Part I

FINANCIAL INSTABILITY

Chapter 1

The Age of Inflation

The inescapable conclusion of any factual study of the major kinds of inflation is that debt, in its many forms, moves restlessly and relentlessly beneath all of them.

—Richard Dana Skinner[1]

The Great Reflation is the term we use to describe the government's massive monetary and fiscal stimulus program. Initially, its purpose was to stop the possible death spiral of the economy in 2008 and early 2009. Now its purpose is to prevent a relapse. The program has triggered an avalanche of new money. It will create a world that will be nothing like anything any of us have seen before. It represents a new and different chapter in inflation, a phenomenon that has prevailed off and on, but mostly on, since the outbreak of war in 1914. Then, almost every important country detached its currency from gold in order to finance the war with a free hand. That was the start of the Age of Inflation. Investors need to understand the historical context; it is important because the roots of inflation are long and deep, and it will not be easily ended.

The Age of Inflation has had a colorful history and consistently demonstrates the notion that money, not backed by something of value, does not look after itself. The discipline that comes with solid backing, traditionally gold or silver, makes it difficult to create too much money and prevents countries from running chronic deficits and surpluses vis-à-vis other countries. It also constrains banking systems from creating too much credit.

Some understanding of the modern history of inflation is important in gaining insight into the all-consuming problem of our day—where is the Great Reflation taking us and what can investors do to profit from the coming changes? In order to answer that question, we first need to focus on the origins of modern inflation, the nature and process of inflation, the different types of inflation, why it has occurred, and how it affects different assets. This understanding is critical for investors because it has the most profound effect on all investments—stocks, bonds, currencies, gold, commodities, real estate—literally everything that has a market price.

What Is Inflation?

Inflation is all about the creation of excess money and credit. Some would call it a disease, others a debauchery. Both would be correct and, unfortunately, the histories of all great empires are littered with monetary excesses and inflation. That is why we must all be so concerned when we see the U.S. empire heading down this path.

Many people think that inflation is just a rise in prices, but it's not that simple. Inflation does cause prices to rise, but it is important to be clear on *which* prices. Inflation is a process that begins with an increase in money and credit above what is needed for the production of goods and services. The second stage—rising prices—is actually a consequence of the first stage of inflation and that is what confuses a lot of people.

There is a clear distinction to be made between two types of rising prices. On the one hand, inflation can cause an increase in prices we pay for things we consume or use on a regular basis—food, haircuts, gasoline, washing machines. This is usually measured by the consumer price index (CPI), and it indicates whether there is a general rise in the cost of living. We will refer to this as CPI inflation.

On the other hand, inflation can raise the prices of assets we own or may want to own. For example, we can think of inflation raising the prices of homes, stocks, bonds, gold and silver, and foreign currencies. These types of assets don't necessarily move together or even in the same direction, nor does CPI or general inflation have to move in the same direction as asset prices. In the past 30 years, for example, the rate of general inflation has fallen while most asset prices have risen sharply (until mid-2008). Investors have to understand the different impacts that money and credit inflation can have on these two types of inflation.

Central banks, like the Federal Reserve or Bank of England, control the creation of money and, to a lesser extent, credit. When we are talking about inflation, we need to keep in mind the role played by central banks. Whenever there is inflation, whether it be in asset prices or the CPI, there is always a central bank to be found; and the central bankers are responsible for the integrity of the money, and that means responsibility for not creating too much of it.

Unfortunately, most central bankers have traditionally focused on the CPI type of inflation and have not applied the monetary brakes to asset inflation. The reason is that central bankers at the Federal Reserve and in most other countries were badly bruised by the raging general price inflation they created in the 1970s. The CPI rose to 15 percent or more in the United States and elsewhere, traumatizing the general public, the authorities, and foreign holders of dollars who saw its value collapse on the international exchanges. Afterward, central bankers focused on keeping increases in the cost of living low and stable and congratulated themselves when they succeeded. However, after the early 1980s, asset prices exploded upward in a series of waves, or cyclical bull markets. Figure 1.1 shows what happened to some key asset prices after 1982. Bonds and stocks began rising first, followed by house prices and much later by gold. However, by the late 1990s they all began rising sharply. Following the stock market decline from 2000 to 2002, all four asset markets exploded upward to the bubble peak in 2008. A rise in asset prices creates a feel-good atmosphere. There seem to be only winners, and the only losers are the ones who didn't play.

