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Brian's Inflation Song Is a Little Pitchy

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In the August 19 edition of *The Wall Street Journal*, Brian Wesbury has written an op-ed piece, "Inflation Is a Clear and Present Danger." He would have been on "thicker ice" had he entitled the piece "Inflation *Was* a Clear and Present Danger."

Yes, by any measure, the rate of increase in general price indices in the U.S., indeed in the world, has accelerated in the past year. But does this necessarily imply that the rate of increase in general price indices will continue to accelerate? While the rate of increase in the prices of goods and services has been accelerating, the rate of change in the prices of *assets* has been accelerating – **to the downside**.

Mr. Wesbury does not seem to understand the significance of this with regard to goods/services price inflation. In the second paragraph of his op-ed piece, Wesbury invokes the name of Milton Friedman with respect that inflation is a monetary phenomenon. So, let's *carefully* examine the facts about current monetary phenomena, something Wesbury did *not* do.

Mr. Wesbury correctly notes that the annualized growth in Reserve Bank Credit (the Fed's balance sheet) in the *last Wednesday* of July compared to the *last Wednesday* of April was 14.4%. But Wesbury failed to tell you that there is seasonal variation in these data and the data he used were *not* seasonally adjusted. Moreover, the data he used were *Wednesday* snapshots. Wednesdays can be quite volatile compared to weekly averages of the data because every *second Wednesday* is the day in which banks must meet their average reserve requirements for the reserve maintenance period. Thus, if banks' *actual* average reserve holdings are below their *required* average reserve holdings going into a settlement Wednesday, the Fed would have to provide reserves on that Wednesday – either through open market operations or through the discount window – in order to enable banks to meet their reserve requirements. Chart 1 shows the differences between Wednesday snapshots of Reserve Bank Credit minus the weekly averages. Notice two things in Chart 1. Firstly, there is quite a bit of variation between the Wednesday level of Reserve Bank Credit and the weekly average level. Secondly, the magnitude of that variation has increased since the credit crisis started in the second half of 2007. This is biasing upwards Wesbury's growth rate for Reserve Bank Credit.

Chart 1
Reserve Bank Credit: Wednesday minus Weekly Average

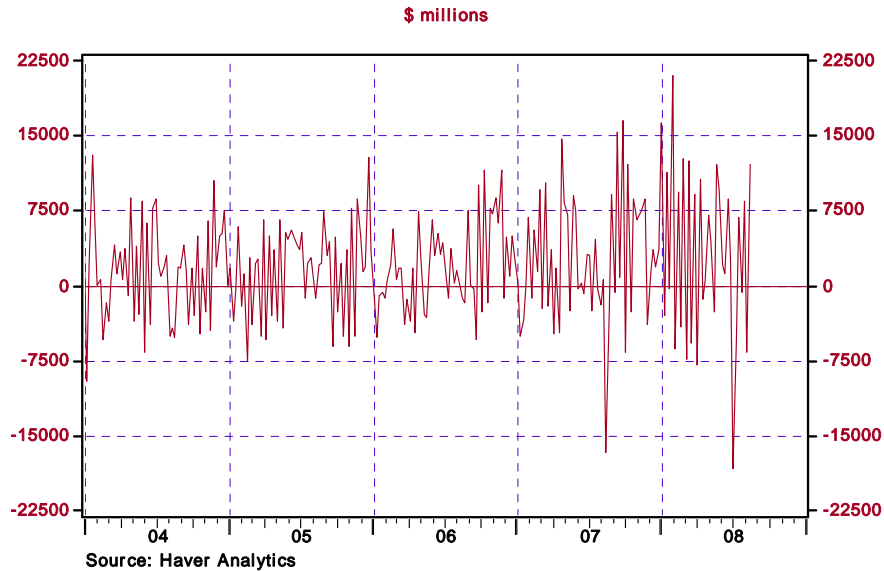
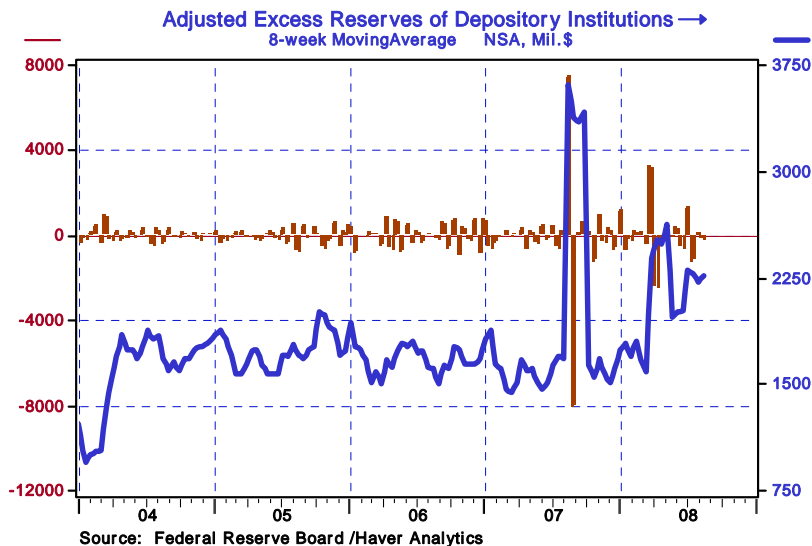


