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Special Report

December 2009

Inflation Prevention Via Dysfunctional Commercial Banks

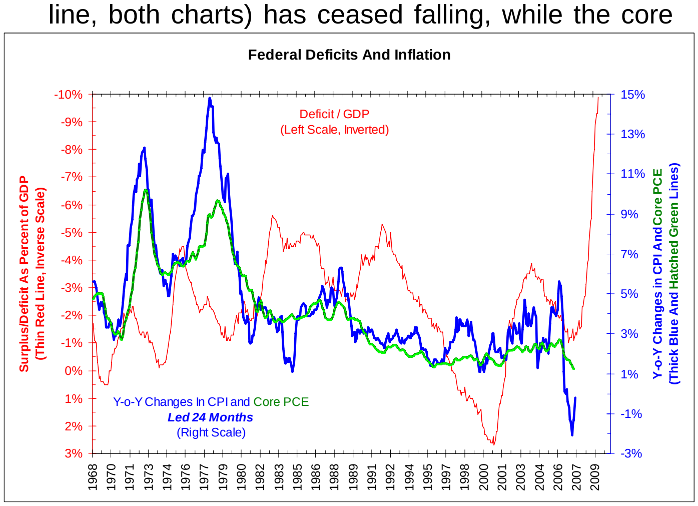
By Howard L. Simons

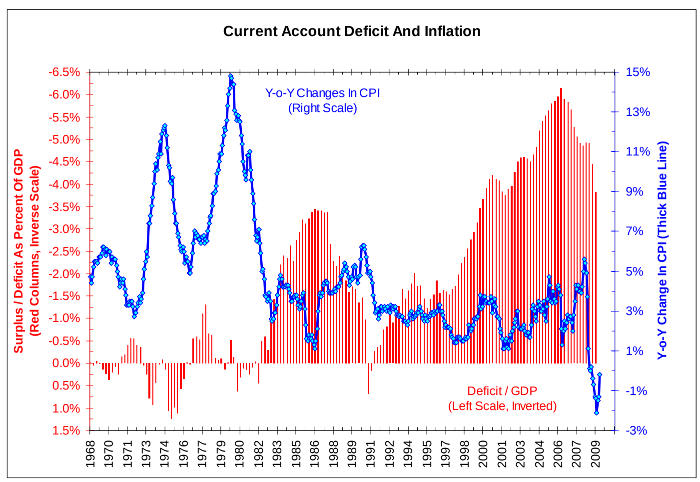
We last looked at a number of macroeconomic and financial market variables linked to inflation in June; we concluded:

> *Until we can incorporate the effects of asset inflation into a general theory of what inflation is and until we can stop pretending changes in monetary policy in a world with a shattered banking system and with carry trades trumping the central banks' intentions, we should stop taking reckless policy shots at an unstable target with a gun capable of firing in every direction but the intended one.*

Headline inflation, as measured by year-over-year changes in the Consumer Price Index (thick blue line, both charts) has ceased falling, while the core Personal Consumption Expenditure deflator's rate of change (hatched green line, left-hand chart) is bleeding lower.

Neither is linked particularly strongly to either of the "twin deficits." The federal budget deficit (thin red line, left-hand chart) is in uncharted waters, and the current account deficit (red columns, right-hand chart) has continued to retreat from its 2006:Q3 nadir under the weight of the recession. **Should the economy recover with any vigor, we should expect the federal deficit to decrease and the current account deficit to increase, but given neither should affect the reported inflation picture significantly.**



