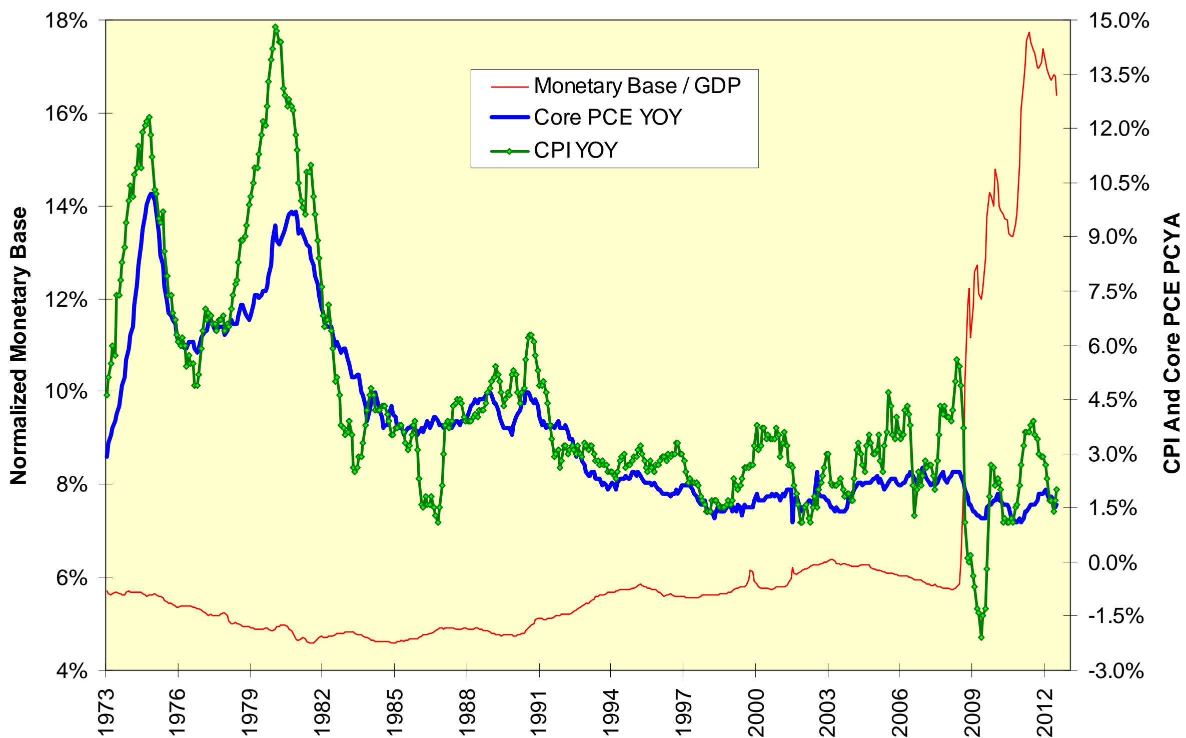
Abusive Monetary Policies And Inflation

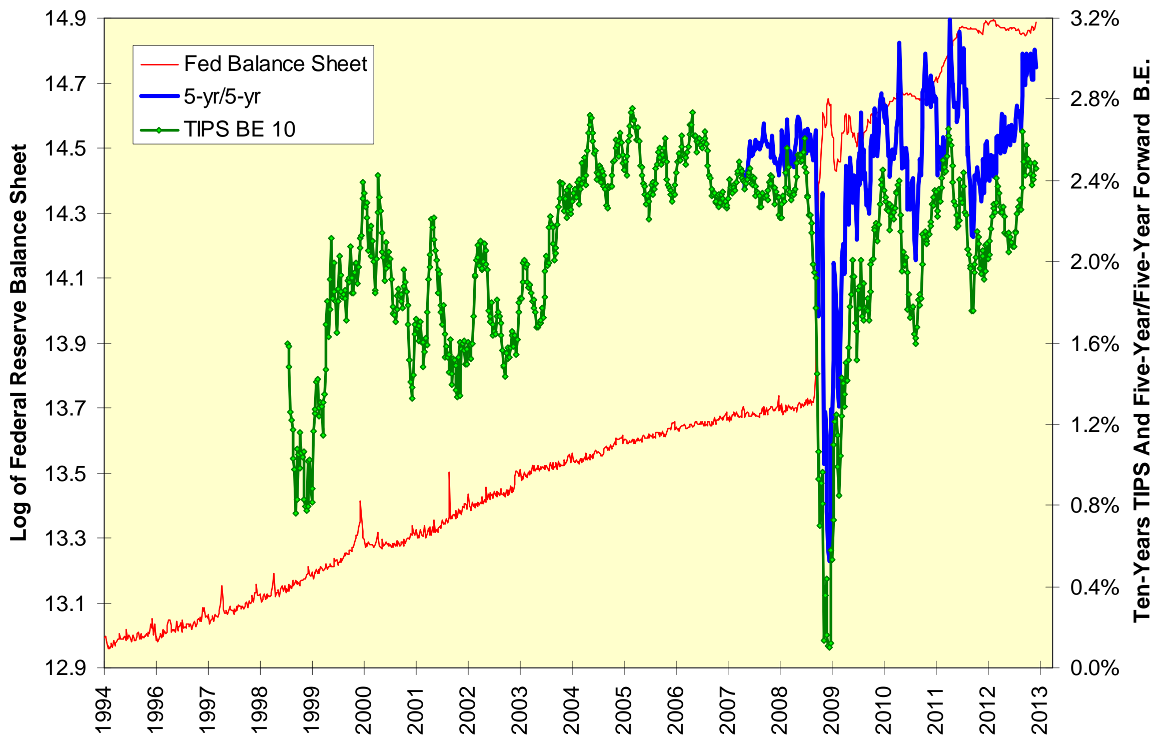
What would the implications be of the statement, “Everything you know is wrong” being correct? Judging from the way both the economy and financial assets have reacted to egregious money-printing by major central banks, our own beloved Federal Reserve included, the answer would have to be, “Not much.”

Silly us; for years we had labored under the delusion hundreds of billions of dollars created at the stroke of a pen or its electronic equivalent would be inflationary. However, the experience since the financial crisis has indicated otherwise. Let’s look at this in two different ways. First, the ratio of the monetary base (cash plus commercial banks’ deposits at the Federal Reserve) to GDP rose from 5.8% in June 2008 to 17.7% in July 2011; it since has retreated to 16.4%. Scary stuff, right? The kind of thing you see circulated endlessly through the blogosphere, right? Yes, but its relationship to two different measures of reported consumer inflation, the year-over-year changes in the CPI and in core PCE has been negligible. No matter how you lead, lag or otherwise transform the data, the explosion in the normalized monetary base has not mattered for consumer inflation.

Normalized Monetary Base And Reported Inflation



Now let’s turn from reported to expected consumer inflation as measured by two different TIPS-based measures, the ten-year and five-year/five-year forward breakevens and shift the monetary measure to the size of the Federal Reserve’s balance sheet. I plot this on a logarithmic scale; even then the expansion over the past four years has been extraordinary. The Federal Reserve’s balance sheet will be growing smartly in the months to come as they will be buying $85 billion per month of mortgage and Treasury securities. Once again, the impact of this monetary expansion and of similar expansions by other major central banks on these measures of expected inflation has been minor.



