Written by **Denise Behreandt** on August 6, 2007

The Specter of Inflation

At a conference on April 16, Richard Fisher, president and chief executive officer of the Federal Reserve Bank of Dallas, warned that the U.S. economy could be facing trouble in the future. "According to official government reports," cautioned Fisher, when it comes to wealth transfer programs including Social Security and Medicare "the gap between what we will take in and what we have promised to pay — now stands at $83.9 trillion."

That's a tremendous amount of money, and it points to a problem lacking easy solutions. Says Fisher: "The potent combination of lower birthrates, higher medical costs and longer life expectancies provides little reason to hope that the figure will fall." In other words, under present circumstances, the problem is only going to get worse.

The problem comes from massive wealth transfer programs that promise more than we — meaning the government — can pay over the long-term future. This suggests that the government will come under tremendous pressure to find a solution when constituencies expect those pay-outs. The pressure, says Fisher, will be on the Fed to monetize the debt (print new money to pay the liabilities). "When fiscal policy gets out of whack, monetary authorities face pressure to monetize the debt," Fisher warned in April. The number of Americans expecting entitlements is growing, and there is not enough monetary compensation to cover this shortfall. But is monetizing the debt the solution? Not to Fisher. It is "a cardinal sin in my mind," he said. Although monetization may seem to provide the simplest solution to covering the unfunded liabilities to social programs, it would vastly increase the money supply, causing an inflationary catastrophe.

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Entitlements

It is worth repeating that programs like Social Security and Medicare are wealth transfer programs. They take money from some people and give it to others. In the case of Social Security, it is largely intergenerational, with today's workers paying not for their own future retirements, but for the pensions of today's retirees.

The period of time used to estimate the funds needed to keep entitlement programs like Social Security and Medicare solvent has been a subject of some controversy. Often, projections based on 75-year periods have been used. Critics alleged, however, that use of a 75-year period resulted in an underestimation of the amount of money needed for long-term solvency. According to Factcheck.org, "The [Social Security] Trustees reasoned that the 75-year window should be extended to the infinite future to give policymakers a better idea of the changes necessary to keep the system sustainable indefinitely — especially beyond 2078 when they said Social Security's deficit will be increasing even faster than during the next 75 years." Consequently, in 2003 funding estimates began to be based on an infinite period, known as the infinite horizon.

The change has been controversial. Some argue that unexpected occurrences, like a severe economic depression, a new baby boom, or substantial changes in mortality rates could cause a major shift in predicted funding needs for Social Security and Medicare. This is just what the American Academy of Actuaries, an organization that sets professional standards for actuaries in the United States, believes. According to Factcheck.org, "The Academy of Actuaries argues that the inconsistencies which arise from such long-range assumptions are 'inevitable' when making projections over the course of infinity. For this reason, they conclude that the infinite-horizon measurement is a 'detriment' to the Trustees Report." Of course no one can tell whether these economic catastrophes will occur during a 75-year period either.

More importantly, there is no realistic chance in the current or foreseeable political climate that these entitlement programs will be abolished. Since we must expect that they will exist to an infinite horizon without a radical change in political climate, it makes sense to analyze funding needs on the same basis as the Social Security Trustees, as does the Fed's Richard Fisher.

In doing so, demographics paint a bleak picture. There is a growing pool of recipients waiting for these entitlements, but the number of workers to be taxed is not keeping pace. This is leading to the shortfalls identified by Fisher: $13.4 trillion from Social Security and $70.5 trillion from Medicare. It is not just the Fed's Richard Fisher who notices a problem with these two programs. Even the trustees of the Social Security and Medicare trust funds are worried about the future.

Each year, the Social Security Administration releases a report on the status of the Social Security and Medicare programs. According to the Trustees' 2007 Annual Report, the "programs remain problematic: we believe their currently projected long-run growth rates are not sustainable under current financing arrangements. Social Security's current annual surpluses of tax income over expenditures will soon begin to decline and then turn into rapidly growing deficits as the baby boom generation retires. Medicare's financial status is even worse."

It is noteworthy that the trustees not only acknowledge the problem but point to the increasingly dire need to take some sort of corrective action. "We are increasingly concerned about inaction on the financial challenges facing the Social Security and Medicare programs," they indicated in their report, warning: "The longer we wait to address these challenges, the more limited will be the options available, the greater will be the required adjustments, and the more severe the potential detrimental economic impact on our nation."

The trustees don't provide any solutions, so what can be done? There are several possible options. One is that the government could default on some or all of its obligations under these entitlement programs. In other words, the government could decide to end the programs, completely cutting off those who are currently receiving entitlements and not granting funding for future retirees. Another possibility is that the government could choose to place limits on who could receive payouts. For instance, it could decide to pay only some recipients, such as those making less than a specified, limited income, or it could choose to pay current retirees only. Either way, however, this would fail. There is already a large and growing constituency composed of those waiting for these wealth transfer payments and politicians are unlikely to risk angering them by cutting off funds.

