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Where's The Inflation? Coming To Your Neighborhood

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In December 2008, the Federal Reserve drove down the overnight federal funds rate to near zero. In March 2009, it announced an aggressive program to purchase mortgage backed securities.

These actions were followed by successive rounds of monetary easing, which were unprecedented in size and scope. Economists have been predicting an outbreak of inflation. Were they wrong?

Critics say the absence of inflation proves the doomsday forecasts were wrong. Some critics, like Paul Krugman, argue even more monetary stimulus is needed. They point to consumer price inflation, which was 1.1% for the last 12 months ending in April, to argue there is ample room for further monetary easing.

Yet Fed Chairman Bernanke's congressional testimony on Wednesday suggests the Fed is beginning to doubt the wisdom of continuing its current policy of monetary ease.

The bottom line is that prices are rising faster than the CPI suggests.

Inflation is defined as a general increase in prices, but the increases need not and normally do not occur simultaneously. But first, I turn to what is causing the apparent inflation shortfall (even a whiff of deflation).

Milton Friedman taught us that inflation is always and everywhere a monetary phenomenon. Much money has been created and, other things equal, there should already be considerable inflation.

Other things have been far from equal.

The unprecedented leveraging up of the balance sheets of homeowners, consumers, and, above all, financial firms fueled a housing boom. When the boom collapsed, borrowers and their lenders found themselves overly indebted relative to the reduced value of the underlying assets.

All the players scrambled to deleverage, i.e., reduce their debt burden, at the same time. An entire credit structure unwound. This process has been going on at least since the collapse of Lehman Brothers in the fall of 2008. Deleveraging has many consequences, one of which is a scramble for cash and other forms of liquidity.

If banks have cash (reserves), they do not want to lend them and especially not to other banks. Each bank assumes rationally that other banks are in as bad shape as they are.

That causes a breakdown in the interbank lending market, which in normal times funds lending. The process is both a scramble for liquidity, and an effort to recapitalize institutions whose balance sheets have become impaired.

Quantitative easing was designed to halt the collapse in the credit structure. Overnight borrowing rates for banks were driven to near zero. And bank reserves at the Fed skyrocketed.

Excess reserves, those in excess of what banks are required to hold, went from essentially zero to almost $1.8 trillion today.

Reserves are the base upon which money and credit structures are erected. It is that explosive growth in reserves that formed the basis for the many predictions of price inflation made over the last four years.

The process of reserve creation should in normal times have led to rapid growth in money, and then price inflation. Based on history and theory, the predictions were sound.

The deleveraging process put a spanner in the works of money creation. The turnover (velocity) of money, the number of times a dollar is spent per year, collapsed. Depending on the measure of money used (broader or narrower), the velocity of money has declined to historic lows or to a level going back decades.

There has been money growth. The 12-month growth rate as of April 2013 for M1, a narrow measure of money, was about 12%; the 12-month growth rate for M2, a broader measure, was 7%. The stimulative effects of money growth have been muted by the decline in velocity (which is a rise in the demand for money).

And there has been price inflation, here and around the world. A consumer price index is a measure of only a subset of all prices.

Prices of consumer goods for Americans have been held down for decades by the entry of China and India into the global economy. That process continues as other low-wage economies export more and more goods to the world.

The list includes countries such as Vietnam and, as we were recently reminded, Bangladesh. Consequently, CPI (or alternate measures of consumer prices) have not been accurate gauges of monetary stimulus for decades.

Money has many channels through which it flows in the global economy.

As we learned in the 2000s, a policy resulting in low (even negative) real interest rates affects the prices of long-lived assets disproportionately and in advance of impacting consumer prices. In an inflationary episode, prices of goods often increase sequentially, and not in tandem.

That sequencing of price increases was understood by economists as diverse in their viewpoints as Keynes and Hayek.

The process involves changes in relative prices and resource allocation, and was first explicated in the 18th century by the Irish economist Richard Cantillon.

Home prices are once again on an upward march, and we will see whether the Fed is helping inflate another housing bubble.

If a bubble is defined conventionally as an unsustainable rise in prices, bond prices are a bubble from any historical perspective. I leave it to the readers to exercise their own judgments on equity prices.

The dollar is the dominant global currency, and its quantity affects prices globally. That channel is most apparent for countries that tie or peg their currencies to the dollar. That list includes countries like Hong Kong, Singapore and even China.

Chairman Bernanke's global helicopter drop of dollars helped fuel housing booms in Hong Kong and Singapore while the U.S. housing market remained in the doldrums.

Countries like Brazil are experiencing substantial price inflation in their consumer goods. For April 2013, the annual rate there is 6.5%.

In short, if you want to see the inflation, look beyond U.S. consumer prices and look around the globe. Monetary expansion has effects beyond domestic consumer prices. There is no presumption that an expansionary monetary policy affects consumer goods prices first.

Inflation is already here, and more is coming to your neighborhood soon. If the past is prologue, the Fed will wait too long to react to inflation.

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