Counterpoint: At least I am "Popular"........

Our most recent Economic Commentary, "The Ultimate End Game?" (April 28, 2011), [attached] starts by quoting a "Popular Pundit" as saying: "There are only two ways to solve a debt Crisis: Default or Inflation".

I take great pride in the fact that at least I am "popular", notwithstanding whether this was meant as a compliment.

Nonetheless, I would like to briefly comment on the thesis that the FED either cannot or will not employ inflation as a policy tool to resolve the debt crisis.

The Bloomberg "debt dynamics" equation is introduced at the outset as the foundation to the notion that "Anticipated Inflation" cannot reduce the Debt to GDP ratio; therefore, any attempt to use inflation as a policy tool would be futile. However, this "closed form" three-factor analysis is only viable in the classroom as it ignores the underlying reality of the FED's plan. This analysis assumes a sentient population acting rationally during a systemic inflation <u>on a linear basis</u>. However, our tax system is NOT linear, it is progressive. As such, higher nominal incomes will be taxed at an increasingly higher rate. This has the effective of raising the "real taxes paid" and will silently shrink the budget deficit. This is an intentional design flaw. Doubt that? Look at the increasing proportion of middle class taxpayers now caught in the AMT net. In fact, the expansion of AMT coverage is one of the critical assumptions that keeps the deficit in the out years from exploding even further.

Vastly more important is that FED induced inflation resolves the largest problem facing the economy, specifically, the housing market. Presently, housing is a dead weight upon the system because it is the largest asset most people own and its value continues to decline. And since this asset is now "under water" for many in the middle class, it acts as a major drag on both cash flow and wealth effect spending. With a Case-Schiller "real housing price" index still about 20% above its 120-year average, housing must be the focus of the FED's efforts.

While most homeowners would never by stocks on margin, they have no problem buying a house at the standard five to one (80% LTV) leverage ratio. This is where FED induced inflation becomes effective. A sprinkling of FED inflation will quickly reduce the 20% overvaluation of housing in REAL TERMS, even as nominal prices languish. Moreover, since the debt owed is "nominal" and the asset owned is "real", inflation pours some gasoline on what is effectively a five to one levered "TIPs trade". And since most mortgage debt is self-amortizing, the critical Bloomberg formula notion that the rollover cost of debt will move in lock step with inflation is rendered moot.

Another concept I refute is that the FED cannot "fool the market" and that rates will rise to offset the purchasing power loss via inflation. Who said the FED wants to fool us. As a matter of fact, I am not sure they can state more clearly that they want inflation. Moreover, they can force the market to accept negative real rates just by keeping the Funds Rate below the inflation rate. While the Yield Curve may hyper-steepen, until the FED raises rates, the front-end will trade freely at negative real yields as "roll down hogs" employ the carry trade. And while Regulation Q is correctly identified as a market distorting factor in the 1970s, we have a new Reg Q, specifically, the FED Funds rate pegged at a negative real rate for an extended period.

As to the notion that the Bond Vigilantes will step up and force the FED's hand, this too is suspect. While forty years ago most investors allocated capital to find the highest after tax return that hopefully retained their "real purchasing power", today the marginal buyer is an Index manager or a Foreign Central Bank. The former is indifferent to the "real return" he produces since he is compensated on a relative basis, not an absolute one. The latter investor is also none to concerned about his rate of return since the overwhelming mandate of these investors has to do with managing bilateral trade balances and the relative terms of trade between exporting and importing countries.

The motivations of the FED are also subject to debate. The fact that the LSAP (QE) program would theoretically lower rates at most by 50bps is almost irrelevant since the FED was hunting bigger game. Classic Monetary Theory states that M*V = P*Q = GDP where M = Money supply, V = Velocity, P = Price, and Q = Quantity. The massive delevering of the economy after the Lehman meltdown slowed Velocity to a crawl. In order to not have a commensurate contraction in GDP, the FED had to increase the money supply. But just adding Money was not enough since that would not reverse the course of Velocity. That is why the combination of the ZIRP and LSAP eventually forced a massive "Asset Substitution". Hence, the 85% increase in the S&P from the March 2009 lows and a new record in the Russell 2000. In short, the goal of the FED is not to lower Rates, their typical monetary lever, but rather to increase Velocity.

Finally, why must we make the core assumption that an "Independent FED" would never utilize inflation as a policy tool? Why is it assumed that economists have pure intentions while the political class cannot be trusted? I would propose that an independent FED can desire inflation as much as politicians do, but in a wholly separate manner. Our last FED chairman advocated massive tax cuts and minimal regulation based upon an almost religious belief in the gospel of Ayn Rand. The fact that this aligned hand in glove with core Republican ideology was purely coincidental.

Just to be clear, the FED is does not have the desire or intention to go down the path of Rudolf von Havenstein and create Weimar style hyper-inflation, but a 4% to 6% inflation rate for two to four years would significantly improve our situation. And I do not believe that this sort of outcome would seriously damage the FED's long-term credibility or independence.

At present, this FED seems to be the only "adult" in the room, at least with respect to taking positive actions to mend the economy. Their good cop::bad cop voiced to the media has been quite effective in creating the illusion of Hawkishness while the printing presses are quietly humming.

For the record, I am not saying that inflation is good or will solve our problems. On the contrary, it will harm the great middle class of the country. That said, it is the least bad of all of our options. Just as a limb that is frostbitten may need to be amputated, so must we have inflation as the best solution to delever the excessive debt we have accumulated over the past twenty years.

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