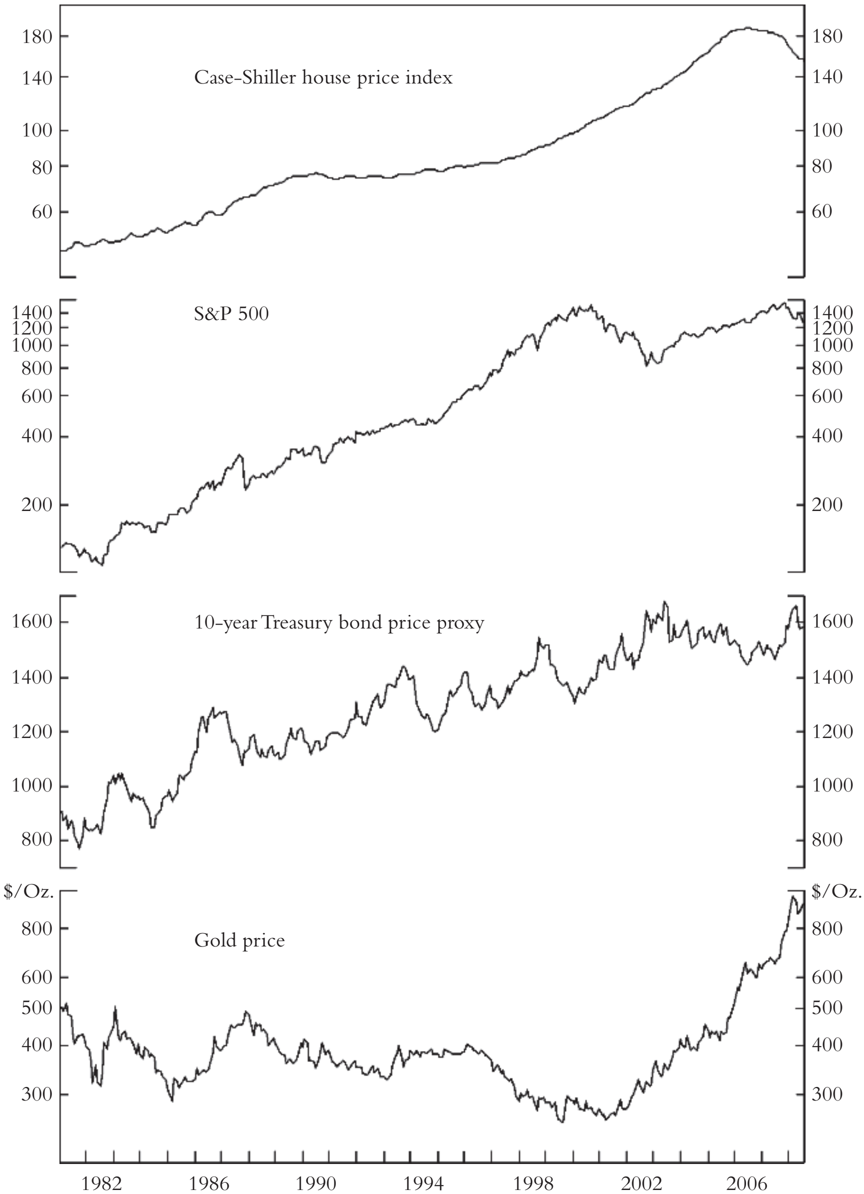

Figure 1.1 U.S. Asset Inflation 1981 to 2008
Source: Chart courtesy of BCA Research Inc.

Bull markets create a wonderful party, and it is not easy for the central bank to "take away the punch bowl."[2]

While central bankers were right to be very concerned when the CPI or some variant moved up rapidly, they paradoxically failed to understand that asset inflations are far more dangerous. They tend to be financed with too much credit. When the bubble bursts, as it always does, asset values drop sharply, as we saw in 2008 and 2009, but the debt remains. The assets can no longer support the debt, leaving balance sheets of people, banks, and businesses seriously compromised. Conversely, in a general CPI type of inflation, the real value of debt declines as prices rise. For example, if I borrow to buy a house and my income and the house value rises, I win on two counts. The mortgage is easier to service out of my higher income, and the debt I owe has fallen relative to the new higher price of the house.

When people use too much leverage in an asset inflation, it does not take much of a fall in prices to wipe out their equity. Creditors become suspicious that assets are no longer adequate collateral. Panic liquidation takes over, and a self-feeding spiral ensues. Prices fall to levels no one thought possible. This is what happened in 2008 and 2009, and is a familiar story to those who have read a little financial history.

The recent burst bubble and near-total banking collapse created a huge risk of another depression. However, it should be understood that the cause of the bubble in the first place was a massive inflation of money and credit that had its origin in the early 1980s, and was reinforced twice more, in the early 1990s and again in the early 2000s. The key to sustaining excessive monetary inflation over this period was falling CPI inflation and interest rates in the United States. The widespread view was that inflation was a nonissue. That is why so few, including the Federal Reserve, saw this crisis coming.

Major asset inflations, paradoxically, occur when the rate of generalized price inflation is falling and often very low. This is referred to as *disinflation. Deflation,* in contrast, is the term used to denote an actual decline in the price level. Severe deflation is a terrible disease because it is associated with recessions, depressions, mass bankruptcies, and high structural unemployment. Once started, it is very difficult to escape from, as the United States learned in the 1930s and Japan has learned since 1989.

Disinflation played a key role in the asset inflations of the 1920s and the nineteenth century. It was of critical importance after the 1970s for three main reasons. First, central banks had shifted temporarily to very restrictive monetary policies as a result of the dramatic rise in the CPI during that decade. Second, the cold war began to wind down after the late 1980s. Wartime spending is always inflationary; its ending is deflationary. Third, globalization opened up trade with rapidly developing low-wage, export-oriented countries like China.

During the almost 30-year period after 1982, interest rates fell steadily to low levels in a series of waves, triggering a borrowing binge. The U.S. government under Ronald Reagan started to run huge budget deficits which, at the time, caused mistaken fears of a new rise in CPI inflation. However, instead of pushing domestic prices up, the deficits resulted in a flood of cheap imports, leading the United States into a huge negative trading balance with foreign countries.

We can visualize this by thinking of Wal-Mart sourcing vast and growing amounts of goods from China at lower and lower prices, which it then passed on to its customers. The result was falling CPI inflation, as excess U.S. spending was deflected overseas, and China became the workshop for the United States and much of the rest of the world. Price inflation in the United States went down, and China created tens of millions of new low-wage jobs. It seemed like a win-win development.

Globalization, rapid growth, and a high savings rate in developing countries had another major effect: Their total savings rose rapidly and the savers were happy to lend virtually unlimited amounts to the United States so it could pay for the flood of new imports. The large inflow of foreign savings allowed the United States to save much less and borrow more, all the time pushing U.S. interest rates down. This, in turn, further stimulated the frenzy of U.S. borrowing and spending.

