## Link

### Stimulus Causes Inflation

#### Inflation remains low but further stimulus will increase it—investor perception is on the brink.

Time Business 12 — Time Business, 2012 (“Fed Inflation Hawks Warn More Stimulus Could Fuel Prices,” Byline Sam Gustin, April 11th, Available Online at http://business.time.com/2012/04/11/fed-inflation-hawks-warn-more-stimulus-could-fuel-prices/, Accessed 06-30-2012)

Are inflation hawks preparing to take flight? That’s the sense one gets reading comments made by two U.S. central bank officials Tuesday, including Dallas Fed President Richard Fisher, who said that corporate chiefs have been sounding the alarm about an increase in prices thanks to the Fed’s easy money policy. Fisher’s latest remarks are sure to fuel a growing debate about whether the Fed should embark on another round of monetary stimulus, especially in light of last month’s lackluster jobs report.

Speaking at the University of Oklahoma’s Price College of Business, Fisher said that he’s heard from business leaders who are concerned that the Fed’s easy money policy could raise inflation, which would increase prices for companies just as they’re trying gain a solid footing. “I’m just reporting what I hear on the street, which is a real concern that with our expanded balance sheet, we are just a little bit in an ember of what could become an inflationary fire,” Fisher said in comments cited by Bloomberg. He said business leaders are telling him, “Please, no more liquidity.”

Separately, Minneapolis Federal Reserve Bank President Narayana Kocherlakota said that the threat of inflation means that the central bank will likely have to begin to reverse its easy money policy as early as the end of the year. “Conditions will warrant raising rates some time in 2013 or, possibly, late 2012,” Kocherlakota said in comments cited by Reuters. That puts Kocherlakota at odds with the policy-making Federal Open Market Committee, which has said since January that it plans to keep interest rates low through 2014.

Fisher and Kocherlakota are well-known inflation hawks, which means they tend to worry more than other policy-makers about the risk that inflation poses to the economy. So it’s not surprising that Fisher, in particular, would voice business leaders’ concerns that inflation could make buying the materials — or inputs — they need to run their companies more expensive. Although both officials are considered to be more hawkish than Fed Chairman Ben Bernanke, their comments could put pressure on their colleagues to resist calls for a third round of quantitative easing, or QE3, something the Fed policy makers have left on the table if the economy loses momentum.

For now, inflation remains under control: as of February, prices had risen 2.3% over the previous year, according to the personal consumption spending index, just slightly above the Fed’s target rate of 2%.

Neither Fisher nor Kocherlakota are among the five Fed presidents voting on the FOMC this year, which may explain their outspokenness. Fisher is the more hawkish of the pair. He’s called the idea of more monetary stimulus a “fantasy of Wall Street,” while Kocherlakota has allowed that “if the outlook for inflation fell sufficiently and/or the outlook for unemployment rose sufficiently, then I would recommend adding accommodation.”

The Fed has already cut its benchmark interest rates to near zero to make it easier for companies to borrow money to invest. The central bank has also purchased over $2 trillion worth of bonds in an effort to increase liquidity. But injecting money into the system runs the risk of inflation, which could hurt businesses. On the other hand, some have argued that a little inflation might actually benefit the economy. For the moment, inflation is under control, not least of all because U.S. economic growth remains modest, which is why policy-makers are focused on conditions six months to two years from now.

Last month’s weaker-than-expected job report raised the prospect of a third round of Fed bond-purchases. The Bureau of Labor Statistics reported that the economy added 120,000 jobs in March, compared to the 205,000 that analysts, on average, had been expecting, a sign that the employment gains of recent months could be losing steam. But Fisher downplayed the report, saying that policy can’t be based on one data point.

The Federal Reserve is in a delicate position right now. The economy is growing and unemployment is falling — but neither by enough for the Fed to rule out another round of action. On the other hand, after two rounds of massive stimulus that has fueled a bloated balance sheet, and a lengthy period of very low interest rates, it’s clear that the inflation hawks are getting a little nervous. For now, they’ve been unable to sway the conventional wisdom. Hopefully, they won’t end up being canaries in the coal mine.

