Inflation Versus Deflation
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By Peter Scholtz

Since the late 1970s the Federal Reserve Bank has diligently fought against inflation, working it lower over time and with good reasons. The largest issue is wealth redistribution. Rising inflation can be highly destructive to an economy as lenders of capital watch the purchasing power of their principal decline. To preserve this wealth, owners shift their assets to things that protect purchasing power which leads them to hard or real assets. Business borrowers find money harder to obtain for economic investments as bond holders leave the market. The economy starts to be starved of the capital it needs for economic growth and wealth is not created. Instead, funds flow into collectables, art, gold and other "nonproductive" assets. Real estate development may be the lone exception and bring the attendant construction of hopefully useful buildings, but much of the nation's capital flees away from lending for capital investment.

Interest compensates the lender for purchasing power loss as well as earning a "real" return, the difference between the nominal interest rate and the inflation rate. Lenders always seek a high real interest rate, while borrowers seek a low one. Low real interest rates encourage borrowing, growing money supply and accelerating inflation as borrowers seek to make profits on real assets with their low cost money. As inflation hits higher levels, fixed rate bonds do not fully compensate the lender, and real wealth is transferred from lenders to borrowers. It is devastating to retired people on fixed incomes. This happened in the United States in 1978, leading to wild speculation in real estate, a booming art and rare coin market and gold reaching unprecedented levels. In the late 1970s, there were cartoons during the period of 12 percent inflation where the marriage counselor would try to urge the couple to stay together for "the sake of their 8 percent mortgage." Another showed a bank branch manager creating an entire branch celebration by announcing that "Mrs. Smith has come in to open a passbook savings account." At the time it was illegal for a bank to pay more than 5.75 percent on such accounts. These two stories speak to the wealth transfer effect from the lender to the borrower. In the first case, it is a couple borrowing a cheap mortgage from a bank and the second, the bank borrowing cheaply from the poor depositor.

In recent years, inflation has slowed to a crawl, and many economies have experienced a certain amount of deflation. During the inflationary decades, the Fed could always lower short term interest rates to a negative real interest rate to stimulate an economy out of a recession. It was a powerful tool in 1982. Today, with no inflation in places like Europe and Japan, the central banks cannot readily create a negative real interest rate. This can only be done if the lender pays interest to the borrower, i.e., a negative nominal interest rate. Indeed, this is actually happening in Germany and Switzerland today as large institutions need to park their cash somewhere safe. The problem is that negative nominal rates get too much psychological pushback from the market place, putting central banks in a box. For this reason, the Fed has in recent years changed its notion of the optimal inflation rate from zero to about 2 percent. In the meantime, out of desperation, central banks have started engaging in Quantitative Easing, the act of forcing money into the system by printing money and endlessly buying bonds in the marketplace. The objective is to raise the inflation rate to enable banks in the future to have negative real rates as an alternative monetary tool. This Quantitative Easing has ballooned money supply, notably in Japan and the United States, but it has been easily offset by a decrease in money turnover (velocity) so that it has not led to inflationary pressure. Regulatory restrictions on capital ratios and fears after the last cycle have dampened many banks' ability and desire to lend. Further, people are willing to let large cash balances sit

32 HAVILAND STREET – SUITE 3—NORWALK, CONNECTICUT 06854
TEL: (203) 714-9900 – FAX (203) 286-7985

in checking accounts earning nothing rather than buying goods or securities. Low money velocity prevents what could be a very high inflationary rate under normal circumstances.

Europe and Japan are caught in a classic liquidity trap whereby economic activity cannot easily be stimulated by monetary policy. Nominal interest rates are at record lows, and there are no borrowers. Both have a huge debt overhang that if the United States is a guide, consumers with improving situations will be eager to pay off debt, rather than buy consumer goods and generate economic activity. The commodity decade is over as Chinese demand for steel, oil and copper has plummeted with the Chinese economic slowdown. Demographically, China is rapidly maturing and there is no reason to expect the huge appetite they once had for commodities will return. So, commodities are plummeting, and declining prices are everywhere. In ironic contrast to the inflationary 1970s, why run out and buy consumer goods if next month the price will be lower? In economies with accelerating inflation, people buy to get ahead of price increases, and in hyper-inflation economies such as Germany in the 1920s, workers ran with their paychecks into the street to buy anything of value, the value of the Mark was dropping so fast.

If deflation continues in Japan and Europe, there is a real danger to these debt-burdened cultures. We now have a wealth transfer effect from borrowers to lenders as the borrowers watch the amount they owe increase in real terms over time, the diabolical opposite of the wealth transfer effect of accelerating inflation. In countries such as Italy where debt levels are already high, a deflationary environment could prove crippling over time. Currently, the most acute problem is in the energy business, as companies borrowed heavily to finance highly profitable oil drilling. Oil companies are seeing their revenue plummet and their profits squeezed until they can no longer afford their debt payments and they default. This has created an unusual relationship between oil and the stock market as they have become highly correlated, moving in tandem. Normally, the broad market goes up with lower energy prices as they benefit businesses and consumers greatly. Unfortunately, the oil decline has been so dramatic that any further oil price decline from here creates an oil debt problem. Like the Great Depression, the debt is written off, which in turn puts financial pressure on lenders who are watching their bonds become worthless through this process with minimal use for the oil as "collateral" or hopes of principal recovery. This puts financial pressure on the banking system and is what happened in 2008 when the default rates in mortgages hit levels not seen since before World War II. Central bankers understand this danger but are struggling with the best policy.

In regard to the outlook for deflation, the key variable to watch is wages. If real wages are rising, debt service and economic demand can remain intact. This puts in check the death spiral of lower prices leading to lower wages leading to lower prices and, ultimately, an unmanageable debt load. The United States seems to have averted this problem, and it is anticipated that wage growth will start to slowly accelerate. By contrast, in Japan, it is debatable which way wages are going. Lower wages rob the economy of demand for goods and services, creating a downward spiral like 1930. Central bankers today understand that you need positive inflation in the system, enabling proper monetary policy through creating high or low real interest rates. In addition, they understand that large debt burdens on economies tend to mute central bank efforts to stimulate because so much incremental income goes to debt service as opposed to final economic demand. This ultimately can lead to a deflationary debt default crisis. I never thought I would say this in my 40-year career, but we could use a little inflation.