Guest Column | Gerald P. O'Driscoll, Jr.

Money, Inflation, and Rising World Commodity Prices

Compliments of Chairman Bernanke.

Posted February 28, 2011

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Are America and the world at risk for another inflationary episode similar to the 1970s and early 1980s? Or do current low rates of inflation portend low inflation for the foreseeable future?

David Wessel revisited this question in his “Capital” column in the February 24 *Wall Street Journal.* He correctly states that the Federal Reserve under Chairman Ben Bernanke takes the position that the course of inflation depends on expectations: Inflation will stay low if people expect it to stay low. Wessel quotes Bernanke: “The state of inflation expectations greatly influences actual inflation and thus the central bank’s ability to achieve price stability.”

The Fed chairman has the causation precisely backwards. Fed policy systematically shapes inflation expectations. His statement focuses on the short-run and ephemeral over the long-run and permanent. In so doing, Bernanke follows in a long line of central bankers.

Central-Bank Mindset

In *A History of the Federal Reserve* (volume 1: 1913-51), Carnegie-Mellon University Professor Allan Meltzer summarizes the central-bank mindset. To the degree there is theory behind the policies of central bankers, it derived from the nineteenth-century banking school thinkers. Chief among them was Thomas Tooke, who “denied that money, credit, or base money bore any consistent relation to prices. Most Federal Reserve officials remained in this tradition in the 1920s. They denied that their actions affected prices” (57-58).

Unfortunately for defenders of current Fed policy, inflation is accelerating around the world. Singapore’s economy has benefited from revived global trade, but consumer price inflation is now running at an annual rate of 5.5 percent. In Vietnam, an emerging economy of note, consumer price inflation is running at 12 percent. Food riots plague India. It is not a question of whether inflation is on the horizon. Inflation is here.

In a February 23 op-ed in the *Wall Street Journal,* retired *Journal* editorial writer George Melloan explained how economics has contributed to the turmoil in the Middle East. Consumer price inflation in Egypt rose to 18 percent annually in 2009 from 5 percent in 2006. In Iran inflation rose to 25 percent in 2009 from an already high 13 percent rate in 2006. Inflation surges hit family budgets hard, especially for the many in these countries living at the margin. Desperate people take to the street. As Melloan wryly observes, “About

the only one failing to acknowledge a problem seems to be the man most responsible, Federal Reserve Chairman Ben Bernanke."

Monetary policy is not the sole culprit in the rise of food prices. There have been a number of negative supply shocks affecting the supply of various food stuffs, and these shocks have certainly contributed to higher prices. Central bankers often point fingers at them to counter accusations that monetary policy is at fault.

Money Updraft

Two points must be made. First, global food production and prices have been rising. Rising prices and output reflect rising demand relative to supply. Second, nearly all commodities, not just agricultural commodities, have been caught in a monetary updraft. Along with food prices, we have seen rising prices of oil (even before the Middle East turmoil), gold, silver, copper, and a whole range of other commodities used in production. One noteworthy laggard is natural gas, whose price has been kept down by positive supply shocks of new discoveries. Natural gas is the genuine supply story, and runs counter to the narrative of central bankers.

Commodities, along with most traded goods globally, are priced in dollars. The Fed creates "base money": bank reserves plus currency. Banks then expand on base money by lending out reserves. The more base money and bank money produced, the higher the dollar prices of commodities and other goods. It is the old story of too much money chasing too few goods and driving up their prices. That is inflation conventionally defined.

The inflation story this time has been complicated by a weak U.S. economy, whose growth is still dampened by the consequences of the housing boom and bust. The bank expansion of the money supply through lending has occurred not in the U.S. economy but in emerging economies, particularly in Asia and Latin America. Bernanke promised his easy-money policy would create jobs, and it has – but not in the United States. Of course, to the degree that prosperity in these countries has depended on the Fed's easy-money policy, it has been a false prosperity. The citizens of these countries are paying for it now in the form of inflation. American consumers are even now beginning to feel the lash of inflation, as any homemaker who goes to the grocery store can attest.

The Fed has been paying a low interest rate on reserves, which to some extent has restrained lending by banks. With loan demand weak or of poor quality, banks have chosen to keep money on deposit at their local Federal Reserve bank and earn a safe return. As loan demand picks up, however, banks will likely begin lending out their reserves. That appears to be happening as this is being written.

Pegged to the Dollar

Here are some details of the linkage between Fed policy and global inflation. The currencies of many countries are pegged to the dollar. Their exchange rates are either a constant or change only slowly. The Hong Kong dollar is an example of the former, the Chinese yuan, of the latter. Even so-called floating currencies are not really floating. Central banks intervene to prevent their value from rising rapidly against a flagging U.S. dollar. The only important central bank that seems to be letting its currency float freely against the U.S. dollar is the Swiss, and the Swiss franc is appreciating against the dollar fairly steadily.

Thus, as a practical matter, when the Fed creates dollars it results in an increased money supply in other countries. It is not necessarily one for one, but it is proportional. The Fed's low-interest policy has fueled not

only a commodities boom, but a real-estate bubble in Asian countries and elsewhere. Some countries have imposed capital controls to counteract Fed policy, but these are seldom fully effective.

The Fed chairman argues that foreign central banks can offset Fed policy. Doing so confronts them with a Hobson's choice. If they act effectively to offset Fed policy by raising their interest rates and exchange rates, they risk sending their own economies into the tank. Based on experience, it is equally likely that higher interest rates in those countries would attract more speculative capital, fueling asset bubbles, commodity prices, and eventually consumer price inflation. The last is what has in fact been happening.

Bernanke is being disingenuous about the options foreign central banks and governments have to counteract the Fed's easy-money policy, which threatens a global outbreak of inflation similar to the 1970s.

(This article expands on a post at ThinkMarkets.)