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ECONOMIC NEWS UPDATE

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Recovery Today, Inflation Tomorrow

Anyone who thought Ben Bernanke and his Federal Reserve Board colleagues were out of ammunition received a rude, or pleasant, shock last week. Rude, if you worry that a few extra trillions sloshing around the economy might one day trigger a wave of inflation; pleasant, if you worry that the economy is sinking fast, and the Obama administration and the congress haven't a clue what to do about it.

The Fed plans to buy \$300 billion of 2-10 year Treasury IOUs in the next six months (more to come if needed), pour \$1.45 trillion into the mortgage market one way or another, and keep interest rates close to zero for "an extended period". There's more in the Fed's

"do whatever it takes" arsenal if these steps don't bring interest rates down so people can borrow more cheaply to buy houses, cars and generally give the economy a lift. But so far, so good: interest rates on 30-year mortgages fell below 5%. Whether that will encourage enough credit-worthy borrowers -- those who can meet tighter income and other requirements -- to sop up the huge inventory of unsold homes much less trigger new construction, is difficult to predict.

But the dollar dropped like a stone. Earlier, Chinese premier Wen Jiabao said he is "a little bit worried" that America might cheapen its currency and pay back the \$1.2 trillion it owes China

in depreciated dollars. Now that the Fed has moved, he must be a lot worried.

The Fed's decision to pump trillions into the money markets comes on top of President Obama's proposal to drive the federal deficit to 12% of GDP by borrowing trillions to fund a few stimulus projects, universal health care, a green energy system, and a host of other programs on his wish list. Obama's assurance that the US would never default on its debt hasn't completely soothed markets: The Wall Street Journal reports that it now costs seven times as much to buy insurance against a US government default as it did only a year ago. Besides, should it become convenient, the US can inflate its way out of its obligations in the time-honored manner of Latin American and other sovereign debtors.

Not to worry, says the President. The economy will soon be racking up an annual growth rate of around 4%. Along with the tax increases to be imposed on the top 2% of earners, billions from the sale of carbon-pollution permits, and reductions in age-related entitlements, the growth will drive the deficit down to a sustainable 3% of GDP in 2013. Unfortunately, 2% of earners can't carry the entire tax burden, the carbon-permit program might not produce the predicted revenues

after Democratic congressmen from coal-producing states chop away at it, and the congressional leadership has told the President any proposal he sends to congress that calls for a reduction in the massive entitlement payments due the ageing baby boomers will be DOA -- dead on arrival.

Where Mr. Wen sees problems, Paul Paulson (no relation to former Treasury Secretary Hank) sees opportunity. Paulson, you will recall, is the hedge fund manager who made \$10 billion in 2007 betting that the subprime mortgage market would implode. The day before Bernanke's announcement, Paulson made another wager. He shelled out \$1.28 billion for a stake in gold-mining company AngloGold Ashanti. Paulson, says the Financial Times, is "betting against governments" that are debasing their currencies en route to a bout of high inflation that, in turn, will produce a flight from paper money into gold. Within 24 hours of Paulson's bet, it paid off, thanks to the Fed: the price of gold jumped about 7%, one of the many commodities to experience large increases.

So here is where we are at. There is little doubt that the combination of the Fed's surprise attack on the credit markets and the President's decision to borrow-

and-spend will give the economy a lift. My own guess, and that of many economists with whom I have spoken, is that by the middle of next year, if not sooner, the economy will start growing again, and at a decent rate.

At that point, Bernanke will have to decide whether to start pulling money out of the system by selling off some of the assets on his swollen balance sheet for cash to put back in the vault, and the Obama administration will have to decide how to bring down the fiscal deficit. Bernanke is keenly aware that during the Great Depression the Fed tightened the money supply prematurely, nipping a nascent recovery in the bud. So he is likely to stall.

Meanwhile, there is little prospect that congress will do what is necessary to bring spending and borrowing down to levels that do not threaten inflation. Politicians just don't worry as much about inflation as about catering to their multiple constituencies by funding bridges-to-nowhere and research to reduce odors emitted by swine. So the Treasury will have more trillions in IOUs to peddle.

But its best customers just might be unenthusiastic about adding significantly to their holdings. Mr. Wen already owns trillions in Treasury bills that are depreciating in value. Besides, China's mounting needs for

infrastructure and an improved safety net will sop up funds once used to buy American securities. Japan, another large customer, is now running a current account deficit, and so won't have as many dollars to recycle. Nor will Middle East buyers, no longer receiving a flood of dollars from \$140 oil. Little wonder that Larry Lindsey, former economic adviser to President George W. Bush, says that he and his consulting colleagues "cannot figure out what combination of foreign buyers is going to acquire ...[the] debt" that Obama's plans will generate.

Which leaves Americans and the Fed as customers. Even if they save more, domestic consumers can't absorb all the bonds and notes that will be on offer. And if the Fed keeps buying, it will pour fuel on the inflationary fires. Even before the Fed's announcement last Wednesday, Professor Christoph Schmidt, one of the five "wise men" who advise the German government on economic policy, told the press, "I see an inflationary risk in the US in the medium term because of the development of money supply there," he told the press last week.

True, the Germans are especially sensitive to the danger of inflation, given the political consequences of their experience with that phenomenon. But Schmidt is only one among many

economists, not all of them German, who fear that Obama has over-estimated the revenues he will get: growth at a rate of 4% is not a sure thing, the 2% of Americans he is planning to squeeze might just decide that the cut in the after-tax rewards of hard work and risk-taking makes the golf course a more attractive alternative to the office. Remember: many of the “wealthy” that Obama has in his sights derive their \$250,000 in family income (\$200,000 if single) from small businesses, which some experts say create 70% of the new jobs in the economy. These entrepreneurs will not only face higher income taxes, higher capital gains taxes when they sell their businesses, and higher inheritance taxes when they pass the business on, but laws that deprive their workers of the right to a secret ballot when union organizers arrive on the scene. Some might decide that the game isn’t worth the candle.

I have never before doubted the resilience of the American economy -- its ability to survive inevitable downturns after periods of excess, and to weather the burdens heaped upon it by politicians, most of whom have never met a payroll or created a job with their own money. Obama, however, has me shaken, perhaps

because I am not stirred by his rhetoric.

Fortunately, even some liberal Democrats are suffering from “bail-out fatigue”, and might deprive Obama of the next billions or trillions that he will request -- especially since Treasury Secretary Tim Geithner’s credibility is at such a low ebb that the administration is considering sending someone else to the congress to make any additional requests for funds. More important, Bernanke has so far shown a sure touch in managing monetary policy, and might head off a bout of inflation by shrinking the money supply when the economy is no longer too cold, has not yet gotten too hot, and is in just the right condition for such a move. If so, Goldilocks might just have a new life.

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