Musings from the Chief Economist

Inflation: Back to the 1970's?

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Executive Summary

- **Oil and food prices have temporarily boosted headline inflation numbers.**
- **Temporary headline inflation numbers are not the same as sustainable, generalized inflation.**
- **At the moment, we are seeing a very sharp but focused increase in food and energy prices, with other prices either flat or declining.**
- **Generalized inflation is an increase in the price of almost everything and is caused by excessive monetary policy.**
- **Without excessive monetary growth, business and consumers have to ration their dollars and make choices.**
- **According to our analysis, monetary growth is not excessive and the Fed has not pumped too much liquidity into the economy. The monetary base is flat to down over the last year; it looks more deflationary than inflationary.**
- **The best way to gauge excessive monetary policy is to view total spending as measured by nominal GDP.**
- **Unlike in the late 1970's, spending growth as measured by nominal GDP is currently low and decelerating.**
- **Without strong spending growth, there is not enough power to spread energy and food price shocks to the rest of the economy.**
- **Wages are the transmission mechanism for spending. If wages are not rising, spending should be restrained. Inflation in the 1970's was driven by a vicious, self reinforcing wage/price spiral caused by excessive monetary growth.**
- **Wage growth is currently slowing. As long as wages are not expanding rapidly, general inflation should be contained.**
- **Labor costs represent almost 70% of production costs and drive inflation.**
- **There is a strong correlation between unit labor costs and inflation, and a weak relationship between inflation and commodity prices. Unit labor costs are low and decelerating.**
- **Oil and food shocks, since they are not a monetary phenomenon and are not due to too strong spending growth, need to be dealt with directly. Tighter monetary policy will not add one kernel of corn or a new barrel of oil; it will likely only destroy demand.**

Although rising oil and food prices have boosted headline inflation rates around the world, this should not be confused with sustainable, generalized inflation. Headline inflation and generalized inflation are not the same thing. Headline inflation can be distorted by large increases in one or two sectors of the economy, but it is not necessarily "inflationary". Everything else being equal, if prices are rising in one or two sectors, consumers will have to make choices about what to buy, causing prices in other sectors to decline. In this way, inflation in one sector can cause deflation in another. For example, energy and to a lesser extent food prices are rising sharply, but prices elsewhere in the economy (wages, retail, housing, technology, equity prices) are stable or falling.

We subscribe to the Monetary Theory of Inflation, which argues that headline inflation becomes more generalized when it is monetized. Broadbased inflation is a monetary phenomenon caused by excessive monetary growth. Unless sector specific inflation is monetized, it cannot spread throughout the economy. For inflation to take hold, a central bank has to push more money into the system, allowing the consumer to avoid making choices and to continue to sustain spending on all goods and services. Until monetary policy becomes too expansive, generalized inflation should remain contained.

We can assess the degree of monetary accommodation today by monitoring the growth in monetary aggregates, real short-term interest rates, the slope of the yield curve, or gold prices. Currently, real interest rates are negative, the yield curve is positively sloped, and gold prices have been rising, which suggest an accommodative Fed. How-

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ever, despite the Fed's attempt at accommodation, the monetary base (the only monetary aggregate the Fed can actually control) is growing at an anemic rate. The monetary base is comprised of cash in circulation and banks' reserves on their deposits. It is the feedstock for bank lending.

Judging from the slow growth in bank lending and the monetary base, the Fed is following a deflationary policy. However, a concept known as velocity complicates the issue. According to the Quantity Theory of Money, money times velocity equals price times quantity or M*V=P*Q. The right side of the equation is essentially nominal GDP (NDGP), with "P" being inflation and "Q" equal to real GDP. Velocity measures how quickly money turns over or exchanges hands. If velocity is stable, monetary growth will be the sole determinant of NGDP growth and the driver of the excess demand that causes inflation. If the economy is currently facing growing inflation pressure and it is not showing up in monetary growth, it must show up in accelerating velocity. However, since NGDP is currently decelerating, velocity cannot be accelerating. If inflation is defined as "too much money chasing too few goods", then the best way to measure excessive monetary policy is to look at total spending as measured by NGDP. If nominal GDP is not accelerating, it is hard to support an inflationary argument.

In the late 1960's and during the 1970's, inflation spread throughout the economy when an expansionary monetary policy accommodated higher prices and wages. Nominal GDP growth exploded. It exceeded 12% per annum in the late 1970's as the monetary base and velocity accelerated rapidly. In contrast, at the end of the first quarter of 2008, year-over-year NGDP growth was running at around 4.8%, with real GDP up 2.5% and the GDP deflator (an inflation measure used in GDP accounts) at 2.3%.

How can inflation be only 2.3% as suggested by the GDP deflator when the headline inflation rate as measured by the CPI at the end of June was running at 5.0%? First, the CPI is based on a fixed basket of goods based in a certain year and is only changed periodically. The GDP deflator monitors the price changes of what is actually purchased with basket weights that are constantly changing. Second, the deflator represents all goods purchased in the economy, not just consumer goods. Finally, while headline inflation is increasing due to rising food and energy prices, the core inflation rate (ex-food and energy) is up only 2.4%.

Food and energy prices have surged due to strong Asian demand and failed energy and agricultural policies. However, these price increases have not spread and become generalized. As mentioned earlier, they have not been monetized, and consumers are being forced to make tradeoffs in their purchases. In addition, lower overseas labor costs have increased competitive pressures and dampened the ability of corporations to increase prices. Global competition is helping to keep wage inflation pressure low and driving productivity gains. Excessive wage growth is the transmission mechanism for excess demand and higher prices.

While a great deal of focus has been placed on rising commodity prices, labor costs are by far a more important driver of inflation, particularly in a service based economy. Unlike commodity prices, unit labor costs (compensation adjusted by gains in productivity) are strongly correlated with inflation. The current trends in compensation and productivity have been pushing unit labor costs lower and should help contain long-term inflation. In the 1960's and 1970's, unit labor costs surged as the Fed accommodated higher wages and productivity declined.

The table on the following page illustrates the points made above and contrasts where we are today compared to the 1970's:

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Indicator	1970's (10-yr. averages ending 1980)	Current (Y-Y) change)*
Nominal GDP Growth	10.4%	4.8%
Real GDP	2.5%	2.5%
GDP Deflator	8.0%	2.2%
CPI	8.0%	5.0%
Core CPI	7.3%	2.4%
Monetary Base Growth	7.6%	2.2%
Productivity	1.8%	3.3%
Compensation	8.7%	4.0%
Unit Labor Costs	7.0%	0.7%
New Home Prices	12%	-5.0%

*Most Recent Available Data

Source: Bloomberg

We do not mean to trivialize the increase in energy and food prices or the great burden it places on many consumers. However, as long as these price changes are not monetized, inflation should not spread. The price increases in these areas reflect real problems and imbalances rather than monetary imbalances. Price signals are being sent to the marketplace to adjust supply and demand. Left alone, supply and demand imbalances should clear themselves, and inflation in one sector should be offset by lower prices in other sectors, leaving the overall inflation rate contained. However, inflation in specific sectors can become ingrained when price signals are distorted by subsidies, windfall profit taxes, price controls and protectionism (as in the 1970's). Hopefully we can avoid making the same mistakes again.

Sources: Bailard Research, Federal Reserve Board, Bloomberg, Ned Davis Research, GaveKal Research

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