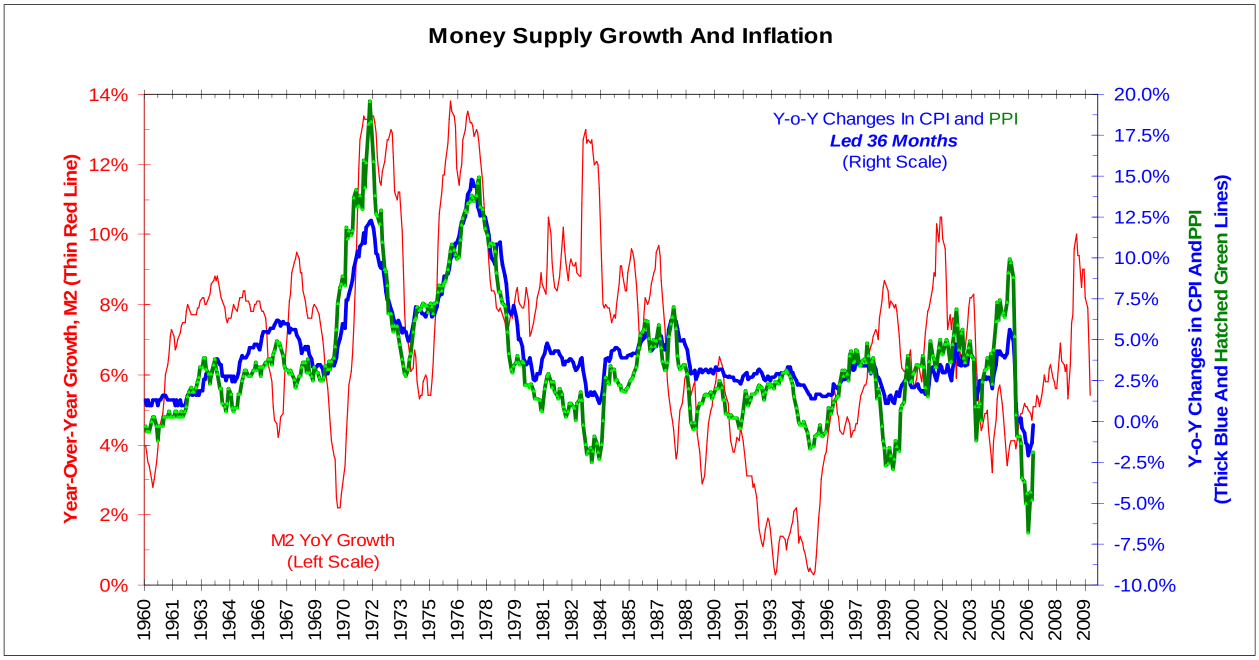


Money And Credit

While monetary statistics in a world with global financing and carry trades may be less important than before, the connection between year-over-year M2 growth (thin red line, following page) and year-over-year changes in both the CPI (thick blue line) and the PPI (hatched green line) led 36 months is difficult to see.

The U.S. money supply's year-over-year growth rate has been contracting rapidly all year as banks have refused to turn excess reserves into credit. This single action, more than any other including the global carry trade, has allowed the Federal Reserve to ease quantitatively without igniting inflation.

