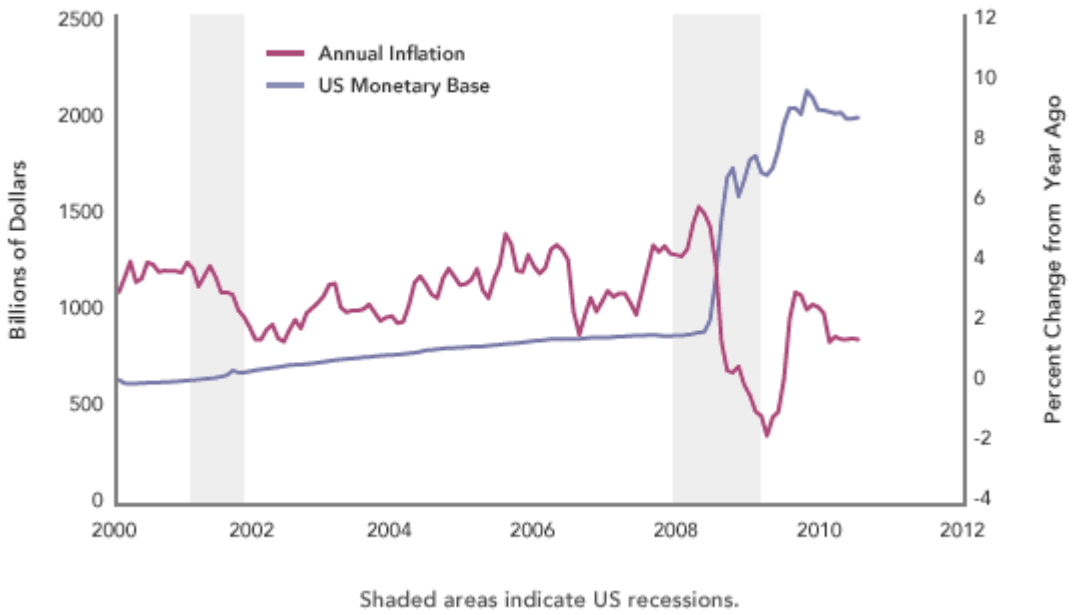
Does Monetary Expansion Stoke Inflation?

Since the financial crisis hit in late 2008, the US monetary base has more than doubled, from about $800 billion in mid-2008 to about $2 trillion in November 2010.[1] When the Federal Reserve announced a second round of quantitative easing (QE2), it raised investor concerns that such actions would stoke inflation.

The chart below shows that the US monetary base has spiked since 2009. While inflation has fluctuated considerably, it has not tracked the changes in the monetary base. Although no one can reliably forecast inflation, we think markets do a pretty good job of sorting through all the macroeconomic data. At present (mid December), the markets do not appear to reflect expectations of runaway inflation in the near future.[2]

US Monetary Policy since 2000

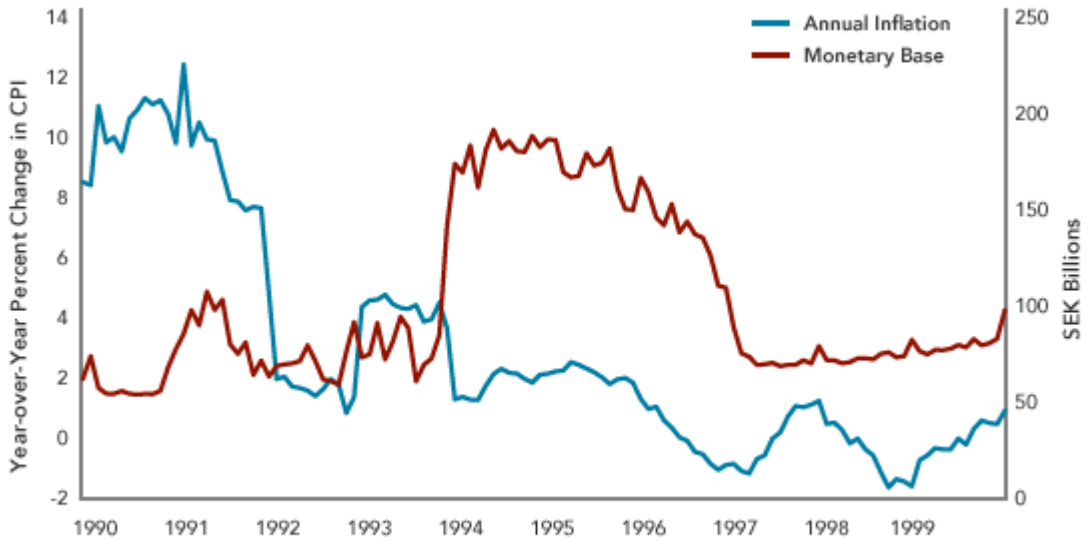


Source: Federal Reserve Board

Nevertheless, investors may be growing anxious in response to media coverage of the Fed's continuing expansionary policy. For those who are certain QE2 will be inflationary, perhaps the recent example of Sweden's monetary base run-up will offer some reassurance.

In the 1990s, Sweden's central bank, the Riksbank, more than doubled the country's monetary base during the Nordic banking crisis, but inflation remained moderate during and after the expansionary period. The graph below documents that even as the monetary base jumped from 1994 to late 1996, inflation did not follow suit, and in fact, remained flat before falling in 1996.

Swedish Monetary Policy in the 1990s



Source: Sveriges Riksbank

Sweden's monetary base expansion is one of several international examples of quantitative easing over the past two decades. These case studies, which include past expansionary periods in the UK, Switzerland, Japan, Australia, New Zealand, and Iceland, are discussed in a recent Federal Reserve Bank of St. Louis review.[3] The researchers concluded that doubling or tripling a country's monetary base does not lead to high inflation if the public views the increase as temporary and expects the central bank to maintain a low-inflation policy.

Of course, many factors may come into play, and we cannot know whether the US will share the same fortune. But at least we know that quantitative easing has occurred without triggering high inflation.

1. Monetary base is the total amount of the liquid currencies circulating in the hands of the public, deposits in financial institutions, and the deposits of the commercial banks in the central bank of the respective country.

2. One indicator of expected future inflation is the difference in rates between US Treasury bonds and Treasury Inflation Protected Securities (TIPS), also known as the TIPS spread. As of December 16, the 10-year zero-coupon TIPS spread was 2.35% (http://www.federalreserve.gov/econresdata/researchdata.htm). Consider, however, that the spread also includes an inflation risk premium, so the spread is not an exact measure of the market's inflation expectations.

3. Richard G. Anderson, Charles S. Cascon, and Yang Liu, "Doubling Your Monetary Base and Surviving: Some International Experience," *Federal Reserve Bank of St. Louis Review* 92, no. 6 (November/December 2010): 481-505.