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The inflation we choose

Following is the text of the remarks that the editor of *Grant's* prepared for delivery on Wednesday, April 10, to the 17th annual Macro Conference of Strategas Asset Management in New York.

Inflation is inherent in our politics, culture and finances. Sometimes it's in the foreground, sometimes in the background. We, the voters, seem not to object, because we ultimately get what we want ("good and hard," said H.L. Mencken). Here's hoping we change our minds.

Trouble starts with definitions. What is inflation? "Too much money chasing too few goods" is helpful as far as it goes. But it posits only one cause of inflation: money. What about the inflation propellant of unchecked public borrowing? And why, apart from the virtue of brevity, the omission of asset prices from the familiar epigram?

On such critical questions, the economics profession is a house divided. A new generation of scholars denies the relevance of money to what used to be viewed as exclusively a monetary problem. Chairman Jerome Powell himself testified in 2021 that we must "unlearn" what we thought we knew about M-2. Some authorities attribute inflation to an excess of public borrowing, others to the public's expectations of rising prices—as if thinking could make it so.

Fortunately, Wilhelm Röpke, a mid-20th-century German economist, provides a definition for all seasons. Inflation, says he, "is the way in which a national economy reacts to a continuous overstraining of its capacity, to demands which are extravagant and insistent, to a tendency towards excess in every and all circles." It's a case, then, of government-instigated overdoing it. But society, by suffering in silence, is government's coconspirator. There's nothing dogmatic in Röpke's definition. It wisely allows for multiple causes: fiscal, monetary, political, cultural.

Röpke has more to say in this vein, and he does not shrink from meting out condemnation to the deserving parties. He hates inflation, as we all should, whatever our preferred school of economic thought—Austrian, monetarist, Keynesian or other. The integrity of the currency is a moral question, because money is work and work is heartbeats and heartbeats are finite. If you accept that proposition, you will have scant patience for the Fed's self-assigned remit of skimming 2% a year from the purchasing power of the dollar. What is it, really, besides monetary shoplifting, tricked out in the econometricians' algebra?

Yet Americans show no signs of restiveness with the two major political parties that compete with each other to say nothing against overstraining. When did you last hear a contender for high office denounce the sprawling public debt or the ready-made dollars that finance it? Polls must tell them there are no votes in it.

I blame our forebears as much as our fickle selves for the choices that have brought us to this pass. Institutionally and legally, America made its bed of inflation long ago. In sending Woodrow Wilson to the White House in 1912, the voters chose inflation, though little did they suspect it. It was Wilson who signed the Federal Reserve Act of 1913, with four gold pens if you please. He created the central bank that, 99 years later, would get it into its head to redefine "price stability" as a perpetual low-grade inflation, the 2%-ish target at which Jay Powell insists he is still taking aim.

A measure of blame also attaches to the Greatest Generation, which elected President Lyndon Johnson, signer of the Medicare and Medicaid Act of 1965. Our parents failed to anticipate that entitlement spending would come to devour the federal budget and that the interest cost of carrying the associated debt would finally overtake defense spending.

Wilson and Johnson were Democrats, but the Republicans have plenty to answer for, too. By electing Richard Nixon, they set in motion the chain of events that, in 1971, would snip the final thread that once anchored the dollar to gold.

Now you may object that each of these inflation-facilitating choices was expedient or even essential. You may defend the welfare state to the death and the Federal Reserve and the pure paper dollar along with it. But each turn away from financial orthodoxy allowed for more overstraining. Each played its part in removing the inhibitions that had guarded against overborrowing and overstimulating. They have sped us to this time of monetary improvisation and fiscal overreach.

For simplicity's sake, we can describe today's monetary predicament as the collision between good inflation and the other kind. By good inflation, I mean the Wall Street, up-and-to-the-right variety. There has been plenty of that. Not once since the federal funds rate began to hot-foot it higher, in March 2022, has the Federal Reserve Bank of Chicago's Financial Conditions Index registered any reading but accommodative.

Which leaves bad inflation, i.e., the unwanted rise in the prices of butter, eggs, baby formula, debt service and such.

Put yourself in Jay Powell's shoes. How do you stop the bad kind of inflation without threatening the good? How, for instance, to reduce the rate of rise in consumer prices without knocking the slats out from leveraged commercial real estate?