Chart 2 shows that excess reserves -- the difference between the level of *total* reserves banks hold minus the level of reserves they are *required* to hold -- became more volatile and have increased since mid 2007. This increase in excess reserves likely reflects banks' *demand for precautionary reserves* due to increased counterparty risk. During the 1930s, banks' *demand* for excess reserves increased significantly. In 1937, on the advice of the Wesburys of that era, the Fed doubled the reserve requirements imposed on banks. This act ended the economic recovery that was underway and ushered in the second leg of the Great Depression!

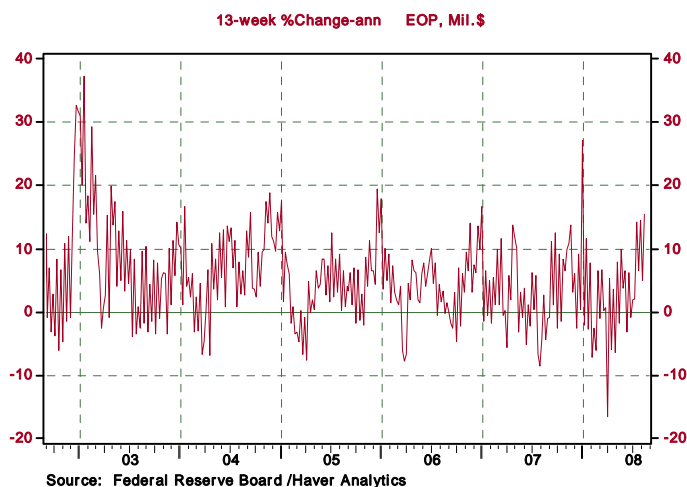
Chart 2
← Adjusted Excess Reserves of Depository Institutions
2-week Change NSA, Mil. \$



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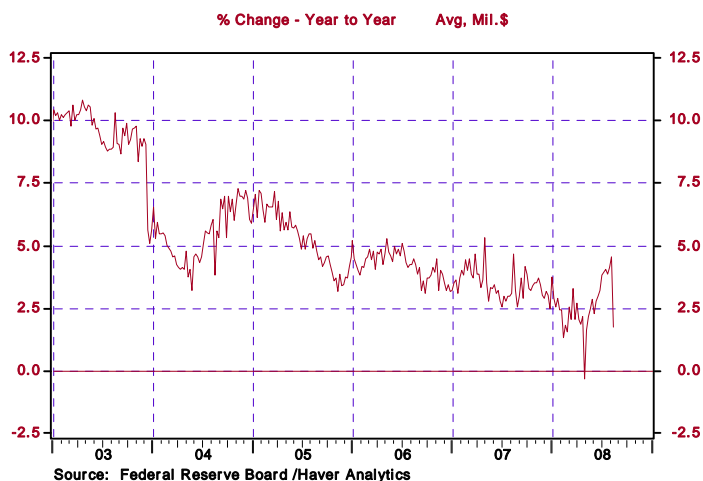
Chart 3 shows the 13-week annualized growth rates of Wednesday readings of Reserve Bank Credit. A definite seasonal pattern is observable. Growth in Reserve Bank Credit waxes at year-end, then wanes, then waxes again in the middle of the year. This is because of seasonal changes in required reserves and currency demand. So, some of the strength Wesbury is observing in Reserve Bank Credit in the three months ended this past July is normal seasonal strength.

Chart 3
Reserve Bank Credit Outstanding



Now, let's look at the recent behavior of *weekly averages* of Reserve Bank Credit on a *year-over-year* basis so as not to run into the seasonal problems (see Chart 4). Back in 2003, the year-over-year changes in Reserve Bank Credit were running around 10%. Since the credit crisis hit in mid 2007, the fastest year-over-year growth in Reserve Bank Credit has been 4.05% in the week ended July 16. In the latest week, August 13, year-over-year growth in Reserve Bank Credit has slowed to a mere 1.76%. Is 1.76% growth in the Fed's balance sheet the stuff of accelerating CPI inflation?

