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THE PRESIDENT HAS SEEN....

Don R.

Sowing the seeds of more world inflation

Economic recovery may set off another bout of double-digit inflation

When the world's central bankers and finance ministers meet in Washington next week at the annual International Monetary Fund Conference, concern is sure to center on the dangers of a renewed burst of world inflation that may accompany the world's economic upturn. At the heart of their worries will be the growing realization that the world's money supply, and therefore to a large extent the world's price level, is no longer fully under their collective control. Moreover, even with today's system of floating exchange rates, no country can completely protect itself from another bulge in the price of commodities traded on international markets, a bulge that would be part of any widespread surge in inflation.

"Collective control over international liquidity is one of the conditions for successfully fighting worldwide inflation," says Otmar Emminger, vice-chairman of the German Bundesbank. "But we do not have any real control over international liquidity," he admits. "If the system is elastic, and international reserves are created just according to needs, then there is no brake on inflation." And noted international monetary economist Robert A. Mundell of Columbia University warns, "The build-up in international money that is going on now will be inflationary in a year or two. The cost of recovery will be inflation."

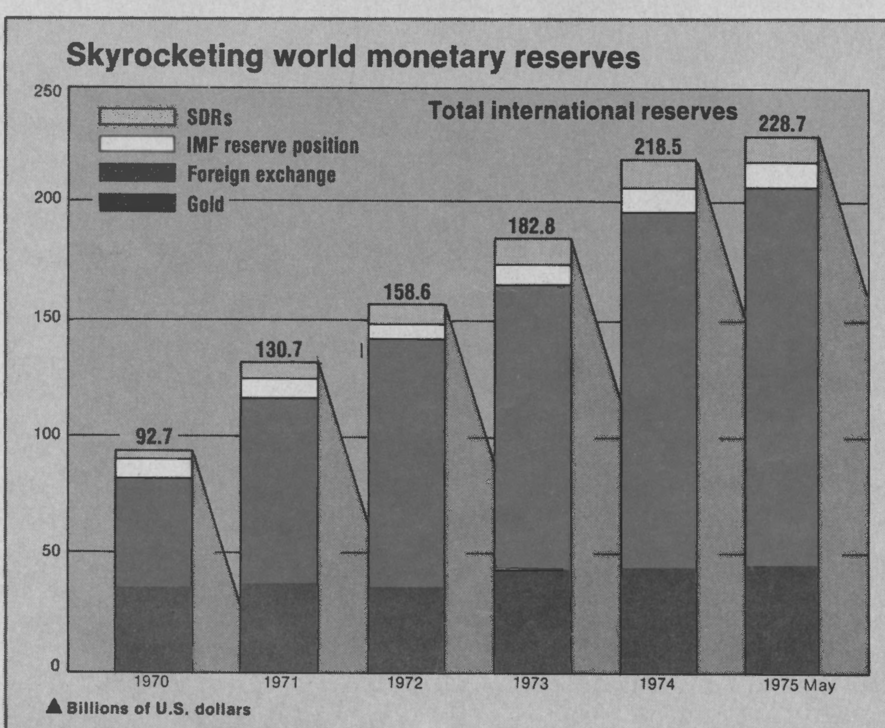
Many international financial experts and economists share Emminger's and Mundell's alarm. And, while few economists argue that the current burst of double-digit inflation will persist through the remainder of 1975, they point to several factors that may lead to a more prolonged double-digit inflation that will start within the next two years:

- There is no effective control over the creation of international reserves—the raw material from which the world banking system manufactures money. The world's reserves have more than doubled since 1970 and, while the growth has moderated somewhat in response to worldwide recession, it is still increasing at a vigorous 10% annual rate—quadruple the rate of the 1960s.
- Record government deficits in the U.S., Europe, and Japan will increase pressures on central bankers to speed the growth of their money supplies.
- Growth in the Eurocurrency market, which came to a standstill last year, has resumed, adding to the liquidity of international money markets.
- Gold reserves may be revalued upward to market prices, which are now nearly four times the official price of $42.20 per oz. That would increase bank reserves by $150-billion and could free gold for use in official international transactions.

