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In Search of Truth



NOT YOUR FATHER'S DEFLATION

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Among those rational enough to perceive the looming economic downturn, a heated debate has arisen that centers on whether the slowdown will be accompanied by inflation or deflation.

Those in the deflation camp believe that money supply will collapse as a natural consequence of the implosion of the biggest credit bubble in U.S. history. As loans go bad, assets, which collateralize these loans, will be sold at fire sale prices to satisfy creditors. It is also argued that a recession will reduce consumer discretionary spending, causing retailers to slash prices to move their bloated inventories. This is the way the situation played out in the 1930's and this is how many expect it to happen today.

However there are several key differences between then and now, which argue against the classic deflationary scenario. In particular, the Fed's ability to pump liquidity into the market in the 1930's was limited by the gold backing requirements on U.S. currency. No such limitations exist today. This distinction is critical. When credit was destroyed after the Crash of 1929, the Fed was not able to simply replace it out of thin air. Today however, the Fed will likely print as much money as necessary to prevent nominal prices from collapsing. In fact, in the infamous speech that spawned his "helicopter" sobriquet, Ben Bernanke explained how the printing press can be used to stop deflation dead in its tracks.

To fully understand the way inflation and deflation affect prices, we need to differentiate between assets, such as stocks and real estate, and consumer goods, such as shoes and potato chips. If we measure prices in gold, as we did during the 1930's, both asset and consumer goods prices will fall, with the former falling faster than the latter. So in that sense the deflationist are correct. However, in terms of today's paper dollars, this outcome is completely impossible. During deflation, money gains value, so prices naturally fall as fewer monetary units are required to buy a given quantity of goods. In the coming deflation, real money (gold) will gain considerable value, so prices will therefore fall sharply in gold terms. Paper dollars however, which have no intrinsic value at all, will lose value, not only as the Fed increases their supply, but as global demand for the currency implodes.

The way I see it there are only two possible scenarios. The more benign outcome would be one where asset prices fall, even in terms of paper dollars, but consumer goods prices continue to rise. This would be the stagflation scenario. The more catastrophic scenario is one where asset prices hold steady or even resume their ascent, while consumer goods prices rise even faster. This of course is the hyper-inflation scenario, and is the worst possible outcome. I see no possible scenario where consumer goods prices fall in term of paper dollars.

Many mistakenly believe that when the U.S. economy falls into recession, reduced domestic demand will lead to falling consumer prices. However, what is often overlooked is the fact that as the dollar loses value, the rising relative values of foreign currencies will increase consumer demand abroad. As fewer foreign-made products are imported and more domestic-made products are exported, the result will be far fewer products available for Americans to consume. So even if the domestic money supply were to contract, the supply of goods for sale would contract even faster. Shrinking supply will be a major factor in pushing consumer prices higher in America.

In addition, since trillions of dollars now reside with our foreign creditors, even if many of these dollars are lost due to defaulted loans, those that are not will be used to buy up American consumer goods and assets. As a result of this huge influx of foreign-held dollars, the domestic dollar supply will likely rise even if the Fed were to allow the global supply of dollars to contract, forcing consumer prices even higher. In fact, a contraction in the domestic supply of consumer goods will likely coincide with an expansion of the domestic supply of money. The result will be much higher consumer prices despite the recession. So even though Americans will consume much less, they will pay much more for the privilege.

The real risk of course is that the Fed gets more aggressive as it realizes that the additional credit it is supplying is not flowing where it wants. If the Fed drops enough money from helicopters it will eventually reverse the nominal declines in asset prices. Unfortunately, that road leads to hyper-inflation and disaster. No matter what, even if the Fed succeeds in propping up nominal asset prices, they can do nothing to sustain their real values. Consumer goods prices will always rise faster, leaving the owners of those assets poorer no matter how high their nominal values climb.

The big problem politically is that hyper-inflation may superficially appear to be the lesser evil. If asset prices are allowed to collapse, ownership of those assets will pass to our creditors. If instead we repay our debts with debased currency, we retain ownership of our assets and shift the losses to our creditors. Since American debtors can vote in U.S. elections and foreign creditors can not, the choice seems obvious. Of course there are some American creditors as well, but since they comprise such a small percentage of the electorate, my guess is that their losses will be seen as acceptable collateral damage.

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