

Where Is The Inflation?

I still stand by my prediction of extremely high inflation. No one can predict the exact moment of arrival, but it eventually has to arrive. The government is spending money it does not have, and is inflating the money supply dramatically. That money is being held by banks because they are reluctant to lend it in the current economic environment—and they are getting paid interest by the government to hold onto it. Although the interest they are getting is low, it is also no risk. The banks can make more money if they lend it to individual Americans and businesses at a higher rate, but they have no confidence in the ability of those borrowers to pay it back. At the same time the government is keeping interest rates artificially low, partly because it wants to avoid people with variable rate mortgages being hit with the reality of their poor borrowing decisions. (That was the same mistake made by former and current Federal Reserve Board chairmen Alan Greenspan and Ben Bernanke, keeping interest rates low to encourage high-risk borrowing so there would be a chicken in every pot, a car in every garage, and a garage for everyone who wanted one—regardless of whether he could afford it.)

China and other nations have been reducing their purchases of American debt. In order to get them to start buying that debt again, interest rates have to be raised. When that happens, the banks will start lending because they will be able to get a greater return on their investment—great enough to offset the losses they anticipate from the percentage of loans that fail. When that cash eventually hits the streets of America, the result will be massive inflation.

Why? Because that *always* happens when the money supply grows and the economy does not. In the history of the world, it has never *not* happened.

The gross domestic product is approximately \$14 trillion. That is the approximate total of the goods and services produced during one year. (The *exact* amount is of course unknown, but the number itself is not that important to this discussion.) If the government prints money and introduces it into the economy—while the economy is *not* growing—we end up with *more cash* chasing after the *same amount* of goods and services. Assume the government adds \$100 billion to the money in circulation. Instead of an economy with \$14 trillion chasing after its goods and services, we will have \$14.1 trillion chasing \$14 trillion worth of “stuff.” That additional \$100 billion will result in higher prices. At some point the prices inch upward, until the money matches the goods and services. *The more money is added to the economy, the greater the inflation.*

Simply adding money does not of course increase the amount of goods and services produced by the economy. The nation as a whole is not making more “stuff” than it did before the money was printed. As that money is introduced into the economy, it gets spent. Those who receive it first make out the best—because they receive the cash before prices go up. But, prices eventually go up because there is more money while people are competing for the same amount of goods and services. (Those who get the additional money first are often defense contractors and union members, depending on how the government “stimulates” the economy.)

As a small-scale example, the “cash for clunkers” program essentially gave buyers \$4,500 in “free money.” The government didn’t actually have the \$3 billion for the program, it simply gave a limited number of people \$4,500 each. (Technically the government issued checks to the auto dealers, but the result was the same as if it had instead given the checks to the buyers.) The lucky car buyers spent the \$4,500 on new cars. The car dealers, faced with more buyers for the *same number of cars on their lots*, boosted the prices of those cars—by not discounting them as much as they would have had the clunkers program not been introduced. Who could blame them? If you have 50 customers rushing to purchase 40 cars on your lot, you’re certainly not going to discount them! (Ask anyone who bought a car with the clunker cash. They will tell you that the dealers were not doing much “dealing.”) Of course, the clunkers program was only temporary; the giveaway stopped after \$3 billion was handed out. And automobile dealers are struggling again.

The cash for clunkers program was inflation on a small scale, but it demonstrates the process. Take that \$3 billion and *instead* make it \$700 billion! The federal government’s deficit for this year is approximately \$1.4 trillion. Whatever it can’t borrow from China or anyone else, the government will have to print. If it can borrow only half of the \$1.4 trillion it fell short, that means *\$700 billion* will have to be printed out of thin air and injected into the economy. But the amount of “stuff” has not grown. In fact, it has actually been *reduced* because of the recession.

More money for the same stuff means higher prices. That is inescapable! All the government can do is try to delay inflation; it cannot stop it. Again, much of that new cash is already out there, but it is still being held by the banks. The government talks about “freeing up credit,” but it is in fact working behind the scenes *not* to do so with its interest rate policies. Why? Because the minute that cash hits the streets, prices will climb. And higher prices means an angry electorate. And an angry electorate means election losses in November 2010 and November 2012.

Obama and the Democrats will do their best to stall the inflation until after November 2012. But they probably haven’t a prayer of doing so. Why? Because the more they work to postpone the inflation, the longer the recession will last. They have painted themselves into the proverbial corner. If they release the money now to kick start the economy, they will cause inflation. If they stall the inflation, that will prolong the recession. It’s not an appealing choice, is it? That’s why Treasury Secretary Tim Geithner and Federal Reserve Board chairman Ben Bernanke have such worried looks on their faces—they’ve been asked to do the impossible. (Geithner seems incapable of accomplishing even the moderately difficult, and Bernanke does his best to hide the printing press behind the curtain.)