#### Stimulus increases inflation—erodes the dollar and floods the economy.

Zupan 11 — Mark Zupan, Dean of the Simon Graduate School of Business at the University of Rochester, 2011 (“Stimulus Is a Recipe for Inflation,” *Kiplinger*, March 30th, Available Online at http://www.kiplinger.com/printstory.php?pid=21057, Accessed 06-30-2012)

Our nation is flirting with resurrecting inflation to levels that are reminiscent of the grim 1970s. A high rate of inflation will, among other things, penalize savers, pensioners and working people, whose raises and cost-of-living adjustments – if they get them – cannot keep up with rising prices.

The root cause of the coming inflation is the Federal Reserve’s easy-money policy in support of the federal government’s stimulus efforts. Rising government spending has been rapidly swelling our debt (now more than $14 trillion). Moreover, the Fed’s actions work to erode the U.S. dollar’s purchasing power. Over the past three years, the dollar has been devalued against many leading currencies, with the notable exception of the troubled euro. A weak dollar means imports become more expensive.

In addition, with more dollars now chasing fewer goods and services, the prices of those goods and services have begun to rise. Based on producer-price increases registered so far this year, we could see consumer prices increasing at a 6%-plus clip later this year.

All of this is occurring as banks sit on $1 trillion of reserves that they have not loaned out. Once they feel more confident about lending and this money hits the economy, it will add to inflationary pressures.

### Link Magnifier: Inflation Fast

#### Err neg—inflation will quickly accelerate out of control.

Sivy 12 — Michael Sivy, Chartered Financial Analyst and former securities analyst for an independent stock research firm, former investment columnist at *Money*, has appeared as a stock-market commentator on ABC, CBS, NBC, Fox, CNBC, CNN and MSNBC, 2012 (“Is It Time to Start Worrying About Inflation Again?,” *Time Business*, February 20th, Available Online at http://business.time.com/2012/02/20/is-it-time-to-start-worrying-about-inflation-again/, Accessed 06-30-2012)

The other problem, though, is actually more serious – and a bit more complicated. Basically, it’s hard to know how much inflationary pressure has been created in an economy as long as it remains latent. Inflation can flare up, however, suddenly and with surprising strength. And at that point, it’s hard to reverse. Here’s the reason: Inflation is the long-term rise in the overall level of prices. A one- or two-month blip does not qualify. Neither does a rise in, say, the price of oil, if it is offset by declines in other prices. A general increase in prices can only be sustained over the long term if the amount of money in circulation is growing. And that depends not only on the amount of money in the banking system, but also on the speed with which people spend it (known as velocity).

In a recession, people spend less, so velocity slows and so does the economy. To offset that, the Federal Reserve pumps money into the banking system. Because the recent recession has been the worst since the Great Depression, Fed Chairman Ben Bernanke has injected an enormous amount of money into the system over the past four years. The only trouble is that as growth picks up, so does velocity. Sometimes velocity accelerates quite quickly – and that can cause a sudden and surprising jump in inflation.

Policymakers always risk erring in one direction or the other coming out of a recession – either prolonging high unemployment unnecessarily or creating inflation pressures that will do damage several years in the future. Political considerations argue for favoring the short run and erring on the side of stimulus. In an election year, that goes double. In addition, a little inflation might seem beneficial right now, since it would bolster home prices, helping both homeowners with excessively large mortgages and banks with bad real estate loans.

You can hope that the Fed and other policymakers get everything right. But there’s honestly no way for anyone to know the right policy mix. Prudence suggests that you should assume any warning signs of inflation you see are for real, especially since oil prices are rising right now (while high energy prices don’t cause inflation, they do help it along). In fact, gasoline prices are the highest ever for this time of year, and some experts think that gas could go as high as $5 a gallon this summer.

