A Deflationary Collapse Followed by Hyperinflation

On the one hand some economists are blasting Central Banks for expanding their respective money supplies at unprecedented rates all over the world. They say Central Banks are "printing" and injecting hundreds of billions of dollar equivalents into their economies yielding pervasive global double-digit monetary expansion. e.g. Calculated M3 in the U.S. expanded at a 15%[(1)] annualized rate during the last quarter of 2007. Eighteen of the top twenty central banks are increasing their money supply at "double digit" rates according to Bloomberg data.

On the other hand another group of economists assures us the Central Banks are ***not*** "printing" excess money, and the money supply is actually shrinking. e.g. the U.S. *monetary base* as reported by the Federal Reserve Bank of St. Louis increased a modest annualized 1.1%[(2)] during the 3rd quarter of 2007; and the more significant M1 ***contracted*** (1.6%)[(2)] in the same period. So, what are we to believe? Is the money supply shrinking or expanding? Is it Inflationary or Deflationary? Finally, is it healthy or harmful?

Milton Friedman advanced the entire macroeconomic analysis world in clarifying with broad endorsement that inflation is "…always and everywhere a monetary phenomenon." Today one could argue that his insight is stating the obvious. Why central banks continue to act innocent or surprised when "inflation" is increasing, as they themselves are the sole owner of expanding the monetary base causing the dreaded inflation, is beyond me. The heart of the challenge is understanding which group in power influences:

1. ***Expansion of the monetary base (M0),*** which ***enables*** the ultimate expansion of M1, M2, MZM, and M3; all of which influence Consumer Price Inflation (CPI), and
2. ***Expansion of primarily the broader monetary aggregates M2, MZM, and M3***, and
3. ***Expansion of financial (stocks and bonds) and real estate asset valuations into bubbles*** far beyond their fundamental justification.

IS IT:

A) The **Central Bank**, or
B) The **"Financial Cartel"** including major Banks, Brokerage Firms, Hedge Funds, Private Equity Firms, Agencies (GSE's), etc.?

ANSWER:
The Central Banks ***directly influence*** the Monetary Base (U.S. $852.3 billion; end of 3rd qtr. 2007)[(2)], which includes non-bank currency and member bank reserve deposits held at the central bank. When Central Banks "monetize debt", they purchase Treasury Securities from the public with "printed money" out of thin air; hence ***directly*** expand the money supply. This activity is guided by the highly visible FED target for the Federal Funds Rate (currently 4.25 %) and executed by the Federal Open Market Committee (FOMC) operations group.

From this point on, starting with the noted "printed money" deposited into ***Member Bank's*** reserve accounts the **"Financial Cartel"** is able to further expand the money supply a ***multiple of TEN times*** via successive borrowing and depositing in financial institutions, a process enabled by our fractional reserve banking system today. A very important point here… ***The "Cartel" can ONLY incrementally expand the money supply by LOANING more money to interested borrowers..!! If borrowers are unwilling or unable to seek new loans, this gigantic part of the monetary expansion puzzle WILL NOT GROW!*** In theory, an initial $1 Central Bank "debt monetization" injection could enable an additional $9 money supply expansion, all of which must be willingly borrowed by someone on earth! This extraordinary leverage is evident by observing the higher-level monetary aggregate values in comparison to the monetary base. At the end of the

3rd quarter 2007, M1 = $1,369.8 [(2)] billion; M2 = $7,328.1[(2)] billion; MZM = $7,743.6[(2)] billion; and M3 = $15,000[(1)] billion.

So, it is the Central Bank that initiates the monetary expansion with its relatively small but powerful dose of debt monetization. Then the Member Banks take charge via the Fractional Reserve System to expand the money supply an order of magnitude greater via successive new loans! HOWEVER, IF THE CENTRAL BANK chooses, they have the POWER to RESTRAIN Member Banks in their ability to expand lending via the noted Fed Funds Interest Rate tool plus another powerful tool, the reserve ratio requirement for Member Banks. IF THE CENTRAL BANK DOES NOT ACT TO RESTRAIN EXCESS LENDING BY UTILIZING ANY OF THEIR TOOLS, THEY ARE COMPLICIT IN THE EXTRAORDINARY EXPANSION OF THE HIGHER LEVEL MONETARY AGGREGATES (M2, MZM, & M3). It is analogous to an armed guard looking away while the prisoners escape "undetected".

If the Money Supply Expands Greater Than Output, Where Can It Go?

Given the massive monetary expansion noted above, it must go somewhere! If, for example, an 11% increase in the total money supply (M3) was strictly chasing after a 1% increased Output (GDP), which is predominantly consumer goods and services, then the inflation rate would be approx. 10% reflected by government's Consumer Price Index (CPI). If alternatively the expanded money supply chased after financial assets (stocks & bonds) and real estate, then those assets would increase far greater than fundamentally justified levels. In this example, if the money supply expansion exclusively chased after financial assets only, and increased them by 10% with a stagnant GDP (0% increase), the government's "official" inflation rate would be 0%. The government's CPI measure of inflation does **not** include the noted asset increases. Thus, it is possible for the Central Bank and "Financial Cartel" to massively expand the money supply and yield little or no "official" inflation for a limited period of time.

