

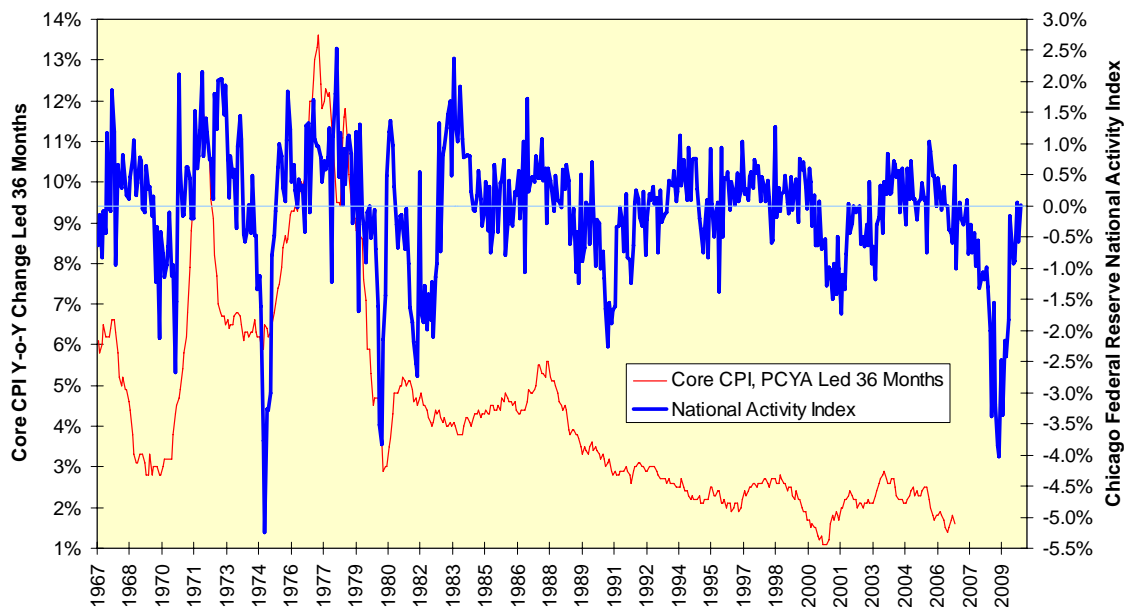
Inflation: Some Day, But Not Tomorrow

St. Augustine intoned, “Grant me chastity and continence, but not yet,” a sentiment of which I share half. Others today with a quasi-religious need for self-flagellation are intoning similar sentiments regarding inflation; one gets the distinct impression they will not be happy until hyperinflation is on the land and the Federal Reserve has to do something along the lines of raising the federal funds rate back toward 20% so that Paul Volcker can die a happy man.

Let’s stipulate the Federal Reserve has created a fine fix for itself and for the rest of us; you are free to guess which concerns them most. No one has experience parking \$2 trillion of garbage on a balance sheet, so it stands to reason no one has any experience removing it, either. The fear is all of these excess reserves combined with all of the funny money our European cousins are going to have to create to create to bail out Greece, et al, will turn into some sort of Friedmanesque too-much-money-chasing-too-few goods extravaganza. And let’s stipulate it will, eventually, unless there is some sort of reprise of a Teutonic “enhanced tourism” approach to resolving European political tensions.

For now, though, deflationary or at least disinflationary pressures are still with us. Let’s take a look at them in two different ways. The first is to dust off the Phillips Curve, the theoretical construct posed in the 1950s of a tradeoff between inflation and unemployment; unlike most economic theories which fail most of the time, this one has failed all of the time. If we expand employment into the Chicago Federal Reserve’s National Activity Index, we can see how it has led the year-over-year change in core consumer prices by 36 months on average since the data began in 1967.

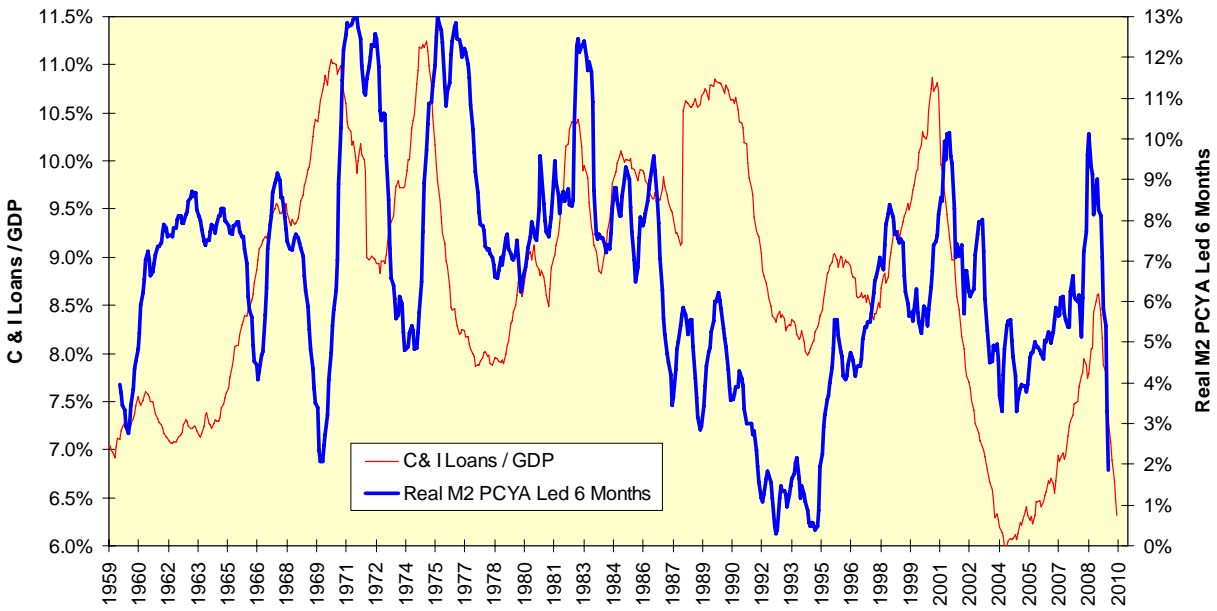
Core Inflation And Real Economic Growth



Even if we were to believe in this Phillips Curve construct, as nearly everyone in the world’s central banking community seems to do, inflation would not respond to the 2009 rebound in the national activity index until late 2011 at the earliest.

Now let’s take a look at the key indicator, the incredible decline of commercial and industrial loans as a percentage of GDP. Banks are not extending credit, which means they are not converting reserves into new money with that fractional reserve multiplier they were trying to teach you back in Econ 101 and which you surely would have learned had you not been ignoring the very same impulses that vexed St. Augustine. This metric leads the year-over-year change in the money supply as measured by M2 by six months. At the end of January, this was growing at a 1.9% clip in an economy that had just come off a 5.7% growth spurt.

Key Credit Indicators Continue Contracting



No bucks, no Buck Rogers: While M2 is not the be-all and end-all of the pool of available credit and liquidity in a global economy; we cannot ignore it and warn of inflation in the near-term. Until and unless the money supply's growth exceeds real economic growth, inflation will remain a concern as opposed to a reality.

I do think this will happen. But not yet.