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The Fed on the Cusp of Worldwide Inflation

By Ronald McKinnon

What do the years 1971, 2003, and 2010 have in common? In each case, an easy U.S. monetary policy was accompanied by a weakening dollar—as with the dramatic Nixon shock of August 1971 when the other industrial countries were all forced to appreciate against the dollar. In all three cases, low U.S. interest rates and the expectation of further dollar depreciation led to massive "hot" money outflows from the United States. The world, then as now, is on a dollar standard where most goods entering foreign trade are invoiced in dollars. Thus in all three cases, foreign central banks intervened heavily to buy dollars to prevent further appreciations and losses of international competitiveness against their neighbors.

When any central bank on the dollar standard's "periphery" issues base money to buy dollars, domestic interest rates are forced down and domestic inflationary pressure is generated. It may try to sterilize this monetary expansion and/or impose controls on capital inflows, but these measures are hard to enforce. In the monetary expansion of the 1970s, the pre-euro countries of Western Europe plus Canada and Japan were the relevant periphery, whereas today it is more the high-growth emerging markets of Asia (think China, India, and a host of smaller countries) and Latin America (think Brazil, Mexico, and so on). If most peripheral central banks expand simultaneously, the result is generalized worldwide inflation.

Primary commodity prices register enhanced inflationary expectations more quickly because speculators can easily bid for long positions in organized commodity futures markets. Excluding oil, Figure 1 shows the surge in the dollar prices of primary commodity prices in 1971-73 coincident with, and following, the anticipated Nixon shock of 1971. Figure 1 also shows the initial

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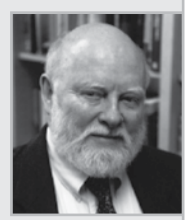
About the Author



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His fields of interest are international economics and development finance. McKinnon has written more than 100 articles and several books, which include *Money and Capital in Economic Development* (1973); *Money in International Exchange: The Convertible-Currency System* (1979); *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy* (1993); *The Rules of the Game: International Money and Exchange Rates* (1996); *Dollar and Yen: Resolving Economic Conflict Between the United States and Japan (with Kenichi Ohno)* (1997); and *Exchange Rates under the East Asian Dollar Standard: Living with Conflicted Virtue* (2005).

His books have been translated into many European and Asian languages, and he has been a consultant to central banks and finance ministries the world over including international agencies such as the World Bank and International Monetary Fund.

commodity price surge during the Greenspan-Bernanke shock of 2003-04, when the federal funds interest rate was reduced to an unprecedented low of just 1 percent followed by a falling dollar (with U.S. government encouragement).

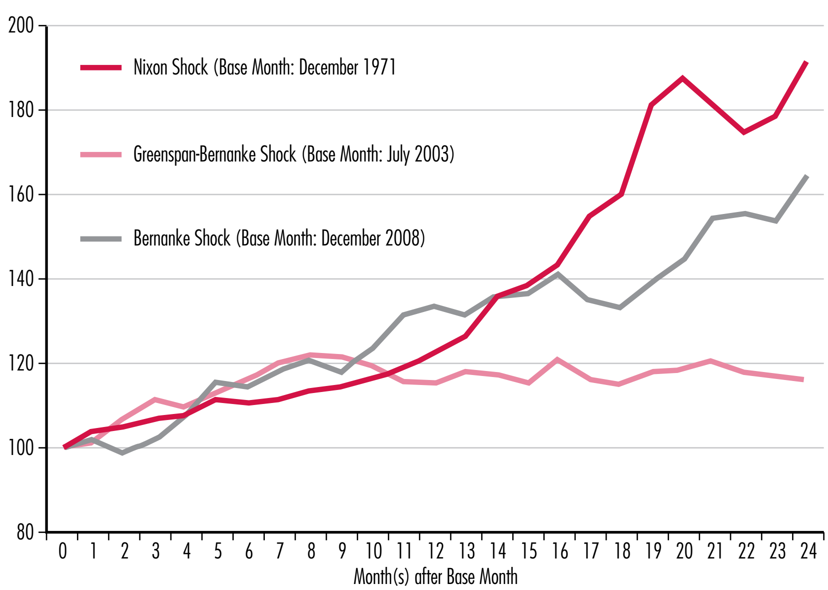
Now with the Bernanke shock, where the Fed has set U.S. short-term interest rates at essentially zero since September 2008 followed in 2010 by QEs1&2 to drive down long rates, Figure 1 shows primary commodity prices in 2009-10 surging once again. Just in 2010 alone, all items in *The Economist's* dollar commodity price index rose 33.5 percent, while the industrial raw materials component soared a remarkable 37.4 percent. As of February 2011, both these annualized increases were greater than 40 percent.

The longer term inflationary and economic consequences over the next decade of this most recent U.S. loose money shock remain to be seen. But we can glean useful hints by looking at the aftermaths of the two earlier shocks. In the 1970s stagflation, CPI inflation combined with cyclical bouts of unemployment and wide swings in exchange rates, seemed intractable. Productivity growth in the mature industrial countries fell sharply.