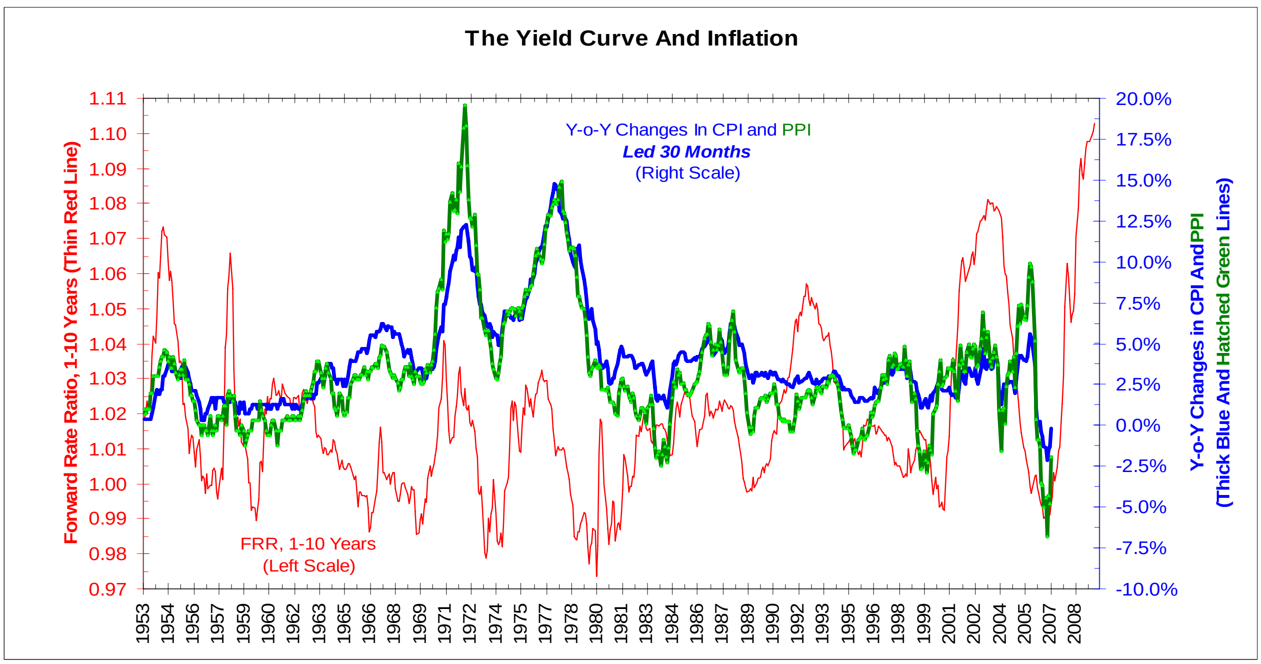
Whether it is a good idea for a central bank to try to affect monetary policy through uncooperative commercial banks is a topic for another day; but the answer on that other day still will be a resounding, "No."



The Yield Curve

We can compare changes in the yield curve as measured by the [forward rate ratio]() between 1 and 10 years (thin red line) to year-over-year changes in both the CPI (thick blue line) and the PPI (hatched green line) led 30 months.

Should the 30-month lead time hold, we should expect to see the inflation measures start responding to the steep yield curve in early 2010. However, we must be mindful of the inability of the commercial banking system to turn excess reserves into credit; this relationship may break.

