

The Inflation Monster

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Looking at the long run behavior of the inflation-adjusted fixed basket of commodities, gives you a good sense of where commodity prices, and eventually consumer prices, are heading in the future. From figure 1, one can see that we are due for a large increase in commodity prices, as a spike appears to occur every 20-30 years. The most disturbing part of this chart shows that each commodity price peak has been higher than the previous, and that we remain near all-time lows for commodity prices despite their 77% run-up of the last 4 years.

Figure 1
Inflation Adjusted Basket of Commodities in the Current Reuters CRB Index
(17 Equal Weighted Components): Years 1920 -2005



Source: Di Tomasso Group

In today's economy, inflation has not been contained strictly to commodity prices. Producer prices at the crude goods phase of production have increased a total of more than 75% between 2001 and 2004 and even the mainstream financial media has tentatively started using the "I – word": inflation.¹

The problem is that the Fed believes it can control long run inflation by raising rates a few hundred basis points or by skewing perception or expectations to prevent inflation accelerating activities such as goods hoarding. Long term inflation can only be prevented through a money supply maintained in equilibrium with economic activity. Price inflation after long-run growth of the money stock, while delayed and initially uneven, is ultimately widespread and lasting. The problem is that once inflation of the money stock pushes through price increases to the consumer, this creates a snowballing effect of people raising prices leading to years of price increases.²

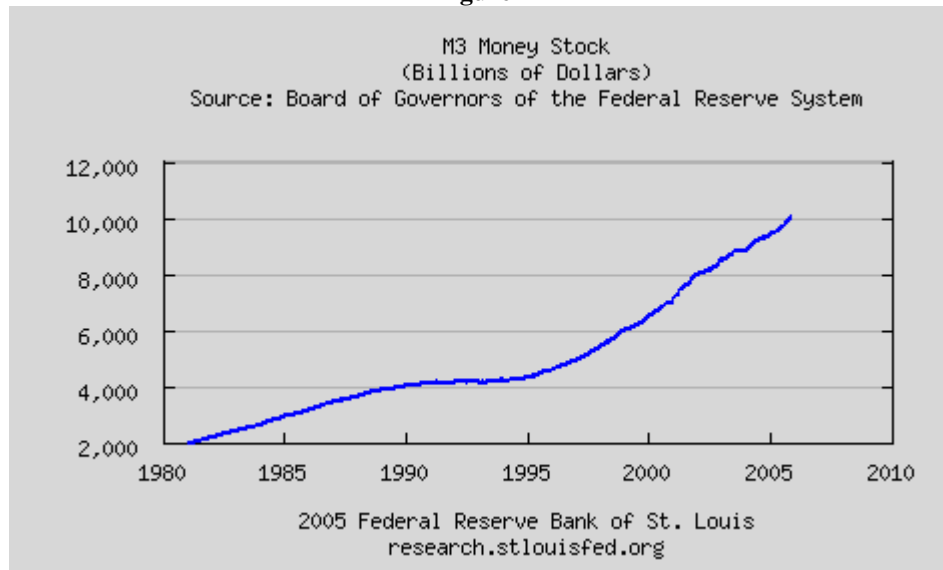
The most recent rapid expansion of the US money stock and the attendant rise in US asset prices, including the dot.com stock market bubble, started in 1995 under Treasury Secretary Robert Rubin's inaptly named "strong dollar policy". The US money stock (most broadly measured by the M3 Money Stock index, shown in figure 2) has increased by 117% from 1995 through 2004. In comparison, the economic output (GDP) of the economy increased 59% during the same period - half the rate of money stock increase.³

¹ David Jensen, "Deceptive Warnings: Nearing Economic Disruption, the Fed Distorts Perception"

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³ Federal Reserve Bank of St. Louis data: December 2004 : M3 = \$ 9,478 Billion ; December 1994: M3 = \$4,372 Billion

Figure 2



In the past, the appearance of strong inflation in the consumer price index has been delayed by up to a decade from the initiation of drastic increases of the money supply as occurred in the 1960s and 70s and as we have also recently experienced. The temporary economic benefits such as rapidly rising stock, bond, and housing markets, declining unemployment and increased government tax revenues, while initially intoxicating, are just that - temporary. Because additional money created by central banks enters the economy primarily as loans through the banking system, delaying the perception of inflation by citizens simply allows prolonging low interest rates and further expanding an already extended credit cycle. The ultimate result is even greater corrective impact when the correction occurs.⁴

Upward commodity price pressures, signaling past inflation of the money stock, will continue to force up interest rates to much higher levels which will have a profound impact on our economic and social structures. With US Consumer Debt surpassing 100% of disposable income, and a savings rate that has gone negative for the first time since the Great Depression, Americans are not in a position to afford higher interest payments as well as higher consumer prices.⁵ The average American isn't even able to save money when they are paying historically low interest rates, can you imagine if rates return to long term averages or worse if inflation really gets going like it did in the late 70's.

We are entering an economic phase very similar to the early 1970s where, after the money supply had been increased at double digit rates for a decade, commodity and consumer goods inflation appears in the economy. Just like the 1970's when the OPEC oil shock took place, we now face the prospects of Iran shutting off its supply of oil as it tries to pursue the enrichment of uranium. What will happen to all the LBO's that are occurring today and the McMansions that people have been built based on historically low interest rates if interest rates double or even triple?

⁴ David Jensen, "Deceptive Warnings: Nearing Economic Disruption, the Fed Distorts Perception"

⁵ JON HILSEN RATH AND MICHELLE HIGGINS, WSJ, "Consumer Borrowing Reaches Record Levels, and Even The Wealthy Are Struggling"