## Impact

### Inflation Hurts Growth

#### Inflation tanks growth—investor perception negates stimulus benefits.

Volcker 11 — Paul A. Volcker, served as Chairman of the Federal Reserve from 1979 to 1987, worked for the federal government for over 30 years serving under John F. Kennedy, Lyndon B. Johnson, Richard M. Nixon, Jimmy Carter, and Ronald Reagan, 2011 (“A Little Inflation Can Be a Dangerous Thing,” *New York Times*, September 18th, Available Online at http://www.nytimes.com/2011/09/19/opinion/a-little-inflation-can-be-a-dangerous-thing.html?\_r=1&pagewanted=print, Accessed 06-30-2012)

So now we are beginning to hear murmurings about the possible invigorating effects of “just a little inflation.” Perhaps 4 or 5 percent a year would be just the thing to deal with the overhang of debt and encourage the “animal spirits” of business, or so the argument goes.

It’s not yet a full-throated chorus. But remarkably, at least one member of the Fed’s policy making committee recently departed from the price-stability script.

The siren song is both alluring and predictable. Economic circumstances and the limitations on orthodox policies are indeed frustrating. After all, if 1 or 2 percent inflation is O.K. and has not raised inflationary expectations — as the Fed and most central banks believe — why not 3 or 4 or even more? Let’s try to get business to jump the gun and invest now in the expectation of higher prices later, and raise housing prices (presumably commodities and gold, too) and maybe wages will follow. If the dollar is weakened, that’s a good thing; it might even help close the trade deficit. And of course, as soon as the economy expands sufficiently, we will promptly return to price stability.

Well, good luck.

Some mathematical models spawned in academic seminars might support this scenario. But all of our economic history says it won’t work that way. I thought we learned that lesson in the 1970s. That’s when the word stagflation was invented to describe a truly ugly combination of rising inflation and stunted growth.

My point is not that we are on the edge today of serious inflation, which is unlikely if the Fed remains vigilant. Rather, the danger is that if, in desperation, we turn to deliberately seeking inflation to solve real problems — our economic imbalances, sluggish productivity, and excessive leverage — we would soon find that a little inflation doesn’t work. Then the instinct will be to do a little more — a seemingly temporary and “reasonable” 4 percent becomes 5, and then 6 and so on.

What we know, or should know, from the past is that once inflation becomes anticipated and ingrained — as it eventually would — then the stimulating effects are lost. Once an independent central bank does not simply tolerate a low level of inflation as consistent with “stability,” but invokes inflation as a policy, it becomes very difficult to eliminate.

It is precisely the common experience with this inflation dynamic that has led central banks around the world to place prime importance on price stability. They do so not at the expense of a strong productive economy. They do it because experience confirms that price stability — and the expectation of that stability — is a key element in keeping interest rates low and sustaining a strong, expanding, fully employed economy.

At a time when foreign countries own trillions of our dollars, when we are dependent on borrowing still more abroad, and when the whole world counts on the dollar’s maintaining its purchasing power, taking on the risks of deliberately promoting inflation would be simply irresponsible.

### Inflation Increases Unemployment

#### Inflation increases unemployment—empirically proven.

Pento 12 — Michael Pento, President and Founder of Pento Portfolio Strategies—a Registered Investment Advisory Firm that provides money management services and research for individual and institutional clients, regular guest on CNBC, Bloomberg, FOX Business News and other national media outlets, 2012 (“Why Higher Inflation Destroys Jobs,” *Forbes*, May 1st, Available Online at http://www.forbes.com/sites/michaelpento/2012/05/01/why-higher-inflation-destroys-jobs/, Accessed 06-30-2012)

What strikes me the most is that neither the Nobel Prize winner nor the Chairman of the Federal Reserve had the sagacity to completely repudiate the idea that inflation can in any way reduce the unemployment rate. Even a cursory look at the data throughout economic history proves that inflation is a destroyer of jobs. All they would have to do is look at the most salient periods of inflation that occurred over the last 40 years and see how negatively it affected the unemployment rate.

