



October 8, 2008, 3:20 pm

Don't Worry About Inflation Accelerating

By [Bob McTeer](#)



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The Federal Reserve has played whack-a-mole in its efforts to hold back the financial tsunami engulfing the United States and now the world. After an aggressive easing of traditional monetary policy (reducing the target federal funds and discount rates), it then invented and implemented a series of special auction facilities featuring relaxed terms and collateral requirements. These have recently been expanded further. Then only Tuesday it announced that it would try to unfreeze the commercial paper market by lending directly to corporations. Wednesday morning it announced a half-point cut in the federal funds and discount rates coordinated with the European Central Bank, the Bank of England and several others.

In a posting in my other [blog](#) Tuesday, I urged the Fed to do exactly what it did, not so much because it would do much good in the United States, which has already reduced rates substantially, but because it would give the E.C.B. cover to cut its rate. I'm reminded of a Vince Gill lyric, "Give me one more last chance before you say we're through."

The question I address here, however, is how can so much liquidity added to the financial system over the past year not cause inflation to accelerate beyond current levels?

The main way the Fed has injected liquidity is through the "discount window," through which financial institutions borrow money from the Fed, usually on a short-term basis. The funds made available to the markets through the discount window, though, have been offset by open market operations, whereby the Fed buys or sells (in this case, emphasis on "sells") government securities. Open market sales of government securities have neutralized, or sterilized, the monetary impact of the lending by taking some money out of circulation. The result has been a redistribution of liquidity rather than large net additions to liquidity.

This conclusion is supported by the slow-to-moderate growth over the past year in the monetary base (currency plus bank reserve deposits) and various measures of the money supply. Most economists agree with Milton Friedman's famous dictum that in the long run, "inflation is always and everywhere a monetary phenomenon."

Over the year through Sept. 10, the monetary base has grown less than 3 percent and bank reserves have grown about 4 percent. Most measures of the money supply have also grown moderately over the past year (the exception being an obscure measure of money called MZM, or "[money with zero maturity](#)"). A caveat: After Sept. 10, a large spike occurs in most of the monetary aggregates, presumably because discount window loans haven't yet been neutralized by open market operations.

From the Fed's viewpoint, its increased lending to banks has been substantially offset by a reduction in its holdings of government securities. Its ability to make credit available is virtually unlimited since, as a central bank, it creates new reserves and money in the process. Its credit creation is not limited by the size of its balance sheet.

The assets on the Fed's balance sheet are relevant, however, to the Fed's ability to neutralize or sterilize the creation of credit. The Fed cannot sell securities on the open market if it doesn't have any securities left to sell. Because of this constraint, the Treasury recently agreed to issue more securities than were needed, to be held in a special account in case the Fed needs them for open market sales.

Using interest rates rather than the money supply as the measure of monetary policy does not change my conclusion that recent Fed actions aren't likely to lead to accelerating inflation.

Recently, we've seen the reverse of our experience when the target federal funds rate — the interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight — was raised from 1 percent to 5.25 percent and long rates never increased. The recent reduction from 5.25 to 2 percent (to 1.50 percent this morning) has likewise not been accompanied by comparable declines in long-term rates, especially mortgage rates. In other words, in terms of potential inflationary impact, the interest rates that matter most have not declined.

Even if money growth had been faster and long-term interest rates lower than they have been, I doubt that inflation would accelerate under present circumstances of slowing economic growth and the freezing up of credit markets. In my opinion, a deceleration of inflation is more likely than acceleration, and the decline in oil and other commodity prices may be the early signs of disinflation. The Fed seems vindicated in its belief that the weakening economy would help restrain inflation while it concentrated on actions to unfreeze credit markets and sustain the real economy.