

Perspective

by Steve Hanke



Bush meets with economic team

The Bush Legacy: Deflation or Inflation?

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SINCE 2001, THE BUSH ADMINISTRATION HAS ENTANGLED the United States in a war that is undefined in terms of its scope, scale and duration. It has also been interventionist in the domestic economy, overseeing what the U.S. Congressional Budget Office terms a “substantial increase in spending” which has put the economy “on an unsustainable path.” Indeed, according to the CBO’s baseline budget projections issued in September 2008, the federal debt held by the public will grow to \$7.9 trillion (in 2008 dollars) over the next decade, a 46% increase over this year’s \$5.4 trillion estimate. And that’s only the tip of what could be a huge debt iceberg. The trustees of the Social Security System estimate that the present value of the system’s unfunded liabilities is \$13.6 trillion. A similar present value calculation by the trustees of the Medicare System results in a whopping \$85.6 trillion estimate. To put these numbers into perspective, keep in mind that last year the United States generated a GDP of \$13.8 trillion.

The Bush administration’s most recent economic intervention—the nationalization of Fannie Mae and Freddie Mac,

two giant government-sponsored mortgage finance companies—could cost U.S. taxpayers hundreds of billions of dollars. Fannie and Freddie were not really private nor purely public—perhaps the worst type of hybrids imaginable. Indeed, both followed a classic public-private partnership (socialist) business model—one that privatizes profits and socializes losses. This was a train wreck waiting to happen. Not surprisingly, the Cato Institute’s Economic Freedom of the World, 2008 Annual Report records a significant fall in the economic freedom index for the U.S.

Given these developments and the squeeze that the credit crunch has put on the U.S. economy, some people have been shocked that the U.S. dollar has staged a spectacular rally against the euro. But in the world of exchange rates, it takes two to tango. Expectations about Europe’s economic prospects have turned negative. Super-negative European expectations, relative to those in the U.S., have pushed the dollar up by over 14% from July 15 to September 11, 2008. And not surprisingly, commodity prices (measured by the Commodity Research Bureau’s Spot Index) have tumbled by 9% over the same period. But consumer price

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and producer price indexes remained at elevated levels, registering year-over-year increases in August of 5.4% and 9.6%, respectively.

Now the U.S. is on a razor's edge between deflation and inflation. This requires one to think through how each of these scenarios might unfold.

The prospect of a debt deflation begins when a central bank pushes interest rates below where the market would have set them. This is exactly what the Federal Reserve did. In July 2003, the Fed funds interest rate target was pushed to a record low of 1%, where it stayed for a year. This set off a credit boom which fueled a massive increase in leverage. Over the past year, we have witnessed financial stress, a stampede to deleverage and an economic slowdown.

These events could be the precursors of a classic debt deflation. It would take the following course:

- Debt liquidation would lead to distress selling.
- As loans are paid off, a contraction in demand deposits would ensue.
- This would slow down the velocity of money circulation.
- This would cause a fall in the general level of prices.
- This would lead to a further fall in the net worth of businesses and an increase in bankruptcies.
- A fall in profits, often resulting in losses, would also occur.
- This would lead to a reduction in output, trade and employment.
- These losses, bankruptcies, and unemployment would generate pessimism and a loss in confidence.
- These waves of pessimism would result in more hoarding and further reductions in the velocity of money circulation.
- The debt deflation process would eventually run its course, but only after asset prices have hit bargain basement levels.

Economists of the Austrian school of economics term this type of debt deflation a "secondary deflation". If the forces of a secondary deflation are strong enough, a central bank's liquidity injections are rendered ineffective by what amounts to private sector sterilization. When people expect prices to fall, their demand for cash increases and soaks up central bank liquidity injections. This phenomenon characterized Japan's economy during most of the 1990s.

But what if the Federal reserve—fearing a secondary deflation, as they feared (incorrectly) a mild deflation in late 2002—pushed

Zimbabwe: The Hanke Hyperinflation Index

Date	Monthly inflation rate	Index
26-Jan-2007	72%	1.6089
23-Feb-2007	52%	2.4509
23-Mar-2007	207%	7.5323
20-Apr-2007	-17%	6.2326
18-May-2007	57%	9.7812
15-Jun-2007	396%	48.472
13-Jul-2007	1%	49.076
10-Aug-2007	-1%	48.461
7-Sep-2007	71%	82.829
5-Oct-2007	165%	219.78
2-Nov-2007	193%	644.55
30-Nov-2007	93%	1,246.8
28-Dec-2007	62%	2,014.0
25-Jan-2008	12%	2,251.5
22-Feb-2008	128%	5,138.9
20-Mar-2008	240%	17,466
17-Apr-2008	110%	36,728
16-May-2008	239%	124,670
13-Jun-2008	2,916%	3,760,400
11-Jul-2008	2,089%	82,297,000
8-Aug-2008	263%	299,080,000
5-Sep-2008	9,914%	29,949,000,000

Sources: Imara Asset Management Zimbabwe and Steve Hanke's calculations

Note: Index reported to five significant figures

the Fed funds rate lower (now it's 2%) and turned on the inflation switch by monetizing more debt? Given the growing mountain of government debt, there is virtually an unlimited potential. It's a scenario worth thinking about.

To appreciate how the process would work in the extreme, consider what's happening in Zimbabwe, the first country to realize a hyperinflation (an inflation rate of 50% or more per month) in the 21st century. The government of Zimbabwe issues debt and the Reserve Bank of Zimbabwe monetizes it by printing Zimbabwe dollars. While the RBZ produces a lot of currency, statistics on the quantity of currency in circulation and the inflation rate are in short supply. The most recent official data for currency in circulation were for January 2008, and inflation data were last released for June 2008. To remedy that shortcoming, I have developed a hyperinflation index for Zimbabwe. As indicated in the accompanying table, the monthly inflation rate on September 5, 2008 was 9,914%. That's a whopping annual inflation rate of 36 billion percent.

To effectively trade currencies, commodities, or for that matter, any assets, traders must build alternative scenarios—like those for deflation or

inflation. To give the scenarios life, probabilities must be attached to each of them. The resulting array can then be used to inform, in part, one's trading activities.

Fortunately, three books are hot off the presses that will greatly assist all traders who wish to engage in the necessary task of scenario building. The authors are all market-tested veterans with first-class minds and experienced hands.

- Brendan Brown, *Bubbles in Credit and Currency: How Hot Markets Cool Down*. New York & London: Palgrave Macmillan, 2008.
- Mohamed El-Erian, *When Markets Collide: Investment Strategies for the Age of Global Economic Change*. New York: McGraw-Hill, 2008
- David M. Smick, *The World is Curved: Hidden Dangers to the Global Economy*. New York: Portfolio/Penguin Group (U.S.A.), 2008. GA

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