Ominous signs. Gerard Villa, economics professor at Belgium's Lovain University and director of Euro-Prospect, a European forecasting group, sees the present build-up in the world's money supply as "the seeds of the hyperinflation of 1978. It's a treacherous process because you don't see the price effect of money supply growth for two years," he adds. Support for Villa's view on the role of world money comes from Michael Keran of the Federal Reserve Bank of San Francisco. Keran shows that increases in world money had a sharp impact on the domestic inflation rate for the world's economies. And even in the U. S., the least open of economies, he finds that increases in international reserves played a significant role in raising prices.

There is good reason to believe that world money will continue to show sharp increases. Governments face budget deficits that must be financed despite already high interest rates. In Germany, for example, the deficit is projected at $24-billion, or 5% of Germany's gross national product, proportionately as large as the record $69-billion deficit projected for the U. S. Japan and the Netherlands are expected to show similarly high red-ink numbers, while Belgium and Britain plan to tap the markets for loans equal to 10% of their GNPs. And if the past is any guide to the future, a good part of this debt will be monetized, creating a flood of new money. Germany's Bundesbank, for example, has already been forced to buy a record amount of government bonds in an unsettled market.

To be sure, almost no one expects a replay of the monetary and price explosions of the past few years. Much of the blame for the explosion in world prices that peaked in 1974 is attributed by monetary economists to a series of events surrounding the breakdown of the international monetary system. Between 1968, when the U. S. abandoned the gold standard, and March, 1973, when the ill-fated attempt to maintain a beleaguered system of fixed exchange rates collapsed, central bankers bought billions of dollars in an attempt to keep their currencies pegged to the dollar. As a result, holdings of foreign exchange reserves quadrupled. That unprecedented rapid expansion of reserves led to huge in-

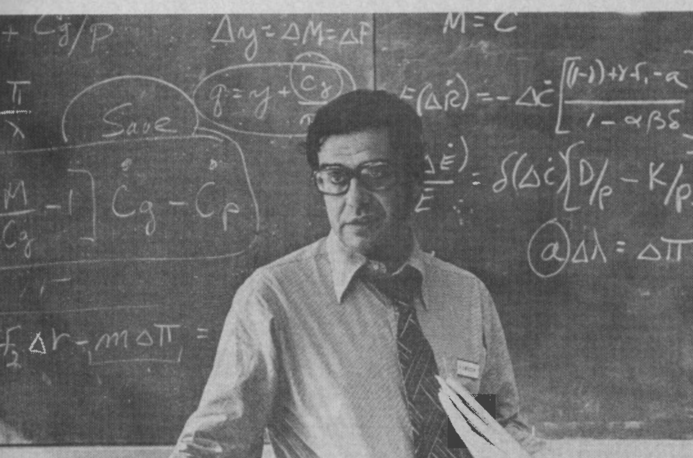


Mario De Vincentis—BW

Data: International Monetary Fund

creases in the money supplies of all countries and the worldwide boom and run-up in prices that was well under way before the oil producers jacked up the price of oil. Now that exchange rates are floating, central bankers are no longer forced to buy dollars.

What is more, the trauma of double-digit inflation has left an indelible imprint on politicians and government officials. The cost of fighting this inflation has been high—the worst recession in 40 years. "But I see a higher awareness and sensitivity to the dangers of inflation at the Fed and in Europe," says William E. Gibson, vice-president and economist at Chase Manhattan Bank. "Political pressures themselves are becoming a powerful discipline on monetary authorities."



Fred Mayer

Alexander Swoboda says expansion of the U. S. money supply has greater impact than similar expansion abroad.

As a result, Gibson and other economists are optimistic about the inflationary outlook for the near term. "There will not be much bang in prices for the next two years," says Keran. "But after that, it is an unknown—it depends on how the world pulls out of the recession."

U. S. impact. To some economists, the U. S. Fed holds the key to what happens to world money. Studies by Alexander K. Swoboda of the Graduate Institute of International Studies at Geneva indicate that expansion of the U. S. money supply has a much greater impact on the world than similar expansion abroad. A 10% increase in the U. S. money supply alone results in a 4% change in the monetary aggregates of the 10 major countries.