Central banks have no real mandate to restrict money and credit creation to stop asset inflations. Their focus, as we said before, has traditionally been on keeping money stable in terms of the cost of living.

Disinflation brings great benefits and almost always marks a time of prosperity and well-being. Interest rates are falling, asset prices are rising, and business activity and employment are strong. Everybody seems to be a winner. However, under the surface, big trouble is brewing because excess credit creation and asset bubbles are unsustainable. The longer they last, the longer people and the country as a whole, have to get in over their heads with debt. By 2008, the vulnerability was so great that it took only a modest tightening of monetary policy and a rise in short-term interest rates to just 5.5 percent to topple the debt structure.

The asset inflations in the United States in the 1920s, Japan in the 1980s, and the United States from the 1980s to 2008 fit this pattern perfectly. Before the 1920s, there were repeated bubbles and manias and, for the most part, they also followed the script closely.

To understand asset inflation, think of money and credit inflation as water coming out of a giant hose that has been stuck in the ground. The water must come out somewhere, but you can't be sure where. When the hose pumps out money, eventually some prices will have to rise. If CPI inflation is weak and falling, the pressure must flow to assets and push their prices up.

The aim of the Great Reflation was to abort a potential depression, repair balance sheets, and generate economic recovery. It is an unprecedented experiment. Subsequent chapters will focus on where the new money might go.

Origins of Modern Inflation

The Great Reflation now underway should be seen as another chapter extending the long-running saga of inflation—excess money and credit expansion—that began in 1914. A hundred years of financial background may seem a little esoteric to some, but it is important to understand that we have been living for a very long time in a monetary world that is without an anchor. When there is no anchor, the monetary system has no discipline. And it is this lack of discipline that is fundamental to where we are now and where we may be going. The Age of Inflation is deep-rooted and enduring but it is not sustainable forever. Anything that is not sustainable has an end point. When that time comes, it will not be pretty.

Money without an anchor to something of solid value is called fiat money. It is money that is in the form of paper, or a book entry in a financial institution. The traditional anchor to prevent excesses was gold, and to a lesser extent, silver. The anchor provides a constraint on central banks. They can print paper but they cannot print gold or silver. With the discipline that comes with gold or silver backing, monetary expansion can exist only to the extent that central banks have additional metallic reserves. It is normal for countries to go on a fiat paper money system temporarily during major wars to finance huge military expenditures. The United States did it during the Civil War and the United Kingdom did it during the Napoleonic Wars. After such wars, what inflation that had occurred was brought back down by the return to a disciplined monetary standard. However, after World War I, the authorities badly bungled the attempt to go back to an externally disciplined system. The gold standard was reestablished at a price for gold that did not take into account the wartime inflation of money and credit, the rise in commodity prices, and the general cost of living. Hence, the value of gold reserves was inadequate to support stable growth, and central banks felt they had to supplement their gold reserves with foreign currencies.[3]

This proved to be a disaster for a system that was already fragile because of war reparations, hyperinflations in the early 1920s in belligerent countries, and widespread political instability. The inclusion of foreign currencies in reserves in the late 1920s aided and abetted the credit inflation and asset bubbles that led to the 1929 stock market blow-off. When the crash came, followed by bank failures, central banks yanked their currency holdings out of other central banks by asking for conversion into gold.

Effectively, central banks ran to gold because they didn't trust each other, a lesson that may become relevant today. As budget deficits ballooned, trust fell even further and no central bank risked losing gold. Countries were then pushed into contractionary policies, such as tax increases, government expenditure cuts, tighter monetary policy, and trade protection, even as economies sank. As a result, the gold standard was blamed for causing the Depression. That was, in good part, an unfair rap, but certainly strict adherence to it while the economy and debt structure of the world were collapsing was catastrophic. Later, we will come back to the danger created by currencies, particularly the U.S. dollar, when used as central bank reserves.

After the Second World War, the authorities avoided some of the mistakes of the post–World War I period. As a result, we got 15 years of relative stability under the Bretton Woods system,[4] which was a mutation of the gold exchange standard of the 1920s. By agreement, the United States pegged the dollar to gold at $35 per ounce, and other countries pegged their currencies to the dollar. It provided stability as long as the U.S. dollar was scarce and had the appearance of enduring value.

However, in the 1960s the first of the postwar asset bubbles formed and the U.S. dollar came under pressure as foreign central banks became concerned with U.S. deficits, too much monetary expansion, and the Keynesian policies of President John F. Kennedy's economic advisers. Their view was that governments should stimulate the economy to get full employment and that a little inflation was acceptable if you could create a few more jobs. Significantly, the free market price for gold rose above the $35 per ounce peg for the first time. The future value of the dollar had now become suspect, and hence the Bretton Woods system was no longer viable.

To delay the inevitable, the U.S. policy response to growing pressure on the dollar was controls, a clear indication that the policy makers had no intention to rein in money growth. They imposed restrictions on who could convert dollars to gold (the gold pool), a tax on U.S. portfolio investments abroad (the interest equalization tax), and manipulation of the government bond market (Operation Twist), and various other interventions were tried. None of them worked, because U.S. policies remained inflationary with the money taps left wide open.

For most of the 1960s, the United States wrestled with the impossible problem of how to keep the dollar/gold-based Bretton Woods system intact while at the same time ignoring market pressure for monetary discipline in the United States. The market won, as it always does in the end: Controls to hold back the consequences of monetary inflation ultimately break down. They are like a dam to hold back running water; eventually the water will find a way around. The markets finally forced the United States to break the link to gold and float the dollar in August 1971, a watershed event in world monetary history. The dollar fell sharply, triggering the greatest peacetime rise in the cost of living in U.S. history. The CPI rose at a 15 percent rate at its peak. The experience was pretty traumatic. Articles on hyperinflation regularly appeared in the press. Cynical money managers extolled the virtues of moving to a log cabin in the woods and loading up on canned food, gold coins, and machine guns for protection against the anticipated mobs!

