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Von Mises Institute: Fed Is Underreporting Inflation

The Federal Reserve admits to increasing the money supply some 16 percent over the past year. "To put this figure into context, the previous high one-year growth in US money supply was 16.9% in 1986," Katz noted, adding that "the money supply figures for the late '70s, which gave us a 13.3% rise in the consumer price index, were in the range of 8%–9% per year."

But our inflationary condition is much worse than that, Katz says. "The reported number is equivalent to an increase of 16% over the past year. The actual number is equivalent to an increase of 70% over the past year."

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How did the Federal Reserve hide more than three-fourths of the actual inflation over the past year? According to a Federal Reserve letter Katz received, the Federal Reserve "reclassified" some $740 billion in checking account deposits as not counting as "money" within its definition of money. The Federal Reserve letter explained that "banks reclassify checkable deposits as savings deposits so as to reduce statutory reserve requirements. Within certain legal bounds, such behavior is acceptable to the Fed. Bank customers are unaware that such reclassification is occurring." Ironically, bank savings deposits are counted as "money," but checking account deposits are not counted as "money" under current accounting standards that are "acceptable to the Fed."

Although bank customers are unaware this banking sleight-of-hand is occurring, it did not slip the attention of Austrian school economists. Katz explains, "Calculating from the end of May 2008 to the end of May 2009, the U.S. money supply has grown from $1.37 trillion to $2.34 trillion. This is an increase of 70%."

So why doesn't such a dramatic increase in the money supply chasing the same amount of goods mean a proportionate increase in dollar-based prices (i.e., an increase in the Consumer Price Index)? That will happen eventually. The Federal Reserve explains that the temporary hold-backs by the banks are delaying the dramatic price increases that are coming. "Banks are holding deposits at the Fed and not making a great deal of new loans (they are making some, but it is a recession after all). If the banks made new loans, that would generate more deposits to be included in [money]."

Ironically, though the dramatic Federal Reserve inflationary policy is being sold to voters as necessary to fight the recession and to prevent supposedly dangerous "deflation," the real political motivation behind the inflation is to allow the federal government to finance its massive deficit spending policies. "Barack Obama has projected a budget deficit for the coming year of $1.8 trillion," Katz explains. "The government's deficits are simply too big and would overwhelm the credit markets of the nation. What every government has done when it faces sizable deficits is to simply print the money. If America is facing a $1.8 trillion deficit later this year, then it will probably print (another) trillion dollars to finance this."

Katz notes that "the current figure for money supply is being given as $1.6 trillion. The actual number is $2.34 trillion." But a deficit of $1.8 trillion-plus would consume almost all of the money in the economy. In the past much of our debt was picked up by foreign nations, especially China and Japan. But both seem less willing to take on more U.S. debt in an inflationary era that will make those dollars less valuable. That’s why the Federal Reserve is likely to have to print additional trillions in new money as the U.S. continues its deficit-spending spree.

Of course, if the Federal Reserve creates yet another trillion dollars in money later in the year, then inflation (along with the nominal prices of goods measured by the Consumer Price Index) will jump all the more.