A necessary but savage disinflationary policy in the early 1980s, where Fed Chairman Paul Volcker imposed extremely high interest rates (the Fed funds rate touched 22 percent in July 1981), ultimately succeeded in killing the inflation and inflationary expectations. With credibility in U.S. long-run monetary policy restored, hot money, which had flowed out in the inflationary 1970s, came back with a vengeance. The dollar soared in the foreign exchange markets and became extremely overvalued by the end of 1984. To prevent even more precipitous depreciations of their currencies, foreign central banks were forced to sell dollars and let their domestic money supplies contract. At the storm's center, the combination of high interest rates, high dollar, and large Reagan fiscal deficits caused a sharp increase in the U.S. trade deficit—mainly in manufactures. The upshot was the worldwide recession of 1982-03 and the creation of America's "rust bowl," particularly in the industrial belt of the Midwest.

The Greenspan-Bernanke interest rate shock of 2003-04, followed by a weakening dollar into the first half of 2008, created what became known as the "bubble" economy (Figure 2). Primary commodity prices began rising significantly in 2003-04, then flattened out before spiking in 2007 into the first half of 2008 (Figure 2). But the biggest bubble in economic terms was in real estate—both commercial and residential. With low mortgage rates of interest and no restraining regulation on mortgage quality, average U.S. home prices rose more than 50 percent from the beginning of 2003 to the middle of 2006. This

FIGURE 1.
Selected Monetary-Exchange Rate Shocks on Commodity Prices



Source: CRB Spot Index (excluding oil). All prices in dollars.

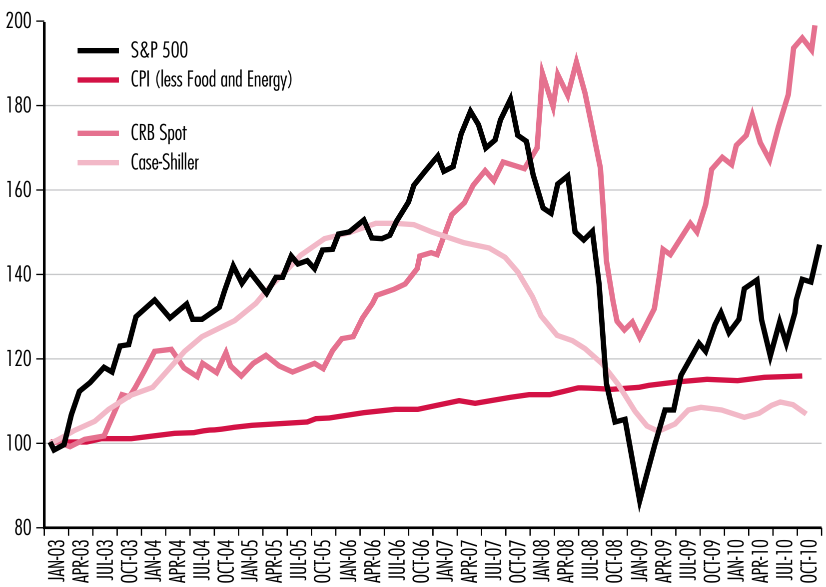
led to an unsustainable building boom—with echoes around the world in such countries as the U.K, Spain, and Ireland. The bubbles in primary commodity prices collapsed mainly in the second half of 2008. But the residue of bad debts, particularly ongoing mortgage defaults, led to the banking crisis and global downturn of 2008 into 2009—all too painfully well known.

So what lessons can we draw from these episodes of U.S. easy money cum weak dollar for the stability of the American economy itself?

First, sharp general price increases in auction-market goods such as primary commodities or foreign exchange, i.e., a weakening dollar, are a useful early warning to the Fed that it is being too easy—a warning that the Fed is again ignoring as we enter 2011.

Second, beyond the rise in primary commodity prices, general price inflation in the United States only comes with long and variable lags. After the U.S. monetary shock, hot-money flows into countries on the dollar standard's periphery cause a loss of monetary control and general inflation to show up there relatively quickly. In 2010, CPIs have shot up more than 5 percent in major emerging markets such as China, Brazil, and Indonesia, while the CPI in the United States itself rose only 1.5 percent. Similarly, after the Nixon shock of 1971, there was much more explosive inflation in Japan in 1972-73 than in the United States. But by December 1979, inflation in America's producer and consumer price indexes was more than 13 percent.

FIGURE 2.
The Greenspan-Bernanke Bubble Economy



Source: Bloomberg and Federal Reserve Economic Data.

Developing countries or "emerging markets" on the dollar standard's periphery are much more sensitive (than mature industrial economies) to sudden escalations in the price of food. Their per capita incomes are lower, and food is naturally a higher proportion of their consumption baskets. Thus the 39 percent increase in primary product food prices over the past year through January 2011 shocks their political systems, which become more febrile and more vulnerable to other sources of discontent—now so visible in the Arab world in North Africa and elsewhere.

The United States is a sovereign country that has the right to follow its own monetary policy. By an accident of history, however, since 1945 it is also the center of the world dollar standard—which remains surprisingly robust to the present day. So the choice of monetary policy by the U.S. Federal Reserve can strongly affect its neighbors for better or for worse.

Beginning with the Nixon shock in 1971, American policymakers have frequently ignored foreign complaints. But by ignoring inflationary early-warning signals on the dollar standard's periphery, with eventual lagged feedback effects into the U.S. price level or further asset bubbles, the Fed has made both the world and American economies much less stable.

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