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RAHN: Return of the money snatche

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COMMENTARY:

When will the next round of inflation hit, and how can we protect ourselves? Many eco and commentators, including yours truly, have warned about the potential of a new rou high inflation due to the great expansion of government spending. But does an increase government spending necessarily translate into higher inflation? The answer is "no," bu often does, and this is why.

An increase in government spending must be financed by increasing taxation, or increas government borrowing, or creating more money by the central bank (the Federal Reserv of the above. Increasing taxation or government borrowing does not directly increase in but if the central bank creates new money faster than goods and services are increased, will result.

President Obama and a majority of the Democrats have promised they will only increas on the rich, which, by their current definition, includes about the top 5 percent of taxpay pay 60 percent of the federal income tax. The problem the Obama Democrats face is tha precisely this group that already pays the highest tax rates (in many cases around 50 pe combined federal, state and local income taxes), and this group is both the most sensitiv rate changes and has the greatest ability to either legally or illegally avoid or evade pay taxes (even by choosing not to work).

Collectively, this group does not have enough income to pay for all of the new governm spending, even if the government could collect it - which it can't!

The United States has been fortunate in recent years because the Chinese, Japanese and other non-American individuals and institutions have been buying U.S. government deb investing in U.S. businesses. This inflow of capital has not only financed the governmer deficits, but has provided inexpensive capital for the U.S. private sector, allowing it to very rapidly.

This is now changing. Because of the global recession, every significant economy, with the exception of Norway, which has a small population and lots of oil revenue, is running a government deficit. Thus, collectively, governments around the world will issue many trillions of dollars of new government bonds in the next few years.

In order to sell all of this government debt, higher interest rates will be offered to induce people to save more rather than consume and to divert their investments from corporate stocks and bonds and venture capital to government bonds.

If people save more and consume less, the demand for goods and services will grow more slowly and fewer new jobs will be created. If people invest more in government securities and less in the private sector, there will be less research-and-development spending, lower productivity growth and less business expansion and job creation.

As interest rates rise, fewer people will be able to afford new homes, and businesses will find fewer profitable investments, all of which will keep unemployment rates high. The Federal Reserve will be under tremendous political pressure to create more money - largely by buying its own government debt - which in the short run can temporarily decrease interest rates, but over the long run will cause interest rates to rise steeply as inflation comes roaring back. The Fed will then have to stomp on the monetary brakes again, which will lead to another recession. This is precisely what happened during the late 1970s and early 1980s until there was the switch in economic policy under former President Ronald Reagan.

The Obama administration is forecasting higher rates of growth, and lower inflation and unemployment than the consensus forecast (Blue Chip Economic Indicators) of private sector economists, while at the same time proposing a series of laws and regulations that, if enacted, would make it impossible to achieve its own forecasts. Specifically, the Obama Democrats are proposing (among other things):

• Massive environmental regulations and taxes, which would depress incomes for most Americans and increase business costs, both of which would depress employment.

• Costly increases in labor regulations, including card check, which would make it much more costly for employers to hire workers and, therefore, fewer workers would be hired.

• A series of truly foolish laws and Treasury regulations whose purpose is to try to get a few

billion dollars in additional tax revenue from businesses and individuals who operate outside the United States, but whose real effect would put at risk trillions of dollars of foreign investment into the U.S. at a time when it is most needed. This, in turn, would cost the U.S. hundreds of thousands, if not millions, of new jobs.

Unless the Obama Democrats suddenly get religion and start applying real cost-benefit analyses to their proposals before they leap, the United States is doomed for a repeat of the late 1970s - higher taxes, higher inflation, slower growth and more unemployment - when productivity growth was less than half the level of the last decade. Individuals can partially protect themselves by buying inflation-indexed U.S. government bonds (as long as they remain available), reducing their debt loads, particularly nonfixed-interest-rate debt, diversifying their assets across the globe, and - perhaps, praying for a new Mr. Reagan.

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