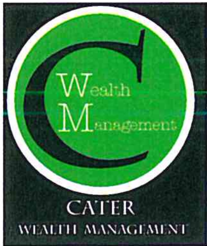

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6/16/2020

Greg Cater Sr. & Greg Cater Jr.

PRICE INFLATION VS MONETARY INFLATION

We learned a great deal from the fiscal and monetary responses to the Great Financial Crises (GFC). Congress approved President Obama's $787 billion stimulus bill, The Federal Reserve dropped interest rates to 0% (Zero Lower Bound) and embarked on a massive bond buying program (Quantitative Easing) that increased its balance sheet from $800 Billion to $4.5 Trillion. The fiscal policies were designed to create jobs and the monetary policies would make money available to lend and spend.

Did it work? That depends on your definition of success.

The stock market hit its low in March 2009 and we embarked on the longest economic expansion in U. S. history. Despite the now infamous public letter to Federal Reserve Chairman Ben Bernanke warning of currency debasement and inflation, the US dollar strengthened and inflation remained tame. On the other hand, the "Recovery" has proven to be the weakest since WWII and inflation has not come close to hitting the Fed's 2% target. Debt, the main culprit of the GFC, is higher today than at the height of the last crisis. Jobs came back, but real wages lagged. Banks had record excess-reserves but didn't increase lending. And then this happened:

COVID-19 AND AN ALMOST COMPLETE SHUTDOWN OF THE ECONOMY

This time both the fiscal and monetary responses were like 2008 on steroids. Congress passed stimulus bills adding $ trillions to the deficit and the Fed has doubled its balance sheet with more to come (unlimited QE). The Federal government is handing out money to just about everyone. The Payroll Protection Plan (PPP) is paying workers not to work. The Fed's Main Street Lending Program is lending to small business, and large businesses are getting direct Federal assistance. Are these policies the correct prescription for our problem? I believe so. Will they be enough...probably not?

I'm waiting for the next version of the public letter (this time addressed to Chairman Powell) warning of currency debasement and inflation. Will they be right this time...probably not?

Those of you who have been following Cater Wealth Management know we are primarily interested in the direction of interest rates. Watching inflation helps us predict future rates. While not a perfect benchmark, A. Gary Shilling PH.D stated in his *Insight* Volume 36, Number 6, that "interest rates have a 60% correlation with inflation." It is important, however, to differentiate between price inflation and monetary inflation. To help understand the difference we need to be familiar with Irving Fisher's Equation of Exchange:

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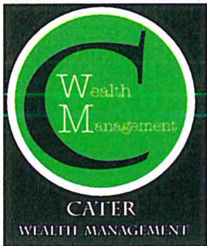

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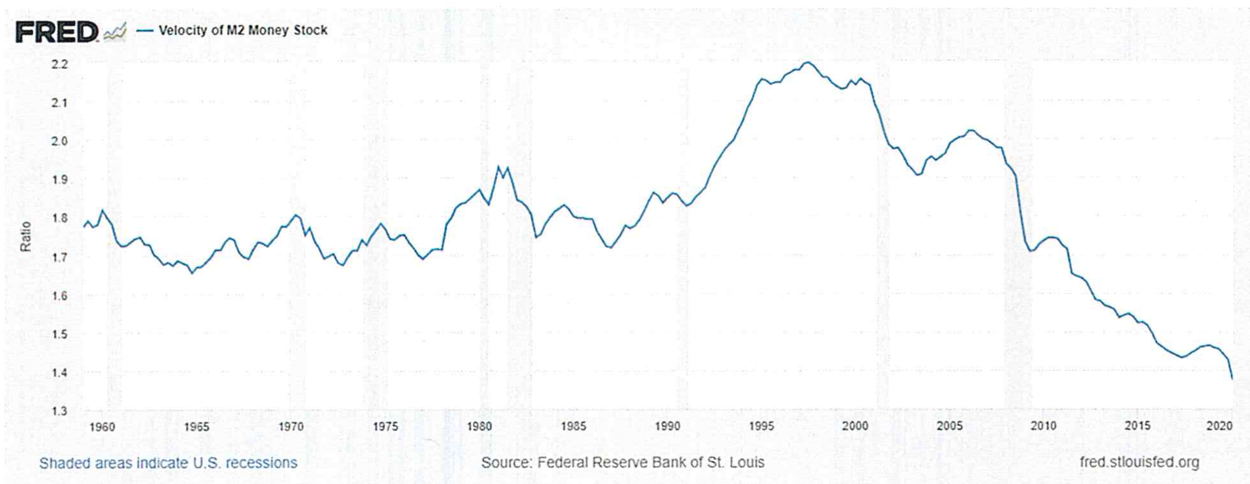
MV = PQ