The older folks among us remember the high inflation of Jimmy Carter’s presidency. Although his foreign policy disasters were most certainly his fault, he can’t be blamed entirely for all of the inflation and unemployment that led to his record breaking “misery index.” Carter, and Gerald Ford before him, were mostly victims of circumstance. The

government printed money to cover the cost of the Vietnam War and other deficit spending, and Gerald Ford and then Carter happened to be in the Oval Office when the inflation volcano erupted. The naïve Ford chose to wear a “Whip Inflation Now” button, and the hapless Carter chose to wear warm sweaters and turn down the Oval Office thermostat. Understandably, neither approach worked. Their appeals to the American public to halt inflation were ridiculous because the public was not the direct cause—deficit spending and printing money to cover it was the cause. (Arguably, the public was the *indirect* cause, because it expected and even demanded the government goodies that led to the deficit spending.)

What should have been done to stop the inflation of the late 1970s? Taxes should have been reduced to kick start the economy, and federal spending should have been cut to the bone to reduce the deficit and stop the printing of “funny money.” Ronald Reagan did *half* of what was required. He reduced taxes to stimulate the economy and in the process generated an incredible increase in federal tax revenue—which Congress quickly spent. But because Reagan wasn’t able to rein in wasteful spending, the giant behemoth of the government kept growing—and future bouts with inflation were guaranteed.

Inflation is why a new house used to cost \$5,000 and now costs \$250,000. Houses may be better than they used to be, but they are not 50 times better. They are still nothing more than big boxes with roofs to keep the rain and the snow out and furnaces to keep the people inside warm. Inflation is why a new car used to cost \$2,500 and now costs \$25,000. Automobiles may be better than they used to be, but they are not 10 times better than they used to be. They are still nothing more than boxes with four wheels that get you from one place to another faster than you can walk. Inflation is why you are not necessarily more content making \$50,000 per year than you were making \$25,000 per year. You may be making twice as much as you used to, but if prices doubled in the same period of time you are no better off than you were. (In fact, you may be worse off if prices *more* than doubled and if the higher income put you in a higher tax bracket.)

Why does inflation even exist? Because the government prints too much money, in order to cover its deficit spending. How much money should the government print? Arguably, the government should only print enough money to replace the cash that wears out and is destroyed, and enough to match the economy’s growth. That is, if the American economy is 4 per cent more productive than it was in the prior year—producing 4 per cent more goods and services—then a four per cent increase in the money supply keeps prices stable. To print too little money would result in deflation, with prices declining while interest rates rise because of a shortage of cash.

If the money supply were kept relatively stable, some prices would go up and some would go down, as a logical result of changes in the economy. For example, if a business owner comes up with a more efficient way to manufacture his product, the price of that product will be lowered. He can then make increased profits from increased sales, even though he has lowered the per unit price. (That is why capitalism is more productive than socialism: there is an *incentive* to work harder and smarter.) On the opposite side of the equation, if there is especially cold weather in Florida, the price of orange juice will go

up. But that increase in the price of orange juice is *not* inflation—it is an isolated instance. Some prices go up and some prices go down, but prices generally remain stable if the money supply keeps pace with the expanding economy. The term inflation applies to price increases on most or all products and services nationwide, as a result of printing too much money.

If the government did not engage in deficit spending and did not print too much money, prices would remain stable over decades. A house might still cost less than \$10,000. Of course, your income might still be only \$5,000 per year—but so what? What matters is not how much money you have—it's only paper, after all—but what you can buy with your money. Making more money while prices increase at the exact same pace is not an improvement.

Why then does the government print too much money? The government resorts to the printing press because it is unable to live within its budget. An individual cannot earn \$30,000 and spend \$40,000 year after year without getting into serious financial difficulties. Yes, you may borrow more than you earn in order to buy a house, but you also commit to paying that loan back—with interest. You live within your means. To do otherwise is asking for trouble.

The government, believing itself to be immune to basic laws of economics, does what a normal person would not do: it continues to spend more than it takes in. It finances some of that with borrowing, but there is a limit to how much it can borrow. If it borrows too much, then there is nothing left to lend to people to buy houses or cars or to start or expand businesses. The other solution is to print more money. The government simply turns on the printing presses and creates more money. Or it sends \$4,500 cash for clunkers checks to automobile dealers. That new cash gets introduced into the economy. But if the economy is not growing as fast as the money supply is growing, the result is inflation. If the economy is growing at a rate of 3 per cent but the money supply is growing at a rate of 7 per cent, there will be 4 per cent inflation. (The cost of some goods and services will go up more and some will go up less, but the average inflation rate nationwide will be 4 per cent.)

The government does this year after year after year. That is why a house no longer costs \$5,000 and an automobile no longer costs \$2,500. That is why you make more money than you used to but are not necessarily better off financially. And as your salary goes up, you are pushed into a higher income tax bracket—which gives Uncle Sam even more of your hard-earned dollars to spend on things you would never spend it on.

The government refuses to be constrained by common sense principles. The politicians give the voters “goodies” in order to ensure re-election, and the non-thinking voters accept the bribe—even though they will pay for that bribe through the higher prices brought about by inflation. (They are bribing themselves with their own money.) Politicians get away with the scam—and it *is* a scam—because it is almost impossible for a person to believe he is worse off when he is making more money than he ever has in his entire life. The politicians count on Americans *not* figuring out their inflation scam.