From 1971 (the year Nixon broke the gold window) through 1974, the annual percentage change on the Consumer Price Index (CPI) increased from 4.4% to 11.0%. According to Krugman and Bernanke, this should have sent the unemployment rate crashing. However, the unemployment rate increased from 6.1% at the end of 1971 to 7.2% in 1974. And since the unemployment rate is a lagging indicator, that figure increased even further to 8.2% in December of 1975.

In 1977 the CPI was 6.5% and it shot all the way up to 13.5% in 1980. Just as it did in the early part of the decade, the unemployment rate increased yet again to 7.2% in 1980 and hit 10.8% by the end of 1982! Finally, the other salient increase in the rate of inflation occurred between 1986 and 1990. The annual percentage change of inflation in ’86 was 1.9;, that shot up to 5.4% in 1990. The unemployment rate started that period at 6.6% and climbed to 7.3% at the end of 1991.

Therefore, I have to ask our dear Fed Chairman and Nobel Prize winner where the evidence is that inflation causes people to find work. In reality, it’s the exact opposite that occurs. Inflation robs the middle class of their purchasing power and sends them onto the government dole. Inflation also destroys investment in an economy because savers have no idea what interest rate is necessary to charge in order to profitably lend out their money over an extended period of time. And inflation causes tremendous economic imbalances, as capital is diverted into ephemeral asset bubbles instead of being allocated in a more viable manner.

If Krugman and Bernanke were correct in believing inflation has a positive influence on the workforce, Zimbabwe and Argentina would both be paragons of how to achieve full employment. The truth is that a high unemployment rate is the simply the result of a weak economy. And an economy can suffer through a recession while experiencing either inflation or deflation. But when an economy experiences a significant increase in the rate of inflation, it nearly always ends up with an unemployment rate that goes along for the ride. We can only hope that central bankers in the developed world assent to that principle very soon. Unfortunately, the ECB, BOJ and Fed continue to believe a positive rate of inflation must be maintained at all costs. That is one of the reasons why a high rate of unemployment has now become a structural condition in most of the developed world.

### Inflation Undermines Confidence

#### Higher inflation will destroy consumer and investor confidence, undermining the economy—empirically proven.

Samuelson 11 — Robert J. Samuelson, Economics Columnist for *The Washington Post*, 2011 (“Inflation is not the answer,” *The Washington Post*, August 24th, Available Online at http://www.washingtonpost.com/opinions/inflation-is-not-the-answer/2011/08/24/gIQAHh3ebJ\_print.html, Accessed 06-30-2012)

It’s a sign of desperation that the latest cure being suggested for the ailing economy is higher inflation. In the 1970s and early 1980s, inflation (peaking at 13 percent in 1979 and 1980) was a national curse. Now, it’s being advanced as an antidote to high unemployment and meager economic growth. It’s bad advice for the Federal Reserve, which holds its annual research retreat at Jackson Hole, Wyo., this week. What seems plausible in the classroom would probably backfire in the real world.

The economy’s central problem today is lack of confidence — fear — reflecting enormous uncertainty. Business managers and consumers don’t know what to expect. Facing stubborn joblessness, falling home values and volatile stock prices, they have become reflexively defensive. They hoard and hold back. A deliberate policy of higher inflation risks compounding the uncertainty and poisoning psychology even more.

That’s what happened in the 1960s and 1970s. Economists argued that modest increases in inflation (say, to 4 percent or 5 percent) would reduce unemployment by allowing more expansionary budget and monetary policies. Slightly higher inflation wouldn’t bother most Americans, and lower unemployment would be a clear gain. But inflation wasn’t kept under control. Unemployment rose (it averaged 6.2 percent in the 1970s compared to 4.5 percent in the 1950s), and accelerating price increases spooked Americans.