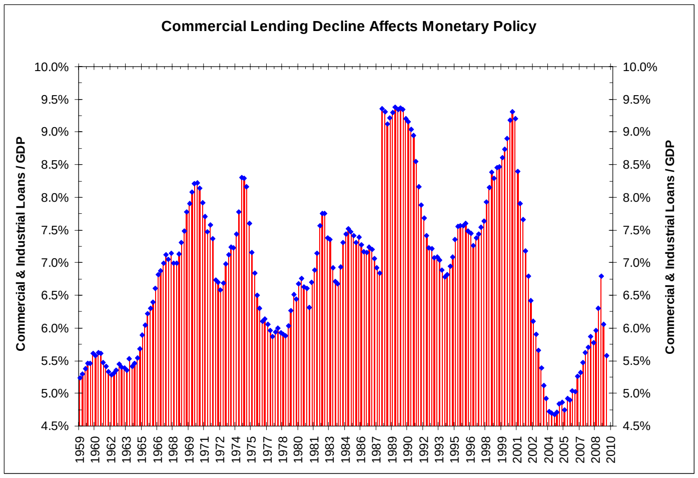


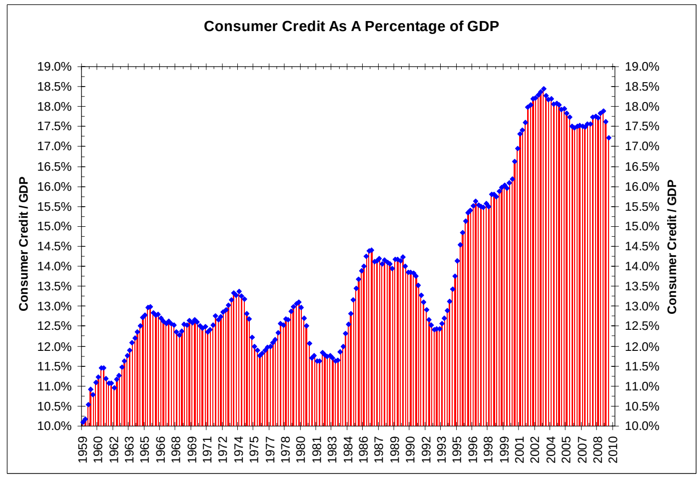
Banking And Credit

Commercial and industrial loans (left-hand chart, following page) have declined since the first quarter.

The same holds true for consumer credit as a percentage of GDP (right-hand chart); it, too, has declined since the first quarter.

These two phenomena taken together stand as prima facie evidence of a failed policy: If low interest rates and excess reserves cannot spur either consumer or commercial credit demand, what good have they been for macroeconomic stimulus?

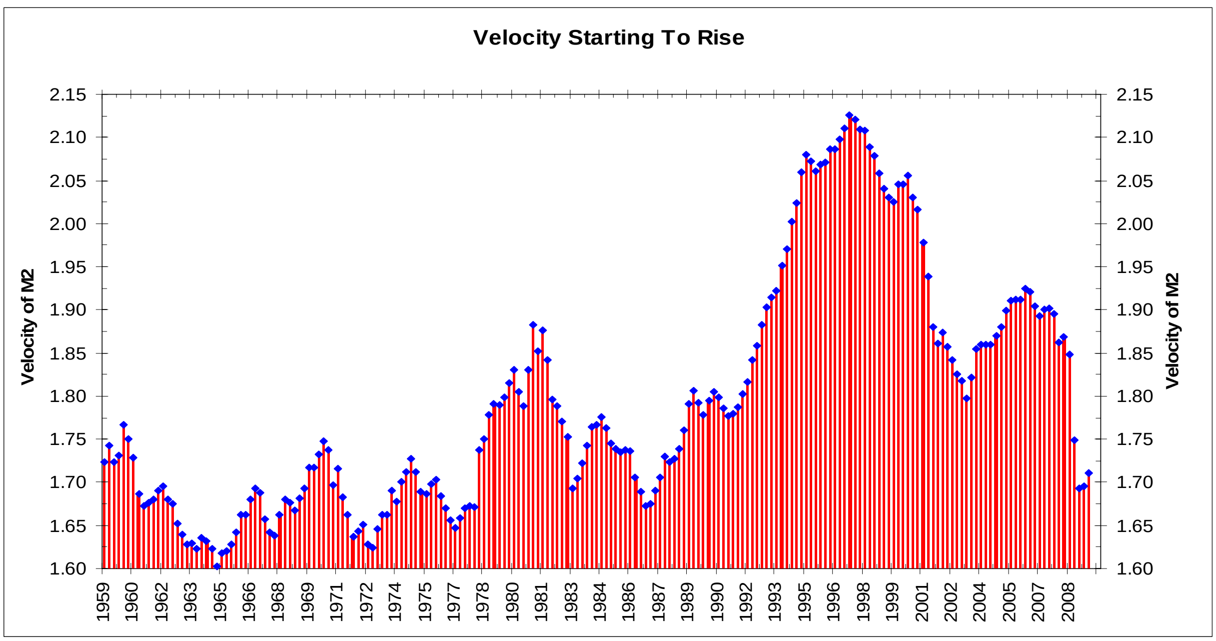




Velocity

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.