Paul Volcker, the chairman of the Federal Reserve, came to the rescue and will probably always remain the most revered central banker in the Fed's history. He courageously gave inflation and the economy a cold bath with very tight money. This created a serious recession and high unemployment, but brought interest rates and the CPI down sharply.

Once the back of that inflation was broken, the Federal Reserve was once again able to become expansionary. The Fed grew the money supply rapidly but the CPI kept falling, confounding the monetarists (people who believe there is a tight link between changes in money, the economy, and the CPI). Monetarists were very influential at the time, and they kept forecasting (wrongly) a major rise in general prices. The explanation was that confidence in U.S. money had returned and people were prepared to hold a lot more of it.

This seeming paradox was what led to the start of the great credit expansion after 1982. Because the CPI and interest rates were falling, no one paid much attention to the surge in credit. It continued to accelerate in a series of waves, with market crashes occurring along the way—1987, 1990, 1997–1998, 2000–2002. After each bubble burst, the Fed stepped up its expansion of money and credit inflation. After the panic of 2008–2009, the Fed moved to once again reflate; but this time its efforts, combined with fiscal stimulus and bailout money, have dwarfed anything ever seen before in peacetime. This is why we call it the Great Reflation.

As evidenced by the short history just discussed, monetary instability clearly has been a regular feature of the investment landscape since the Age of Inflation began almost a hundred years ago. It has produced a roller-coaster economy and financial system because there was no brake on the monetary engine, and we cannot count on politicians and central bankers to provide one in the future. As investors, we need to think about what the limits are to this process. Just as a car needs brakes, so does the monetary system.

The Great Reflation experiment now underway, while critical in avoiding a 1930s debt deflation spiral, ensures that we are a long way from writing the last chapter on the post-1914 Age of Inflation. The managed paper money system has been a huge failure, and lies at the root of the persistent tendency to inflation, instability, and debt upheavals. There are obvious political advantages to inflation in the short run, and a paper system with no brakes is a great temptation to politicians with one eye always on the next election. For that reason, it is important to explore what lies behind this temptation to inflate.

Why Do We Have Inflation?

Money, as we explained before, is at the root of all inflations. When there are no effective brakes on the monetary system, the creation of too much money and credit inevitably follows. And in the modern world, there is a central bank to be found whenever there is inflation. However, the political authorities are the ones that ultimately pull the trigger. They have the power to create or stop inflation. If the government wants monetary stability, no central bank will try to subvert that policy.

The reason we have inflation is because there are political advantages in the short term. It is all too common for politicians to try to exploit them, particularly when economic conditions are dismal and the public is looking for easy solutions. The central bank is merely the tool of governments when push comes to shove. Almost always governments would like interest rates a little lower, credit a little easier, and the economic environment more supportive to financing their deficits so they can spend more money.

We have centuries upon centuries of experience with inflation, from the Greeks and Romans onward. Politicians inflate to save their own necks, either when economic conditions turn the people against them or to finance wars, lavish public works, or other expenditures that cannot be financed with higher taxes. Whenever there is inflation, there are always political promises that it will be temporary and the people are told that they should not be concerned because they will be the beneficiaries of better times.

Goethe, one of the Western world's greatest writers, captured, in his *Faust,* the spirit of the inflation process and how it unfolds—from money creation, false promises, short-term full employment, and the early signs of currency depreciation to disillusionment, collapse, and popular disgust.

> Here and behold this leaflet rich in fate
> That turns our woes to prosperous estate
> "To whom it may concern, this note of hand
> Is worth a thousand ducats on demand,
> The pledge whereof and guarantee is found
> In treasure buried in the Emperor's ground."
> None has the power to stay the flying chits,
> They run as quick as lightning on their way,
> And money-booths kept open night and day,
> Where every single note is honoured duly
> With gold and silver—though with discount truly.
> From there it flows to wine-shops, butchers, bakers,
> With half the world as glutton merry-makers, …
> "His Majesty!"—toasts flow and cellar clatters. …
> Now see the charming mob all grabbing rush,
> They almost maul the donor in the crush.
> The gems he flicks around as in a dream,
> And snatchers fill the hall in greedy stream.
> But lo, a trick quite new to me:
> The thing each seizes eagerly
> Rewards him with a scurvy pay,
> The gift dissolves and floats away. …
> Some grab, and catch frail butterflies.
> The rascal offers wealth untold,
> But gives the glitter, not the gold.[5]

Investors should never forget that politicians, unless they are elected on a hard money platform following disillusionment with inflation, will always be tempted to buy short-term popularity when economic and financial conditions are difficult, even though experience demonstrates that all inflations end in disaster. Ultimately, the public discovers it got only "the glitter, not the gold." Nor should people forget that, if there are no effective brakes built into the monetary system, as we discussed earlier, the creation of excess money is all too easy a temptation for politicians.

The Inflation Process

Lenin, in referring to the consequences of inflation, may have said it better than anyone: “The best way to destroy the capitalist system is to debauch the currency.” Inordinate increases in money and credit—those beyond the needs of production—have a profound effect on prices, but the way such increases enter the economic system and have their impact is complex and not well understood by the average person.