#### That takes out and turns their internal links—empirically proven.

Samuelson 11 — Robert J. Samuelson, Economics Columnist for *The Washington Post*, 2011 (“Inflation is not the answer,” *The Washington Post*, August 24th, Available Online at http://www.washingtonpost.com/opinions/inflation-is-not-the-answer/2011/08/24/gIQAHh3ebJ\_print.html, Accessed 06-30-2012)

All this explains why higher inflation appeals to economists across ideological lines. While Rogoff is slightly right of center, liberal economist and columnist Paul Krugman also favors it. The trouble is this: Inflation is hard to manipulate in precise and predictable doses. Once people become convinced that government will tolerate or encourage it, they adapt in unforeseen ways. We can’t know what would happen now, but we do know what happened in the 1960s and 1970s.

One adaptation was that companies and workers raised wages and prices much faster than expected. Higher interest rates followed. Rates on 10-year Treasury bonds went from 4 percent in 1962 to 8 percent in 1978. The stock market stagnated for nearly two decades. Consumers reacted to greater uncertainty by increasing their savings rates from 8 percent of disposable income in 1962 to 10 percent by 1971. That’s exactly the opposite of today’s goal — more, not less, consumer spending.

#### That causes dollar flight.

Samuelson 11 — Robert J. Samuelson, Economics Columnist for *The Washington Post*, 2011 (“Inflation is not the answer,” *The Washington Post*, August 24th, Available Online at http://www.washingtonpost.com/opinions/inflation-is-not-the-answer/2011/08/24/gIQAHh3ebJ\_print.html, Accessed 06-30-2012)

There might be other unpleasant surprises. If retail prices rose faster than wages — a good possibility with unemployment at 9.1 percent — higher inflation could act as a drag on the economy by reducing workers’ “real” purchasing power. If investors decided that the Fed had gone soft on inflation, there might be a panicky flight away from the dollar on financial and foreign exchange markets.

#### Confidence is the crucial internal link.

Samuelson 11 — Robert J. Samuelson, Economics Columnist for *The Washington Post*, 2011 (“Inflation is not the answer,” *The Washington Post*, August 24th, Available Online at http://www.washingtonpost.com/opinions/inflation-is-not-the-answer/2011/08/24/gIQAHh3ebJ\_print.html, Accessed 06-30-2012)

Inflation is not the answer. Remember: The economy’s basic problem is poor confidence spawned by pervasive uncertainties. The Fed shouldn’t make the problem worse by embracing policies that, whatever their theoretical attractions, will create more uncertainties in the real world.

#### The impact is magnified: higher inflation breaches investor trust, undermining overall confidence.

Watson 11 — William Watson, Professor of Economics at McGill University, 2011 (“The inflation swindle,” *Financial Post*, August 10th, Available Online at http://opinion.financialpost.com/2011/08/10/william-watson-the-inflation-swindle/, Accessed 06-30-2012)

The real fairness problem is that inflation is a swindle. It improves the balance sheets of borrowers, but worsens the balance sheets of lenders. Having got themselves overly indebted, governments engineer inflation to reduce the real value of their obligations, thus simultaneously reducing the real value of the assets of people and institutions that in good faith lent them the money.

It’s not quite the Bernie Madoff swindle. But it’s a swindle. Governments and others borrow money that they eventually pay back in dollars or euros or whatever that are worth substantially less than when their debt were contracted.

Once people see what’s going on, then of course they insist on inflation protection in their lending, either by demanding high interest rates or explicit indexing, as in the case of real-return bonds. But the generation of lenders that was caught unawares, having grown to trust government commitments to inflation targets, finds itself out of pocket and, needless to say, unlikely to trust governments ever again.

Lots of social science research over the last couple of decades has pointed to the overriding importance of trust in explaining why some societies and economies work better than others. Deliberately inflating our way out of a fiscal crisis would be a cynical breach of trust and a callous and costly way to solve the problem.