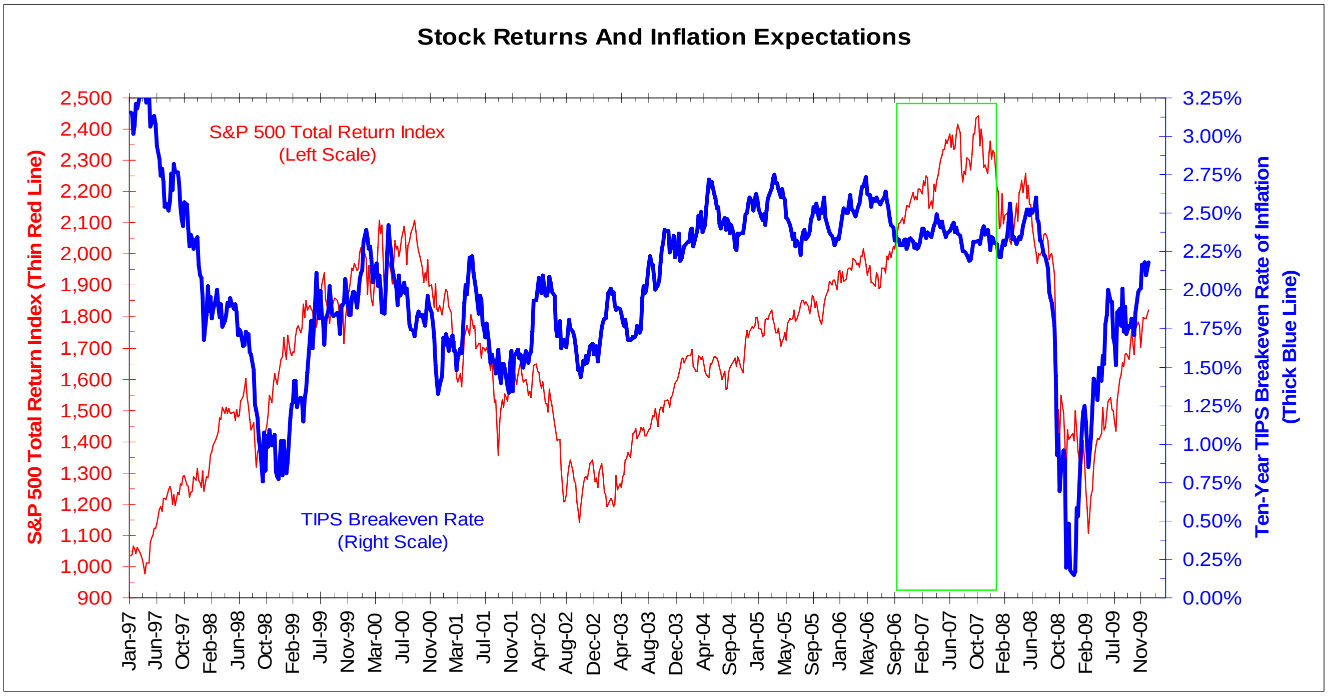
It is now rising from a depressed level. Any upturn in bank credit combined with an upturn in velocity could lead to a very quick expansion in the money supply at the very time the Federal Reserve may be contemplating its first moves to tighten credit.



Inflation And U.S. Equities

Stocks often succumb to money illusion as new liquidity flows into financial assets before it flows into real plant and equipment. The total return of the S&P 500 (thin red line, following page) has moved parallel to the ten-year TIPS breakeven rate of inflation (thick blue line) in recent years with the prominent exception of the May 2006 – January 2008 period (green rectangle) when central banks made some effort to raise short-term interest rates.

Money illusion is operating once again in the stock market. In fact, the U.S. stock market rally has been lagging the rise in TIPS breakevens. While stocks may be a better inflation hedge than bonds, today's traders should consult veterans of the 1970s to see how long this foolishness will last.