Extreme forms of general inflation are called hyperinflation when money becomes worthless. Fortunately, these are rare in developed countries and always occur during major wars or in their aftermath when the government has no tax revenue because the productive system has been destroyed. In that case, the government must print money to finance itself. The central European powers all experienced hyperinflation after World War I. More recently, the only countries that have experienced hyperinflation are economic basket cases like Zimbabwe. In these situations, the only limit on the government’s ability to inflate is how many zeros it can get on a banknote. Figure 1.2 shows a reproduction of the recently issued 100 trillion Zimbabwe dollar note, which became worthless in a matter of days. It is now a collector’s item.

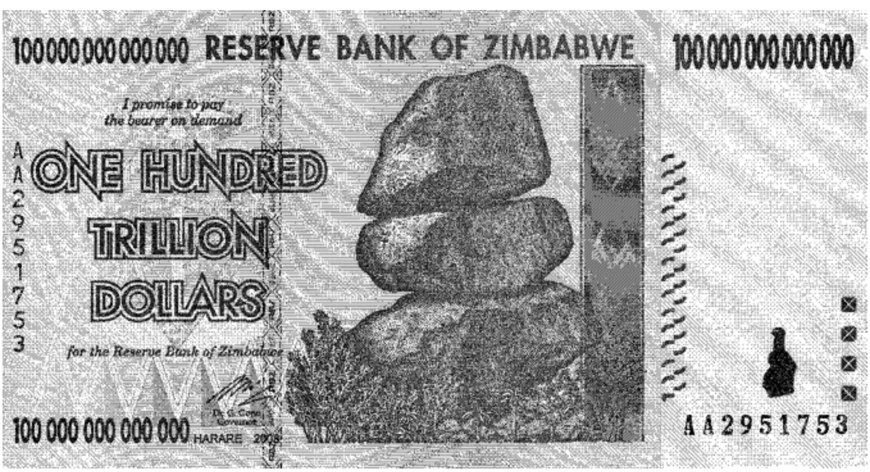

Figure 1.2 Zimbabwe $100 Trillion Note

Even though hyperinflation is rare in advanced economies, that doesn't mean that CPI inflation cannot rise to dangerous levels. As we pointed out earlier, it did reach 15 percent in the United States at the end of the 1970s and an even higher rate in some other countries at that time, and that was enough to create havoc in financial markets and near panic among a large part of the population.

Asset inflation has also hit extraordinary extremes in virtually every advanced economy in the past 30 years, sometimes repeatedly. It is therefore important to understand the mechanics of the inflation process—how inflation is actually created.

Central banks—formerly called banks of issue—are at the center of the money and credit creating process through their monopoly of the issuance of paper currency and, more importantly, through the requirement that commercial banks must hold reserves in the form of deposits at the central banks. These reserves are assets of commercial banks and liabilities of the central bank. They are normally set as a certain proportion of bank assets. The ratio limits the growth in commercial bank assets and liabilities. The latter are mainly deposits, which together with Federal Reserve notes make up the money supply. Banks also have to hold a certain amount of capital relative to their assets, another rule that helps to control them.

The main liabilities of the central bank are composed of currency held by the public and reserves held by commercial banks. Therefore, it is important to watch what the central bank is doing with its balance sheet. When it is adding to its assets, its liabilities must be rising, and hence the money and credit generating engine is expansionary. When the engine runs too fast it causes inflation.

Fast-forward to the Great Reflation. Figure 1.3 shows the extent to which the Federal Reserve expanded its balance sheet after the crisis. The unprecedented explosion in Federal Reserve credit reflects the Fed's response to the liquidity crisis by buying securities with all kinds of risk attached in order to bail out the financial system. Figure 1.4 shows the monetary base, which reflects the reserves of commercial banks when the Federal Reserve creates credit. It is also called high-powered money because it lies at the heart of the money and credit-generating process for the economy as a whole. It shows clearly the vast magnitude of high-octane money that has been created by the central bank.

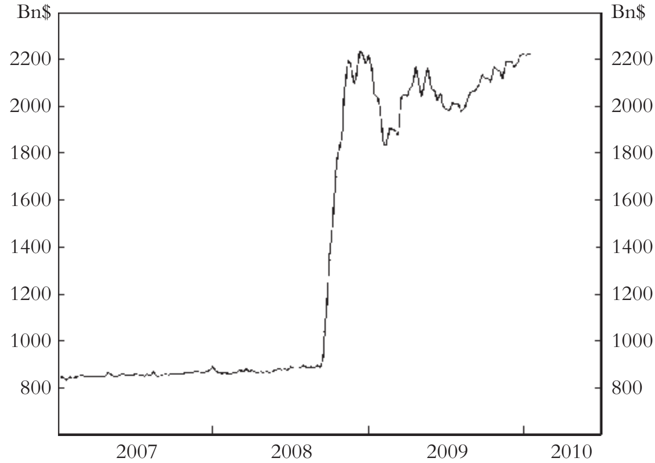

Figure 1.3 U.S. Federal Reserve Bank Credit
Source: Chart courtesy of BCA Research Inc.

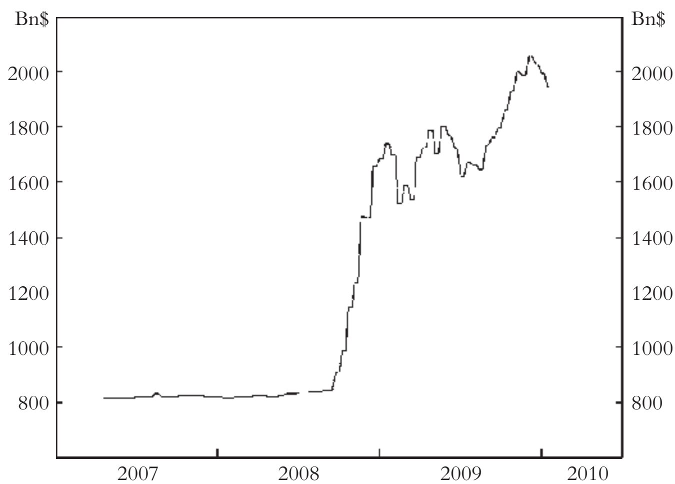

Figure 1.4 U.S. Monetary Base
Source: Chart courtesy of BCA Research Inc.