A dozen years of interest rate suppression masked the cost of public borrowing. It facilitated the fad for "paying higher-than-S&P prices for near-distressed credit-quality micro-caps with a heavy sector bias toward tech and health care," as the investor Dan Rasmussen cogently described the private equity business a couple of years ago. It made possible the suspension of disbelief about the future value of profitless venture-capital business plans. It facilitated what has turned out to be a years-long sleepwalk to a kind of national leveraged buyout. It breathed life into the nostrils of a dormant CPI.

The savings data open a picture window on America's overstraining. The economist Lacy Hunt reminds us of the three tributaries of national savings: private, foreign and government. Last year, government savings, at minus $1,808.7 billion, swamped the other two sources combined, at $1,737.9 billion. It yielded a negative net value of $70.8 billion.

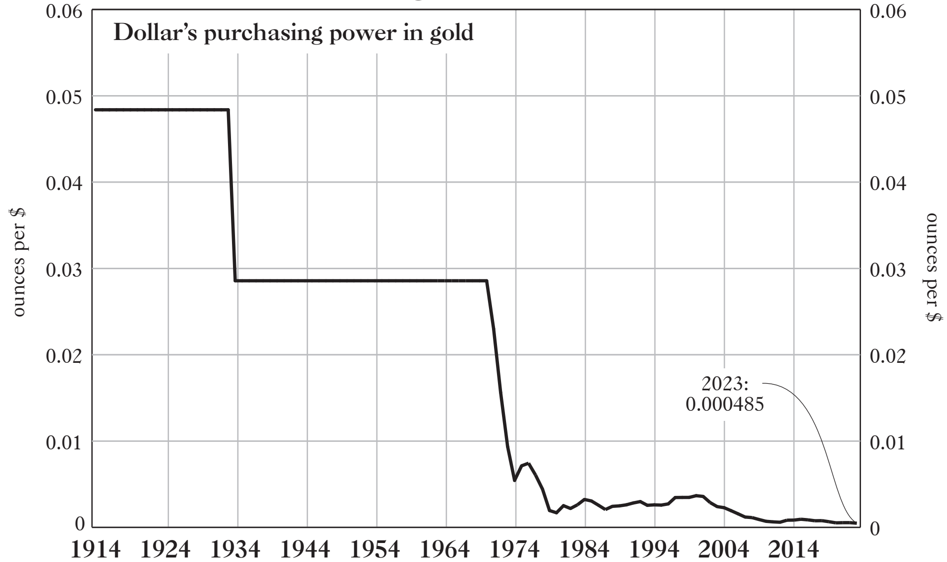
"And now," Hunt recently told the host of the *Hidden Forces* podcast, Demetri Kofinas, "we have a condition of negative national savings. Without net national savings, we cannot have net physical investment. Without net physical investment, we cannot increase the capital stock."

But the capital stock fairly cries out for renewal. Artificial intelligence is about to strain the nation's electrical grid. The planned "energy transition" will make its own substantial electricity demands. The Navy needs ships, Baltimore a bridge, Silicon Valley advanced computer chips. So no net physical investment would seem a nonstarter.

Could the Fed not lend a hand, Hunt asked himself and went on to answer: "You can increase the money supply, but that will just have an inflationary effect. There's no way to inflate our way out of the problem." And he added, "What you're basically doing is, you're using your depreciation to live on."

Net negative savings is no everyday occurrence. Prior to 2023, the U.S. Bureau of Economic Analysis identifies only seven prior examples since 1929. Each was a period that most Americans would probably not care to relive: 1931–34 and 2008–10. Last year was the only one of the seven that was not the occasion of, or in close proximity to, a major slump.

What the Fed has wrought



sources: The Bloomberg, MeasuringWorth.com

Carter Glass, roll over
(Zip Lexing / Alamy Stock Photo)

Inflation has its cultural and political roots, too. You don't contract the money disease without letting down your monetary and fiscal hair a little bit. Recall the rigors of the classical gold standard. Base money expanded at something in line with the growth in gold production and world population. By convention, government budgets were balanced. There was no welfare state to unbalance them. There were episodes of inflation and episodes of deflation, but prices were stable over the long run.