So far the Federal Reserve has shown signs that it intends to keep a lid on monetary growth by holding the growth in the narrowly defined money supply (M_1) at or below the 7.5% target Fed Chairman Arthur F. Burns set as an upper limit early this year. After M_1 exploded at an annual rate of 15% in May and June, for example, the Fed moved aggressively in the money markets to soak up liquidity and brought the growth rate back to zero in July, before allowing a modest expansion during the first half of August.

Out of reach. The real worry, however, springs from the realization that central bankers may be more a victim than a controller of monetary events in the coming years. "Much of the growth in the stock of world money is out of the reach of the U. S. monetary authorities and likely out of the combined reach of all monetary authorities," says Arthur B. Laffer of the University of Chicago.

Laffer points to the $220-billion Eurocurrency market as the prime example. This market is, in effect, a private banking system, based in London but operating around the world. It is a marketplace unto itself, with no reserve requirements and no control by central bankers. The debate still rages as to whether it is merely an intermediary market analogous to the savings and loan industry—matching borrowers and savers but creating no new liquidity—or a fractional reserve banking system, like U. S. commercial banks, that create liquidity by maintaining only fractional reserves. But the evidence is growing that this huge market—equal to roughly four times the money supply of Germany—is an important and independent source of world spending power. The annual increase in dollar balances of London Eurobanks has been as much as 20 times the increase in liabilities they hold in U. S. banks. "The difference is the credit component of the expansion process," says Columbia's Mundell.

An even more compelling study done under Laffer at the University of Chicago indicates that changes in the world money supply are more closely correlated with world inflation and changes in world nominal GNP when Eurodollars and changes in the dollar's exchange rate are included. "There is little doubt that Eurodollar creation and the movement of the value of the dollar on foreign exchange markets have played a growing role in determining world liquidity, and therefore, world inflation rates," concludes Laffer.

Unlocking the gold. An additional potential for inflation is now locked in the vaults of many central banks. IMF rules prohibit the transfer of gold at more than the official price. So, since 1968, when gold's market price began to diverge from the official price, central bankers—with only a very few exceptions—have understandably refused to use their gold in international transactions.

Negotiations to unpeg the price of gold, however, have been underway for a year. And the Europeans, especially the French, are pushing for freedom to transfer gold among central bankers at market-related prices.

Such an agreement would unlock about $200-billion in central bank assets. The increase in central bank liquidity could, all by itself, swamp any efforts made by central bankers to maintain stable prices.

Another possible source of reserve creation—central bank willingness to hold foreign exchange (mostly dollars)—as official reserves, remains unchecked. The quadrupling of the price of oil and the subsequent accumulation of reserves by the oil-producing countries, for example, would normally have forced a reduction in the central bank reserves of the oil-importing countries. Instead, almost half of the oil-producer surplus was financed through new reserve creation via borrowing in the Eurodollar markets.

Keran: 'Not much bang in prices for the next two years. After that, it is an unknown'

Floating rates. International control of domestic monetary policies is further reduced by today's system of floating exchange rates. "In the past, when countries ran into balance-of-payments deficits, they had to contract," explains Allan H. Meltzer of Carnegie-Mellon University. "But now they can devalue, or let their exchange rate float downward, and continue to expand their money supplies."

That option allows countries to pick their own rate of inflation by pursuing independent monetary policies, argues Meltzer. Britain and Australia can have high rates of inflation, while Germany and Japan can protect themselves from excessive monetary growth in the rest of the world.

But there are limits to the protection that even floating rates can provide from any widespread run-up in prices. Domestic markets are still closely linked through world trade and fully integrated capital markets.

So at next week's IMF meeting there may well be efforts to begin new negotiations on a formal, multilateral agreement to control world reserves and money creation. That issue was at the heart of the negotiations to reform the entire international monetary system that were shelved two years ago in the face of double-digit inflation and the fourfold increase in the price of oil. If the world's bankers do not soon come to grips with controlling world money, there may well be a second round of rampant worldwide inflation. ■