Economic & Market Update, February 2015

Deflation

By Richard Morey

Fourth quarter U.S. economic growth numbers were reported on Friday, January 30. As expected, they showed weakening growth in our economy. The only supposed bright spot was consumer spending. However, if you look at the increases in consumer spending you find by far the largest contributor was dramatically rising healthcare spending. This isn't surprising, since we already know the holiday shopping season was pretty much a disaster for retailers, so consumers obviously weren't spending more at the mall (or even online during the holiday season). The report also detailed a huge increase in inventories, meaning businesses produced goods they haven't yet sold. This will reduce growth going forward. In addition, the economic drag from the oil and gas crash is just beginning to show up in the numbers. Finally, once again wages and salary gains disappointed.

Looking beyond last quarter, in this report we are going to look at the big economic picture, both here and abroad. These days one word is on the lips of most central bankers and leading economists – deflation. A few economists have been warning of deflation for several years, but during most of this time I was skeptical. In retrospect my skepticism was skewed by watching the price increases in commodities such as energy and food as well as increases in healthcare and education. It certainly looked to me as if the prices consumers were paying for a large portion of the things they have to buy were going up substantially in price. Since the government excludes food and energy from their inflation calculations, the government's numbers on inflation indeed were not very high, but I thought this was basically misleading.

The last 6-7 months have changed my views, as during this time period the prices of most commodities have collapsed. <u>We know oil prices have plummeted, but most people probably do not realize other commodity prices have also crashed, including iron ore, copper, corn, cotton, etc. – all of which have dropped over 50%.</u>

Deflation scares central bankers more than anything else, with good reason. This is because deflation typically occurs during depressions. We're not talking about recessions but actual, bona fide depressions. Plus, historically deflation has proven extremely difficult to counteract.

The definition of deflation is simple: deflation is a decrease in the general price level of goods and services. There are many supposed causes of deflation, but in this report we are going to focus on the one that appears to be in effect today. This is called 'debt deflation.' This concept was proposed by Irving Fisher who was considered the leading economist in the country before and during the Great Depression. The basic idea is that when a nation becomes over-indebted over a period of many years, during the following years the economy slows and prices drop. Eventually debt must be repaid by the borrowers (or written off by the lenders as being uncollectible). If the borrowers throughout an economy start paying off their unsustainably large debts, they can no longer spend that money on purchasing new goods and services. As a result, businesses have to lower prices to attempt to get buyers in the door.

Before moving on to the theoretical "cure" for deflation, let's look at one of the other primary causes given for deflation, which is a reduction in the velocity of money. Velocity refers to how often money changes hands. (Personally I consider this not a cause but more like a symptom of deflation.) When money isn't moving, consumers aren't spending as much or as often. Once again, this leads businesses to reduce prices to try to attract customers. If we do end up in deflation, I am certain the primary cause will be the over-indebtedness. At the same time, we can safely say it will be associated with a collapse in the velocity of money, as the following chart showing how much money has been percolating through the U.S. economy in recent years illustrates. This chart shows the velocity of money from 1980 to the present (data from FRED, the St. Louis Federal Reserve Board).

Since prolonged deflation is nearly synonymous with depression, i.e. the worst possible economic situation, knowing how to stop deflation is of great interest to economists. There are two basic views on how to deal with deflation. The first was created by economists after the Great Depression and then expanded and championed by an economics professor from Princeton named Ben Bernanke. As the Chairman of our Federal Reserve Board from 2006-2013, Bernanke was given the opportunity to try his theories out on our country.

Bernanke's theory is that deflation can be halted by printing money. This makes some sense, as if you print enough money banks have more to lend. Increased lending to businesses should lead to business and therefore jobs growth, giving consumers more money to spend, thereby driving prices higher. Unfortunately for Mr. Bernanke – and for our country – at this point we can say with some confidence that Bernanke's views are wrong, perhaps disastrously so.

Evidence to support that last statement comes from several sources. The first is Japan. After their financial collapse that began in 1990, they had falling prices throughout their economy. They read Bernanke's theories and decided to try them out. The Japanese printed trillions and trillions of Yen. The result: Over the last 25 years their economy has grown barely 1% a year, and they have never succeeded in fully defeating deflation. Just as troubling, over the last year they have embarked on a new program of printing Yen. They decided the problem wasn't that printing money doesn't fix their economy but they simply had not printed enough! While it may be a bit early to call their ramped up money-printing a complete failure, thus far the results have been terrible. They have gone back into recession. They have succeeded in driving up the prices of many goods, but wages have gone down. This leaves their citizens in the worst of all economic dilemmas – prices rising while income is falling.

