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# Why 'Stimulus' Will Mean Inflation

*In a global downturn the Fed will have to print money to meet our obligations.*

Article

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By GEORGE MELLOAN

As Congress blithely ushers its trillion dollar "stimulus" package toward law and the U.S. Treasury prepares to begin writing checks on this vast new appropriation, it might be wise to ask a simple question: Who's going to finance it?



Chad Crowe

That might seem like a no-brainer, which perhaps explains why no one has bothered to ask. Treasury securities are selling at high prices and finding buyers even though yields are low, hovering below 3% for 10-year notes. Congress is able to assure itself that it will finance the stimulus with cheap credit. But how long will credit be cheap? Will it still be when the Treasury

is scrounging around in the international credit markets six months or a year from now? That seems highly unlikely.

Let's have a look at the credit market. Treasuries have been strong because the stock market collapse and the mortgage-backed securities fiasco sent the whole world running for safety. The best looking port in the storm, as usual, was U.S. Treasury paper. That is what gave the dollar and Treasury securities the lift they now enjoy.

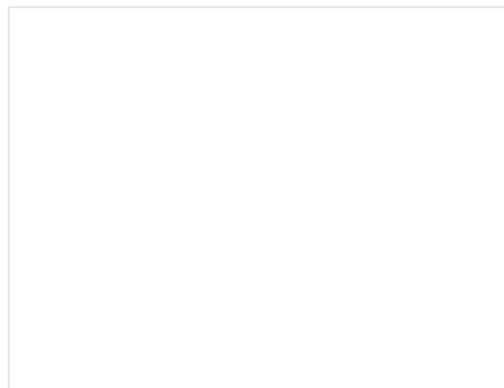
But that surge was a one-time event and doesn't necessarily mean that a big new batch of Treasury securities will find an equally strong market. Most likely it won't as the global economy spirals downward.

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For one thing, a very important cycle has been interrupted by the crash. For years, the U.S. has run large trade deficits with China and Japan and those two countries have invested their surpluses mostly in

U.S. Treasury securities. Their holdings are enormous: As of Nov. 30 last year, China held \$682 billion in Treasuries, a sharp rise from \$459 billion a year earlier. Japan had reduced its holdings, to \$577 billion from \$590 billion a year earlier, but remains a huge creditor. The two account for almost 65% of total Treasury securities held by foreign owners, 19% of the total U.S. national debt, and over 30% of Treasuries held by the



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In the lush years of the U.S. credit boom, it was rationalized that this circular arrangement was good for all concerned. Exports fueled China's rapid economic growth and created jobs for its huge work force. American workers could raise their living standards by buying cheap Chinese goods. China's dollar surplus gave the U.S. Treasury a captive pool of investment to finance congressional deficits. It was argued, persuasively, that China and Japan had no choice but to buy U.S. bonds if they wanted to keep their exports to the U.S. flowing. They also would hurt their own interests if they tried to unload Treasuries because that would send the value of their remaining holdings down.

But what if they stopped buying bonds not out of choice but because they were out of money? The virtuous circle so much praised would be broken. Something like that seems to be happening now. As the recession deepens, U.S. consumers are spending less, even on cheap Chinese goods and certainly on Japanese cars and electronic products. Japan, already a smaller market for U.S. debt last November, is now suffering what some have described as "free fall" in industrial production. Its two champions, Toyota and Sony, are faltering badly. China's growth also is slowing, and it is plagued by rising unemployment.

American officials seem not to have noticed this abrupt and dangerous change in global patterns of trade and finance. The new Treasury secretary, Timothy Geithner, at his Senate confirmation hearing harped on that old Treasury mantra about China "manipulating" its currency to gain trade advantage. Vice President Joe Biden followed up with a further lecture to the Chinese but said the U.S. will not move "unilaterally" to keep out Chinese exports. One would hope not "unilaterally" or any other way if the U.S. hopes to keep flogging its Treasuries to the Chinese.

The Congressional Budget Office is predicting the federal deficit will reach \$1.2 trillion this fiscal year. That's more than double the \$455 billion deficit posted for fiscal 2008, and some private estimates put the likely outcome even higher. That will drive up interest costs in the federal budget even if Treasury yields stay low. But if a drop in world market demand for Treasuries sends borrowing costs upward, there could be a ballooning of the interest cost line in the budget that will worsen an already frightening outlook. Credit for the rest of the economy will become more dear as well, worsening the recession. Treasury's Wednesday announcement that it will sell a record \$67 billion in notes and bonds next week and \$493 billion in this quarter weakened Treasury prices, revealing market sensitivity to heavy financing.

So what is the outlook? The stimulus package is rolling through Congress like an express train packed with goodies, so an enormous deficit seems to be a given. Entitlements will go up instead of being brought under better control, auguring big future deficits. Where will the Treasury find all those trillions in a depressed world economy?

There is only one answer. The Obama administration and Congress will call on Ben Bernanke at the Fed to demand that he create more dollars -- lots and lots of them. The Fed already is talking of buying longer-term Treasuries to support the market, so it will be more of the same -- much more.

And what will be the result? Well, the product of this sort of thing is called inflation. The Fed's outpouring of dollar liquidity after the September crash replaced the liquidity lost by the financial sector and has so far caused no significant uptick in consumer prices. But the worry lies in what will happen next.

Even when the economy and the securities markets are sluggish, the Fed's financing of big federal deficits can be inflationary. We learned that in the late 1970s, when the Fed's deficit financing sent the CPI up to an annual rate of almost 15%. That confounded the Keynesian theorists who believed then, as now, that federal spending "stimulus" would restore economic health.

Inflation is the product of the demand for money as well as of the supply. And if the Fed finances federal deficits in a moribund economy, it can create more money than the economy can use. The result is "stagflation," a term coined to describe the 1970s experience. As the global economy slows and Congress relies more on the Fed to finance a huge deficit, there is a very real danger of a return of stagflation. I wonder why no one in Congress or the Obama administration has thought of that as a potential consequence of their stimulus package.

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Mr. Melloan is a former deputy editor of the Journal's editorial page.

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