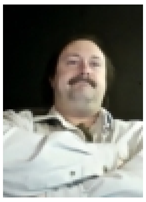
How to Stop Inflation



That's cause for celebration, apparently. At least it was cause for one major paper, *The Washington Post*, to put the stat in its own headline, with *Post* staff writer Frank Ahrens penning a story pointing out that the drop was the first since 1982.

It's not time to celebrate yet, though. The fact is, any inflation is too much inflation. And in the U.S., there is good reason to think there is substantial potential inflation waiting in the wings.

The reason? Because banks are holding huge reserves that have not shown up in the economy at large just yet. In remarks to the Minnesota Bankers Association on Feb. 16, Narayana R. Kocherlakota, President of the Federal Reserve Bank of Minnesota, explained the situation and warned of the consequences:

> Deposit institutions are holding over a trillion dollars of excess reserves (that is, over 15 times what they are required to hold given their deposits). These excess reserves create the potential for high inflation. Suppose that households believe that prices will rise. They would then demand more deposits to use for transactions. Banks can readily accommodate this extra demand, because they are holding so many excess reserves. These extra deposits become extra money chasing the same amount of goods and so generate upward pressure on prices. The households' inflationary expectations would, in fact, become self-fulfilling.

The extra reserves are not the sole problem either. Federal debt, which is astronomical, also plays a role. According to Kocherlakota, "the amount of government debt held by the private sector has gone up by over 30 percent" since 2008. That can only be paid off in two ways — either through increased taxes or, says Minnesota Fed chief, "by the Federal Reserve's debt monetization (that is, by printing dollars to pay off the obligations incurred by Congress)."

Increased taxes aren't politically feasible. That leaves debt monetization, and the Fed has shown over the last decade that it has no fear of pouring on the money supply when it's expedient to do so. If the Fed monetizes the debt, and bank reserves flow into the economy, the additional increase in the money supply will jump start inflation. Kocherlakota thinks this isn't likely, but he gives no specifics other than the standard mantra — trust the Fed to manage the economy and it will be ok. Platitudes aside, a realist could be forgiven for adopting a pessimistic outlook when looking objectively at the current state of the economy and the prospect for future ruinous inflation.

An alternative solution to just trusting the Fed, and one that would actually work, would be to insist on a new era of fiscal responsibility for Washington. You have to go back a long time indeed to find that idea kicking around in the mainstream, but there actually was such a time in American history.

To find it all you have to do is locate a stack of magazines from the 1950s. It can even be a mainstream organ like *Life* magazine. In fact, looking recently at a well-preserved issue of *Life* from 1959 I came across a full page advertisement from Met Life. But the ad in question didn't talk at all about the value of life insurance or the reliability of Met Life, as opposed to say New York Life, Prudential, or Northwestern Mutual. Instead, it took the form of an article advocating a cure for inflation.

The cure, according to Met Life? Fiscal conservatism. The ad observed that inflation hurts everyone and that there is no such thing as just a “little” inflation. Instead, the ad pointed out: “As long as prices keep rising year after year, the value of the dollar declines and people — particularly those on fixed incomes — are seriously hurt.”

To prevent this the ad argued that government should “pay its current expenses out of current income” as opposed to running up debt that, as Kocherlakota noted, might need to be monetized causing inflation. The ad also pointed out that citizens should help “the government to limit spending to services which are truly necessary.”

The Met Life people didn’t identify what those might be, but fortunately we have those readily identified in the Constitution itself. Limiting government to it’s Constitutional mandate would immediately result in vast savings on the order of many hundreds of billions of dollars, savings that would put more money in the pockets of the American people and that would be used to jump-start our sagging economy.

It’s an idea that seems as reasonable now as it did in 1959 to Met Life execs.

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