The Washington Times

Close Print

Originally published 04:17 p.m., February 9, 2010, updated 04:31 p.m., February 9, 2010

RAHN: Where is the inflation?

Richard W. Rahn

Most economists, including yours truly, have been saying that the huge budget deficits the country is running will result in inflation. So, where's the inflation? Inflation normally lags changes in the growth of the money supply by one to two years. The big monetary expansion took place in the last half of 2008. So if the economy follows past trends, one would expect to see growing inflation by the latter part of this year.

There are several reasons why inflation does not occur simultaneously with a sudden growth in the money supply. (Remember, inflation is caused by the money supply growing faster than the supply of goods and services.) The Fed greatly expands the money supply when it sees the economy is entering a recession in order to temporarily reduce interest rates and increase the supply of loanable funds. But a recession is a decline in business activity. When business declines because of a fall in demand, the normal reaction of businesspeople is to cut prices (deflation) to reduce excess inventories.

It appears that the inventory-reduction portion of the business cycle is over, and the data show that most businesses have begun to rebuild inventories. This inventory rebuilding is increasing the demand for basic commodities, but the rise in commodity prices has not yet overcome the big productivity gains the U.S. has experienced over the past three quarters.

When an economy goes into a recession, there normally is a fall in labor productivity because employers are reluctant to lay off workers, and hence, most businesses find themselves overstaffed, which means that output per hour of work declines. Employers eventually are forced to cut staff, and the workers who are let go usually are the least productive ones. When there are enough workers to meet demand for the product, but not an excess of workers, productivity normally shoots up because the more productive workers (and more motivated ones) are the ones who have kept their jobs. The increase in productivity means goods and

services can be produced at lower costs, and this effect masks the monetary inflation.

When inflation rises (or is expected to rise), interest rates rise - except during the early stages of the business cycle, when there is a paradoxical result of larger government deficits being most often associated with lower interest rates. The noted economist John H. Makin explained this effect very well in a recent American Enterprise Institute paper in which he wrote: "in the United States, nonfederal government debt (currently about $27 trillion) is nearly four times as large as federal government debt (currently about $7.2 trillion). When the economy enters a recession, countercyclical fiscal policy boosts deficits and government debt while private debt falls. Given that the stock of private debt is so much larger than government debt, the drop in private borrowing in a recession overwhelms the impact on total borrowing of a rise in government deficits."

But alas, all of this is temporary. As the economy begins to recover, both business and individual borrowing increases, putting upward pressure on interest rates. Government borrowing merely accelerates the rise in real, inflation-adjusted interest rates. The higher interest rates go, the more costly it is for consumers to buy new homes, automobiles and other items they normally buy on credit and the more costly it is for businesses to borrow for new plants and equipment. These interest-rate increases begin to choke off demand for consumer durables and business plants and equipment, which slows down or even reverses economic growth.

The Federal Reserve and other central banks around the world can mask the rise in interest rates for awhile, as they are now, by making money available to the banks at very low rates (presently close to zero for short-term borrowing). And individuals and businesses can squirrel away much of the new money by increasing their savings rates. But what happens if people see a rise in inflation and at the same time are unable to obtain sufficiently high interest rates on their savings to cover the inflation and then some? Many increasingly will flee from holding cash balances and just buy "stuff," which can lead to an accelerating rate of inflation or even hyperinflation.

Or, as has happened in Japan, the people see the government accumulating so much debt that they don't believe the government will be able to fulfill its promises for the Japanese equivalent of Social Security and Medicare, so they hoard cash in a belief that they will need it for their retirement. A rising savings rate means lower consumption with little or no inflation, or even deflation, leading eventually to economic stagnation, which is what the Japanese have.

Studies show that once the government ratio of debt to gross domestic product rises above 90

percent, interest rates begin to accelerate to destructive levels. The debt projections by the administration and the Congressional Budget Office show the U.S. getting very close to such a level in the next few years, while more objective private forecasters see the debt-GDP ratio rising to much more than 100 percent.

The alternatives are simple - greatly reduce the growth in government spending or suffer a huge rise in inflation and/or economic stagnation. (Increasing tax rates, which already are at high levels, slows economic growth and job creation, which in turn increases the demand for government services and payments - and hence becomes more of a problem than solution.) Who, among our politicians, has actually produced a real plan to reduce the growth in government spending to the necessary levels?

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.

Ads by Google China Economy Inflation Forecasts Inflation Rate Chart Inflation 2009 US Inflation