

*Don't Hold Your Breath  
Waiting for Inflation's Arrival*

We may be in the summer doldrums, but economic arguments continue to raise temperatures. Will we see inflation or deflation? Has the recession ended? Will there be more unemployment before the year's end?

Nationally, unemployment figures for the month of July provided unexpected relief from the long-term siege of blistering economic news. For the first time in seven months unemployment dropped to 9.4 percent. That piece of information, coupled with a slight increase in sales levels, 0.4 percent, compelled some financial pundits to declare an end to this recession, the longest since World War II.

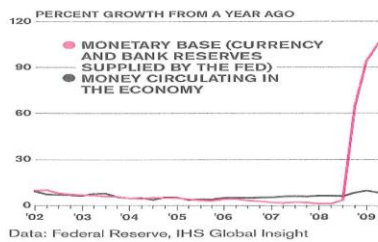
At Norris, Perné & French we're not quite ready to put on the rose-colored glasses, despite diminishing bad news, and even a few encouraging signs. These are unprecedented times, and the table has been set for a major contest between two significant forces: the credit collapse and the monetary base (money printing by the Fed and other central banks, or quantitative easing).

All of this brings us to this article's discussion point: Will we see inflation or deflation in the near and long-term futures?

Pundits predictably are lining up on both sides of the argument. Historically, support for an inflationary trend is buttressed by the association of inflation with economies where rising demands put pressure on pricing. Or, as economist Milton Friedman explained, "too much money chasing too few goods and services." And the U.S. government's massive infusions of cash into the financial system would appear to be a surefire incubator for inflation.

That prolific printing of money – the U.S. monetary base presently is estimated to be approximately \$1.7 trillion – has been coupled with massive governmental borrowing to finance the burgeoning deficit. Germany in 1923, Hungary in 1946, and Turkey and Zimbabwe in this century, all are examples of those two conditions combining to create hyper-inflation.

Again, our economic conditions are like no others we've experienced. And the likelihood of inflation rising significantly is mitigated by another factor: the amount of money actually making its way into the economy. A chart using Federal Reserve data presents what we consider to be the best indication of what to expect for the near term future. (Insert Attachment).



This chart identifies how much of the money ostensibly injected into the system actually has made it into circulation. And the answer is: very little. While we've seen the monetary base grow ten-fold, the circulation has barely felt a nudge. The reality is that most of the money injected into the system – predominantly through the shoring up of the country's largest banks – has been used by banks to improve their balance sheets. The unprecedented expansion of the monetary base has been out-matched by an increase in bank reserves. The money is not in circulation and until banks begin to inject those funds into the economy by increasing lending levels inflation levels will remain relatively benign.

So when it comes to this epic contest of the credit collapse and corresponding response, and the infusion of money into the economy, in the short-term the credit collapse and its response are winning, helping banks restore respectability to their strained balance sheets, while having little impact on the consumer.

Banks continue to be cautious about expanding lending activities with some justification. Defaults continue to rise, which in turn minimize their profits and make it difficult for the institutions to improve their balance sheets. This puts banks in the interesting position having the potential to create inflation in the future – and presently providing an impediment to inflation.

We forecast through the end of 1009 -0.5 percent inflation for headline inflation, and 1.5 percent to 1.7 percent core inflation. Members of the Federal Open Market Committee (FOMC) have emphasized “core” inflation, which excludes food and energy prices. For most households, it's those two prices which matter the most. Those prices also are among the most volatile. The Fed emphasizes core inflation to track and predict persistent inflation to try to better measure inflationary trends.

At Norris, Perné & French we continue to look for inflation to be a story 2010, at the very earliest. As explained above, inflation is likely to become a story when bank lending begins to thaw, and this isn't likely to happen until the economy truly begins to

experience recovery, and for banks the threat of defaults begins to wane. This will allow banks to report improved balance sheets based on profitability.

The specter of inflation also can be eased by Fed actions, if it makes an effort to reduce the level of money. That may be easy to say but it's much harder to do, given the gargantuan level of monetary expansion.

Fed Chairman Ben Bernanke spoke to Congress in July of his conviction in the Fed's ability to automatically unwind its efforts as the economy recovers. But should monetary policy require tightening before the unwinding is complete he listed as tools in the Fed's toolbox:

- Payment of interest on balances held at the Fed by its depositors. This will encourage banks to hold their balances risk-free at the Fed rather than supplying them to the market;
- Conducting reverse repurchase agreements: selling securities from the Fed's portfolio with an agreement to buy-back at a later date. This will help the Fed manage its bank reserve levels
- Sell longer-term securities to drain reserves and raise short-term interest rates.

Bernanke spoke of his confidence in the Fed's ability to raise interest rates as necessary to impact price stability and maximum employment. The timing and extent of any future inflation depends upon the extent and speed of the Fed's actions to restrain it.

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