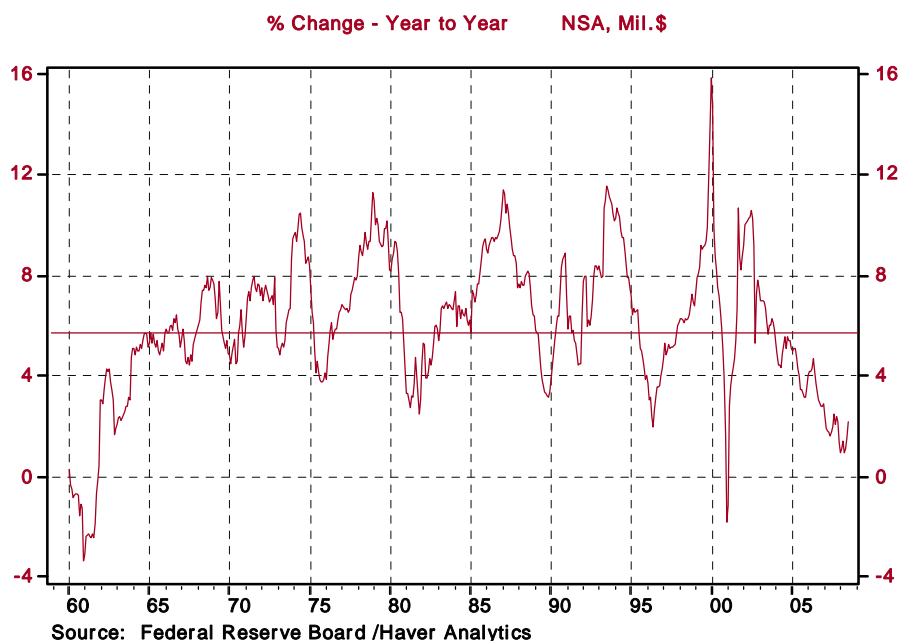
Chart 4
Reserve Bank Credit Outstanding



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The monetary base is essentially the same thing as Reserve Bank Credit. The Fed provides monthly readings on the monetary base as monthly *averages of daily figures* in the month (as opposed to the last Wednesday of the month). Chart 5 shows the year-over-year changes in the monthly averages of the monetary base starting in 1960. From January 1960 through July 2008, the median year-over-year change in the monetary bases has been 5.75%. In July 2008, the monetary base was up just 2.19% from July 2007. This is the stuff of a clear and present inflation danger?

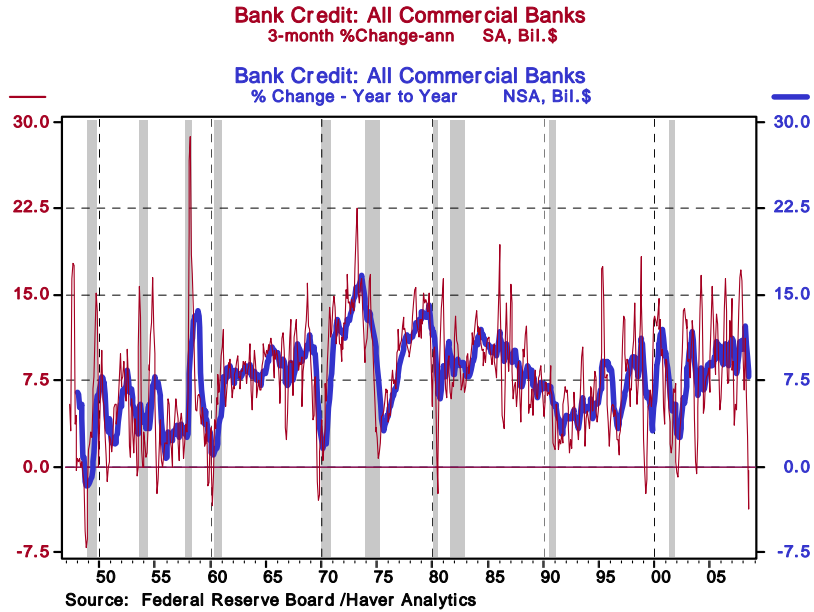
Chart 5
Monetary Base



As I mentioned earlier, asset prices are now falling, especially the asset backing over \$11 trillion of debt. Of course, I am referring to residential real estate assets and mortgage debt. Home mortgages are the largest single class of debt instruments in the U.S. economy. The fall in residential real estate prices is resulting in billions of dollars of losses for financial institutions, including commercial banks. This *debt deflation* is inhibiting banks from expanding their balance sheets. That is, evaporating capital positions are constraining the expansion of bank credit – loans and securities. Chart 6 shows that there has been a collapse in commercial bank credit in the past three months. In the three months ended March, *seasonally-adjusted* bank credit was growing at an annualized rate of 11.15%. In the three months ended July, bank credit was *contracting* at an annualized rate of 0.29%. On a year-over-year basis, *unadjusted* bank credit was growing 12.24% in March. In July, this growth had slowed to 7.76%.

