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Inflation Targeting – Is Bernanke Really An Expert On The Great Depression?

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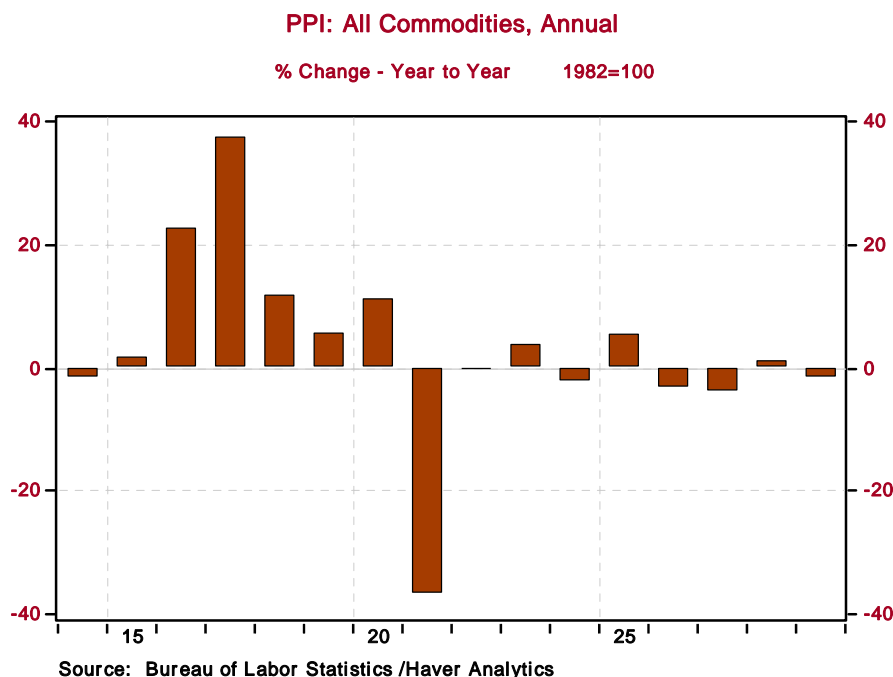
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The new Fed chairman, Ben Bernanke, is known for (at least) two things – his desire for a formal Fed inflation target and his knowledge of the causes and consequences of the U.S. Great Depression. I will argue that inflation targeting by the Fed in the 1920s led to the asset price bubbles of the late 1920s and that *implicit* Fed inflation targeting of the 1990s led to the asset price bubbles we have experienced in the past ten years. I will further argue that the Fed should *not* target *any prices* – prices of goods and services or prices of assets – but rather should target a *quantity* – the *quantity of credit* it creates. Specifically, I will argue that the Fed cannot know what the “correct” level or growth rate of prices – goods/services and assets – should be and that by the Fed restricting the supply of credit it creates, free markets can better determine equilibrium prices of goods/services and assets. In sum, I will argue that inflation targeting can and has led to major imbalances in the economy – imbalances which can and have contributed to major economic declines.

Created by an act of Congress in 1913, the Fed actually began operations in 1914, when, coincidentally, World War I, the war to end all wars, began. Although the U.S. did not formally enter WWI until 1917, the demand for U.S.-produced goods and services increased significantly because of the war. The Federal Reserve created a lot of credit during the period of WWI, which led to high rates of inflation during and for two years after the war (see Chart 1). But after the end of WWI, the Fed decided to fight inflation. This led to a short, but sharp recession of 1920-21 in which wholesale prices actually fell. Thereafter, the Fed embarked on a policy of price stabilization, establishing in 1922 the Open Market Committee to buy and sell securities for the purpose of achieving this goal. And, as Chart 1 suggests, the Fed did a good job of stabilizing the price of goods between 1921 and 1929. Not only was the year-to-year variation in prices relatively small, the wholesale price level in the seven years ended 1929 grew at an annualized rate of change of only 0.3%. A prominent economist at the time, Irving Fisher, praised the Fed’s policy by saying that “stabilization ushers in a new era for our economic life ... adding much to the income of the nation.” This is the same Irving Fisher who on October 16, 1929 exclaimed: “Stock prices have reached what looks like a permanently high plateau. I do not feel that there will soon, if ever, be a fifty or sixty point break below present levels ... I expect to see the stock market a good deal higher than it is today within a few months.” Between October 1929 and June 1932, the monthly average of the S&P 500 stock market index fell by 83%. So much for prominent economists’ forecasts of stock market performance.

