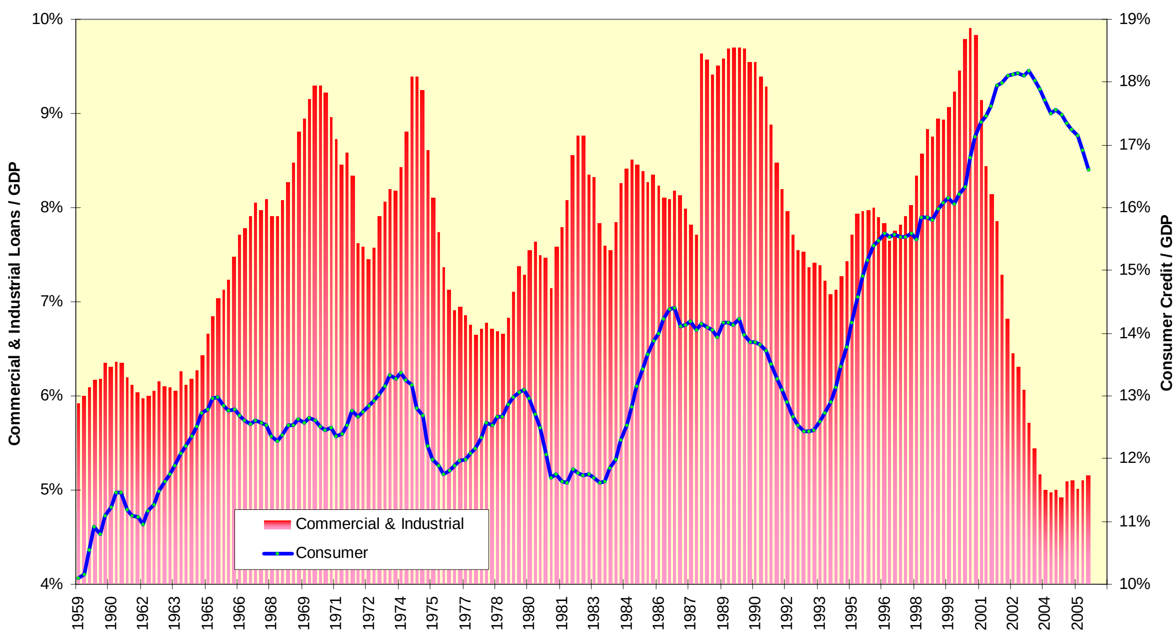
This is one reason the Federal Reserve's rate-cutting campaign of 2001-2003 was slow to stimulate the economy: In a manner parallel to Japan's insolvent banks being unable and unwilling to lend in the 1990s, American banks saw weak loan demand in the early part of this decade. Monetary base may have been expanding, but credit was not.

We have mentioned federal debt and commercial and industrial debt. How has consumer credit as reported in the Federal Reserve's G-19 table moved as a percentage of GDP? After all, the behavior of the consumer once the housing boom is in the rearview mirror is a prominent source of concern in financial markets.

The answer is mixed. The trend in recent quarters has been lower, but the decline has been toward a level first breached in the fourth quarter of 2000. Part of this decline reflects the strong growth in the U.S. economy from 2003 onwards, and part may reflect an ignored possibility stemming from "equity extraction" in the housing market.

We appear unwilling to allow the possibility of household balance sheet repair, but the data suggest the famously profligate American consumer may be doing exactly this.

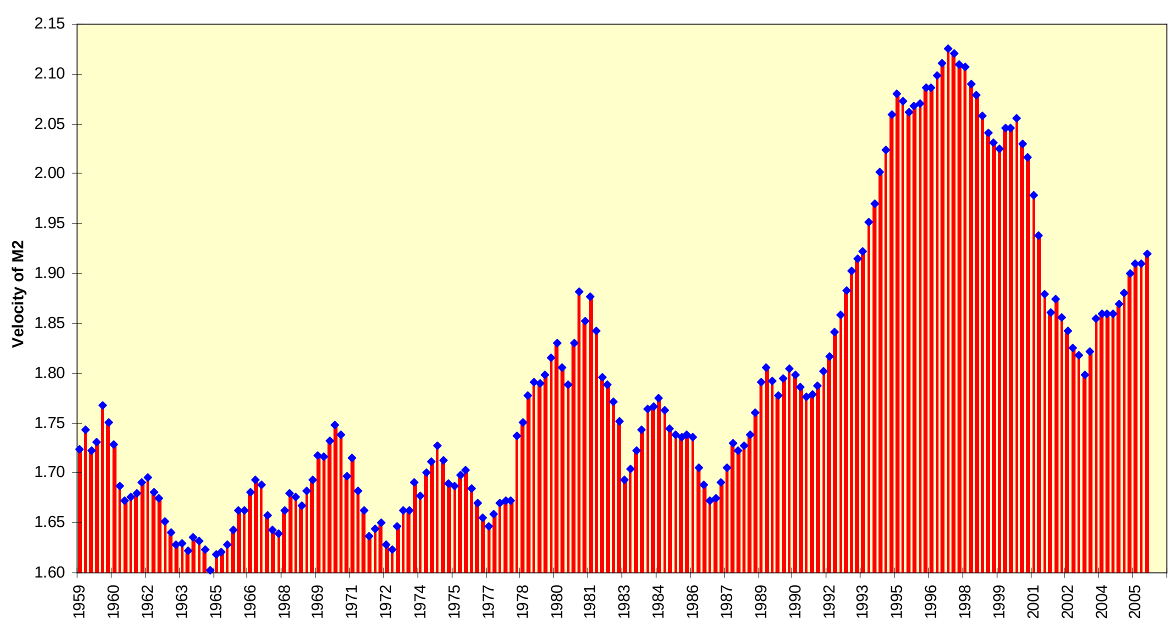
Chart 4: The Differing Paths Of American Debt



Velocity

We have time for one more misconception, and that is the American economy is becoming less efficient. Nonsense. We can combine the effects of all these measures into the velocity of M2; this is the ratio of GDP to M2. The higher velocity is, the more efficient the economy into converting a given quantity of money into goods and services. It is a productivity measure for money. Monetary velocity accelerated from 1987 through 1998, and then turned significantly lower into 2003. It is now on the increase again. All else held equal, higher velocity exerts downward pressure on inflation. Take heart, dear reader, we are not getting older, we are getting better.

Chart 5: Velocity Starting To Accelerate



All told, the macroeconomic perspective on inflation is, "not so bad." However, we do have to remember our system for collecting and interpreting economic data has fallen behind the modern economy. It was designed to track tangible goods in an industrial economy, not to chase bytes around the world. We will not chase bytes either, but we will view the effects on markets next month and see whether the benign outlook on inflation noted above will persist.