

The Y2K+8 Deflation Hoax

By Adrian Douglas

Do you remember the fear that gripped the whole world in the late 1990's that proclaimed that the world would descend into chaos on January 1, 2000 because of the computer software bug which caused the year to be only stored as two digits? We were told that planes would drop from the sky, bank accounts would be lost, power grids would fail, nuclear missiles could be accidentally launched etc. It is estimated that 300B\$ was spent globally to prevent this Domsday scenario. In 2003 James Taranto of the Wall Street Journal called this "The Hoax of the Century". It can be argued that it was the enormous preparation and prevention that averted worldwide calamity but running counter to that claim is the evidence that third world countries that did next to nothing, in terms of prevention, did not experience cataclysmic events.

In 2008 the fear mongers were warning that the world could sink into a debilitating economic deflation. One of the biggest fear mongers of them all was Ben Bernanke. We supposedly were to believe him because he was a student of the Great Depression and he apparently knew how to save us. The fear mongering was so successful that Ben Bernanke and Hank Paulson assumed extraordinary power to create and spend massive amounts of money without Congressional oversight or approval.

It is less than one year since the fear of deflation gripped the world. Ben Bernanke last month made his semi-annual testimony to the House and Senate on monetary policy.

<http://www.federalreserve.gov/newsevents/testimony/bernanke20090721a.htm>

This testimony contains 2,898 words. However, the word "deflation" is not one of them! The word "inflation" appears five times in the report!

What happened, Ben? Did the mythical monster of deflation that was supposed to be lurking in the shadows of our financial system for years to come just die of natural causes?

The Deflation Scare of 2008 was very much like the Y2K bug hoax, and what I have termed the Y2K+8 hoax! It had enough substance for the uniformed to believe it was a terrifying threat. But it was never a real threat, which is borne out by the fact that one year later it doesn't even merit mentioning by the only person that counts when it comes to monetary policy, the Chairman of the Federal Reserve!

If you have a prolonged power cut at your home does it mean that there is an energy crisis? The answer is “no”. The loss of power is temporary while an energy crisis would mean that power interruptions would become widespread and systemic. However, if you were in the middle of a power cut that had lasted several days how would you know that it wasn't a long term energy crisis? It would certainly feel like one! This is a good analogy for what happened in 2008.

Austrian economists define deflation as a contraction in the money supply which will manifest itself as a fall in the general price level, while less strict definitions define it as a fall in general price level. Last year the fact that the price of houses, stocks, commodities and many other assets fell dramatically led to a widely accepted notion that the world was in the grips of a cruel deflation. John Willaims at shadowstats.com compiles data that shows that the money supply by any measure has not contracted; only its rate of expansion has slowed.

But why should we be afraid of falling prices? I love it when stocks fall and I can buy them cheaply, or house prices fall and I can make a smokin' deal, or new cars are being discounted below cost. Of course, that is a buyer's viewpoint; the seller is not so enamored by falling prices! If “low prices” are the problem the problem is soon solved by low prices spurring increased demand and then as demand grows, prices rise again and economic growth resumes.

The cataclysmic aspect of true deflation is not falling prices per se but the fact that money can not be made to circulate in the economy. Economists typically discuss inflation or deflation in terms of the “money supply” but essentially this is incorrect. So let's discuss the mechanics of pricing. The price of goods and services will be determined by what quantity of goods and services are available for purchase compared to the quantity of money actively seeking such goods and services. In other words what affects pricing is the amount of money circulating in the economy. If the Federal Reserve creates one trillion dollars for the Government in exchange for Treasury debt and the Treasury keeps it in its bank account the money supply will have increased but there is absolutely zero inflationary effect because it is as if the money didn't exist if it is not circulating. Now if the Government spends the money then that is inflationary. Changes in prices will come about by either an increase or decrease in the money in circulation and/or an increase or decrease in the amount of goods and services for sale. In a similar vein to our money supply discussion the amount of goods and assets in existence do not affect prices. If you were told there are 100 million homes in the USA you might think house prices should be very low, but only about 600,000 homes are for sale at anyone time. It is those 600,000 homes and the fluctuation in that number that are actively seeking buyers compared to how much money is circulating that determine home prices.

In our modern economy where bartering of goods is almost non-existent, you can not have economic activity without money circulating. If money is not circulating then there are no goods changing hands and so there is no economic activity. In

general governments want high economic activity because their tax revenue is a percentage of it and their re-election is tied to the health of the economy. For this reason governments, with the aid of their crony Central Banks, always follow inflationary policies, which is akin to administering increasing amounts of steroids to an athlete on a continuous basis. Although governments can create currency they can not necessarily make it circulate. It is individuals and companies who constitute the productive economy who decide if they are going to spend and/or manufacture goods. If spending habits start to go down dramatically then it can descend into a vicious cycle because as economic activity declines companies fire workers, those unemployed workers can not spend as they have no salary, this makes economic activity decline further and so more workers are fired etc. The economy will eventually decline to subsistence level where discretionary spending is almost zero and people and businesses buy only the bare essentials.