If inflation can be defined as too much money chasing too few goods and services, then why have these inflation measures been so well-behaved? Several explanations are suggested. The first is debt overload and slack capacity have combined to short-circuit the growth of money and credit in the commercial banking system. Velocity, or the ratio of GDP to the money supply, continues to make six-decade lows.

A second reason is the diversion of capital from the private sector to finance low-productivity transfer payments has done little to spur economic growth and to create a robust increase in final demand. Viewed in this light, the orgy of money-printing has led to an opportunity loss of wealth. Restated, we do not see the money price of goods and services increasing; we see the quantity of goods and services consumed falling short of where it should be. While inflation leads to consumer impoverishment by sapping the purchasing power of the dollar, inflation in this form leads to impoverishment via a reduction in the capacity to consume. Either way, ersatz money has bad effects.

Finally, if low interest rates pull future consumption into the present and reduce the return on invested capital, then the last four years will lead to even slower growth going forward. If we add in trillions of dollars of new debt and higher taxes, we will be looking at slow and below-capacity growth for a long time to come.

Financial assets, especially growth instruments such as stocks, will be able to outperform the real economy in such an environment as strange as it all seems. Higher taxes on investments will turn your portfolio into a conduit between the printing press and those who do not have these financial assets. Consider yourself lucky: Earlier societies resolved such imbalances through non-financial instruments such as the guillotine.