### A2: Inflation Motivates Investment

#### Inflation won’t jumpstart investment—other barriers trump.

Miron 11 — Jeffrey A. Miron, Senior Fellow at the Cato Institute, Director of Undergraduate Studies in the Department of Economics at Harvard University, former Chairman of the Department of Economics at Boston University, holds a Ph.D. in Economics from the Massachusetts Institute of Technology, 2011 (“Can Inflation Kickstart the Economy without Killing It?,” *NPR*, November 21st, Available Online at http://www.cato.org/publications/commentary/can-inflation-kickstart-economy-without-killing-it, Accessed 06-30-2012)

Higher inflation will not necessarily stimulate the economy because interest rates are not the only, and likely not the most important, factor that is limiting investment and hiring. Instead, pessimistic expectations by businesses about consumer demand, concern about an anti-business tilt in government policy, and fear of large tax increases to pay for entitlements, are plausibly playing larger roles. Thus raising the Fed's inflation target might generate higher inflation, with no other benefit to the economy.

### A2: Inflation Reduces Debt

#### Inflation can’t effectively reduce the debt—short-term refinancing.

Samuelson 11 — Robert J. Samuelson, Economics Columnist for *The Washington Post*, 2011 (“Inflation is not the answer,” *The Washington Post*, August 24th, Available Online at http://www.washingtonpost.com/opinions/inflation-is-not-the-answer/2011/08/24/gIQAHh3ebJ\_print.html, Accessed 06-30-2012)

Moreover, the power of higher inflation to erode the real value of U.S. government debt is limited, because much of that debt is short-term. About 30 percent matures in less than a year; another 25 percent or so matures in less than three years. All this debt will be refinanced. With higher inflation, it would probably be refinanced at higher interest rates that investors would demand as protection against rising prices.

### A2: Fed Will “Turn Off” Inflation Later

#### Policymakers won’t be able to effectively control inflation—political pressures.

Sivy 12 — Michael Sivy, Chartered Financial Analyst and former securities analyst for an independent stock research firm, former investment columnist at *Money*, has appeared as a stock-market commentator on ABC, CBS, NBC, Fox, CNBC, CNN and MSNBC, 2012 (“Is It Time to Start Worrying About Inflation Again?,” *Time Business*, February 20th, Available Online at http://business.time.com/2012/02/20/is-it-time-to-start-worrying-about-inflation-again/, Accessed 06-30-2012)

Some commentators argue that inflation isn’t a problem yet for several reasons: First, the consumer price index typically gives higher inflation readings than some other measures. Second, the economy is still relatively weak and unemployment remains high. That means any short-term price increases are likely to die out rather than fueling a self-sustaining inflation spiral. And third, policymakers have to balance the risks of inflation against the need to keep the economic recovery going and reduce unemployment. As long as unemployment is above 7%, inflation is a lesser risk than slipping back into recession.

Those arguments are perfectly reasonable if you believe that government technocrats are generally able to fine-tune the economy and are also uninfluenced by political considerations. Unfortunately, neither of those things is true. The political problem is obvious: It’s easy to announce that you are going to cut interest rates or take other steps to stimulate the economy. But it’s much harder to raise interest rates or otherwise cause short-term economic pain for the sake of a healthier economy at some point in the future. The temptation for policymakers will inevitably be to wait and be sure unpleasant measures are absolutely unavoidable.

#### Err neg—inflation is too hard to control.

Watson 11 — William Watson, Professor of Economics at McGill University, 2011 (“The inflation swindle,” *Financial Post*, August 10th, Available Online at http://opinion.financialpost.com/2011/08/10/william-watson-the-inflation-swindle/, Accessed 06-30-2012)

Then there’s the problem that inflation is hard to control. Alas, Ken Rogoff himself wouldn’t actually be in charge of the inflation he proposes. Politics and institutions would be and there’s no guarantee they’re capable of the deliberate and precise pedal-down, pedal-up policy he envisions. What if we get stuck, as we did for a long time in the 1970s, with the inflation pedal down?