How does such a scenario come about? Lets' consider the gold standard monetary system that existed at the time of the Great Depression. Under a gold standard "money" does not circulate, it is "currency", a paper money substitute that circulates. That is to say the monetary system is asset backed but the money is stored safely in a bank vault and the bank issues a bank note that represents, and is redeemable at anytime for, the gold on deposit.

What happened during the roaring 1920's was that the government issued more bank notes than it had in gold, and banks made loans that were not backed by gold. In other words the currency supply was inflated, not the gold supply. When the inflationary excesses couldn't be maintained there were bank runs as people rushed to the banks to redeem their bank notes for gold. Many banks failed as they simply didn't have enough gold. Many scholars who have studied the Great Depression have concluded that the Federal Reserve didn't do enough to inject more money into the system. But the problem was that there was already an excess of currency (bank notes) and not enough gold. The only "money" that can be injected into the system to solve the problem is unencumbered gold...but that can not be created out of thin air. As bank notes were redeemed the currency in circulation reduced causing a massive slow down in the economy which caused massive job losses. This was deflation. The problem was essentially a total mistrust of the banking system. The banks had committed fraud by issuing more bank notes than could be honored so, in response, citizens withdrew their gold. If the trust is not restored then the theoretical extreme limit can be reached where the citizens have all the gold and the banks have none. They can then not issue any currency at all. As it is currency that circulates to make the economy function the economy goes into a death spiral. Money becomes more valuable than all other goods...but in this sense I am referring to money as being gold NOT the currency. However, because the establishment clings to a fixed dollar to gold exchange as required by the gold standard it appears that the dollar is also more valuable than all other goods. This leads to a general decline in the price of goods with respect to gold or dollars (as the relationship is fixed) and is what could be truly defined as deflation. There is nothing the government can do to

“stimulate the economy” under such circumstances which would require it to coax or cajole the gold out of the hands of the citizens to encourage them to spend it. This is because in order to spend it citizens would need to deposit their gold back into a bank in return for currency; but with a total mistrust of the banks this will not happen. If the government spends more paper currency into existence to boost economic activity the paper is taken to the banks to be exchanged for gold and the currency is removed from circulation almost as quickly as it is created.

The analogy we can make is of a football game. The currency (or money) is the ball. The players are all motivated to get the ball but when they get it they are ready to pass it on. This is like a healthy economy as money circulates and economic activity is brisk. The analogy for deflation is that one player doesn't trust any other player to pass the ball so he holds onto it, and takes it to the locker room! The game will come to a complete stop just like an economy where participants refuse to part with their hoarded money.

The solution President Roosevelt took to the problem was to forcibly take the gold back into the banking system by confiscation and deliver substitute “currency” in exchange. Although the dollar was still ostensibly backed by gold convertibility was annulled. Then by inflating the currency citizens were forced to spend their dollars and not to hoard them or their spending power would decline. This was the beginning of the reversal of the deflationary phase and this reversal picked up speed with the inflow of gold in the Second World War as America became the supplier to the Allied Forces.

In the monetary system we have had since 1971 the US dollar is backed by nothing. However, there was a fascinating observation to be made from the credit crisis of 2008. When banks failed customers lined up for hours to retrieve their “money”. They were given cash in some cases but most often they were given a cashier's check which is regarded by most people as the equivalent of cash! This is quite astonishing crowd behavior! It means that “currency” is the electronic dollars that are wired from bank to bank, or spent on debit or credit cards or by check while the “money” that is on deposit for which the electronic currency serves as a substitute is a hard copy paper voucher! In other words electronic dollars are backed by and redeemable in paper dollars, just as paper dollars were backed and redeemable in gold under the gold standard. Try not to laugh but that is exactly what can be observed!

This is why the Gold Cartel, acting under orders of the US Government, hammered down the price of gold and silver with massive short selling in July 2008. It was imperative that paper money was viewed as the ultimate safe haven. People who withdrew dollars from the bank kept it at home. The Federal Reserve and the Government made sure that all comers got their cashier's check or paper dollars. So nobody lost any money from bank failures! Now every Friday one or two banks fail (73 have failed in 2009 at the time of writing!) and the people shrug and consider it totally irrelevant to their daily lives.

The money supply growth by the Federal Reserve has declined but has not come close to becoming negative. But in 2008 assets were liquidated on a massive scale and as a result dollars were withdrawn from circulation by paying off debt or hoarding.

This caused a temporary deflationary effect on prices of commodities, houses and financial assets and on discretionary consumer items. Borrowing by the public has nose dived but the Government has elected to borrow instead of the general public and is spending on a multi-trillion dollar scale, putting dollars back into circulation. As this circulation gathers pace price inflation will be the result, which is already becoming evident in the price of commodities, food items, health care, and the stock market. The massive contraction in economic activity and resulting GDP means there are far fewer goods and services on offer which will further amplify inflation. As the US dollar loses its purchasing power hoarded dollars will be sucked back into circulation and fuel even more inflation.

The spending by the Government is not productive and does not invest in activities that will be self sustaining and that can generate future revenues in the absence of government stimulus spending. For this reason, the Government spending will become more addictive than heroine and the end result will inevitably be hyperinflation.