If the monetary policy practice were to continually debase our money supply at a consistent rate, say 2% annually, then all markets would generally adjust to that condition and asset bubbles would not form. If productivity was a matching 2%, then all Goods and Services would remain static in price as the increased real output would match the increased money supply. Bond and stock prices in aggregate would become conditioned to expect the 2% inflationary base and their prices in total would rise 2% greater annually than they would with 0% inflation.

If monetary currency debasement policy induces predominantly an asset boom such that asset prices rise faster than inflation plus Output growth (GDP), and has a less predominant impact on Goods and Service prices, then we have created a classic ***asset bubble***. The asset prices have "disconnected" from the fundamental Real value of the stock, bond, or real estate parcels. A bubble is an illusion of wealth that exists and will remain in place until the market discovers the illusion. Once discovered, they invariably diffuse or pop. The least politically damaging method to facilitate the bubble valuation correction is to debase the currency (inflation), which ***maintains*** the illusion of wealth for dollar and dollar-based asset holders. e.g. The nominal value of a stock may remain stable in its dollar-based price, but if those gradually cheaper dollars buy fewer eggs and gasoline, the asset holder has experienced wealth diffusion, compliments of his central bank policy. If the magnitude of the bubble is historically significant, the likelihood of a "pop" bust is much greater.

Assuming a "significant magnitude bubble" condition, when the central bank embarks on the practice of debasing our currency in extraordinarily aggressive visible moves via significant interest rate cuts and massive debt monetization, those holding dollars and dollar-based assets tend to "get it" and begin selling regardless of the consequences. They "get it" because their expectation as a creditor to be paid back in full, plus interest in money with the same buying power is rapidly wilting. Clearly, if numerous investors "get it" within a short period of time, then a self-reinforcing downward spiral in asset prices along with the usual teasing short-term rallies will progress.

Two Opposing Forces; Deflation & Inflation

The size of the debt bubble today is approx. $30 trillion[3]. Since the lion's share of that bubble was created via the "Financial Cartel" by approving, re-packaging, and selling "toxic-waste" poor quality loans, they along with all those owning inflated bubble assets will suffer the valuation contraction (deflation) as loans default and the horrific liquidity expansion reverses (deflation) back to an equilibrium. HOWEVER, the political forces will be out in earnest encouraging the Central Bank to start winding up Ben Bernanke's infamous helicopter to monetize debt (inflation) at extraordinary rates, but there is a huge problem with conducting this rescue operation under today's conditions. Those holding massive dollars and dollar-based assets all over the world will have a real issue with their stake withering in value (deflation) proportional to the rate of money printing (inflation). They will "get it"…! As they "get it" on a visible scale, they will be motivated to dump the dollars and dollar based assets (deflation) before they become totally worthless. This much more powerful market force of those who "get it" will facilitate a downward spiraling asset devaluation UNTIL the inflated asset bubbles have shrunk significantly enough (deflation) and the rate of money printing (inflation) by the less powerful Central Bank finally overwhelms the slowing rate of asset devaluation. I anticipate this will be 1-3 years. Ultimately, the hyperinflation will dominate goods and services, all assets, and even the family pets.

The Internal Restraint in Our Central Bank to Blatant Monetization

Mind you, there is a contingent of "hawks" within our own central bank resistant to literally dropping billions out of helicopters overnight. This resistance favors the likelihood of asset deflation before the "hawks" finally capitulate and support massive hyperinflation. This debt monetization behavior on a massive scale would be as obvious as a pathetic third-world fiat currency debasement stunt performed time and again throughout history. i.e. if it is pathetically obvious to the masses, investors and the governments representing them will be pressured to dump the rapidly depreciating dollars and dollar-based assets regardless of the consequences on the world economy. Eventually, as the economy sinks into depression and the asset valuations drop to more rational levels, our central bank monetary helicopter expansionists will gain the upper hand. They will be forced to "Inflate or Die"… regardless of the sentiments of our screaming hapless long-time trading partners.

Conclusion

The more powerful market force of deflation will have the upper hand initially because of the size of the credit market bubble that must be diffused today; approx. $30 trillion [3]. The opposing force of inflation by the central bank will pale initially in comparison. Their efforts to create yet another illusion by papering over the credit contraction with $50-100 billion a week (e.g. post 9-11 & post Katrina) monetization injections will lose to the greater force ($30 trillion bubble) for

1-2 years, then will finally take over. At that stage the momentum of inflation will be in its own Ponzi self-feeding frenzy, thus launching us into the hyperinflationary phase. At some point the dollar will follow the same fate as countless fiat currencies have in history… It will become worthless. At that point I am optimistic real money (gold, silver, etc.) will return at center stage and keep a very short leash on the "Financial Cartel" to prevent them from re-launching another systemic speculative charade of illusory financial wealth that would lead us yet again down the same reoccurring path in history.

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References:

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(2) Federal Reserve Bank of St. Louis Monetary Trends; Jan 2008
(3) Total Market Debt as % of GDP; 12-31-2006 Ned Davis Research; See the logic on page #2 and the graph on page #3 here: http://austrianenginomics.com/AndNowTheGreatestBustinUSHistoryA.pdf