The Inflation Cycle - The Last 50 years.

By Peter Scholtz
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March 8, 1978 was the day Jimmy Carter, as president, appointed G. William Miller as Fed Chairman against all of his advisors' advice. They strongly recommended the New York Fed president, Paul Volcker. The economy was at full employment and there was an election in 1980. Carter felt that the only way to be re-elected was to maintain employment and growth at any price. To do so, Miller embarked on a monetary expansion by lowering interest rates below the inflation rate. The cheap money created loan growth, and prices of all goods started to accelerate upward. Consumers, with their strong balance sheets, quickly learned that borrowing at 8% made sense, as the couch they wanted to purchase would cost 12% more a year later. The financial community was dumbstruck by the Fed's behavior.

I entered Columbia Business School in early 1978, and the buzz in the hallways regarding Fed policy was common. Not a single student understood why the Fed was not trying to control inflation. I remember employing my colleagues at school, "shouldn't we be buying condos?" We agreed, but who had money to speculate on real estate? That fall, I took a course, *Federal Reserve Policy*. One day after class, six of us approached the Professor. We explained that we understood the Milton Friedman models he was teaching, but why was the Fed oblivious to the accelerating inflation rate? I was shocked when he said that he didn't have a clue, but if any of us did, he would love to hear it. Inflation continued to rise until the summer of 1979; the CPI hit an annualized rate of 16%, while the Prime Rate was pegged at 8%. On August 6^{th}, seventeen months after his appointment, Miller resigned. Very quickly, Paul Volcker was appointed Fed chair, and he began raising rates immediately. I remember thinking all along that this would end very badly. Everyone in the streets seemed serene, but I knew this would be very different within a year. Volcker was put in charge of a runaway train that he could not possibly stop on a dime. The Prime Rate got to 21% in early 1980, and at one point you could earn 18% in a money market fund. The economy plummeted. The Fed backtracked and started quickly lowering rates, and the economy and inflation reversed again. The Fed raised rates again back to the recent high levels and then the economy went into a deep recession, as deep although not as enduring as 2008. Unemployment hit 10%. We had finally turned the painful corner on inflation. It is so regrettable that so much suffering was caused as a result of Carter's and Miller's blunder.

I had attended a Columbia Business School black tie affair for Paul Volcker at the Waldorf-Astoria in New York on May 5, 1986. He received a ten-minute standing ovation before he even spoke. Ten years later I found myself alone with Paul Volcker in an elevator in New York. "Aren't you Paul Volcker?" I asked. "Who's he?" he said with a smile. I wanted to tell him how brave he was for doing what was right even though it caused such suffering. I wanted to thank him for saving the world economy from collapse. He asked how Alan Greenspan was treating me, and all I could think of saying was how Miller confused us all so terribly. Here I was next to the biggest rock star in the world, and all I could do was hem, haw, and freeze.

The legacy of that time was a relentless drive by the Fed to eliminate inflation. As the decades rolled by, debt as a percent of GDP continued to rise, but the Fed constantly raised rates in the face of increasing inflation, cooling off the economy, creating the occasional slowdown or worse, recession. For thirty years people have sounded the alarm on the debt buildup at the Federal level. It was interrupted by the strong economic growth of the late 90's of over 4% a year for three years in a row. Due to the slower growth in government spending, we had a temporary budget surplus. As we entered the recession of 2000, the deficit ballooned again. The following expansion created a large increase in consumer debt, culminating with the housing bubble. The housing bubble burst created a mountain of bad debt where the asset pledged (i.e. the house) did not cover the amount of debt owed. Defaults and loss of principal ensued. This is similar to 1930 when the stock market collapsed, wiping out investors as well as creditors due to their margin debt.

Each cycle since World War II has seen a weaker recovery than the previous ones. The recovery in 2003 was initially referred to as the "jobless recovery." The larger debt load each cycle leads to a slower recovery as the initial increase in incomes is more and more directed to paying off debt. Large amounts of debt are deflationary, as any rise in interest rates increases interest payments for a much larger percentage of the economy. Recoveries have become slower and more fragile. The playbook for the Fed is always, in a recession, to decrease interest rates below the inflation rate to stimulate borrowing. Borrowing leads to consumption which leads to recovery. The problem in 2008 is that inflation was so low, the low interest rates plus the high debt levels did not lead to instant recovery as it had decades ago. The Fed therefore embarked on "Quantitative Easing," the deliberate printing of money to buy treasury securities and mortgages to force interest rates to a very low level. During the current recovery, consumers have not felt it wise to borrow like the 1970's since the prices of goods are not rising. Clothing, in particular, has been declining in price so why borrow to buy when the item will only get cheaper. In addition, the consumer already had a high debt burden. Speculators did not readily have an investment that would warrant increasing debt to purchase assets. Loan growth has been subdued. Real estate, overall, has been tepid, commodities flat. Note that when Bernanke began Quantitative Easing, the financial community screamed it would lead to large increases in inflation. It has not.

