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No, Asset Bubbles And Inflation Don't Stimulate The Economy

By James A. Dorn

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The notion that inflation is "dangerously low" is gaining ground. Harvard economist Kenneth S. Rogoff holds that "a sustained burst of moderate inflation is not something to worry about," given the slow pace of recovery. With core inflation well below the Fed's target of 2%, Rogoff would like to see the target temporarily lifted to 6%.

Fed Chairman Ben Bernanke tends to agree. In July, he stated: "Low inflation is not good for the economy because very low inflation increases the risks of deflation, which can cause an economy to stagnate." One should distinguish, however, between deflation due to strong economic growth (relative to the money supply) and deflation due to a sharp decline in the money supply as occurred in 1929—33.

Although CPI inflation remains low, the Fed's massive expansion of its balance sheet during the last five years, through ultralow interest rates and quantitative easing, has created asset price inflation and a misallocation of credit.

Investors have taken on more borrowing and more risk, while conservative savers have been severely penalized. The Fed has monetized government debt and is now the largest purchaser of net new Treasury debt.

The monetary base (currency in circulation and reserves held at the Fed) has skyrocketed, but that increase has been largely sterilized by the Fed's policy (begun in 2008) of paying interest on excess reserves.

Fed officials should be more concerned with inflation, not deflation. The asset price bubbles the Fed is now creating cannot be sustained.

When interest rates rise, as they must, the party will end badly. Advising the Fed to increase its inflation target is not a panacea for prosperity; it's a recipe for stagflation.

Price stability is not an enemy of robust economic growth. During the classical gold standard (1880—1914), the United States experienced low inflation (or even mild deflation) as well as strong economic growth.

Long-run price stability was the norm under the market-driven supply of money, which was limited by the convertibility of dollars into gold.

Today, in contrast, there is no monetary rule and the Fed has wide discretion to create money out of thin air. In theory, the Fed could limit the supply of money and maintain long-run price stability. But as an agent of government, the Fed finances government debt and engages in fiscal policy. Governments have always used central banks as part of the fisc.

During the gold standard, the federal government was more in tune with economic freedom and individual responsibility. That era ended with World War 1 and the creation of the Federal Reserve in December 1913.

There was an erosion of sound money and the transition to pure fiat money, culminating in August 1971, when President Richard Nixon closed the gold window. Without a golden anchor and without a monetary rule, the dollar's purchasing power has steadily depreciated.

High marginal tax rates, costly regulations, labor market restrictions, lack of educational choice, an entitlement mentality, and a central bank that has no clear rule to guide it (and limit its power) have all combined to slow economic growth and increase unemployment.

When Fed Vice Chairwoman Janet Yellen appears before the Senate Banking Committee this week, the first question should be: "Do you favor more inflation to lower unemployment?"

If the answer is "Yes," then the second question should be: "Would you favor Rep. Kevin Brady's bill to establish a Centennial Monetary Commission to examine alternatives to pure discretionary government fiat money?"

The Senate Banking Committee might also consider the need to check inflation now instead of later and learn from the "Interim Report of the Cabinet Committee on Price Stability for Economic Growth," submitted to President Dwight D. Eisenhower in June 1959.

That committee rejected the following misconceptions: (1) "that a small amount of inflation is no cause for concern"; (2) "that inflation will stimulate economic growth"; and (3) "that 'a little inflation is inevitable.'"

Members of the committee recommended three actions Congress should take to ensure prosperity and price stability: (1) make "price stability an explicit goal of federal economic policy"; (2) balance the federal budget, reduce the national debt, and hold the line on spending; and (3) separate fiscal and monetary policy, and do not allow the Fed to monetize government debt.

In addition to those recommendations, which were to be "direct defenses against the present danger of excessive price rises," the committee recommended longer-term measures designed to foster free markets and sustain robust economic growth. Tax reform was at the top of the list. The committee was also responsible for improving "public understanding of the conditions necessary for maintaining growth and price stability."

Congress, are you listening?