Chart 1



The 1920s marked a period of great technological advance in the U.S. The use of electricity expanded, information and entertainment were broadcast over radio waves and motor vehicle transportation of people and goods came of age. These along with other technological advances greatly *increased* the potential *supply* of goods and services available in the U.S. economy. Thus, given this great “rightward shift in the aggregate supply curve,” the prices of many goods and services would likely have *fallen*, if left to their own devices, rather than have been stable. Falling prices under these circumstances would not have been an impediment to real economic growth. This is one of those instances when the concept of “making it up on volume” would not have been the punch line of a joke. Although profit margins might not necessarily have widened, the increased volume of sales of goods and services due to their price declines would have enabled businesses to reap increasing profits and encouraged them to increase production. But the course of prices was not left to their own devices. Instead, they were *prevented* from falling by the Fed’s policy of price stabilization.

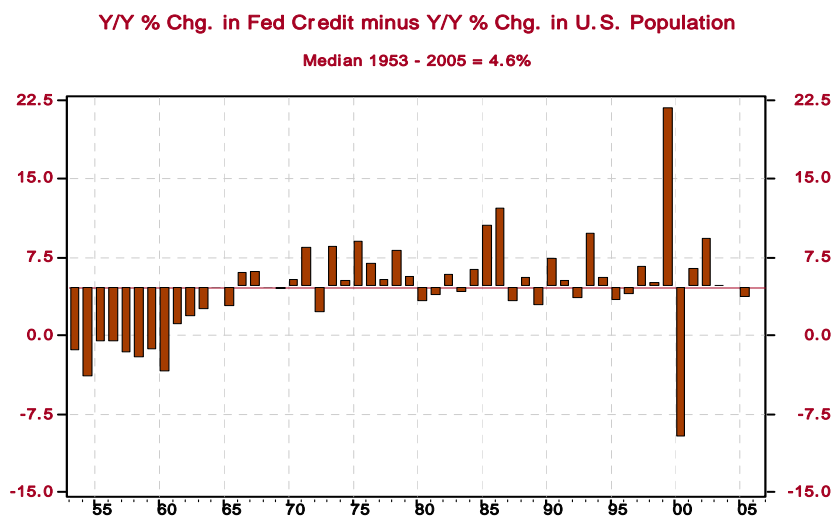
In order to prevent the prices of goods and services from falling, the Fed had to create more credit. This increased Fed-created credit led to price increases in something else – real estate and corporate equities, or asset price inflation. When the Fed got concerned about the increased “froth” in asset prices in 1928, it began to restrict the credit it created and the rest is history.

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Let's fast forward to the 1990s. Like the 1920s, the 1990s were a period of great advances in technology. In addition, China and India entered the global trading arena. Similar to the 1920s, the 1990s ushered in a period in which the global aggregate supply curve was shifting rightward at relatively rapid pace. The natural inclination would have been for the prices of many goods and services to fall. But the Fed, along with other major central banks, prevented this by creating excessive amounts of credit. The inflationary impact of this credit creation appeared in the prices of assets rather than the prices of goods and services.

Let's look at some post-World War II data pertaining to Fed credit creation, goods/services price inflation and asset price inflation. In Chart 2, I have plotted the difference between the year-over-year percent change in Fed credit (the assets on the books of the Federal Reserve System) and the year-over-year percent change in the U.S. population. In effect, this is the per capita growth in Fed credit. From 1953 through 2005, the median value of per capita growth in Fed credit has been 4.6%. Notice that from 1953 through 1965, per capita growth in Fed credit was *below* its 53-year median. In fact, from 1953 through 1960, per capita Fed credit was contracting, i.e., its "growth" was below zero. But from 1965 forward, per capita growth in Fed credit has more often than not been above the median value. Only once since 1960 has per capita growth in Fed credit contracted. That was in 2000 after the surge in 1999, which was designed to accommodate the pre-Y2K increased demand for currency. I might add that it was in 1971 that any remote restriction to the amount of credit the Fed could create was severed when the U.S. announced that it would no longer pay out gold for U.S. dollars to foreign official entities. A reasonable hypothesis is that the acceleration in per capita Fed credit growth after 1965 laid the foundation for the severing of the limited dollar-for-gold convertibility.