The Fed's emergency response to the crisis, which is so clearly portrayed in Figures 1.3 and 1.4, was an absolute necessity to avoid a complete meltdown of the financial system. However, the Fed must reverse the massive liquidity injections as soon as borrowing and lending start to normalize if it hopes to achieve long-term stability. The Fed is in the extremely uncomfortable position of having little or no room to maneuver, because very strong forces of deflation will linger while fears of inflation increase.

The Fed does have the distant precedent of 1937 to keep in mind, as well. Fearing a return of inflation then, the Federal Reserve embarked on a premature tightening of monetary policy when the economy looked like it was recovering. However, the reality was that the recovery was fragile, and the tightening policy sent the economy and stock market into a tailspin and ratcheted up the fiscal deficit even further. This could easily happen again because the economy and financial system will require years in the convalescent ward. But inflation scaremongers are already sounding the alarms. Failure to address the risks of future inflation potential could easily affect expectations and send asset prices out of control, eventually forcing the Fed to act in an even more dangerous situation. The Fed has received plenty of well-deserved criticism for ignoring the last bubble. It will almost certainly move faster on the next one—but how and when is an open question. Such action would increase short-term volatility but would not stop the inflationary engine over the longer run.

There is a systemic reason for this concern. The global financial system is and will remain flawed as long as it is based on fiat paper money. Lots of proposals to fix this have been floating around for years, but trying to do it immediately after a banking collapse and near depression would be a high-wire act. It would be better left to a time when conditions are more stable, if that is possible. In the near term, the lesser risk is letting reflation push asset prices higher, which improves balance sheets—a key objective of reflation efforts. In 2009, the rise in asset prices, while substantial, should be thought of as a recovery from very depressed levels, not yet a new bubble. However, market action in 2010 and beyond will have to be watched carefully for signs that the so-called recovery has become something more dramatic. In the meantime, we must rely on the discretion and judgment of the central bankers themselves and, unfortunately, that has not worked very well for many years. As a result, we will all have to live with the great uncertainty of whether a return to stability is even possible.

The Advantage of Stable Money

Earlier, we emphasized the inherent conflict between the short term and the long term in a managed paper money system. The short term is driven by political/populist demands for low interest rates, full employment, and perpetual prosperity. The long-term focus should be on achieving stability and equilibrium. Only with the latter conditions will key economic decisions relating to savings and investment be made with some degree of certainty as to what the more distant future will be like. However, very few politicians are concerned with anything beyond the next election. Their short-term focus creates instability and severe fluctuations in prices and economic activity, which, in turn, forces economic decisions to become even more short-term oriented.

Prior to 1914, most countries of the Western world adhered to a monetary regime that *legally* restricted the amount of money a central bank could create based on its gold holdings.[6] It was an external, rules-based system that avoided the inherent conflict between politicians and central banks that occurs in a paper money system. Countries adhered to the discipline except in time of major wars. This system has had many critics[7] and certainly did not prevent fluctuations in the economy. Nor did it prevent asset inflations and market panics. However, it did produce stability of prices in the long run, something with which people today are not familiar. Figure 1.5 demonstrates what long-term price stability can look like. The purchasing power of the dollar was little changed in 1914 compared with 1820. Figure 1.6 shows that over the 95-year period from 1914 to 2009, the purchasing power of the dollar fell by 95 percent.

Interest rates over the 100-year period up to 1914 fell on average. By the early years of the twentieth century, companies and governments could sell bonds with a maturity of 100 years, such was the confidence people had in the purchasing power of long-term contracts. People developed strong habits of saving and planning for the future, and these were deeply ingrained in decision making.

The experience since 1914 has demonstrated that instability and inflation cause needless hardship for people and enormous resentment. Windfall gains go to the lucky or successful speculators, and hard work is less well rewarded. It should be noted, however, that countries do not

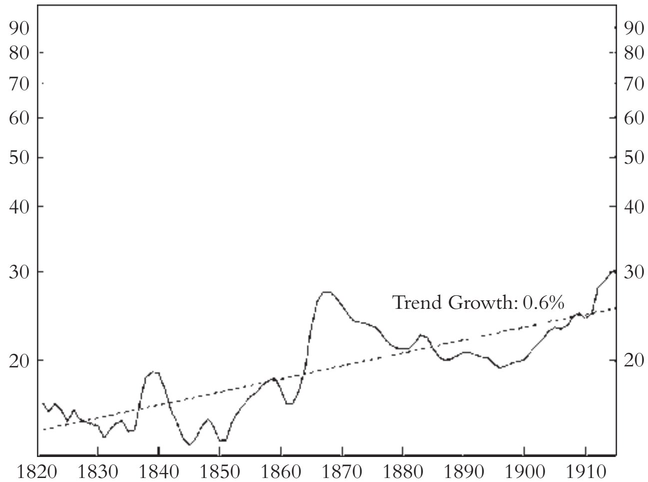

Figure 1.5 U.S. Consumer Prices and Time Trend, 1820 to 1914
Note: U.S. producer prices from 1820 to 1830.
Source: Chart courtesy of BCA Research Inc.

