The Facts of Life

As a parent, you know that someday your child will come to you and ask, “Where do babies come from?”

Most advisors know that someday a client will ask, “Where does inflation come from?” It can be challenging answering “the (economic) facts of life”.

The answer to the inflation question can sometimes be illustrated by looking at the extremes, and today’s extreme on the inflation front comes from Zimbabwe, where prices are doubling every month. This means that in just six months, gas at $4.00 per gallon would climb to $128.00 per gallon!

So why is this happening? Is it due to rising commodity prices or rising wages? No. Zimbabwe is experiencing “hyperinflation” because the government is printing money to meet its payroll. They have printed so much money that it has become virtually worthless.

In my college economics class, I remember studying the inflation that ravaged Germany following both world wars. I still see the picture of a woman in a tattered dress navigating a wheelbarrow full of the millions of currency (German Marks) needed to buy a single loaf of bread.

As Milton Friedman, noted economist taught, inflation is everywhere and always a monetary phenomenon. The only way inflation can exist, let alone expand, is if a central bank or government prints more money than the economy needs. Of course, this begs the next question, “What determines the need for money?” The answer is the increase in goods and services.

If the money supply grows faster than the growth rate in goods and services, then the value of money will decline. Inflation is simply defined as too much money chasing too few goods and services.

Brian S. Westbury, Chief Economist for First Trust, provided this example: “Imagine an economy with 10 apples and a money supply of $10. Each apple will cost $1. If the money supply were increased to $20, then the price of each of the apples would rise to $2 each (inflation). Now, if you increased the apple supply to 20 apples, and the money supply to $20, then each apple would cost $1 each.”

Rising oil and food prices by themselves are not inflation. Remember, as long as the money supply does not increase, then any increase in spending on oil or food would be offset by a decline in demand for other goods, such as autos. The prices of other goods would have to fall; the overall price level (think apples) would remain unchanged.

The European Central Bank, (the ECB is Europe’s version of our Federal Reserve) understands this economic fact of life. By law, the ECB has a single mandate for monetary policy. This mandate is “price stability” (translation – low inflation).

Contrast this single mandate to the “dual mandate” of our Federal Reserve. Congress says the Fed must promote “price stability *and* maximum employment”. Doesn’t this dual mandate seem conflicting? In fact, the more the Fed focuses on employment and economic growth, the higher the likelihood that commodity prices (oil) will rise, thus leading to a rise in inflation.

Will the Federal Reserve increase the supply of money, risking price increases (inflation) or will the Fed raise the interest rates, to cool the economy and reduce the risk of inflation?

I think it would be easier to answer the question about where babies come from.

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