Macro Indicators Point To Lower Inflation

The one population subset incapable of winning an American election consists of those who believe government inflation numbers. But this is not just one more tinfoil-hat, black-helicopter rant – those will cost you extra, mister – it simply relates to the sheer number of backward-looking ways we have of measuring inflation.

Not that there is a perfect solution to the problem. As discussed here first in October 2003 in the context of futures contracts on the CPI, all measures of inflation based on price indices only can record what has happened, an irrelevancy to economic decision-making at the household, corporate and government levels. Behavior is founded on expectations, not on history.

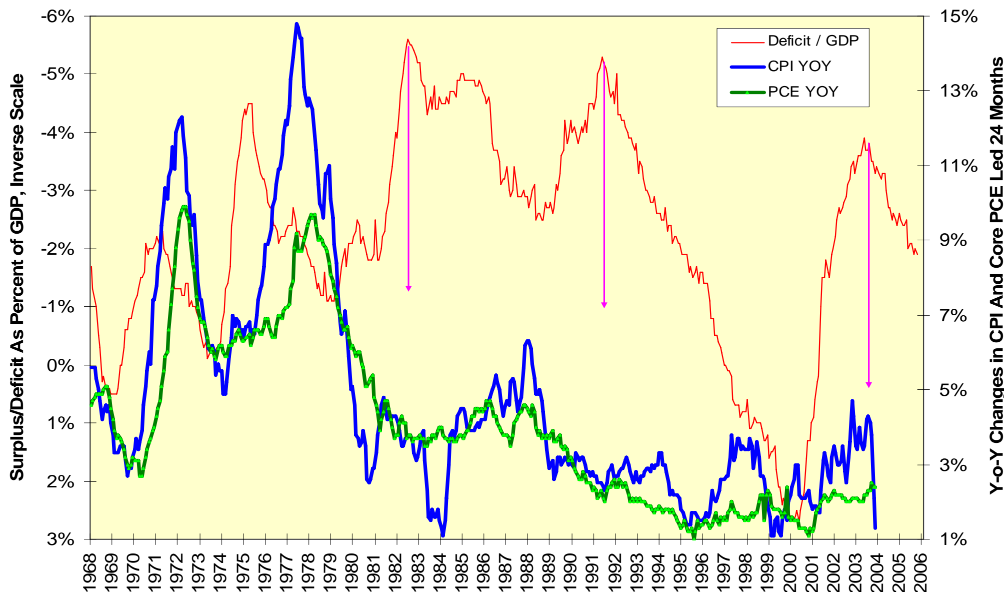
But, even so, we are left with the Prospectus Conundrum: Yes, past performance does not predict future results, but what else are you going to use? With that in mind, let's do a little tour of various macroeconomic indicators that affect inflation, money and credit in the vain hope their momentum will continue long enough for them to be relevant. And, in what might be my best rationalization of 2006 as it dwindles to a close, we can expect the Federal Reserve's expectations to be based on the past, not on the future. John Nash of game theory (and *A Beautiful Mind*) fame told us our best move is a reaction to our opponent's anticipated move, not an objective standard.

Red Meat Indicators

It is an article of faith in certain circles that federal deficits lead to higher inflation. The causal chain is the Treasury issues bonds to pay for federal spending, the Federal Reserve buys some portion of these bonds with the simple stroke of a pen, and the money thus created from thin air raises the overall price level.

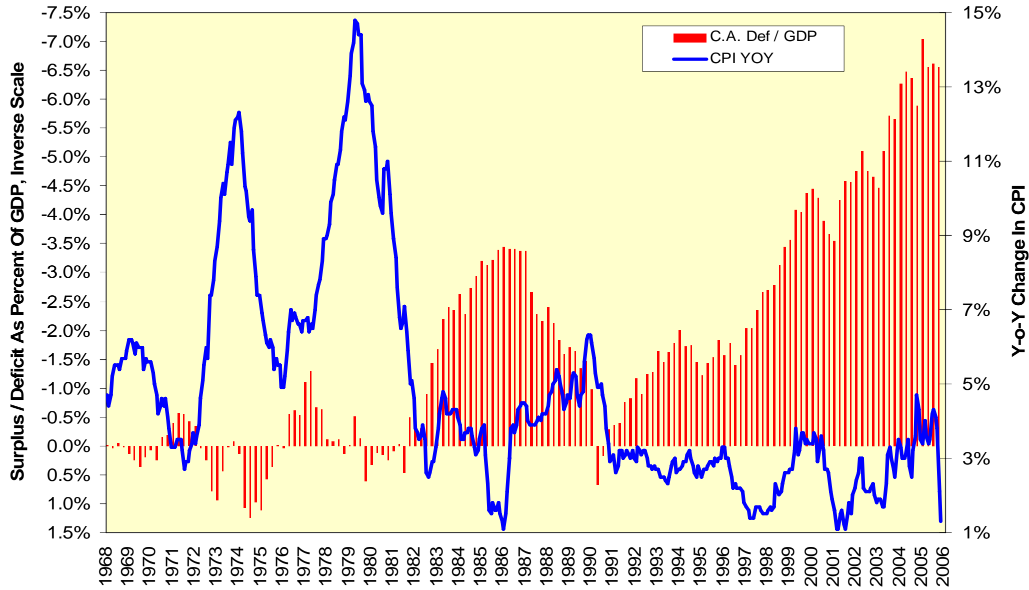
However, there is precious little evidence to say such fiscal stimulus actually operates that way. If, as I calculated, the statistical lead time between deficits and changes in the CPI is 24 months, we see only a moderate and further delayed response in inflation in response. However, the opposite is not true: Contractions in the deficit after passage of the 1974 Budget Control Act have led to declining rates of inflation. The impact is more direct for the year-over-year changes in the CPI than it is for core personal consumption expenditures. The Federal Reserve has stated its preference for this last measure because, after all, who amongst us is foolish enough to squander our income on food and energy when hedonically adjusted personal computers are available?