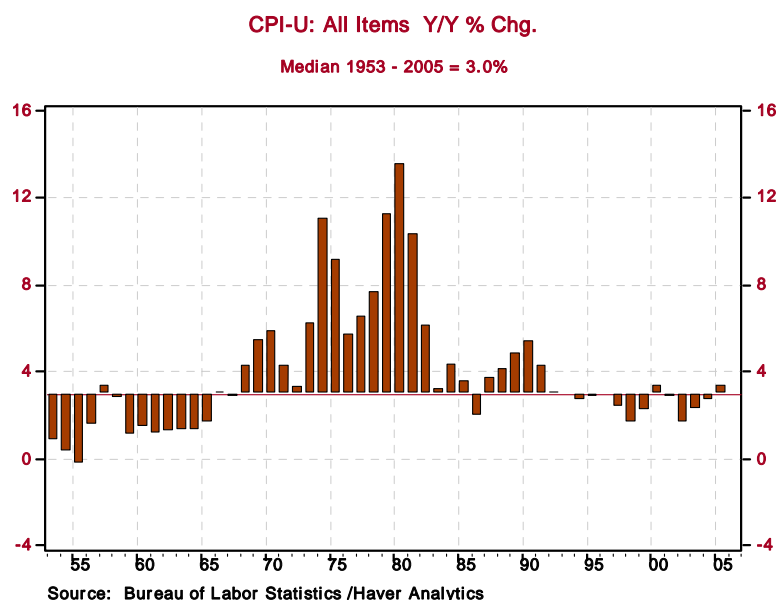
Chart 2



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Plotted in Chart 3 is the year-over-year percent change in the CPI. The median value for this period is 3.0%. From 1953 through 1966, there were only two years – 1957 and 1965 – in which the annual rate of CPI inflation was above the median for the whole period. This is interesting inasmuch as the growth in per capita Fed credit was below its median value from 1953 through 1965. Coincidence? Perhaps. But also notice that from 1993 through 2005, CPI annual inflation has been below its median value except for 2000 and 2005. Recall that in the early 1990s, as mentioned above, the global aggregate supply curve might have started to shift out faster because of technological advances and the entry of China and India into the global trading arena.

Chart 3



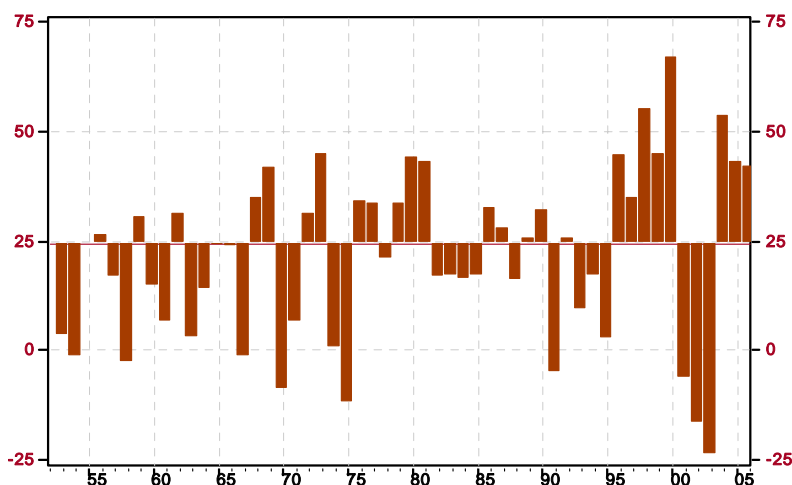
Although inflation in the prices of goods and services may have slowed down starting in 1993, asset price inflation picked up starting in the mid 1990s. Plotted in Chart 4 are the annual holding gains on assets at market value for households as a percent of disposable personal income. From 1952 through 2005, the median percentage relative asset appreciation was 24.2%. In 8 out of the 11 years ended 2005, holding gains as percent of household after-tax income have been above the long-run median. The three years when holding gains were not only below the median but negative were 2000, 2001 and 2002 – the recent bear market in stocks. Prior to 1997, the largest annual relative asset appreciation was 44.6% in 1979. In 1997, 1999 and 2003, annual relative asset appreciation was 55.4%, 67.1% and 54.05, respectively.

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Chart 4

Households: Holding Gains on Assets as % of Disp. Personal Income

Median 1952 - 2005 = 24.2%



As we observed in the 1930s, the unwinding of asset price inflation can be just as economically pernicious, if not more, than the unwinding of goods/services price inflation. I would argue that the Fed, or any other mortal, has no idea what the “right” prices of an airfare, a Miami condo or a share of Google stock are. Rather than targeting the prices of goods/services or assets, the Fed would do better to target the quantity of credit it creates because, in the final analysis, it is this created credit that artificially inflates prices. If the Fed were to concentrate on increasing the assets on its balance sheet at the rate of growth of the population, it would not have to worry about inflation or deflation of goods/services price or asset prices. Some prices would rise, some would fall. But the movements in prices would be the outcome of underlying economic fundamentals, not Fed-created credit.

Note: The inspiration for this commentary came from a series of essays on Austrian economics monetary policy written by Richard M. Ebeling for The Future of Freedom Foundation (<http://www.fff.org/toc/monetarypolicytoc.asp>). For a more articulate and complete understanding of my arguments, I recommend that you read Professor Ebeling’s essays.

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