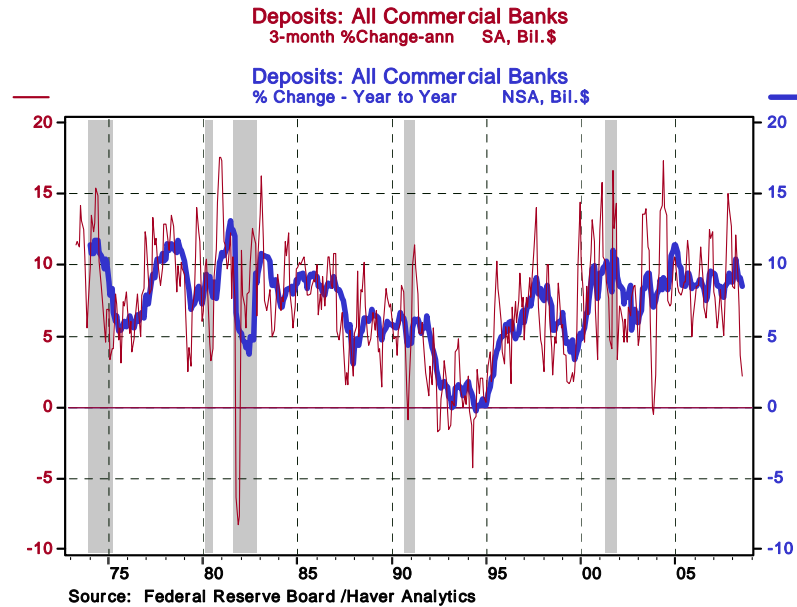
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Chart 6



On the other side of banks' balance sheets from bank credit are bank deposits. If bank credit is weakening, we might expect the same for banks deposits. Thank goodness for double-entry bookkeeping. Chart 7 shows the behavior of deposits at commercial banks. In the three months ended March, *seasonally-adjusted* bank deposits were growing at an annualized pace of 12.16%. In the three months ended July, *seasonally-adjusted* bank deposit growth had slowed to only 2.10%. On a year-over-year basis, *unadjusted* bank deposits grew by 10.37% in March. By July, this growth had slowed to 8.45%.

Chart 7



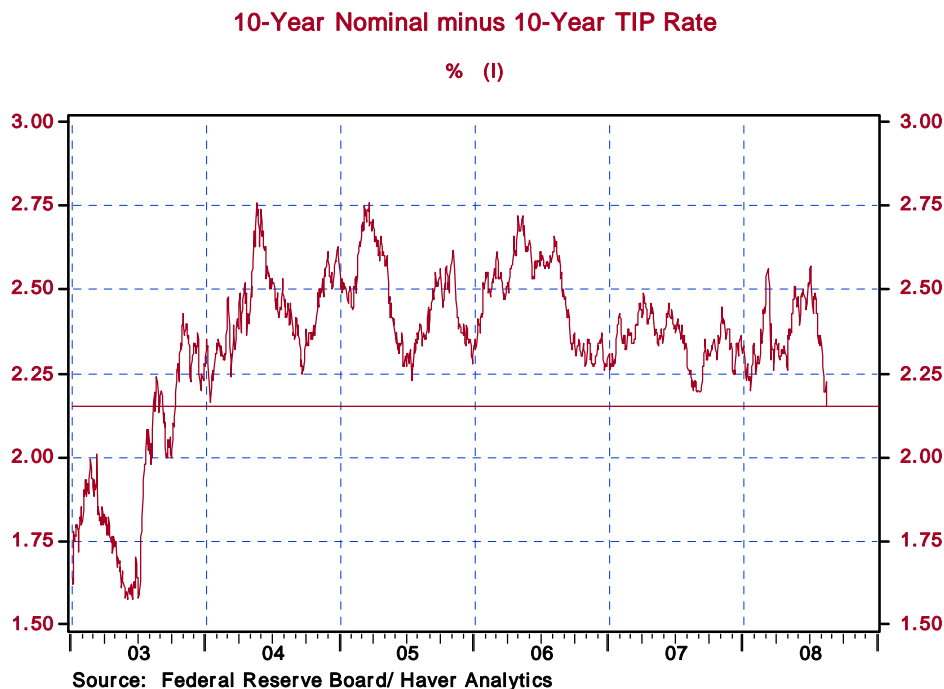
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I will not deny that bank credit growth and bank deposit growth on a *year-over-year* basis remain high. But Wesbury cannot deny that the *three-month* growth rates in these variables are quite low and suggest a sharp deceleration in CPI inflation going forward. Moreover, the three-month growth rates in these variables suggest that their respective year-over-year growth rates will be falling in the next several months.