Now let's look at the United States. Bernanke and his successor Janet Yellen as Fed Chairpersons printed over $3 trillion. However, printing money only works to stimulate the economy to the extent the velocity of money increases, i.e. the money goes out into the economy. The chart above shows just how disastrous that has been. Instead of going out into the economy, the money the Fed printed has either sat idle in the banks' accounts (earning interest paid by taxpayers) or the banks have used the newly printed money to speculate in stocks, high-yield bonds and other risky assets all over the world. Why would the banks waste their time lending out money to earn as little as 4 or 5% when they can make so much more gambling in markets around the world? Proper lending takes lots of time, paperwork, and good human judgement, and some of the borrowers don't even pay it back!

Let's look directly at Bernanke's money-printing theory versus the rate of inflation/deflation in this country. The Fed printed several trillion dollars from 2009-2014. But we are now faced with the very real prospect of deflation. Like Japan, we have followed Bernanke's theory of what to do to avoid deflation and the result is…. deflation.

Then we have the rest of the world. While overall prices of goods and services have not yet gone negative here in the U.S., Europe is seriously flirting with actual deflation. And their response (of course) is now to begin printing Euros – as many and for as long as needed to generate inflation. While most mainstream economists applauded our Fed's money-printing and even Japan's latest attempts, even those who would never deign to question Bernanke (or Yellen's) omniscience are skeptical printing Euros will benefit the Eurozone economy. There are many reasons given, most of which ignore the basic question of the efficacy of money-printing but instead are based on the structural impediments involved in their monetary union.

But the largest deflationary force in the world is undoubtedly China. It is there we will see just how much impact debt can have on prices. In the year 2000 total debt in China equaled approximately $1 trillion (U.S.) dollars. By the end of last year this total had exploded to $25 trillion! In only two recent years they produced more cement than we did in the United States in the entire 20th century. Anyone observing this objectively could see their historic debt-financed spending binge could not continue indefinitely, and it isn't. Now they are slowing down, and this is a huge deflationary fact for the entire world. With a slowing economy, they are now over-producing vast amounts of goods. They either need to let many, many large corporations go bankrupt or keep production up and sell everything they can overseas. With such a large over-supply, they will be selling at cheap prices, driving down the prices of goods throughout the world.

The economist who has consistently been the most accurate forecaster in the world is named Albert Edwards of Societe Generale, a large French multinational bank. Here is what Mr. Edwards recently said when looking at the world economy in 2015:

"The weak oil price, which many commentators see as "good deflation" is in large part a Chinese demand led phenomena that is affecting the whole commodity complex. Weak oil prices are telling us China has a major deflation problem – as witnessed in the Q4 GDP inflation data – and just as in the minutes before a tsunami the tide goes out and all seems quiet (i.e. good deflation) only later will we, in the west, realize that this is a prelude to being overwhelmed by a deflation tidal wave cascading from China to the west." Hmm… if deflation is indeed the worst-case scenario feared by economists, a "deflation tidal wave cascading" towards our shores doesn't sound promising!

So it looks like serious deflation is heading our way – ***after*** we have tried the Bernanke money-printing approach for six years. Personally I would have thought this approach would have been dismissed by looking at Japan over the last 20+ years. Most likely the reason nations embraced printing money to deal with our economic difficulties is because it was, by far, the easiest way to respond.

However, I would say printing money has been the exact wrong response to the debt crisis we had in 2008-2009. Printing money to deal with deflation has missed the point entirely. The key point is we are facing ***debt*** deflation. Printing money only works to stimulate the economy and therefore keep prices from falling if the banks lend out the money, i.e. if debt increases. But if the problem is we have too much debt, the solution surely is not to add to this problem. Therefore, the entire theory of printing money in order to confront deflation only makes sense at all (and then only theoretically) if the problem is caused by a lack of money supply restricting a needed increase in debt. I cannot imagine a scenario further from the reality we are facing today.

We have looked at how money-printing has not worked to diminish deflationary risk in actual practice. What we have not done is examine the fact printing trillions of dollars puts the economy at great peril. I have discussed this risk in numerous previous articles. However, in reality we really do not know the risks or how they will play out. Worldwide money-printing is a grand experiment. While it has not worked to achieve its originally-stated goal of increasing bank lending and getting economic growth back to pre-financial crisis levels, it has led to mind-numbing distortions in world markets. Banks have had a huge of amount of new money with which to speculate in risky assets around the world. Believing the central banks would (and could) protect them from all risk, they have speculated with trillions and trillions of dollars.

