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# Why Inflation Hawks Should Stand Down

By KELLY EVANS

No amount of huffing and puffing can inflate a leaky balloon.

The Federal Reserve's balance sheet has swelled to record levels amid the credit crisis, prompting concern that sharp U.S. inflation is soon to follow. But in spite of the Fed's bulging balance sheet, the nation's money supply is barely growing. That makes the prospect of near-term inflation less likely.

On Thursday afternoon, the Fed is due to release its latest weekly balance-sheet report, expected to show a small uptick from its prior \$2.3 trillion level to a record high. To put that in perspective, the Fed's balance sheet was running around \$800 billion before the credit crisis.

The Fed's holdings have soared over the past two years as policy makers opened a variety of emergency lending facilities, then embarked on a \$1.25 trillion program to purchase mortgage-backed securities.

These holdings could create the potential for inflation down the road as they are deployed in the economy. But right now, the system has sprung a leak.

The nation's money stock, known as "M2," includes physical currency, bank deposits and households' money-market holdings. The money stock's growth, which historically averages around 5% a year, has stalled over the past 18 months since the credit crisis intensified in late 2008.

The money supply contracted outright during much of January and February compared with its level 13 weeks prior, a gauge economists use to help smooth out weekly volatility.

"It shows there isn't actually a lot of liquidity out there, contrary to popular belief," says Paul Ashworth, senior U.S. economist at Capital Economics. "It's not a good sign of healthy economy."

The problem is twofold: the credit that serves as the lifeblood of the U.S. economy and helps create money is still in short supply, and demand for it is still weak.

That raises the risk of deflation in the near term, not inflation. Indeed, core consumer prices fell in January from the prior month for the first time in 28 years.

The silver lining is these conditions also give the Fed more leeway to keep interest rates low for longer without stoking inflation. For now, inflationary fears look overblown.

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