The Ghost of Milton Friedman

"Inflation is always and everywhere a monetary phenomenon." So wrote the late Nobel Prize winning economist and inflation-obsessed, Milton Friedman, in his 1963 magnum opus, *A Monetary History of the United States*. And Friedman's contention is, of course, unassailable. Certainly, the more money sloshing around in an economy, the higher goods and services' prices will rise. This logic in hand, the number-one concern we hear from clients these days is that the unprecedented expansion of the Federal Reserve's balance sheet (i.e., the money the Fed is injecting into the economy to cushion the effects of the financial meltdown) combined with exploding Federal budget deficits can only result in high inflation.

One of the first terms you'll hear in an undergraduate economics class is the Latin phrase, *ceteris paribus*. Loosely translated, it means "all else constant." Economists typically assume *ceteris paribus* when they explain how a change in one variable affects other variables. For instance, an economist might say that, *ceteris paribus*, rising prices for hamburger would cause lower consumer demand. And in theory that's correct. Unfortunately, in the real world "all else" rarely stays constant. For instance, if household incomes are rising even faster, household demand for hamburger could still increase despite its higher cost.

Similarly, assuming *ceteris paribus*, the enormously stimulative actions taken by the Federal Government and Federal Reserve in recent months are undoubtedly inflationary. But here again all else isn't constant. Several mitigating factors exist that should keep the ghost of Milton Friedman at bay for years to come.

Consider first the fundamental reason prices rise – demand exceeds supply. Today our problem is precisely the opposite. To wit, the Congressional Budget Office expects the output gap in the U.S. (the supply of goods and services we're capable of producing at full capacity minus current demand) to average about 7% of GDP over the next two years, or $1 trillion a year. Note that this estimate includes ballooning Federal Government spending without which the output gap would be even *wider*.

Such excess supply exists because, for at least a decade (and some argue the past 25 years), ever-increasing debt levels artificially boosted the economy. We had a good time of epic proportions. But bad loans, unfortunately, are often made in good times. Thus, loan defaults have soared and our major financial institutions now teeter on the cusp of insolvency. Households (generally) no longer have the capacity to borrow and even if they did, most financial institutions are in no position to lend. Demand for goods and services has therefore shrunk drastically, leaving behind a huge oversupply of everything from homes to office space to gas-guzzling SUVs.

So again we return to that stubborn law of supply and demand. As long as we have all that excess supply, most producers will find it extremely difficult to raise prices. How long do we have before demand catches back up? Economists at Goldman Sachs recently estimated that the U.S. economy would have to grow 4.75% a year through 2015 for the output gap to close. If we grow *just* 3.75% a year it'll take a decade. But what if, as has historically happened after the bursting of a massive debt bubble (because debt is paid down and savings rates rise), GDP grows even slower?

The case for inflation, therefore, must be predicated on the idea that all the money the Federal Reserve is creating will soon work its way into the economy, spur torrid demand growth, and rapidly close the output gap. The trouble, however, is that at least in the private sector the Fed is effectively pushing on a string. Specifically, it can increase the money supply, but it can't force already heavily indebted consumers to borrow more or damaged financial institutions to lend. Thus, much of the money the Fed has created is mostly languishing in the coffers of financial institutions, accomplishing little in the way of stimulating demand for goods and services. And while the Federal Government is spending prodigiously, the overall amount remains far too small to close the output gap.

But surely households and businesses will eventually start borrowing again and banks will start lending. And when that happens won't all the money the Fed creates today ultimately cause inflation? If the Fed was literally "printing" money and dropping it from helicopters (as current Fed Chairman Ben Bernanke once off-handedly suggested as an antidote to persistent deflation) the answer would be yes. But understand that the Federal Reserve is not printing currency but rather extending credit to banks, corporations, and the Federal Government. *This money will eventually be repaid*. And as it is the money supply will naturally shrink back to size.

The Fed's recent actions, therefore, differ starkly from those of governments that have inflicted hyper-inflation upon their citizens like the post WWI Weimar Republic (Germany) and more recently third-world nations like Zimbabwe. In those inflationary episodes, governments literally printed enormous quantities of currency, which, once floating around their economies, couldn't be withdrawn.

The final worry of those expecting inflation is that China and other foreign central banks will cease financing our spending (i.e. lending us money by buying our bonds), precipitating a crash in the U.S. dollar. A plunging dollar would then cause import prices to skyrocket and inflationary pressures to surge. But upon closer examination these fears look overblown. For one thing, the vast majority of goods and services consumed in America are still made in America. In fact, only 16% of what we buy today comes from overseas. Thus, a dollar crash of 50% would only imply a 16% rise in overall prices (likely spread out over several years).

But a dollar decline of that magnitude is highly unlikely anyway. What would the dollar crash against? The Euro? The Yen? Europe and Japan have even bigger economic and demographic problems than we do. And it would be tantamount to economic suicide if China allowed the dollar to crumble relative to its currency, the Yuan, as China is as dependent on us as we are on them. If the Yuan doubled overnight relative to the U.S. dollar, China's exporting industries – the foundation of their entire economy – would collapse (their products would be twice as expensive so Americans would buy significantly less). Tens of millions of Chinese workers would lose their jobs, and civil unrest would be a serious threat. So rest assured that the Chinese can no more stop buying U.S. Treasuries than we can stop issuing them to finance our deficits. As a director general at the China Banking Regulatory Commission, a Mr. Luo Ping, resignedly commented this past February (reported by the Financial Times),

> "Except for U.S. Treasuries, what can you hold? Gold? You don't hold Japanese government bonds or U.K. bonds. U.S. Treasuries are the safe haven. For everyone, including China, it is the only option….We hate you guys but there is nothing we can do."