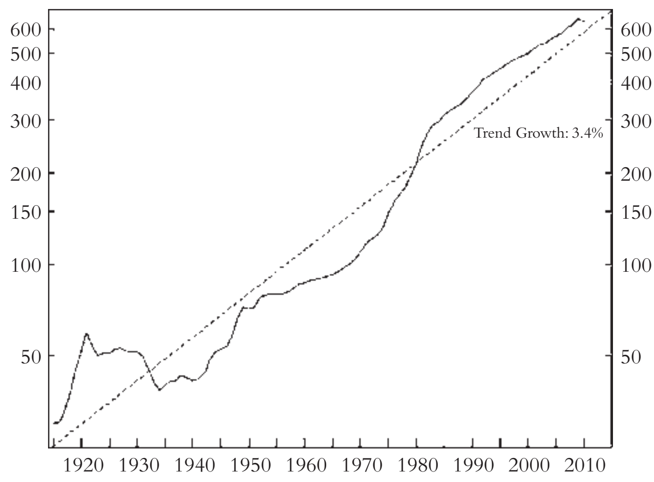

Figure 1.6 U.S. Consumer Prices and Time Trend, 1914 to 2009
Source: Chart courtesy of BCA Research Inc.

need a lot of monetary inflation to grow. Germany and Japan achieved seemingly miraculous growth out of the ashes of World War II with very stable prices. China did so as well after 1978 when market reforms were introduced, although price stability did not occur until more recently.

The United Kingdom and United States grew steadily more prosperous in the nineteenth century with long-term stability of money. Japan got into trouble only after it had created a credit inflation and asset bubble in the 1970s and 1980s.

In spite of signs of economic recovery in 2009, those who downplay the advantages of stability in the purchasing power of the currency and the dangers of asset inflations should not forget that the final bill for the credit bubble of the previous 25 years has not yet been presented.

A monetary system based on an external discipline provides a set of rules for money, just as a constitution works for its citizens. A rules-based monetary system prevents politicians, apart from emergencies, from messing with a country's money for short-term electoral advantage. Long-term stability creates the expectation that it will endure. Short-term instability also tends to be self-perpetuating because it destroys a sense of predictability.

Some people, fed up with our chronic inflation and instability, advocate a return to the gold standard in a search for sound money. It did work to bring about stability and prosperity for 200 years before 1914 for the countries that followed the so-called rules of the game.[8] There were a number of reasons why it worked so well, but probably two were most important. First, governments were small and fiscally conservative. They did not run budget deficits in peacetime and were not expected to take responsibility for full employment and business prosperity. They would never sacrifice external stability for domestic political considerations. Second, wages, which are by far the largest cost component in any economy, were relatively flexible prior to 1914. As a result, deflationary adjustments that were needed could be accomplished without political upheavals, even though they were not without pain. Hence, politicians in stable countries like the United States and United Kingdom were not tempted to inflate except in wartime, when they had no choice but to do so.

After 1914, conditions changed dramatically. The rise of trade unions made wages relatively rigid and, therefore, downward adjustments became impossible without severe political disturbances and steep declines in output. Since the Great Depression, governments have taken on unquestioned responsibility for domestic employment and would never sacrifice jobs for external reasons unless they had absolutely no choice. Therefore, the preconditions required to make a return to the gold standard possible are not present. If it were tried now, it would be a deflationary catastrophe, particularly given the fragility of the world economy and tremendous fiscal imbalances in all developed countries as a result of stimulus packages.

Unfortunately, no one has come up with a practical, acceptable alternative to the gold standard that would have the basic virtues of discipline and the elimination of currencies held as central bank reserves. We will, therefore, remain on an undisciplined paper money system with a huge and precarious overhang of dollars in the hands of foreign central banks. The authorities continue to believe or hope that they can fine-tune the paper system and avoid the mistakes that caused previous disasters. That is wishful thinking. After each bout of inflation and instability, the authorities go on to either make new mistakes or repeat the old ones.

The key point is that, in the absence of a system that has real discipline, we will remain on a purely paper, anchorless fiat money system with its inherent tendency toward inflation and instability. Periods of stability will occur, but they will be temporary and result in increased risk taking and accelerating credit expansion because the system has no brakes.

The Globalization of Inflation

Before 1914, inflation was a domestic matter with the one exception of new gold and silver discoveries. The reason was that the gold standard rules of the game not only allowed, but automatically caused, countries to increase money and credit when they had an inflow of precious metals. Without an increase in the world stock of gold and silver, one country's increase was matched by another country's loss. There are two good examples of inflation caused by an increase in precious metals. When gold and silver poured into Spain from the New World discoveries in the sixteenth and seventeenth centuries, a general inflation occurred. The same was true after the South African discoveries in the late nineteenth century.

In the 1920s, with the introduction of the gold exchange system whereby countries could hold dollars and pounds sterling (mainly) and other currencies as reserves, inflation could and did occur much more easily.[9]

The globalization of the inflation process works like this. The world monetary system is based on the U.S. dollar, which is a floating currency, not redeemable into anything except other currencies at whatever exchange rate is prevailing at the time. It is at the center of the international monetary system because most central banks' reserves, which are held for a rainy day, are kept in dollars. When the United States runs large, persistent balance of payments deficits, it means that more dollars are spilling out of the United States than are coming back in. The overall international deficit can arise either from trade or from net capital outflows. The latter occurs when Americans buy foreign financial assets such as stocks and bonds, or invest in plant and equipment in foreign countries. Capital outflows can also occur when foreigners pull their money out of U.S. assets.