Federal Deficits And Inflation



The declining federal deficit as a percentage of GDP is, in the Keynesian sense, contractionary. While much of the Keynesian oeuvre regarding inflation was discredited thoroughly by the early 1980s, it does seem to apply somewhat in the present situation. A second deficit, the U.S. current account, also constitutes a fiscal drag in the Keynesian worldview. Even though the perennially wrong cite this deficit as inflationary – here it is the foreign central banks that create money to buy our bonds – we must note how the CPI grew more rapidly prior to this deficit's explosion in the mid-1980s and again after 1991.

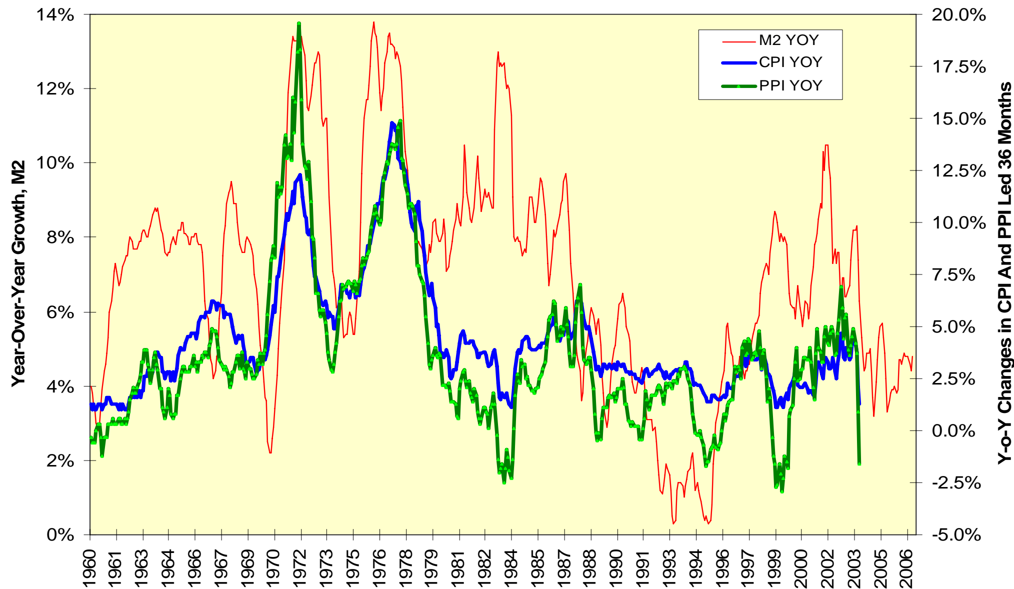
Current Account Deficit And Inflation



The Root Of All Evil Today…

…Is money, so they say. If the two deficit indicators above are pointing towards Keynesian fiscal drag, what about that other bugaboo, excess money supply growth? Here the statistical lag is 36 months between year-over-year growth in M2 and changes in both the CPI and PPI. At the last data available, M2 growth of 4.2% was less than nominal GDP growth of 6.0%, which suggests money supply growth is anything but inflationary.

