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Transmission Not Broken

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Inflation can take hold even in a sluggish and credit-impaired economy.

An article in the *Wall Street Journal* over the weekend repeated a commonly held notion that inflation "won't become a problem until consumers begin spending and banks lend again." This is the so-called "transmission mechanism" by which inflation purportedly becomes manifest. It is, however, a fallacy. Inflation can occur whether consumer spending or lending are rising or falling. The worst episode of US inflation since the Civil War broke out in the mid-1970s at the same time consumption was in a tailspin. Zimbabwe is currently experiencing hyperinflation, apparently in the absence of a great deal of spending and lending.

Update to strategic view

GOLD: We often hear that gold, as a bet on inflation, is a "consensus trade." Yet we see no consensus that inflation is even likely, because of the widespread belief that the "transmission mechanism" of inflation can't operate in a sluggish and credit-constrained economy. This is a myth -- inflation can take hold even in a weak economy if money supply far outpaces money demand. We see that dynamic already starting to play out, and continue to believe that, after the present retrenchment, gold will ultimately move to new highs.

[see Investment Strategy Dashboard]

Inflation takes hold when the supply of money outpaces the demand for money. Or another way of looking at it, using nominal consumption growth as a proxy for money demand, when that demand falls relative to the goods for which it exchanges, velocity rises. The US recently had the opposite experience. In the panic of the fourth quarter last year, demand for cash soared as consumption collapsed. Velocity in the fourth quarter last year -- defined as the ratio of annual nominal PCE growth (down 3%) and M2 growth (up 16%) -- fell at a rate of about 19%. That was evidence of the powerful *deflationary* forces unleashed by the extreme risk abhorrence that set in during the worst of the credit market crisis.

With the passing of that panic, velocity is now shifting higher. M2 growth, is now running at an annual rate of about 7% through February. PCE, meanwhile, has risen at a 1% rate. Thus the fourth quarter's velocity of about -19% has risen to 15%. While any reading below 100% indicates declining velocity, this is nevertheless a move in the right direction, indicating that the preference for holding money over offering it in exchange has substantially begun to subside. This shift can be considered a normalization from a deflationary situation, without significant inflationary implications so far. But with the Fed committed to remaining in hyper-easy mode

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indefinitely, there is good reason to expect the trend to continue, resulting in a period of rising inflation.

The process by which velocity accelerates and inflation is generated can be illustrated by the workings of the commodities market. With liquidity in balance, buyers and sellers offset each other and prices remain stable, or respond to changes in real supply and demand factors. When liquidity runs in excess, the marginal buyer will have an extra dollar to spend, thus reducing his demand for money relative to the demand for a given commodity. We recently noted that the Chinese announcement of a large purchase of copper amounted to such a decision to substitute dollars for a tangible product (see "China Calling" March 17, 2009). As this evolves over a period of time, the eroding value of money as reflected in commodities and other sensitive indicators causes further reductions in demand for money, raising the prices of non-money goods. The same process plays out at every level of the global economy, even as a single consumer makes the micro-decision to part with the marginal dollar in exchange for, say, the marginal apple.

Growing concern about the implications of the Fed's stance with regard to the value of the dollar can be seen in the recent calls by China and Russia for development of an international reserve currency to replace the dollar. Their proposals were intended as preparatory to the G-20 meeting in London this week, and the forum may include a discussion of their ideas. While there is no likelihood that any concrete steps will be taken any time in the foreseeable future to find a replacement for the reserve currency status of the dollar, the restiveness of these important emerging market economies with huge dollar reserves should be understood as a gesture of falling confidence in the dollar, and particularly its management by the Fed.

On the bright side, the recovery of velocity is a critical precondition for the resumption of economic growth. While a sustainable expansion depends on a revival in the market's capacity to bear risk with a resumption of capital formation, relief from the crushing cash demand seen late last year is at least an indication that the worst of the economy's slowing is probably past. But if that is so, then velocity should turn positive -- and then it will be the Fed's challenge to commensurably slow money growth by reducing the enormity of its balance sheet. We remain extremely pessimistic that the Fed will have either the wisdom or the daring to do that, and indeed at present the central bank is doing just the opposite (see "Taking It Up A Notch" March 27, 2009).

BOTTOM LINE: We often hear that gold, as a bet on inflation, is a "consensus trade." Yet we see no consensus that inflation is even likely, because of the widespread belief that the "transmission mechanism" of inflation can't operate in a sluggish and credit-constrained economy. This is a myth -- inflation can take hold even in a weak economy if money supply far outpaces money demand. We see that dynamic already starting to play out, and continue to believe that, after the present retrenchment, gold will ultimately move to new highs.