The Stan Clark Financial Team's

PERSPECTIVES

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Assett Allocation

Inflation vs. deflation: Which is more likely? Part 2

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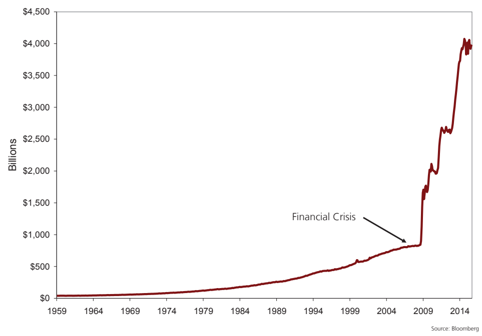
As discussed in last month's issue, many economic experts believe that the U.S., and other related countries like Canada, are more likely to face deflation than inflation in the years to come. These experts point to the theory of *debt deflation*. When debts are excessive and people try to reduce their debts by selling assets, also known as *deleveraging*, it puts downward pressure on prices and can result in deflation. Many economists view deflation as more harmful to the economy.

The low interest rates we see now on U.S. 10-year bonds of around 2% prove that many savvy investors are betting deflation is very possible.

U.S. Monetary Base

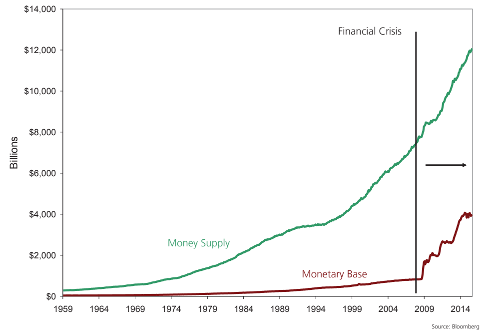


But we also hear other economists and investors worrying about the future high levels of inflation. Many cite the unprecedented increase in the monetary base in the U.S. The monetary base has increased almost five-fold from $843 billion in August 2008 to $4 trillion currently (see above).

The monetary base consists of all the notes in circulation and in bank vaults. It also includes the reserves that the banks have on deposit at the U.S. Federal Reserve. The Federal Reserve increased the monetary base, mainly through its series of financial rescue programs in 2008, and then by its quantitative easing programs in 2009 through 2014.

The monetary base is only a fraction of the money supply. The money supply (see below), or *M2*, consists of notes in circulation plus all the money in bank accounts. The concern is that the large increase in the monetary base can cause a big increase in the money supply because of the multiplier effect. Historically, the multiplier averages 10 times. That means for every dollar increase in the monetary base, the banking system increased the money supply by $10. So, some experts worry that increasing the monetary base by almost five times could theoretically mean increasing the money supply by almost five times – resulting in lots of inflation.

U.S. Money Supply



Up to now that hasn't happened. The money supply increased, but only about as much as the monetary base increased. There was no multiplier to the new reserves because the banking system was hesitant to lend. Plus, many borrowers are trying to reduce their borrowing.

Another thing: The money supply is linked with inflation through what's called *velocity*, the number of times the money changes hands in a year. Velocity is normally pretty steady and has averaged around 1.8 over the past 50 years. Velocity fell from 1.86 in the second quarter of 2008 to just 1.50 today, since more people are sitting on their money than spending it. These are the reasons that the increased money supply has not increased inflation. Not yet, anyway.

This is not an easy topic, but think of the economy as a tire. With a financial crisis, banks, companies and individuals try to move to safety. They do this by reducing borrowing and hoarding cash. This is comparable to your tire having a slow leak. If the central bank does nothing, then the tire will deflate and go flat. This is what happened in the 1930s. Pumping more reserves into the banking system is like pumping more air into the tire. Because of the leak in the tire, this doesn't cause the tire to over-inflate. In fact, pumping keeps the tire from deflating.

To date, these actions have been successful at preventing deflation while not causing inflation. So far, so good. However, the real test will come when the leak in the tire is eventually plugged; that is, when confidence returns, banks will want to increase lending and people want to increase spending. When that happens, the Federal Reserve will have to be equally aggressive in removing these excess reserves from the system. Why? So the excess reserves don't cause a balloon in the money supply and excessive inflation. The Fed certainly has the ability to do this, and they are very aware of the risk. The question is this: Does the Fed have the wisdom and the will to do so? It wasn't successful in preventing the sub-prime bubble last decade. We can only hope the Fed has learned from that and won't be fooled the next time around. ■

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