M	=	Money Supply
V	=	Velocity of Money
P	=	Price Level
Q	=	Total Output (Goods and Services)

While relatively unknown to the masses, Irving Fisher is an economic icon. Both Nobel Prize winners Joseph Schumpeter (who coined "Creative Destruction") and Milton Friedman (Father of Monetarism) called Fisher "The greatest economist the U. S. has ever produced". So what's happening to M V P and Q today and what is it telling us? I want to leave M for last; this is where most get it wrong.

V -The velocity of money, or rather the annual turnover of a dollar in our economy is at a record low.



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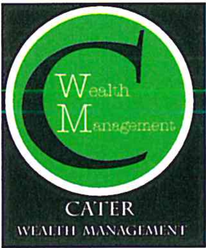

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P - The Fed's official measure of inflation (PCE) = 0.5% YOY vs 2.0% target.

Q - GDP, the total market value of all goods and services produced = 0.2% YOY and getting weaker.

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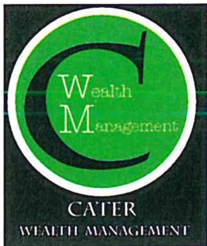

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So far we have V↓, P↓, and Q↓, which leaves us with the Money Supply (M).

A common line of thinking is that increased government deficits lead to increased government debt (money), and a growing Federal Reserve balance sheet increases the money supply (and therefore inflation). This is only part of the story. Both fiscal and monetary policy will increase the monetary base (MO). MO, however, is small when compared to private sector money. Let's look at what happened during the Great Depression.

In 1929 the total money supply was $27 billion; $23 billion private money (credit) and $4 billion Federal money (MO).The Fed responded with a 25% increase in MO to $5 billion but the private sector reduction in money (bank money and credit) of $8 billion resulted in a 25% decline in M four years later. When banks closed, deposits disappeared. We didn't have deposit insurance in 1929. When companies defaulted on their debts, assets (credit) were destroyed. Even though the Fed increased the monetary base from $4 billion to $5 billion, the total money supply, the monetary base plus the credit that kept the economy vibrant, declined from $27 billion to $20 billion. The result was a decline in M, V, P, and Q. This is Fisher's Debt Deflation scenario.

M↓V↓=P↓Q↓ == Deflation (or at least disinflation)

To solve our current crisis, we will increase Government debt and the Fed's balance sheet, which will in turn increase the monetary base, but the private-sector debt destruction resulting from a near total shutdown of our economy will dwarf the increase in MO. In this scenario, we do not expect to see monetary inflation; in fact, the opposite is more likely, making our 2020 equation look like the one above.

Monetary inflation is not the same as short-term price inflation which results from imbalances in supply and demand. While we might see some pockets of short-term price inflation, the private sector is very good at adjusting supply to meet changes in demand. This is one of the many reasons why we can be relatively confident about our long-term forecast, while our short-term predictions remain fuzzy.

We believed that rates were headed lower before the Covid-19 shutdown. Now we are even more secure in our belief that rates will trend down in the long term.

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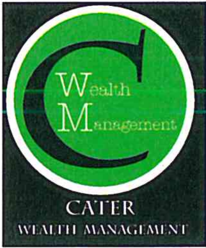

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