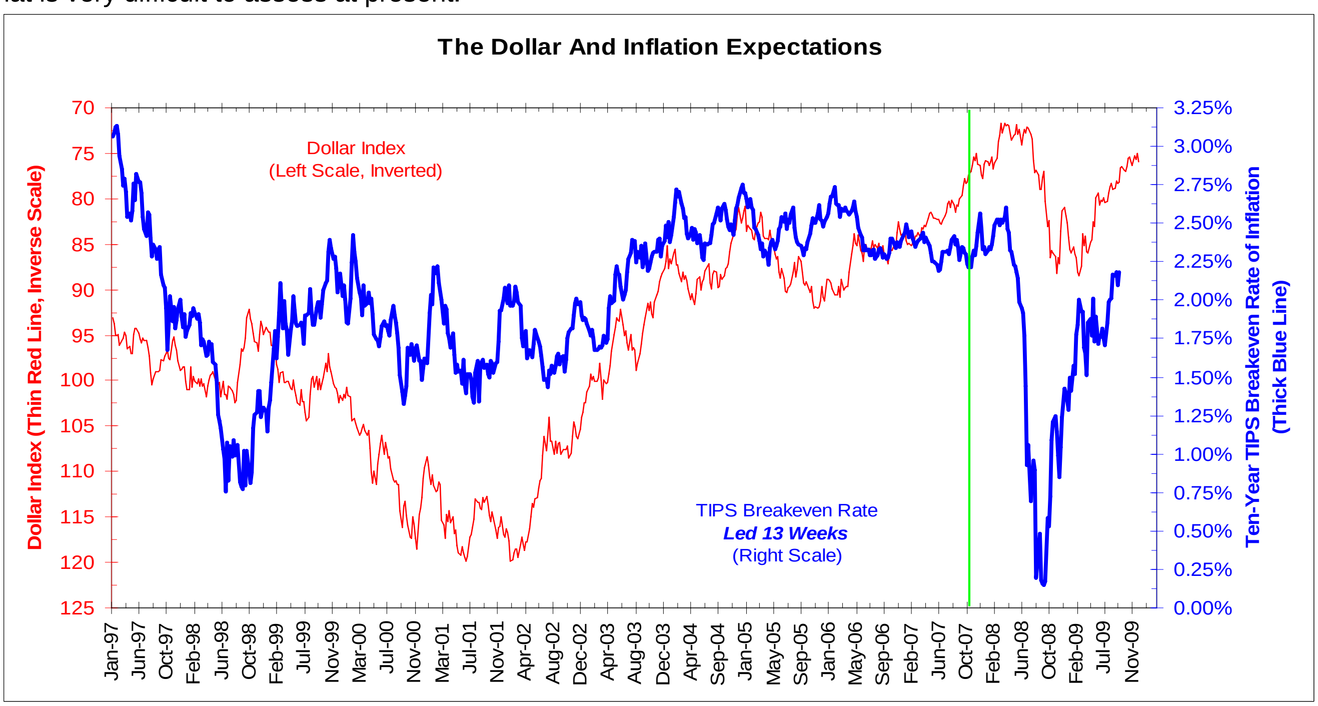


Inflation And The Dollar

The fundamental currency equation compares the nominal interest rate cost of carry between two currencies. As there can be only one real interest rate worldwide at any given maturity – anything else would present a free arbitrage opportunity – this equation devolves quickly into a comparison of expected inflation between two currencies. We should expect the currency whose expected inflation relative to its partners is on the rise to weaken, but that is very difficult to assess at present.

If we map the dollar index (thin red line, inverted scale) against the ten-year TIPS breakeven rate of inflation (thick blue) line, led by the 13-week lag embedded in the standard 90-day non-deliverable currency forward, we see little connection after the financial crisis began in earnest in July 2007 (green vertical line).

