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The Inflation Genie

President Obama faces a serious military and economic dilemma. Unfortunately, Mr. Obama does not have a magic lamp. If he did, his three wishes might be as follows.

- To conclude the war on terror.
- To witness an increase in domestic employment
- To see the U.S. economy rebound.

If any of these wishes were to come true, it would lessen our current economic hardship. Unfortunately, wishes do not always come true.

In the past 50 years the United States has had one major bout with inflation. There were two major causes.

- Increase in Government Spending
    - Vietnam War
    - Great Society (Social spending programs)
- Arab Oil Embargo

The government dramatically increased their spending by funding the Vietnam War and the huge entitlement programs of the Johnson administration. To add more pain, superimposed on the cost of the war and entitlement programs, was an OPEC-contrived spike in the price of oil. The oil cartel increased the price of oil by limiting the supply, thus causing a dislocation of the supply and demand curve for oil by-products. The dramatic increase in consumer prices for energy and other staples created by this shortage was sudden and unanticipated. The pain was felt by consumers throughout the country.

In many ways, this is similar to our current economic environment. War, social spending and fluctuating energy prices once again haunt the economy. But this time around, the U.S. is also confronted with massive trade deficits, a climbing national debt, and the trillions in government bailout funds to individuals and corporations affected by the credit crisis. The Great Recession of 2008-2009 can also be linked to fiscal and monetary policies that created easy credit, excessive leverage, and artificially low interest rates. These governmental regulations and FED “easy money” policies resulted in irresponsible and corrupt personal and corporate behavior.

In the future it is reasonable to expect a structural adjustment in the unemployment rate, a significant increase in government deficits, and continued consumer duress which, without a new technological break through to drive new growth, will last for the foreseeable future.

PIMCO’ s highly regarded co-manager, Mohamed El-Erian, in a July 2, 2009, article, suggests that a new paradigm is unfolding in the United States. He postulates that the likelihood of persistent high levels of unemployment for a prolonged period is very probable, and that “the post-bubble U.S. economy faces considerable headwinds to sustainable job creation.”

Consumers are also pulling in the reins, content to save instead of spend as in the recent past. The negative savings rate of 2008 is now at a positive 6.5% rate. Increased savings will benefit the consumer and the economy in the long-term, but will be a fiscal drag in the short-term. The current level of

unemployed consumers also hurts the ability of federal, state, and local governments to obtain tax revenues.

The outlook for a continuation of uncontrolled government spending is not without serious risks. Politicians at every level are not showing fiscal constraint. California and a number of other States face budget shortfalls. The nations' historic dependence on foreign oil, a negative trade balance, and the continuing war on terror will continue to erode our Treasury. We now owe more to foreigners than we owe to ourselves. **The entitlement payments and other debts now "on the books" are in excess of 55 trillion dollars.** We have a very real dilemma as a nation. Unable to grow the economy rapidly, the government has no alternative but to print money to pay our obligations. If this creates inflation at 12%, we lose 50% of our purchasing power in just 6 years.

President Obama and Congress have no magic lamp. This Genie is of our own creation. The bottle is now open and soon, the inflation Genie will be raising its ugly head!

Roger L.Johnson