Popular Economics

Promoting a Popular Understanding of Economics

Financial FAQs

What Inflation?

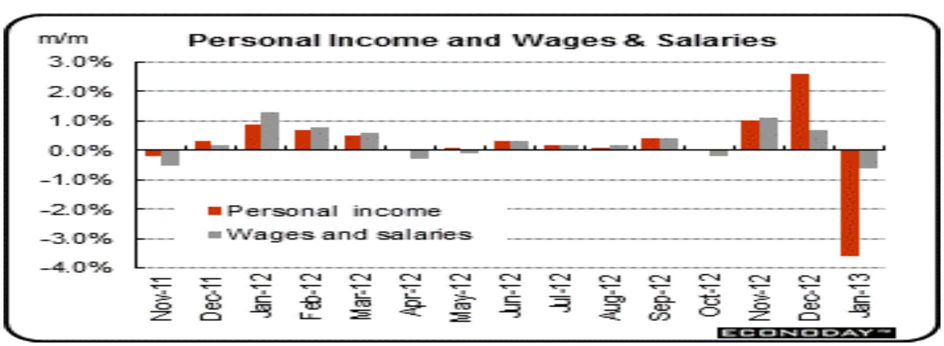
We have seen this before during past budget battles. How much spending is necessary to create future economic growth, and jobs? A corollary is whether the Federal Reserve's current easy credit policy will create runaway future inflation with its Quantitative Easing programs that inject massive amounts of money into the economy.

So is inflation rising or falling? Is it a danger, or is inflation necessary for growth? This is what the whole deficit-debt debate is really about. How much inflation hurts economic growth by eroding spending power (and the value of debt), vs. how much inflation is needed for companies to raise their prices, hence profits.

Graph: WSJ Marketwatch

The Federal Reserve prefers the Personal Consumption Expenditure inflation index, because it measures the widest basket of goods and services purchased by consumers when the Commerce Department calculates the total amount of their personal expenditures.

And it has been less than 2 percent for more than one year. Why? Because consumers cannot afford to spend more when household incomes have barely kept up with inflation. Wages and salaries have become stagnant, in other words, as household earning power has eroded.

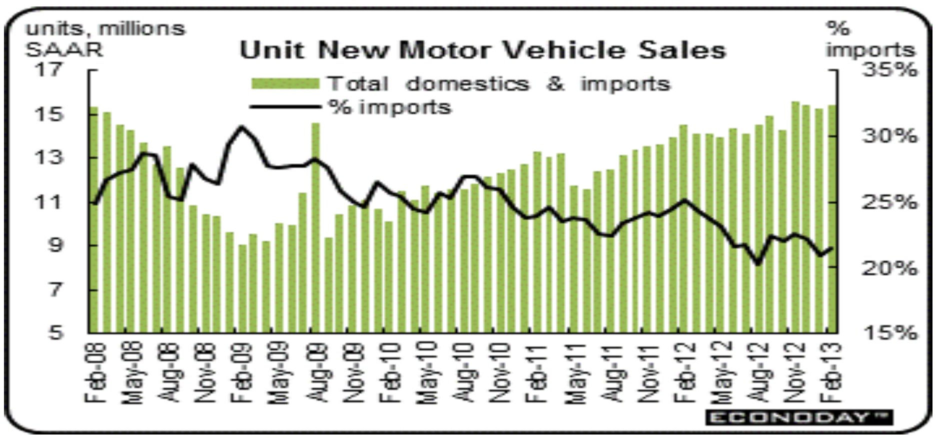


Graph: Econoday

And since consumers power 70 percent of economic activity, and two-thirds of product costs, their spending power is the main determinate of overall prices. But what about raw material costs, such as for oil? Those costs are also dependent on the demand for the finished products they make, whether it is gasoline or animal feed, or plastics.

The inflation debate is really about Federal Reserve policy for the moment. The Fed has said that as long as inflation remains moderate, then it can keep interest rates at record lows. This in turn increases the demand for loans, since cheap money encourages borrowing, and borrowing encourages both spending and investment.

This has boosted vehicle sales, in particular, and brought back Detroit. Motor vehicle sales have been very strong the last four months, above a 15 million annual unit rate compared to low 14 million rates through much of last year.



Graph: Econoday

So we don't have to worry much about much inflation, or the Fed tightening credit soon. This is why they have focused on the unemployment rate being 6.5 percent or lower before tightening begins. Another historical correlation of inflation has been full employment, and historical unemployment fell to between 4 to 5 percent before that happened.

In fact, past administrations have tolerated up to 8 percent inflation rates in order to bring back full employment. Today, 5-6 percent unemployment could be tolerated without much damage to consumers' spending power. And it should be tolerated, if that gets US back to full employment.

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