And even though Americans certainly know that a \$1.4 trillion deficit is not a good thing, they somehow believe they will escape the consequences. “They’ll just raise taxes on the rich, so I don’t care.” The problem is that there simply aren’t enough of the “rich.” Luckily, millions of Americans have figured out the scam, and they voiced their concerns with their “tea party” protest demonstrations across the United States and in Washington, D.C.

When the government spends more than it takes in it can borrow what it needs, print more money, or engage in a combination of both. We are now at a point where the borrowing cannot continue, because foreign countries (like China) have realized that they will only be paid back with more of that “funny money” the United States government is printing in the back room. If you lend someone \$20 on the condition that he pay you back \$25 in two years, you are not better off if inflation erodes the value of the dollar so much that \$25 in two years will buy less than what \$20 will buy today. The Chinese government is smarter than far too many American voters, and is now essentially saying it will lend Uncle Sam \$20—but it wants \$30 back when the contract expires. Next week China may demand \$35, regardless of the gifts Secretary of State Clinton may bring to Beijing.

The federal government’s total debt is now so great that the interest it pays each year is several hundred billion dollars. It cannot continue to borrow more than one trillion dollars each year because it will not be able to afford the interest, let alone pay down the total outstanding debt—which now stands at about \$12 trillion (and that’s not counting various “unfunded liabilities” such as the Social Security benefits owed to soon-to-be-retiring “baby boomers.”) For decades the government has essentially been paying off one credit card with another. It is now running out of credit cards, and China is (understandably) refusing to raise the credit limit.

The only way out of the mess is for the government to do what Americans are now doing: spending only what they can afford to spend and paying down the credit cards. The government must cut federal spending to the bone, stop borrowing money, and start paying down the debt. It won’t be easy—but it is the *only* responsible solution.

Will Obama and Congress now cut taxes and spending? Not on your life. Obama isn’t about to let the crisis go to waste. The worse things get, the more power he can amass in the federal government. As Americans increasingly believe their situations are hopeless, they will relinquish even more power to the government. Liberty, schmiberty—they’ll be so desperate they will accept anything Obama proposes. And that is precisely what Obama wants to happen...

What can you do? Vote the bums out of office. The more “free stuff” you are promised by a politician, the more you should avoid him like the swine flu. That means most Democrats and a fair number of Republicans. Retain those who voted against “TARP” in late 2008 and against the “stimulus” bill in early 2009. Their party affiliation is irrelevant. (Republican Senators Lindsay Graham, Susan Collins, and Olympia Snowe have got to go, along with most Democrats.) If they voted to spend money the government doesn’t

have, vote against them. Period. Ignore what they have “done for your district.” Ignore their seniority on a House or Senate committee. Deficit spending means inflation. Period. Throw the bums out. Period.

What else can you do? Pay down your *high* interest debt (such as credit cards). But don’t be in too big a hurry to pay down *low* interest debt (like a 4.5 per cent fixed mortgage), because you can pay that off over time with cheaper dollars as inflation kicks in and you get wage increases.

Beyond that, buy gold, stock in copper companies, and other commodities. In other words, invest in “stuff”—because money will be worth a lot less. Copper is used in manufacturing, and inflation will raise the price of that copper. If you own copper stock, it will be worth more. Granted, inflation will eat away at whatever you have in the stock market, but it’s still better to have stocks than cash—if you have the right stocks. While the U.S. is heading faster down the road to socialism, other countries have seen that capitalism is the answer. They are busy making stuff, while Americans are busy whining about the need for free strep throat tests. Buy stock in companies in India, China, and Brazil. Their citizens are working to make profits for their employers while we’re drinking lattes at the coffee shop.

If you can’t afford to invest in the stock market, you can still invest in “stuff.” If inflation is on the way, the price of everything will go up. That means toilet paper, canned goods, shoes, paper, tires, etc. if you have room in your house, buy extras when you can afford it. If toilet paper hits \$6 per roll, you’ll be glad you bought a case or two.

“What? Toilet paper at \$6 per roll? That’s ridiculous!” Maybe, but if someone had told you in 1957 that a new Chevy would someday cost \$25,000 you would have told him he was crazy too.

If things are so bad, why did the Dow Jones Industrial Average hit 10,000 on October 14? Partly because investors had nowhere else to park their money. The DJIA will tank again, and much of that will be a result of the coming collapse in commercial real estate. There are thousands of vacant strip malls and half-vacant office buildings across the country, and at some point their owners will declare bankruptcy. Banks may lose even more than they did with subprime home mortgages. It will not be pretty. But will Washington, D.C. bail them out? That may be a tough sell. There will be almost no public sentiment for additional federal bailouts, because the taxpayers have had enough. “Too big too fail” has most certainly lost its sales appeal. The Washington Mall “tea party” will look like a small birthday party if Obama has Tim “TurboTax” Geithner ask for another \$700 billion in bail out funds.

And that prompts some additional investment advice. If you want to make some money during the coming crash, invest in the printing of “Let Them Fail!” protest placards.

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