So What About Inflation? July 23, 2011

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Recent spikes in the price of oil, food and autos may seem to be the forerunner to “runaway inflation.” There is a common misconception that soaring inflation will eventually be the result of the huge amount of liquidity that was injected into the system while the Fed was printing and the Treasury was borrowing vast sums of money during the financial crisis of 2007-2008. Many people have had the “knee jerk” reaction that these events will ***inevitably*** result in an inflationary spiral similar to what we had in the 1970s...or worse.

Recent events indicate that inflation is beginning to ease. Gasoline is down at the pump from a high of $3.98/gallon in April to $3.61 today according to AAA. This is a 10% decline in a product that represents 5% of the CPI. We have had three major back-to-back declines in basic food prices over the past three months of 10%, 7% and 7%, respectively.[1] And finally, auto prices should stabilize and begin to soften as Japan continues to come back online with production following their earthquake, tsunami and nuclear event.

But, what about the longer term? When are we going to pay the price for avoiding a financial meltdown during the credit bubble and subsequent credit burst near the end of the last decade?

“Inflationists” claim that the Fed has created a huge amount of excess reserves which will flood the system with liquidity and cause inflation to climb. They don’t understand the pivotal role that the banking system plays in the U.S. economy.

The only way that all that money will get into circulation is though lending by the banking system. It would take a huge amount of credit growth to cause the type of inflation that the inflationists worry about. People would have to borrow at a very high rate in order to spend enough to generate any significant inflation growth.

That brings us to the question of why the banks are sitting on all this liquidity?

Credit growth has remained very limited and the growth of credit demand is very weak. Housing starts are down 85%. FICO scores are down. Corporations’ balance sheets are in better shape than they have been for a long time and they don’t need to borrow.

The feds have moved from very loose regulations that led up to the housing bubble (and burst...See *The Hangover* blog link on this page) to a very tight regulatory environment today which includes higher capital requirements for the banks.

With unemployment hovering around 10%, there is no catalyst for wage inflation and the unions have nowhere near the clout that they had in the ’70s when they could demand higher wages to match inflation expectations. And it is highly unlikely that housing will explode to the upside again anytime soon.

None of this translates into “runaway inflation”. There is absolutely no evidence to support an inflationary period now or in the foreseeable future.

So it appears to us that the U.S. reported rate of inflation has either peaked or will peak shortly at around 3 1/2% assuming no explosion of oil prices (always the “wild card” in the inflationary scenario). The inflation rate will calm down in 2012 to the 2% to 2 1/2% range.

Inflation is not a big concern, at least here in the U.S.

[1] FP Online 06/28/2011