As I mentioned earlier, Wesbury appealed to the authority of Milton Friedman to justify his inflation argument. But it is clear that Wesbury is only a superficial student of Friedman's. One of the Friedman's tenets was that monetary authorities should not be guided by the *level* of interest rates but by the behavior of monetary aggregates. An interest rate level of 2% could only be judged as accommodative or restrictive in light of the behavior of monetary aggregates. As I have shown, the recent behavior of monetary aggregates could only be interpreted as restrictive.

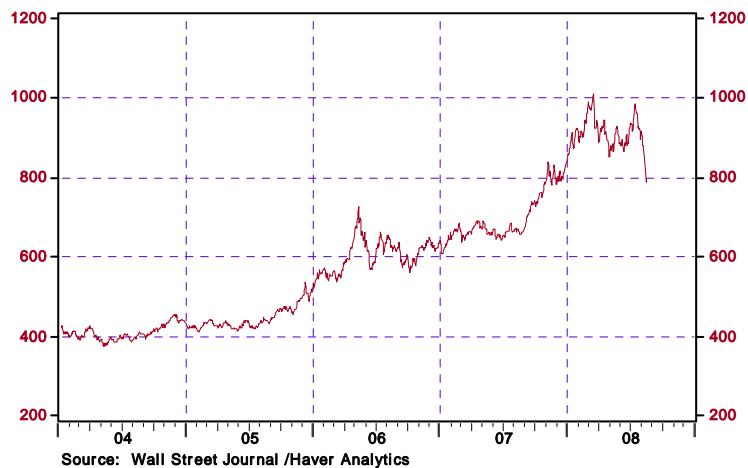
It is interesting that such an allegedly free-market kind of guy such as Wesbury has so little faith in the message being sent by the free markets when it comes to inflation. For example, in recent weeks, the *free market's* expectations of CPI inflation over the next 10 years has fallen sharply to its lowest reading since 2003 (see Chart 8). And if accelerating inflation is such a threat, why is that perennial barometer of inflation expectations, the price of gold, falling from almost \$1,000 an ounce back down to about \$800 an ounce (see Chart 9)?

Chart 8



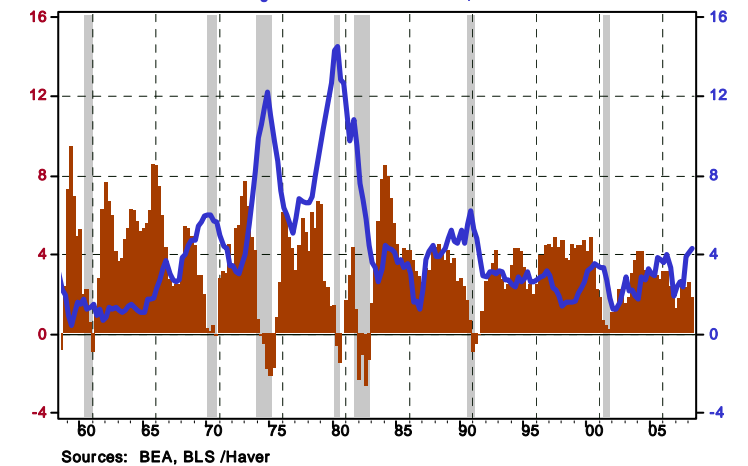
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Chart 9
 Cash Price: London Gold Bullion, PM Fix
 US\$/Troy oz (l)



Lastly, doesn't Mr. Wesbury know that inflation is a *lagging* economic indicator? As Chart 10 clearly shows, in U.S. business cycles, *first* the real economy goes into a recession, *then* several quarters later inflation starts to moderate.

Chart 10
 Real Gross Domestic Product
 % Change - Year to Year SAAR, Bil.Chn.2000\$
 CPI-U: All Items
 % Change - Year to Year NSA, 1982-84=100



Am I the only one who misses the days when the op-ed page of *The Wall Street Journal* contained objective and well-researched commentaries on monetary policy such as those written by Lindley Clark?

Paul Kasriel is the recipient of the 2006 Lawrence R. Klein Award for Blue Chip Forecasting Accuracy

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