Culturally, politically and financially we have evolved, and in our democratically evolved condition we want what we want, and we want it now. In Röpke's terms, we lay "extravagant and insistent" demands on our national productive capacity. We might call this time of ours the Age of Disinhibition.

Imagine you are strolling along Central Park South when the open-air phone conversation of a fellow pedestrian makes you privy to the details of an ugly divorce. The guy with the cellphone to his ear can't be unaware that you know what, in the analog age, you would never have been in position to find out. And you think to yourself, Are there no boundaries any more?

Older members of the audience may remember an item of street furniture called the telephone booth. It was a kiosk to accommodate the user of a pay phone. For the sake of discretion it established physical boundaries for a private call. It's a marker of the change in American social mores that so few seem to miss it.

Gone like the phone booth are the founding principles of American finance. The Hamiltons and Adamses set boundaries around the dollar and the public debt. They defined the currency as a weight of gold or silver and made it exchangeable into that value of coin at the option of the currency holder. They established a sinking fund to retire the public debt. Having seen quite enough of inflated paper money and fiscal ruination during the Revolution, they wanted no recidivism. A Congress of saints would require no sinking fund and no silver or gold with which to define and collateralize the currency, but the people elected politicians.

In 1913, the founders of the Federal Reserve likewise established guard rails. The dollar—the new Federal Reserve note—would continue to be defined as, and convertible into, gold at the then customary rate of $20.67 an ounce. The government would have nothing to do with the integrity of that note. Its value would be supported by a more-than-adequate gold cover and by the strength of American banking institutions.

Carter Glass, a principal legislative author of the Federal Reserve Act, laid emphasis on the double liability of bank stockholders. There was yet no federal deposit insurance. If a bank failed, it was the owners of the stricken institution who got a capital call, not the taxpayers. Congress extinguished such double liability in 1935, shortly after the creation of the Federal Deposit Insurance Corp.

But the holders of shares in the regional Federal Reserve Banks retained their double liability. And who might those investors have been? Why, just who they are today, the member depository institutions. Each, in proportion to the size of its own capital, must subscribe to shares in its district Reserve bank. And they, like the commercial bank stockholders of yore, bear the risk of a capital call in the event of the impairment or insolvency of the Federal Reserve branch bank in which they invested.

It's a cinch that Jamie Dimon formerly spent none of his carefully managed time as the CEO of JPMorgan Chase & Co. contemplating the risk of the insolvency of the Federal Reserve Bank of New York. However, because the Fed is paying more than 5% on its liabilities while earning just 2% or so on its assets, it has rung up $161.3 billion of system-wide operating losses on capital of $43.1 billion. Of the grand total of loss, $101.3 billion is apportioned to the New York Fed, which shows only $14.9 billion in capital.

To emphasize, these are operating losses, not mark-to-market losses in the System Open Market Account. As of Dec. 31, 2023, such cumulative unrealized losses on the consolidated Federal Reserve securities portfolio summed to the immensity of $948.4 billion.

The central bank, indeed, would be a notorious bankrupt except for the Treasury's interposition and the Fed's DIY accounting. By the central bank's own generous reckoning, its operating losses count not as losses but as deferred assets. Or one might count them as loans from the Treasury, i.e., the fiscal arm of the government from which the Fed is proud to be perfectly independent. The loans, as far as the reader of the footnotes to the weekly H.4.1. form can tell, come interest-free. Nor are they due on any particular date. They are payable at the convenience of the Fed, if, as and when the central bank returns to earning a spread between the funds rate, on the one hand, and the yield on its bills, bonds and mortgages, on the other.

