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Why Worry Over Inflation Is Much Ado About Nothing

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Even inflation may be in the eye of the beholder.

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With the unemployment rate at 9 percent and the economy posting less-than-spectacular growth in recovering from the worst downturn in seventy years, inflation may seem an unlikely threat. But that hasn't stopped a growing number of doomsayers on Wall Street and Capital Hill from crying "Fire!".

What's driving the thinking, however, is arguably less a matter of current and leading economic indicators than a powerful cocktail of empirical wisdom, deficit politics and ideological debate about the role and powers of the Federal Reserve in managing the economy.

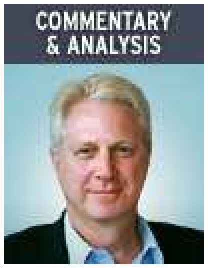
"It's just hard to believe that you can pump all this liquidity into the system without it {inflation} popping up," says Mark Calabria of the Cato Institute and a former senior staffer on the Senate Banking Committee. "QE2 was the straw that broke the camel's back. Bernanke's the remaining face of the bailout. And if you are a run-of-the-mill Republican, then everything you don't like in government, Bernanke is for.

"The simplest answer is that during normal times, we would see inflation," says Josh Bivens of the Economic Policy Institute. "What people are missing is these are not normal times."

The big fear is enormous fiscal spending and monetary stimulus during the financial crisis and ensuing recession-recovery period will inevitably explode into a prolonged bout of unusually high inflation unless interest rates are hiked and the budget deficit shrink-wrapped.

Boom Bust Era

Such was the case n the 1960s-1070s, when massive federal spending on social programs (The Great Society) and the Vietnam War, as well as two oil shocks, created a 15-year, boom-bust cycle.



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Between 1969 and 1982, **the consumer price index** managed to register a reading below 4 and a half percent only once, while posting double-digit gains in four other years. The Fed hiked interest rates relentlessly towards the end of the cycle to snuff out inflation

Growth was erratic in the period, which included two deep and long recessions. **The economy actually shrank in four separate years**, but in four others in grew by more than 5 percent.

Numbers like that have not been seen again and since that time the US economy has experienced both its longest peace-time expansion and worst recession in history.

"Given the depth of the downturn, we should be expecting 5-7 percent growth," says Dean Baker, co-director of the Center for Economic and Policy Research.

Though the current debt-to-GDP ratio is 62 percent and the budget deficit-to-GDP ratio around 11 percent, state and local governments have been cutting their budgets, offsetting some of the federal spending, which was not the case in the prior case. **(Latest Obama budget.)**

What's more, Japan's nearly two-decade-long recovery from the collapse of its asset bubble, which included massive government spending and borrowing, has been marked by modest, yet nagging deflation and has yet to unleash inflation.

In the current inflation debate, however, more recent events are also shaping perceptions.

Memories of 2008

Inflation worrywarts point to rising **commodity prices**, particularly **energy** and **grains**, as the greatest immediate threats, drawing comparisons to the first half of 2008.

"There's concern that the Fed is ignoring that," says Calabria.

Though these factors should not be taken lightly, compared to 2008 the price increases are smaller and the situation far less perilous.

In 2008, gasoline prices increased at a 35.2-percent annual rate leading up to the record high oil price of almost $150 a barrel in July, following a 29.6-percent increase in 2007. The cereals and bakery products category rose 10.2 percent (and food 5.5 percent) for all of 2008.

By comparison, gasoline prices increased 13.8 percent in 2010 after rising 53.5 percent in 2009; cereals and bakery products were actually down 0.2 percent on a annual basis food was up 1.5 percent. **(January inflation data is due out February 16 and 17.)**

Overall, the CPI rose 3.8 percent in 2008. The energy-price spike took a big bite out of discretionary income. That and other factors caused the first back-to-back quarterly declines in consumer spending in decades.

In 2010, the hangover was more than evident. Annual CPI rose 0.8 percent, the lowest in history, following modest 1.8 percent-gains in both 2008 and 2009.

Globalization. much like in the past two decades, is keeping a lid on inflation.

"We are in a structurally low-inflation economy," says Bivens. "We were also in one going into the recession. I am not concerned about inflation over the next two-three years. I'm much more worried about growth."

Inflation averaged about 2.8 percent in the last decade and GDP just 2.6 percent during the expansion from 2003-2007. (GDP was essentially unchanged in 2008).