BOB HOYE

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Inflation: Out of Control?

The strongest run of "Inflation" in more than forty years is underway, and pundits claim that it has much further to go. Indeed, popular and highly regarded financial talk shows are reporting that "All paper currencies have eventually gone to zero". Inevitably, such would indeed be catastrophic.

Not widely appreciated is that there are three types of inflation. The headline one that everyone knows is an uncomfortably soaring cost of living Then there are times when financial asset prices soar, which after "Inflation" makes everyone feel good. What accompanies either is a massive inflation in credit and/or currency. And when speculation in "things" or then "paper" blows out the crashes are painful. Particularly when the mania has been in the latter. These have been followed by contractions, of up to two decades.

So, let's start with a definition that works for both events "Inflation is an inordinate expansion of credit". And deflation is an even faster "inordinate contraction in credit".

Central banking began with the Bank of England in 1694, rampant inflation in financials brewed up for the first time with the South Sea Bubble that climaxed in June 1720. All five Great Bubbles since have had common set ups, common climaxes and common crashes.

The "Roaring Twenties" that completed in September 1929 is the best known. Ours completed in January 2022 and events since have been close to the typical path to contraction.

The distinction between the disturbing rise in the cost of living and the fun of soaring stock prices have been labeled in real time. Beyond the "Twenties", Mark Twain described the wonders of soaring financial asset prices as the "Gilded Age". That Bubble completed in 1873. The period through the Bubble that ended in 1825 was labeled as the "Era of Good Feeling", in real time.

With the ambitious hatred of the Global Left for ordinary folk through our Great Bubble the period may not be blessed with a glowing name.

The problem with the view based upon intuitive theories rather than empiricism is that these pundits have long understood that the Fed will always try to depreciate the dollar. But this is not always associated with "Inflation". Yes, it's disguised as extending credit to "keep the recovery going". Of course, the original promoters of the Fed understood that as "lender of last resort" – Presto! – no more recessions.

There have been 18 cyclical recessions since. In more forthright disciplines only one failure is sufficient to condemn a theory.

That recessions are impossible it is ironical that with a severe recession, their tout is that they can prevent from becoming a depression. Indeed, in the mid-1970s a Wall Street economist boasted that the Fed had prevented all six recessions since WW2 from turning into a depression. He did not know that typically there were some ten business cycles on the long expansion that concludes with a Great Financial Bubble.

Which sets up the next Great Contraction, when most asset prices deflate.

The financial wonders of stock and bonds have reigned over much of the last decade, quite like the 1920s. That global commodity boom soared to 1920, driving the US CPI (annualized) to +16%. In 1921 commodities crashed sending the CPI to -11%. Wary of deflation the Fed kept easy monetary policies not understanding that another Great Financial Bubble was brewing up.

And as we all know that culminated in September 1929, followed by a typical Post-Bubble Contraction when most asset classes suffered deflating prices. Economists bereft of history thought it was exceptional and began dreaming up schemes to end it as well as to prevent future repetitions.

And generations of economics departments have been preaching theory rather than reviewing history.

On the previous example, commodities and "Inflation" peaked in 1863 and a decade later so did stocks and bonds. That was in 1873, the year that the esteemed Walter Bagehot published "Lombard Street", within which he theorized that the Bank of England could prevent a contraction by easing credit. That summer, the NY Herald editorialized that nothing could go wrong, because the Treasury System would be better at providing credit than a central bank, constrained by a gold standard. On a non-backed currency, the Treasury could provide whatever credit was needed to avoid a recession.

In 1884, UK economists began calling unusual weakness as the "Great Depression", which ended in 1895. There is an index of farm prices and they declined from 1873 to 1895 with only one year without a decline.

The key concept is that there are two kinds of "Inflation", but each had a common component – credit. What's more, the transitions from "Inflation" start with precarious excesses and are followed by deflations. The ones following the Global Commodity Boom have been brief and set up the "New Financial Era" that completes and is followed by the disaster of another long Great Contraction.

Ironically, as today's clarions of "Inflation" are in full voice, the financial and social world is on the path to another lengthy deflation. Moreover, the transition path has been methodical and worth updating:

- Copper's real price goes up and then down, which is the happening.
- Gold's real price goes down and in turning up confirms the contraction. This is working out.
- Real long-dated Treasury Rates turn up in the contraction. So far, from -1% to +2%, which is becoming insufferable. The typical increase has been some 10 percentage points.
- The senior currency becomes chronically firm.

Inflation is not likely out of control, but history is getting ready for another deflation. "Inflationists" should not be positioned in their convictions.