Rising Interest Rates Won't Stop Inflation

The Federal Reserve announced yesterday that it raised the "discount rate" by 25 basis points to 0.75%. This move was meaningless because very few institutions use the Fed's discount window, in comparison to more widely used overnight lending. The current balance of discount window borrowing is only $14 billion, compared to the $1.1 trillion in excess reserves currently being hoarded by banks.

By the Fed raising the discount rate but not the overnight federal funds rate, they are clearly trying to talk up the U.S. dollar and push down gold and silver prices, without reducing the supply of cheap credit. Considering that gold and silver prices rose slightly yesterday following the Fed's announcement and held strong today, it is our belief that the market is calling the Fed's bluff and beginning to realize that artificially low interest rates are here to stay.

Many people forget that gold's bull run from $35 to $850 per ounce during the 1970s came during a time of rising interest rates. Historically, one of the best performing periods for precious metals has been when the Fed starts to raise artificially low rates. When the Fed raises exceptionally low rates, traders often initially make the mistake of believing that inflation will no longer be a concern. They erroneously believe that with the Fed focused on bringing interest rates back to "normal" levels, it will be easy for them to contain inflation. They don't realize that the excess liquidity from artificially low rates will remain in the system until the Fed raises rates to artificially high levels and keeps them there for an extended period of time.

With the Fed having held the federal funds rate at 0%-0.25% for the past 14 months, we may need to see interest rates of 15% or higher for 14 months straight, in order for inflation to no longer be a concern. With 1 in 5 mortgages in the U.S. currently underwater with low interest rates, it will be impossible for the Fed to raise rates dramatically without causing the mother of all Great Depressions. Therefore, we believe the Fed has chosen to risk hyperinflation in the name of fighting a depression.

Based on the Bureau of Labor Statistics (BLS)'s CPI report released today, the official annual rate of inflation in January was 2.63%. This purported "low" rate of inflation will give Federal Reserve Chairman Ben Bernanke further cover to keep interest rates low. However, NIA estimates the real rate of inflation to be approximately 3-4% higher than what is indicated by the CPI index. Based on the real rate of inflation, NIA believes the Federal Reserve urgently needs to raise the federal funds rate to between 5 1/2% and 6 1/2% immediately, if it wants to prevent a breakout of double-digit inflation from occurring as soon as the second half of 2010.

There is no economic recovery in the U.S. Oil prices today reached a five-week high of $79.95 per barrel not because of a strengthening economy, but solely due to inflation. Rising gasoline and food prices alone accounted for more than 1/4 of the U.S. Census Bureau's reported 4.71% year-over-year increase in January retail sales; the rest can be attributed to rising prices of other consumer goods and simple bottom-bouncing from last year's panic. In fact, if you go by Gallup's survey of consumers, retail sales actually declined in January from a year ago.

President Obama yesterday signed an executive order to create the "National Commission on Fiscal Responsibility and Reform", with a mission to "propose recommendations designed to balance the budget, excluding interest payments on the debt, by 2015". Obama is obviously trying to redefine a balanced budget as not including interest payments on our national debt, because he knows it will be impossible to truly balance the budget. This is similar to how Obama is deceiving Americans by not including Fannie Mae/Freddie Mac's $6.3 trillion in debt on the government's balance sheet, when they have clearly become government controlled corporations.

In December, China sold $38.8 billion in U.S. treasuries while purchasing only $4.6 billion worth of new ones, reducing their U.S. treasury holdings by $34.2 billion to $755.4 billion, its lowest level since February of 2009. China has led the world with Australia as being the first to tighten lending standards. China clearly recognizes that inflation is the biggest threat to the world's economies. It will be interesting to see if China steps up to purchase the 191.3 tonnes of gold being offered by the IMF. Instead of making a direct gold purchase from the IMF like India, China might try to quietly accumulate this gold in the open market, in an effort to prevent a panic and protect the value of their remaining dollar-denominated assets.

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