When a foreign country is faced with a net inflow of dollars, its central bank can either buy those dollars to prevent its own currency from rising or it can let the dollar fall. If it buys the dollars, it must do so by creating more of its own currency, which expands the central bank's balance sheet and domestic bank reserves in that country. We discussed earlier how such an action creates high-powered domestic money. The result is that buying dollars tends to flood a country's own economy with too much liquidity, causing domestic inflation, asset bubbles, and frequently excessive capital spending. If the country doesn't buy dollars, its currency will rise, which creates deflationary pressure. In a world with high unemployment, every country is trying to avoid deflation and hence does not want its currency to rise. So, to put it simplistically, U.S. balance of payments deficits get monetized by foreign central banks. Foreign countries that peg to the dollar effectively adopt the monetary and interest rate policy of the Federal Reserve.

The current international monetary system is called Bretton Woods II. It allows surplus countries like China to keep their own currencies artificially cheap by buying dollars on the foreign exchange markets. China has bought almost $2 trillion in recent years to keep its currency from appreciating, and it is still doing so. This has tended to inflate credit and asset prices in China, as can be seen in its property and stock market booms, prior to the crash and once again in 2009. However, that is not the end of the story. When China reinvests those dollars back in the United States, the credit base of the United States is further increased in spite of the U.S. balance of payments deficit that initially moved dollars from the United States into the hands of the Chinese.

Under a system with external discipline, the U.S. deficit would have led to a contraction in credit in the United States and reduced the expansion of credit in other countries. That would have tended to restore equilibrium in the U.S. balance of payments, restrained U.S. spending and credit creation, and significantly reduced the tendency for asset bubbles. However, the current undisciplined system is like a perpetual motion machine. Jacques Rueff called it "deficits without tears." The debtor keeps spending and borrowing, and the creditor keeps building industrial capacity, lending, and experiencing asset inflation. This goes on until a crisis puts an end to it. At that point, the debtor has too much debt and the creditor has inflated asset prices and excess productive capacity. Both create deflation, a view well articulated by Richard Duncan.[10]

We have always agreed with this concept that inflation and deflation are two sides of the same coin with the difference being in the timing. Too much inflation always ends in deflation, and deflation paves the way for the next inflation so long as the central bank is able to reflate. The great flaw in the world monetary system is that the United States—the main reserve currency country of the world—runs unlimited deficits that inflate foreign economies while at the same time progressively undermining confidence in the dollar's future value. It is a system that is unsustainable and dangerous. If not reformed, it will ultimately end in a very big crisis that the United States and the rest of the world may not be able to reflate their way out of.

As mentioned earlier, a financial and credit system without brakes does not have a natural tendency toward stable equilibrium. All persistent debtors—those living beyond their means through the good graces of foreign lenders—come to enjoy the seeming benefits of such behavior and assume that their creditors will allow it to go on indefinitely. The United States is no exception and, like all chronic debtors, has become arrogant and blind to the long-term consequences of its behavior. Experience shows that debtors really come to think that they have an entitlement. As long as the United States is allowed to live beyond its means, the global money and credit system will remain inflation prone and the dollar vulnerable to crises. That is, until the music stops.

Conclusion

Investors face an obvious conundrum: Do they bet on inflation or deflation and over what time period? The dilemma is natural. Inflation and deflation are two sides of the same coin. The more advanced an inflation, the greater the threat of deflation and debt defaults.

In this chapter we discussed how each bust triggers a political response and the authorities revert back to reflationary stimulus—easy money and fiscal deficits. Over time, it is evident that crises have been getting more severe. Experience shows that it has taken increasing amounts of money, credit, and fiscal deficits to generate each recovery. And then inflation, with a lag, accelerates once again. The unsettling question is: When and how will it end?

It feels like we are traveling down a narrowing road with inflation on one side and deflation on the other. We keep bouncing from one side to the other with increasing force. The implication is that eventually we will get to an end point and experience both inflation and deflation together. The monetary and fiscal levers won't be able to pull us out. At that point, some prices may be going up, but living standards and wealth will be falling.

After the crash of 2008–2009, most people ceased to be concerned about inflation. They started saving again, paying down debt, doing whatever they could to get liquid and restore their balance sheets. However, astute market observers have not forgotten that inflation follows deflation.

(continued)

In the latter part of 2009, the early signs of another potential asset inflation were already visible. Real estate prices were rising sharply once again in China, peripheral Asian countries, Canada, Australia, London, and elsewhere. Stock prices had risen from their lows by between 70 percent and 120 percent in many developing countries such as China, India, Russia, and Brazil. Commodity prices had also risen sharply, and gold broke well above the magic barrier of $1,000 per ounce, the top in 1980 and in 2008–2009. Oil prices doubled from their lows by late 2009.

Asset inflations occur, as we pointed out earlier, when economies tend to be weak and CPI inflation is low, stable, or falling. They are frequently driven by investor expectations of higher prices in the future, otherwise known as speculation. As a result, market conditions can become extremely volatile.

It is likely that the Age of Inflation will remain intact for at least one more cycle. An avalanche of new money appears to have already started the next round of asset inflation. How fast and how far it goes can only be conjecture, but it is not likely to last long, because the economic underpinnings are not solid.

Investors will be playing a cat and mouse game with the Fed. As investor expectations of inflation heat up, pushing asset prices higher, the Fed will be tempted to stop it. The Fed could easily tighten too much too soon, or it could do too little too late out of fear of triggering another bust in housing, stock prices, and the economy. The reality is that the Fed has little or no room to maneuver because the underlying structure of the economy and financial system is still rotten. The problem is too much debt, the subject of the next chapter. Debt got us into the crisis, and it has not come close to being sufficiently liquidated to avoid another one.