In 2008-2009 the financial crisis was caused by the U.S. mortgage market. Today there are financial imbalances much larger than our mortgage market throughout the entire world – funded by central banks' newly printed money. While it is difficult to even guess how this will end, we have all the ingredients in place for another, larger financial crises.

Before moving on, I would have to say the central bank academics who studied the Great Depression appear to have learned the wrong lessons. Yes, during the Great Depression we made several huge mistakes, such as raising interest rates too early at one point (something our Fed plans to do fairly soon) and attempting to balance the budget in a depression, plus our banking system was fraught with risks which exacerbated the economic problems. Federal Reserve Board academics think the fact central banks and governments made those mistakes somehow means central banks can fix the problems suggested by deflation. No, we can avoid the mistakes of the 1930s, but this does not mean central bank policies can positively correct debt-induced deflation.

Next let's move on to the hard part. <u>If the mainstream view of stopping deflation through increasing the money supply and lending is not the solution, what is the right answer?</u> The difficulty in answering this question is inherent in the nature of dealing with debt-induced deflation. When you have far too much debt, you have already spent a large amount of future consumption. You must spend less going forward to pay the interest and principal. This by definition leads to a slower economy and lower prices. In fact, the largest study done on this topic, by Kenneth Rogoff and Carmen Reinhart, the results of which were published in their book entitled *This Time is Different – Eight Centuries of Financial Folly* – showed economies slow down by at least one full percentage point a year when their government debt reaches 100% of GDP. Here in the United States we are presently just over that figure, while countries in Southern Europe are far above this threshold, and Japan has near 250% government debt to GDP. If you add in private debt to the calculation you see China has gone far, far beyond the level of debt associated with sustainable future growth.

In other words, the economy is going to slow down going forward – period. How much it regresses depends first and foremost on how deep a hole your economy is in at the beginning. Our "debt hole" is large, though not as big as the gaping chasms faced by Japan, the Eurozone and China.

The main alternative view of dealing with debt deflation begins with this recognition. This alternate view is loosely connected to the Austrian school of economics. This viewpoint looks at deflation not as the cause of the problem but as a result of over-indebtedness. When attempting to fix a problem, you do not focus on the effects but on the underlying causes. You can start to see why the mainstream economists and financial media do not want to even consider looking in this direction, as with this alternative view we admit from the very start the economy is going to slow down. We also admit deflation, considered the worst possible economic outcome, may very well descend on us. Nobody wants to admit the consequences of dealing with too much debt, but the only way to keep from experiencing those consequences is to….. create more debt. But the sooner we stop going down this path, the sooner we can come out successfully at the other end.

If this alternative view does not support printing money to pile on more debt, what positive ideas does it offer? The answer to this question is to examine what actually creates economic growth. Instead of focusing on trying to get over-indebted consumers to consume more – through more debt – we focus on creating successful businesses. Yes, it is much, much harder for new businesses to succeed when consumers are accumulating less debt, but good entrepreneurs have always been able to succeed, even in challenging times.

The news on business creation at this time is truly dismal. The most definitive study on this topic is done by Gallup, and here is their summary of the state of small business creation (by Jim Clifton, Gallup CEO & Chairman):

"The U.S. now ranks not first, not second, not third, but 12th among developed nations in terms of business startup activity. Countries such as Hungary, Denmark, Finland, New Zealand, Sweden, Israel and Italy all have higher startup rates than America does.

We are behind in starting new firms per capita, and this is our single most serious economic problem. Yet it seems like a secret. You never see it mentioned in the media, nor hear from a politician that, for the first time in 35 years, American business deaths now outnumber business births.

The U.S. Census Bureau reports that the total number of new business startups and business closures per year -- the birth and death rates of American companies -- have crossed for the first time since the measurement began. I am referring to employer businesses, those with one or more employees, the real engines of economic growth. **Four hundred thousand new businesses are being born annually nationwide, while 470,000 per year are dying."**

Over the last dozen or so years I have carefully listened to every proposal by both of our political parties on supporting small business creation and success. It has been shocking how little I have heard on this topic. During elections politicians often talk about the need to support small businesses, but they typically offer no concrete proposals – and when they do those proposals are almost always ignored once elected.

