

Bernanke and the Beast

By N. GREGORY MANKI

IS galloping inflation around the corner? Without doubt, the United States is exhibiting some of the classic precursors to out-of-control inflation. But a deeper look suggests that the story is not so simple.

Let's start with first principles. One basic lesson of economics is that prices rise when the government creates an excessive amount of money. In other words, inflation occurs when too much money is chasing too few goods.

A second lesson is that governments resort to rapid monetary growth because they face fiscal problems. When government spending exceeds tax collection, policy makers sometimes turn to their central banks, which essentially print money to cover the budget shortfall.

Those two lessons go a long way toward explaining history's hyperinflations, like those experienced by Germany in the 1920s or by Zimbabwe recently. Is the United States about to go down this route?

To be sure, we have large budget deficits and ample money growth. The federal government's budget deficit was \$390 billion in the first quarter of fiscal 2010, or about 11 percent of gross domestic product. Such a large deficit was unimaginable just a few years ago.

The Federal Reserve has also been rapidly creating money. The monetary base — meaning currency plus bank reserves — is the money-supply measure that the Fed controls most directly. That figure has more than doubled over the last two years.

Yet, despite having the two classic ingredients for high inflation, the United States has experienced only benign price increases. Over the last year, the core Consumer Price Index, excluding food and energy, has risen by less

than 2 percent. And long-term interest rates remain relatively low, suggesting that the bond market isn't terribly worried about inflation. What gives?

Part of the answer is that while we have large budget deficits and rapid money growth, one isn't causing the other. Ben S. Bernanke, the Fed chairman, has been printing money not to finance President Obama's spending but to rescue the financial system and prop up a weak economy.

Moreover, banks have been happy to hold much of that new money as excess reserves. In normal times when the Fed expands the monetary base, banks lend that money, and other money-supply measures grow in parallel. But these are not normal times. With banks content holding idle cash, the broad measure called M2 (including currency and deposits in checking and savings accounts) has grown in the last two years at an annual rate of only 6 percent.

As the economy recovers, banks may start lending out some of their hoards of reserves. That could lead to faster growth in broader money-supply measures and, eventually, to substantial inflation. But the Fed has the tools it needs to prevent that outcome.

For one, it can sell the large portfolio of mortgage-backed securities and other assets it has accumulated over the last couple of years. When the private purchasers of those assets paid up, they would drain reserves from the banking system.

And as a result of legislative changes in October 2008, the Fed has a new tool: it can pay interest on reserves. With short-term interest rates currently near zero, this tool has been largely irrelevant. But as the economy recovers and interest rates rise, the Fed can increase the interest rate it pays banks to hold reserves as well. Higher interest on reserves would discourage bank lending and prevent the huge expansion in the monetary base from becoming inflationary.

But will Mr. Bernanke and his colleagues make enough use of these instruments when needed? Most likely they will, but there are still several reasons for doubt.

First, a little bit of inflation might not be so bad. Mr. Bernanke and company could decide that letting prices rise and thereby reducing the real cost of borrowing might help stimulate a moribund economy. The trick is getting enough inflation to help the economy recover without losing control of the process. Fine-tuning is hard to do.

Second, the Fed could easily overestimate the economy's potential growth. In light of the large fiscal imbalance over which Mr. Obama is presiding, it's a good bet he will end up raising taxes for most Americans in coming years. Higher tax rates mean reduced work incentives and lower potential output. If the Fed fails to account for this change, it could try to promote more growth than the economy can sustain, causing inflation to rise.

Finally, even if the Fed is committed to low inflation and recognizes the challenges ahead, politics could constrain its policy choices. Raising interest rates to deal with impending inflationary pressures is never popular, and after the recent financial crisis, Mr. Bernanke cannot draw on a boundless reservoir of good will. As the economy recovers, responding quickly and fully to inflation threats may prove hard in the face of public opposition.

Investors snapping up 30-year Treasury bonds paying less than 5 percent are betting that the Fed will keep these inflation risks in check. They are probably right. But because current monetary and fiscal policy is so far outside the bounds of historical norms, it's hard for anyone to be sure. A decade from now, we may look back at today's bond market as the irrational exuberance of this era.