Money Supply Growth And Inflation



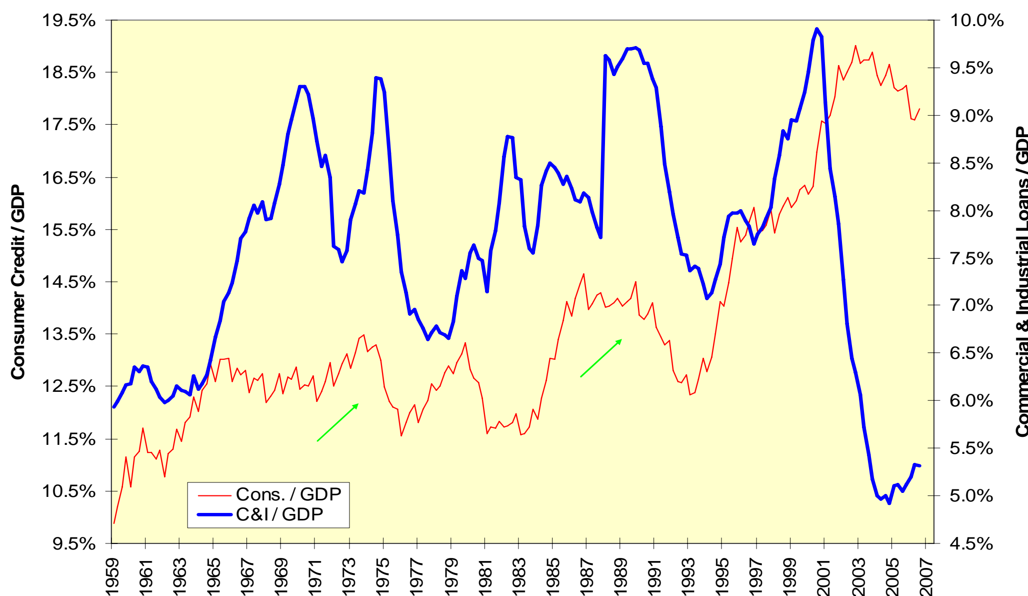
And if money supply growth itself is too slow, its velocity or ratio of GDP to M2 is rising. This is characteristic of an economy able to grow without triggering higher inflation in response; see the long period of velocity expansion between 1987 and 1997.

Velocity Starting To Accelerate

Give Me Credit

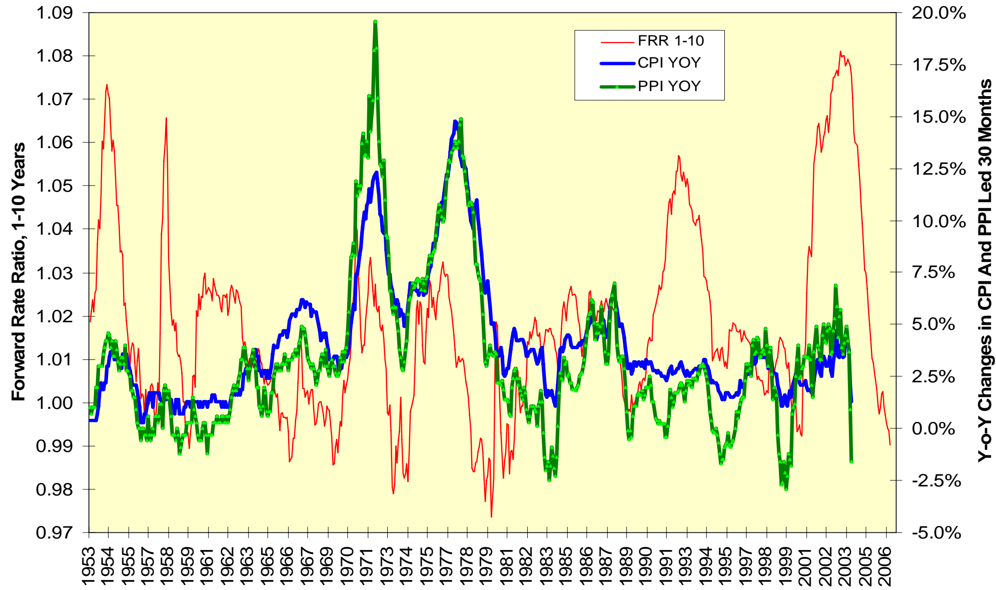
As last discussed in September 2005, the Federal Reserve does not control the money supply; that is influenced far more by the actions of the banking system. Here we can take two measures of credit in the economy expressed as percentages of GDP, commercial and industrial loans and consumer credit. The former plunged dramatically between 2001 and 2004 as corporations found themselves both flush with cash and bereft of new investment opportunities simultaneously. The latter, considered prima facie evidence of our profligate ways is now turning lower; previous episodes of declining consumer credit coincided with periods of declining growth in inflation (marked with arrows). Neither measure is pointing toward an acceleration of credit that will lead to a surge in future inflation.

Changing Mix of Credit Affects Monetary Policy



Yield Sign

Finally, what about the influence of our famously inverted yield curve as measured by the forward rate ratio between one and ten years; this is the rate at which you could lock in borrowing for nine years starting one year from now divided by the ten-year rate itself. It leads changes in both the CPI and PPI by 30 months on average. Its inversion trend led the downturn in inflation's rate of change right on schedule.



The end result of all this is a set of indicators pointing toward declining inflation. Hmm, aren't the members of the FOMC doing their best Paul Revere impersonations warning inflation is coming? Either these indicators have no forecasting value or the market, which is expecting lower rates in 2007, is wrong, or the FOMC is wrong. How can we reconcile this, or is nobody right if everybody's wrong? In some cases, we just ask the questions; the answers will have to come from elsewhere, and yes, they will cost you extra.