Another potential solution would be to raise taxes. But this too is unfeasible because of the scale of the required increase. As Fisher points out, "the total unfunded liability from these programs encompasses about 7.5 percent of U.S. GDP from here to eternity, which works out to 68 percent of all federal income tax revenue for use only on Social Security and Medicare." According to Fisher, if the solution is higher taxes, we would have to "permanently raise income taxes to 68 percent." Not only would that be unpopular, economically it is very ill-advised.

Of course, we can always continue to finance these programs through debt. But that's no solution. Sooner or later — probably sooner — the debt will come due. Then what?

Monetize the Debt?

This brings us back to Fisher's "cardinal sin" of monetizing the debt. In his April 16 speech, Fisher pointed out that the dollar is a "'faith-based currency' … like the euro, the yen, the British pound and other currencies." A so-called "fiat" currency, "it is backed only by the federal government's power to raise the revenues needed to meet its obligations and by the rectitude of the U.S. central bank."

That "rectitude," however, is an illusion. The illusion is based on the idea that the value of a dollar will be relatively stable. But it is very easy — and overwhelmingly tempting — for government to debase or devalue the currency. To do this, all it has to do, in essence, is print more of it through the Federal Reserve System. As this happens, the number of dollars available in the economy will become more plentiful and, as with any other commodity, the value of those dollars will drop. That is, those dollars won't purchase as much as they once did. Thus, printing money leads to an inflationary economy.

That's what's been happening. In their recent book *Empire of Debt*, authors Bill Bonner and Addison Wiggin point out: "In the early 2000s, the U.S. monetary base expanded at the fastest rate in 30 years; it rose 20 percent or more in 2003 and 2004." This, Bonner and Wiggin point out, "was the work of the U.S. central bank," the Federal Reserve, which was, in essence, printing money — and it led to the recent housing bubble that has since burst.

It will be much worse if the Federal Reserve is pressured into monetizing the gigantic debt stemming from our entitlements programs. The first thing that would happen is the value of the dollar would plummet.

Economic Turmoil

If the value of the dollar plummets because the Fed is forced to monetize the debt, what would that mean in real terms for the U.S. economy? To find out what this could mean it is useful to look at the experience of Germany during and immediately after the first World War. This was the period of hyperinflation in Germany.

Thinking the First World War would be short, the government of Kaiser Wilhelm II funded the war through deficit spending, running up a large debt that grew as the conflict continued. After the war, the staggering debt was funded by monetization. "A growing percentage of government debt thus found its way into the vaults of the central bank and an equivalent amount of printing press money into people's cash withholdings," recalled economist Hans F. Sennholz in his book *Age of Inflation*. "In short, the central bank was monetizing the growing debt."

That action had a destructive effect on the German economy. According to American University economist Bradley R. Schiller, "At the beginning of 1921 in Germany, the cost-of-living index was 18 times higher than its 1913 prewar base, while wholesale prices had mushroomed by 4,400%." After that it got worse. "Between May and June 1923, consumer prices more than quadrupled," Schiller noted. "Between July and August, they rose more than 15 times; in the next month, over 25 times; and between September and October, by 10 times the previous month's increase." Price increases were so frequent that employers allowed their workers to take extra break s during work hours for shopping in order to beat the next price hike on goods they needed to purchase. As a result of these increases, German currency became virtually worthless.

The consequences for Germans were severe. In his book *Paper Money*, author George J.W. Goodman, writing under the pen name Adam Smith, recounted: “The law-abiding country crumbled into petty thievery. Copper pipes and brass armatures weren’t safe. Gasoline was siphoned from cars. People bought things they didn’t need and used them to barter — a pair of shoes for a shirt, some crockery for coffee.”

Will the experience of the German hyperinflation be repeated here? That is a difficult question to answer but already there are some parallels with the earlier German experience. The news is rife, for instance, with reports of thieves stealing wiring and other copper items from buildings. The East Central Illinois *News-Gazette* reported on July 6 that for “three weeks in a row, thieves struck St. James United Methodist Church — not for money or computer equipment, but for downspouts” because “the copper they’re made from makes them valuable.”

Still, there is no American hyperinflation at the moment, but if the Federal Reserve is pressured into monetizing the debt, as Dallas Fed official Richard Fisher expects, that would dilute the value of the dollar, meaning those with dollar savings would see the value of their nest eggs wiped out. And it would have an effect on foreign governments, like Japan and China, that hold large dollar-denominated reserves. “If you are a foreign holder of dollars, and you suspect that the U.S. … may be warming up the printing presses, you will probably not wait until inflation reduces the purchasing power of your money,” write financial analysts Bill Bonner and Addison Wiggin. “A 50 percent fall in the value of the dollar would wipe out half the real value of the U.S. overseas debt — an amount greater than the entire dollar currency reserve holdings of all Asian central banks put together.”

That prospect might cause foreign countries holding large reserves in dollars to reduce, and possibly even dump, their dollar holdings. If that happens, the U.S. economy would suffer. “A sudden flight from U.S. assets could severely weaken the dollar and disrupt the domestic economy,” American University economist Bradley Schiller has warned. That could be set in motion by monetizing the mounting debt from entitlements.

Thanks to ill-conceived entitlement programs, the future looks increasingly insecure. But the future will come, and we must meet it as best we can. And that means phasing out the entitlement programs, recognizing that it has taken decades to create the problem and will take decades to totally eliminate it.

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