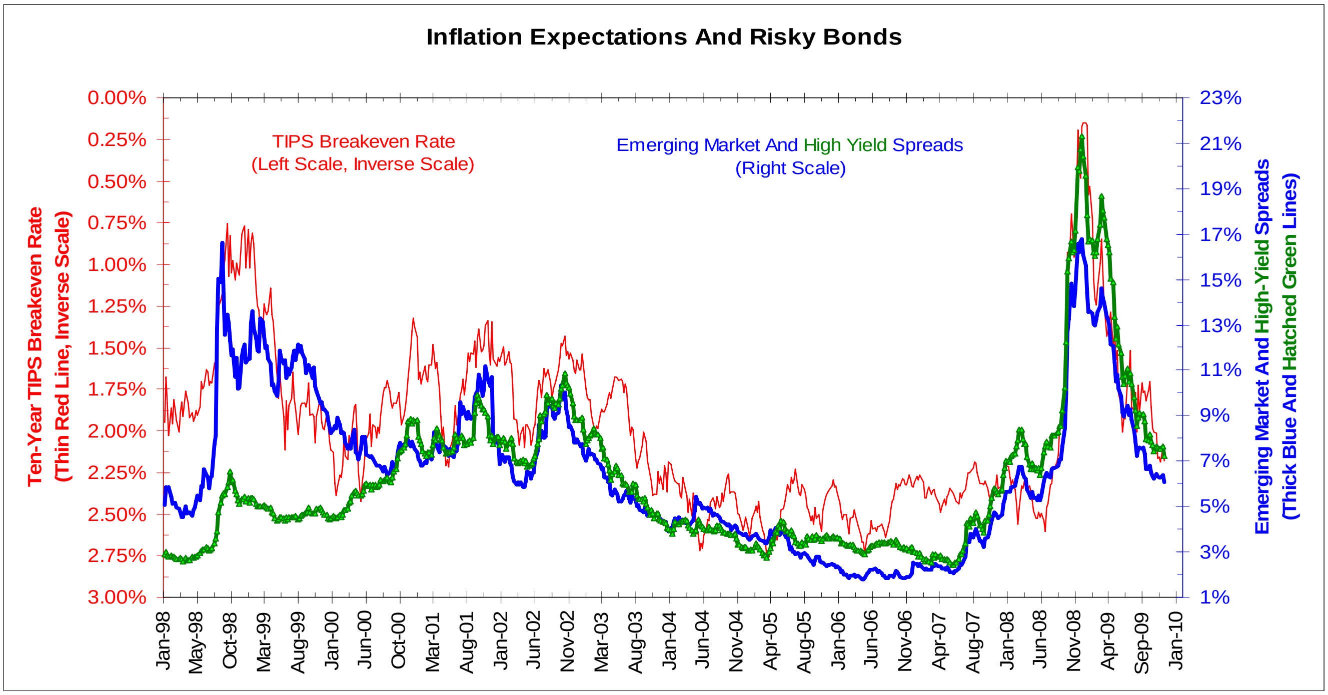
As we have on other occasions, we can eliminate the dollar as a proximate cause of changes in inflation expectations.



Inflation And Risky Bonds

One of the strongest relationships has been between the spreads on emerging market and high-yield bonds (thick blue and hatched green lines, respectively) and TIPS breakevens (thin red line). The r^2 values since the Federal Reserve's first declaration of war on deflation in May 2003 have been .801 and .831, respectively.

We never have been impressed with TIPS as inflation insurance, and apparently investors agree: As prospective inflation rises, credit spreads compress as the risky bonds are seen as superior total return vehicles.



Conclusion

Financial markets are trading as if they are linked to rising future inflation: this is visible for stocks, risky bonds and, of course, gold.

The traditional macroeconomic links to expected inflation have yet to ratify this view, but this is due almost solely to the behavior of commercial banks. Once the dam breaks and excess reserves are turned into credit in an environment where both consumers and businesses have been credit-starved, the slow growth of the money supply could explode higher.

Restated, neither the Federal Reserve nor the bond market "vigilantes" are acting as the brake on inflation; a dysfunctional banking system is. **As one goal everyone can agree on is an improved commercial banking system, reliance on a failed one to protect us from an inflationary spurt is nothing more than a celebration of stupidity. The banking system's failings should not be a substitute for central banking sanity.**

If and when credit expands, the Federal Reserve will find itself behind the curve. It can then choose to remain behind the curve, as it did in 2004-2006 and raise rates in 25 basis point chunks, or it can do something it has not done since the days of Paul Volcker, raise rates aggressively and let the markets and the economy deal with the shock. Neither outcome is to be anticipated eagerly.

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