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Greg Cater Sr. and Greg Cater Jr.
What Causes Inflation?

Shortages in the goods and services that we want. It really is that simple. We have been predicting lower interest rates and lower inflation for years. We posted our first "Note" on our website in August 2013 under the "Resources" tab: Rates Are Going Up, Right?"

http://www.caterwealthmanagement.com/

In August '13 the 10-year-Treasury-Bond yield reached a high of 2.89%, today it's 1.75%; 40% lower.

The yield on the 30-year-Treasury-Bond posted similar results; 43% lower.

Despite the political rhetoric the U. S. is predominantly capitalistic. Capitalism is a deflationary business model. Competition forces companies to strive for competitive advantage to stay in business. If they don't, someone else will. They must continually increase productivity, increase quality and reduce prices or they will fail. Our country has been producing more for less since our independence in 1776.

1) **Canals:**
   Construction began on the Erie Canal in 1813. It connected New York to the Gulf Coast lowering the cost of transporting goods dramatically.
2) **Railroads:**
   The Intercontinental Railroad was completed in 1869. It lowered the cost of transporting goods coast to coast.
3) **Electrification:**
   Thomas Edison built the first commercial electric system in New York City in 1882. The first long distance high-voltage transmission line was completed in 1917. Electricity increased productivity and reduced costs in manufacturing dramatically.
4) **Automobiles:**
   Henry Ford produced the first Model T in 1913; by 1927 he had produced 15 million of them. Transport by truck reduced costs again.
5) **Interstate Highway System:**
   Now that we had cars and trucks, we needed good roads. The Federal Aid Highway Act of 1921 followed up by Eisenhower's legislation in 1956 created 48,181 miles of Interstate highways by 1992.

Canals railroads and trucks moved goods efficiently, but the "goods" still had to be sold. The "Amazon" of the times was the Sears Catalog. It sold everything from hubcaps to prefabricated houses delivered anywhere in the country. Mr. Sears advertised the catalog as "The Cheapest Supply House on Earth".

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Capitalism Reduces Prices

In 2012 the Federal Reserve officially adopted 2% as it's inflation target. Many at the fed say its close, but it doesn't look close to me. It started 2019 at 1.8%, and it's currently 1.4%. Based on the Fed target, inflation seems to be headed in the wrong direction. So the question remains:

What can the Fed do to increase inflation in a capitalistic (deflationary) economy?

When I got into this business, 40 years ago, the Fed thought controlling the money supply was the answer. In the same way that we now wait on monthly job numbers, back then we waited patiently for the monthly report on M2 (a measure of the money supply). If the money supply was increasing, surely inflation and interest rates would follow. The decade of the '70s experienced the highest inflation since WWI, 7.25%. M2 was also growing rapidly. The prevailing consensus at the time was that the increase in the money supply was causing inflation. This idea happened to be from the great monetarist Milton Friedman. It also happened to be wrong. It's the old correlation vs causation debate. Here's what really happened:

In the 1970's we experienced not one but two oil shocks, the OPEC oil embargo and the overthrow of the Shah of Iran. Both caused oil prices to increase dramatically. This dramatically increased prices for every single business in the country. Steel producers and other manufacturing companies paid dearly for the energy they needed, even accountants who needed to turn on the lights to see their ledger books (before computers) paid higher utility bills. These unexpected increases in the cost of doing business were immediate. Everyone experienced the pain, and although not immediate, the eventual result was higher prices across the board. Everyone needed interim financing. Businesses went to their banks and requested money; the banks obliged. Then banks went to the Fed and requested money; the Fed obliged. Money was created; M2 went up.

So now that we have the background information, we can answer some questions:

Did increases in the money supply cause the increase in inflation (prices), or did increases in inflation (prices) cause the increase in the money supply?

We believe higher prices caused an immediate increase in the demand for money, which was provided, first by the banks and then by the Federal Reserve.

What can the Fed do to increase inflation in a capitalistic (deflationary) economy?

Not much as evidenced by its consistent failure to reach its 2% target.

Those waiting for higher inflation and higher interest rates could be in for a long wait.