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‘Flation: Which Kind Will it Be?

There are a number of ‘flations out there. Inflation, deflation and from the poorly understood 1970s stagflation. And the intention of this article is to review historically that there are two kinds of “inflations”, one is bad and the other is good. And only one kind of deflation, which is bad.

While the big tout is that “Inflation is back!”, sure there will be ‘flation, but the subject needs some ‘splaining – particularly about “Deflation”.

The financial world is in another tizzy about “inflation”, meaning the 1970s kind when the cost of living soared faster than wages, which throughout history has been distressful to most people. They end up hating that kind of inflation.

Of course, the reason being is that the Fed is evil in its compulsion to depreciate the currency, which is the dedication of every central bank in the world. But in conjunction with America’s Marxist administration the Fed will now drive inflation higher. Indeed, some have been calling for another “Weimar Inflation” that destroyed Germany on the 1920s.

The subject requires thorough historical review, which this writer did ages ago and the observation has been that there are two kinds of inflation. The one that most, including central bankers, understand, which is a soaring cost of living.

However, there is another kind of ‘flation that is not widely understood and it is inflation in financial assets. Otherwise known in real time as a “New Financial Era”, or a “Bubble”, which features soaring stock and bond prices that most enjoy.

Indeed, in the 1825 example it was called the time of “Good feelings”, the 1870s example was described by Mark Twain as the “Gilded Age” and the example that ended in 1929 was called the “Roaring Twenties”.

With each being a time when “animated spirits” are celebrated rather than dreaded.

Also, another term from the 1970s is getting headlines, which is “stagflation”, whereby CPI inflation prevailed as the economy stalled. This was distressful to interventionist economists as their convictions were that arbitrary injections of credit always “stimulated” business activity. Ancillary was that CPI inflation “caused” good employment numbers.

The latter was called the “Phillip’s Curve”, which roughly considers that as CPI inflation goes up, so does employment. Financial violence through the 1970s laid that nonsense to rest, confounding the establishment.

Since the advent of modern financial markets in the late 1600s, when in London there were enough companies trading to call it a stock market. Further, in 1692 John Houghton

began publishing London's first stock market letter and in 1694 the Bank of England was formed, creating the world of modern finance.

Which unique accomplishment has been the stock market bubble, the first being the South Sea Bubble that climaxed in June 1720. After desultory action through the Summer, it crashed in the Fall, attended by a severe contraction as most asset prices collapsed.

As described at the time, the transition from boom to bust was relatively quick:

"My shares which on Monday I bought
Were worth millions on Tuesday, I thought
So on Wednesday I chose my abode;
In my carriage on Thursday I rode;
To the ball-room on Friday I went;
To the workhouse next day I was sent."

The setup was a decade or so of war and soaring inflation, that reached its peak in 1711 and crashed. Out of the ashes, devasted financial markets stabilized and then enjoyed a lengthy bull market that culminated in a wild mania.

Setting a pattern that has repeated.

Inflation in tangible assets, with a major war soared to a climax and crashed. Then, there was the bull market in financial assets that climaxed less than a decade later, and crashed. Which was followed a by a severe financial and economic contraction.

This pattern has repeated with the timing between commodities being close to a decade in each case and it involves two kinds of "inflation" – in tangible and then in financial assets.

Each of the latter manias was followed by a serious deflation in most asset prices, from stocks and bonds to residential real estate and commodities.

So, the most critical event has been the great financial bubble, of which the present one is the sixth, 1929 being the fifth.

Lord Overstone a prominent banker in the 1840s observed: "No warning can save people determined to grow suddenly rich", which conviction marks the climax of a bubble.

The bubbles that completed in 1720, 1825, 1873 and 1929 were followed by lengthy and at times severe contractions, not by an inflationary boom, such as widely called for now.

Somehow, this remarkably consistent pattern seems to be avoided by the standard economics textbooks.

However, it prompts inquiry about a credit theory that applies to both kinds of inflation. And while needed right now, it is found in what could be called classical economics:

"Inflation is an inordinate expansion of credit".

Which clearly describes the mechanism attendant to the two kinds of "inflation", whereby credit expands against whatever game the public chooses to speculate in. In one decade against tangible assets and in the next against financial assets. And then contraction.

And this researcher is not bold enough to say “This time it is different”.

The last high for Consumer Price Inflation was in 2011, and a decade later a magnificent bubble in financial assets seems to be climaxing. And over this decade, the Fed has been concerned that inflation has been too low and with “easy” credit has been hoping to prevent deflation. Ironically not understanding that excess credit would go into another magnificent inflation in financial assets.

And then deflation.

Has this happened to the Fed before?

With WW I, the global boom in commodities drove the US inflation to 24 percent in 1920 and with the consequent crash, it plunged to minus 16 percent. Making the Federal Reserve System very concerned about deflation so “easy” credit polices prevailed – not understanding that it was time for another great financial mania.

That “Great Depression” was not caused by any policy error, it was the natural consequence of a great financial mania made worse by naïve central bankers. Sadly then, not understanding that the consequence of a great financial bubble is a severe contraction.

And now the Fed has in knee-jerk fashion done the same thing.

And if one needs culprits to explain a contraction Mother Nature and Mister Margin will do.