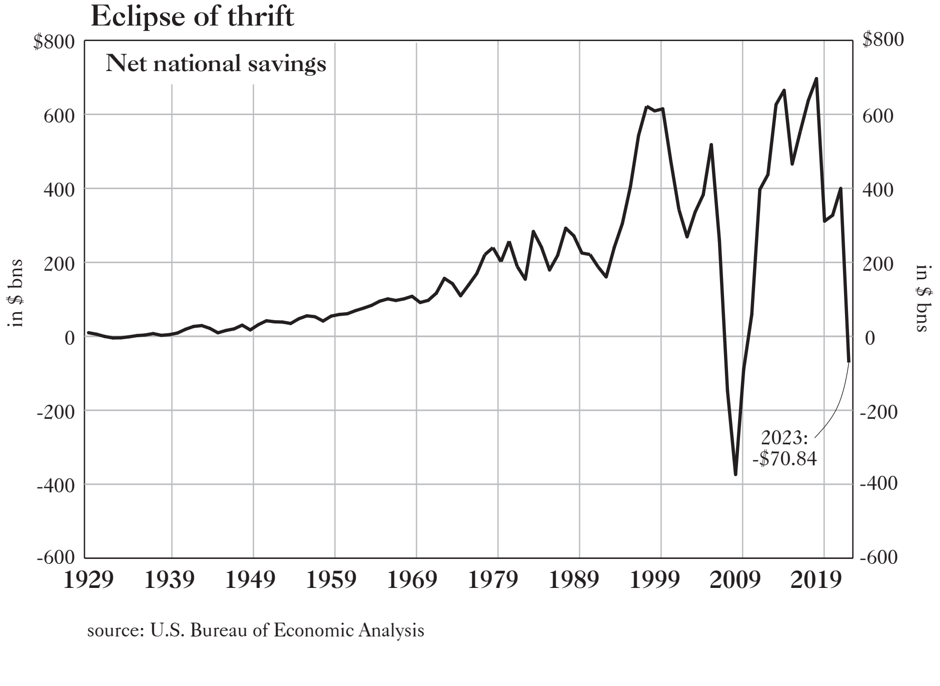
The shambles of the Fed's balance sheet is an open secret, but the chairman and the governors acknowledge no embarrassment, let alone impairment. "The deferred asset," says the press release accompanying the 2023 audited financial statements, "is the net amount of excess earnings the Reserve Banks will need to realize before their remittances to the U.S. Treasury resume. A deferred asset has no implications for the Federal Reserve's conduct of monetary policy or its ability to meet its financial obligations." KPMG, LLP, the auditor, blessed the figures.

A financial history of the United States, published in 1903, looked back on the not-entirely-successful financial management of the previous quarter century. The author, Davis Rich Dewey, did not despair, but rather suggested that the country was economic policy–proof. Not even the government could restrain the enterprising American spirit.

"The natural resources of the country and the opportunities for enterprise," wrote Dewey, "made it possible for the country to press forward by leaps, which no mistakes of taxation, monetary issuance, or treasury borrowing could withstand."

Are we still so armored? A little more than a century after Dewey wrote, the pure paper dollar is the world's reserve currency (as the gold dollar of Dewey's day was not), and the split-rated U.S. Treasury remains a port in a storm. And which country doesn't envy the enterprise, ingenuity and even the excesses of Silicon Valley?

Eclipse of thrift



source: U.S. Bureau of Economic Analysis

But we are talking about inflation, a disease of political and cultural character as much as it is of monetary and fiscal malpractice. Which brings us to the 2024 presidential election. Sound money and a balanced budget may be the furthest things from the mind of either likely candidate. Former President Trump plumped for negative nominal interest rates during his first term. President Biden is once more pressing for the extrajudicial forgiveness of student loans.

In the testimony that Trump gave in the suit that was brought against him by New York State Attorney General Letitia James for allegedly inflating the value of his encumbered real estate, the defendant spoke for himself. But he said nothing, in substance or in spirit, I am going to speculate, that his presumptive Democratic opponent would not have uttered had Biden, too, made his career in commercial real estate.

Arthur F. Engoron, the presiding judge in the trial, quoted Trump's testimony about the fair value of the Mar-a-Lago Club.

"When confronted with the 2002 deed, in which he signed away, in perpetuity, the right to use or develop Mar-a-Lago as anything other than a social club, in exchange for a conservation easement tax benefit," the judge recounted, "he offered that 'when you say you "intend," intend doesn't mean we will do it.' "

We mean no partisan jibe against the Republican, only against the topsoil of today's national politics. It is the kind of dirt in which the weed of inflation can cast a root.

"Anything Goes," is the name of a hit song that Cole Porter wrote in 1934, coincidentally one of the seven years of recorded net negative national saving. It so happens that the CPI rose by 3.5% in 1934. It was the highest rate in 13 years.

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