Inflation

Inflation is a very complex subject. What makes it difficult to analyze is that the normal state of an economy is deflation of prices. Why is that?

The ascent of man has been marked by continually improving efficiency and productivity. In the absence of monetary inflation, prices will always go down. For example, look at the cost of agricultural products. Wheat costs less than it did 75 years ago. Improved seed, fertilizer, insecticides, and the application of energy in the form of mechanization have vastly improved productivity.

Another example is the cost of computing power. Vastly more powerful computers sell for a small fraction of the price 20 years ago.

The extent of monetary inflation can only be appreciated by looking at the cost of items that have not experienced significantly improved productivity. The price of a symphony ticket, a baseball game, an ounce of gold are 10-20 times more than they were 75 years ago. Automobiles have improved tremendously in style and performance, but they also cost 10 times more than they did in 1970.

What does this mean? So long as productivity improves at rate close to the rate of monetary inflation, the price effect, on average, is substantially dampened. If this is true, who is hurt by monetary inflation? The simple answer is: those that are not on the improving productivity train. Retirees, those on relatively fixed income, and those industries that are not innovating in the application of new technology and capital.

The inputs to improved productivity are exploitation of cheap resources, capital investment, technology, and continual improvement in the economies of scale. As an industry matures, its ability to use these inputs to improve productivity slows.

The inflation that everyone sees in the form of sudden price increases is different that that described above. True, monetary inflation is always a problem, but the inflation today is being driven by strong demand, and inelasticity of supply of a number of key industrial inputs. The most important of these is energy. How monetary policy responds to this inflation will determine the rate of overall inflation.

Public policy responses to the “artificial” energy crisis of the 1970’s were tragically inept. Political expediency ruled the day, and the result was a set of rules that prevented the marketplace from responding to the crisis. The crisis was prolonged and cost the consumer much more than should have been required to clear the market.

We have had energy crises before. The first was the depletion of the supply of wood. As each of these crises unfolded, mankind was able to develop alternative energy supplies. Very often these alternatives were much cheaper than the original source. I forecast that outcome for the current shortage of oil and gas.

The decline of oil and gas production does offer some severe political challenges. The competition for these dwindling supplies is global. Moreover, the US uses a large proportion of these supplies and is poorly located geographically to compete militarily for the bulk of the production. Add to that the severe financial imbalances in the US economy, and you have the potential for a medium term financial crisis.

The politics of this combination are not promising. Demagoguery and political expediency are likely to rule the day. As a consequence, I can forecast with confidence that a severe inflationary period lies just ahead. How it will happen is hard to forecast. Monetary policy is likely to be as rational as circumstances permit. Fiscal and regulatory policy will likely be a repeat of the 1970's. Whatever the mix, you can be confident that a series of poor choices will be made.

Another factor which might outweigh all others is the possibility of expanded military conflict over dwindling energy supplies. Serious military conflicts are very inflationary, and in this modern military era, they could be very dangerous for the US. It would be easy to take an anti-war stance, if it could be shown that our standard of living could be maintained.

However, many of the electorate never concern themselves with economic viability. When you ask them how the oats for the racehorse will be produced, they hand you a new set of regulations and higher taxes on the activity in short supply.

Wonk - June 20, 2007