Globalization and technology are two primary reasons why prices of most things have remained in check. World trade has kept price competition keen in technology and many consumer goods. Applying technology to production has kept many costs of goods low. These factors have kept downward pressure on prices, but equally as important, consumer debt has been declining as a percent of consumer income and as a percent of GDP. The consumer has been repairing their balance sheet.

Debt creation creates inflation as it increases demand beyond growth in incomes. Since growth in income roughly equals GDP (output), any increase in demand beyond that income level means demand for goods and services exceeds supply, and an upward pressure on prices is the result. Likewise, net debt liquidation is deflationary as demand falls short of supply as income is siphoned off for debt service. Since 2008, government debt has grown as a percent of GDP, but consumer debt has declined, creating a flattening of debt overall. There is no upward pressure on prices as this 50-year debt cycle appears to be over. If this is true, where does this leave us today?

Japan and Europe are way ahead of us in terms of extreme debt levels. Japan's economy has stalled for two decades, partially due to demographics, but also due to a massive amount of government debt as a percent of

GDP. Europe has similar problems. Today, 25% of all sovereign (government) debt, $13 trillion, is at negative interest rates. The reason is that large institutions can't park the money anywhere else nor can they accept cash. The mountain of debt, combined with the low inflation rate, has meant that monetary stimulus in Japan and Europe has been only mildly effective. Mario Draghi, head of the European Central Bank, has declared he will do whatever it takes to keep the European economy afloat. The massive amount of quantitative easing has occurred with the economy barely growing. This has led critics to say the policy has gone from "whatever it takes" to "whatever is left."

All central banks wish they had inflation of roughly 2%, and they wish they had interest rates comfortably above inflation. They refer to that as "normal" in a world where loan demand cannot easily be stimulated. There are two main reasons central banks want higher rates. First, interest rates below inflation over time lead to bad behavior. Speculators that might not normally borrow and leverage to buy assets might be tempted to do so. Consumers can be lulled into more bank debt or a higher mortgage. Any rate rise with this leverage might create payment problems like in 2008. Second, low or negative interest rates greatly hurt the banking system. Banks normally own a certain amount of government securities, which in Germany today, are paying roughly -0.30% for the ten-year bund. European Banks don't charge people to deposit money with them, so they are losing money on low and negative interest rate investments. This also incentivizes them to lend to more risky borrowers, which increases risk in the banking system. Unlike the American banks that have greatly increased their capital, as well as not needing to own negative yielding paper, the European banks are very fragile, with Deutsche Bank seemingly the most at risk. If banks can achieve an interest rate above the inflation rate while maintaining solid economic growth, then they have to ability to stimulate the economy with much lower rates when things go bad.

Thank god that the U.S. has high interest rates relative to the other major economies, but our government rates are under pressure as European and Japanese investors see our ten-year government bond of 2.00% as very attractive. They continue to push down our interest rates with intense buying of Treasuries. This has led to some long rates being lower than short term government rates, called an inverted yield curve. The Fed is very sensitive to this, as it has been an accurate predictor of recessions historically. In decades past, the bond market would always react with higher rates on any fears of increasing inflation, helping to keep inflation in check. In the 1980's, bond investors earned the nickname "Bond Vigilantes." Today, the bond market is lowering rates before the Fed. There is an old saying, "Don't fight the Fed." It means that if the Fed is accommodative, buy securities, and if they are tightening, get defensive. Our Fed has recently pivoted since December from trying to tighten to being on the verge of lowering interest rates due to the long-term rates dropping. As one manager said, "we fought the Fed and won." Expect lower rates soon and then who knows.

I must confess it is difficult to know how this ends. It is very encouraging that the U.S. consumer is paying off debt, but Europe and Japan are not so lucky. A logical end result is that we, at some point, experience deflation, and we have another debt crisis like 2008. This would be the result of a recession which every central bank is desperate to avoid, especially given the debt levels in their economy. China has a lower debt level than most, but it has been rapidly increasing. They also have a demographic brick wall to contend with over the next decade, with a rapidly aging population like Japan. The thing to watch is the health of the European banks, as well as the junk debt market, both a potential source of the next debt problem. By watching the weak links, we can monitor the potential problems.