Without going into too much detail, I can think of several things governments could do:

1) Reduce regulation on small businesses. Throughout much of Europe new businesses hardly have a chance to succeed due to excessive regulation. This is also true in some industries here in the U.S. Personally I have always had mixed feelings about business regulation in our country. On one hand I see the gross negligence and fraud in many of our corporations, and left unregulated I know they would do even more. On the other hand, in practice our government regulations often appear to have little or no impact on the larger corporations while presenting a large hurdle to the creation of new businesses. In other words, the regulations typically don't actually prevent larger corporations from engaging in bad behavior while keeping those corporations' competition limited. I know this is how regulation is done in financial services, and I suspect the same holds in at least some other industries. Since our government creates the regulatory process, this could be remedied.

2) Change the tax code to encourage small business success. Whenever taxes on small businesses are discussed, the idea is usually to lower the rate on the upper tax brackets. Instead, if anything I would raise taxes on the upper brackets for small business owners. I don't want to incentivize small business owners to pay themselves a $300,000 salary. Those who do will probably never create a larger, successful business, as this typically requires some sacrifice while the business is initially growing. I want business owners who will take less money for themselves so they can hire more

people to turn the small business into a large one. To incentivize this, I would have the taxes on the business owner's salary relatively high as the business is building, but then I would reduce or preferably eliminate capital gains taxes when the now successful owner sells his or her business. This would incentivize owners to take less for themselves as the business grows, leaving more to hire to expand the business. Then at the end the successful business owner would have, hopefully, a huge windfall. That would be a "win-win."

3) Subsidize small businesses for new hires. I would pay for some or, preferably, all of the wages of new employees hired by small businesses for the first 1-2 years. This idea was actually discussed by the Obama administration in the spring of 2009 – for a few minutes. Larry Summers, President Obama's top economic advisor (and the man who made nearly all decisions regarding the economy in the White House in 2009-2010), said this had been tried and it doesn't work, so the topic was immediately dropped. I disagree. I am confident we would have more business creation and success, and more hiring, if small business owners received subsidies for new employees in the early stages of their business. Of course, some of this money would be wasted, as some of those employees would be fired and some of the businesses would fail. But we have tens of millions of working age Americans who aren't working, many if not most of whom are living off checks they receive from the government. I would much rather have some of those people receiving their government assistance for working in a new job.

4) Reinstate the Glass-Steagall Act. This is the law, passed during the Great Depression in 1933, that made it illegal for banks to gamble with depositor money. It was repealed in 1999, an act which was a major cause of the financial crisis in 2008. We desperately need to return to the traditional banking system in which banks simply accept customer deposits and lend this money to qualified borrowers. This would prevent future financial crises and also be a boon to small businesses. Right now banks do not want to lend money to small and even mid-sized companies, as the banks can make so much more so quickly and easily investing their money in risky assets around the world, convinced the Fed will protect them from losses. But if banks could only make their money through lending, that's exactly what they would do. Of course, they would not make nearly as much profit during good times, but they would also avoid massive losses during bad times. In other words, banking would be the relatively stodgy old industry it used to be when it actually performed the function it was supposed to do in an economy, i.e. protect and pay interest on customer deposits and lend out the money (to qualified borrowers).

This is a relatively short list, and I'm sure others could come up with many more and probably better ideas (except the last one on Glass-Steagall – this desperately needs to be done without reservation). I am not a politician, tax law expert or labor economist. I do, however, know we need to do *something* to encourage the one activity most needed to grow this economy, which is small business creation and success. The entrepreneurs are the absolute key, and the government definitely cannot assure small business success. But we could at least remove government-created obstacles and perhaps do a few things to encourage and support those entrepreneurs.

Summary

Deflation looks to be heading our way, as deflationary risk is now confronting the entire world. Mainstream economists and most central bankers view deflation as the biggest danger that must be combated at all cost. Their primary tool is to print money, and then print more money. Their basic premise is the new money will be loaned out to businesses and consumers who will then spend more, driving up prices. They are correct in thinking the economy would grow if more debt was created. However, this is neither a prudent nor effective path to take when too much debt is the actual cause of the deflation.

An alternate view would be to recognize deflation is occurring, or in danger of occurring, because the world economy is slowing down due to too much debt. In this situation there is actually little central banks can do to help. They can flood banks with new money, but they cannot force them to lend it out or force businesses and consumers to borrow it. Actual experience – over 20 years worth in the case of Japan – shows this approach does not work. It does, however, expose the economy to very large, unknown and unknowable risks.

Instead, the alternate view would be to have any positive intervention be undertaken by elected government representatives, not the Federal Reserve Board academics. I know this may be a scary proposition these days, but in a democracy this is what we do. And the focus of those elected representatives needs to be on supporting – or at least not thwarting – the creation and success of small businesses. They create the new good jobs our economy desperately needs to grow.