What to Do About Inflation

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Global Research, February 17, 2022

Region: USA
Theme: Global Economy

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Americans live from threat to threat. Now that the "covid threat" and the "Russian threat" have played out, we have the "inflation threat," but is it any more real?

It is true that the Central Bank has poured out unprecedented amounts of money for more than a decade. The excuses were: to cause a 2% annual inflation that would stimulate economic growth, and to save the economy from the banks financial speculations.

I didn't think the Federal Reserve could create so much new money without driving up inflation and interest rates and driving down the dollar and equities. But the money went into the prices of financial assets–stocks and bonds–and into home prices. If you were loaded up with stocks and bonds and residential real estate, the Fed made you rich. The money also went into bank reserves as the Fed bought troubled assets from the banks and put them in the Fed's portfolio.

So the expected inflation in consumer goods and services did not occur.

Now suddenly here is inflation with some measures knocking on double-digit doors. Judging by high stock and bond prices, this is not inflation from previous money-printing being drawn out of stocks and bonds to spend on consumer goods. Some claim that the checks sent to locked-down people to substitute for missing pay checks are at fault, but this money, at best, only replaced the money in the missing pay checks.

So what is the cause of the inflation? Or, more precisely, is it really inflation, that is, prices driven up by excessive spending, or is it a reduction of supply in relation to demand? If the latter, the solution is to increase supply, not reduce demand with higher interest rates or higher tax rates.

The better part of the rise in prices is the direct result of the foolish and counterproductive lockdowns. The lockdowns reduced supply. Much work came to a halt. Supply chains were adversely impacted. Many businesses failed and have not reopened. Real GDP declined, but money didn't.

With the flow of goods and services reduced while money wasn't, prices rose. Many service businesses, such as pool services, heating and air, jumped at the chance to raise prices. Supermarkets have to bid for items in short supply, and this has pushed food prices up.

Other idiotic policies of governments, such as vaccine mandates for truckers, have tied up delivery trucks in protests. The California governor banned half of the US trucking fleet from entering the state, because it doesn't meet emission standards. This means the docks at the ports can't be unloaded, which means the ships waiting to unload can't unload.

The fake "Russian threat" sent up the oil prices. The extraordinarily low interest rates caused a house building boom, driving up prices of construction materials.

Equity valuation driven by money creation is not a good thing. But the Fed has been at it for so long, how does the Fed stop without unwinding values based on Fed liquidity? Washington's abusive misuse of the dollar as reserve currency by imposing sanctions on other countries has led to Russia and China organizing their own system of international payments. This will cause the use of dollars, and therefore the demand for dollars to drop, leaving the Fed with the problem of dollar depreciation, which will add to inflation. A less valued dollar raises import prices.

To sum up, the sources of today's rising prices are three. The Fed quantitatively eased to save the banks and went on from there to make the rich richer by driving up stock, bond, and real estate prices, and rents rose with real estate prices. Washington undermined the dollar by discouraging countries from its use with sanctions. The lockdowns shrank supply and set back the ability to produce, resulting in supply and demand sending prices up.

The solution to this problem is not higher interest rates. There is no doubt that interest rates are artificially low because of the Fed's bond purchases, but raising interest rates will not repair the damage to supply caused by the lockdowns and caused by the financialization of the economy that the Federal Reserve has aided and abetted.

A financialized economy is one in which debt service–mortgage, car, credit card, student loans–uses up a large percentage of monthly income, leaving little discretionary income to drive economic growth. Financialization was worsened by the repeal of the Glass-Steagall Act. The repeal permitted commercial banks to be investment banks. This changed the nature of bank lending and behavior. Instead of lending for new plant and equipment, the banks finance takeovers of existing assets and engage in financial speculation.

The solution to the causes of the current inflation is to remove the policies that restrain the growth of output. There has to be a supply-side solution. In the early Reagan years the solution was a reduction in the high marginal tax rates that restricted output. Today the supply-side solution is policies that move the economy away from the absorption of income in debt service and toward supporting the expansion of output.

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