The analogy for inflation is that have a football game played with more than one ball! The game can still be played and it will be fast paced but it would be far from being like a conventional football game! The analogy for hyperinflation is when there are 22 players and 22 balls. There is no point in playing; there is no point in any player chasing after a ball as each player already has one and by the same token there is no point in trying to pass a ball because no one wants to receive one! The limit of hyperinflation is exactly this. Everyone has billions of dollars but nobody wants to receive them in commercial trades. The economy grinds to a halt and crashes as the money becomes worthless due to massive over-issuance. At this point a new currency with a certain scarcity will be introduced. Those that win will be those holding real valuable assets like gold and silver not those holding worthless currency.

The monetary sleight of hand that makes paper dollars appear to be real money and electronic dollars to be the circulating currency means that prolonged deflation is just not possible unless the Federal Reserve wanted it to be so. The FED and the Government has nothing to gain from a completely stalled economy in the grips of true deflation. It is abundantly clear from US Government policy that the intention is to inflate the dollar supply. Inflation and hyperinflation are guaranteed outcomes.

If there is any doubt about the Government's commitment to inflate then I recommend looking at the Inspector General of the TARP, Neil Barofsky's,

testimony to Congress last month. He testified that the 50 or so recovery/stimulus programs have total spending capacity of 23.7 Trillion dollars! A Treasury spokesman later stated that only 2T\$ had been spent so far. That “only 2T\$” represents an annualized increase in the money supply of over 20%. This also raises the question about the integrity of the money supply reporting because there is no such increase evident unless it is in the now unreported and secret M3. I do not have any illusions that if government officials are given a spending limit of 23.7 T\$ that they won’t spend it in its entirety.

Precious metals are the ultimate protection from such determined and wanton wealth destruction.

There is no precedent for deflation occurring in a purely unbacked fiat monetary system. Many economic historians hold up the example of Japan in the 1990’s. But as can be seen from figure 1 Japan’s money supply never actually contracted to any significant extent, but did exhibit chronic slowing rates of growth and even had times of zero growth. Japan suffered falling prices due to asset liquidation as the real estate and stock market bubbles burst. But during the so called deflationary period Japan remained one of the most expensive countries in the world. This is hardly synonymous with what would be imagined with debilitating deflation!



Figure 1: Japanese Money Supply and CPI

The main issue with trying to stimulate economic activity in Japan was that the BOJ had the lowest interest rates in the world such that money was borrowed in Yen and exchanged into foreign currency (mainly dollars) and invested overseas in what became known as the “Yen Carry Trade”. Efforts to inflate the domestic money supply failed as Yen were returned directly to the BOJ in exchange for foreign reserves. The large trade surplus Japan enjoyed allowed this to continue far longer than could have been the case with many other countries.

What is missing from almost every discussion I have read that predicts deflation is the massive derivatives market. The OTC derivatives market reached a peak

of 1.4 Quadrillion dollars of notional value in 2008. This completely dwarfs any other market on the planet, and dwarfs the global GDP of a mere \$60 Trillion. Such an elephant can not be excluded from the discussion. What was the function of this market? The derivatives market was one of the major instruments of the US Government and its crony allies to depress the price of commodities and interest rates as explained by Peter Warburton (http://www.gold-eagle.com/gold_digest_01/warburton041801.html). In the US just five US banks completely dominate the OTC derivatives market, owning 96% of the notional value! This is manipulation at its finest and out of the glare of the media, the regulators and most of all the general public. The average person has never even heard of a “derivative” let alone know what one is. Greenspan vehemently defended the derivatives market against all oversight and regulation claiming that it would reduce the efficacy of the market! Yes, it would certainly have torpedoed the ability to suppress prices of real things and the ability to prop up the value of the dollar so that the USA didn't need to produce any exports to earn a living apart from the manufacture and export of US dollars. The derivatives market serves as a phantom offer of future supply of commodities and a phantom bid for US Treasury debt. The fact that since the credit crisis the derivatives market has dropped in dramatic fashion means that as it unwinds the opposite effect should be observed namely higher commodity prices and higher interest rates. This is already becoming an obvious trend.

A 1.4 Quadrillion dollar gorilla was sitting on the opposite side of the see-saw to counterbalance the massive dollar creation of the last 15 years. The BIS reported that the notional value of OTC derivatives had fallen to 592 T\$ at the end of 2008. As risk aversion and physical shortages cause this gorilla to shrivel, die and fall off the see-saw there will be nothing to hold down soaring prices of real things and interest rates. The true global imbalance that has been masked with financial wizardry will be suddenly exposed. The results will be rampant inflation and then hyperinflation which will end in total destruction of the US dollar, the seeds of which were planted 15 years ago, but the plant only produced ripe and poisonous fruit in 2008.

When all this is weighed together the macroscopic picture is clear. There is absolutely no chance of the US suffering from deflation. This is why the word “deflation” was completely absent from Ben Bernanke's semi-annual speech to the House and why inflation was the only type of “flation” that was mentioned. The man behind the curtains knows what a fraud the wizard really is, and he gave us a clue from this Freudian omission.

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