

# THE ELLIOTT WAVE THEORIST

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## CAN THE FED STOP DEFLATION?

### Consensus Opinion Concerning Deflation

Seventy years of nearly continuous inflation have made most people utterly confident of its permanence. If the majority of economists have any monetary fear at all, it is fear of inflation, which is the opposite of deflation. Two of the world's most renowned economists have reiterated this fear in recent months in *The Wall Street Journal*, predicting an immediate acceleration of inflation.

As for the very idea of deflation, one economist a few years ago told a national newspaper that deflation had a "1 in 10,000" chance of occurring. The Chairman of Carnegie Mellon's business school calls the notion of deflation "utter nonsense." A professor of economics at Pepperdine University states flatly, "Rising stock prices will inevitably lead to rising prices in the rest of the economy." The publication of an economic think-tank insists, "Anyone who asserts that deflation is imminent or already underway ignores the rationale for fiat currency — that is, to facilitate the manipulation of economic activity." A financial writer explains, "Deflation... is totally a function of the Federal Reserve's management of monetary policy. It has nothing to do with the business cycle, productivity, taxes, booms and busts or anything else." Concurring, an adviser writes in a national magazine, "U.S. deflation would be simple to stop today. The Federal Reserve could just print more money, ending the price slide in its tracks." Yet another sneers, "Get real," and likens anyone concerned about deflation to "small children." One maverick economist whose model accommodates deflation and who actually *expects* a period of deflation is nevertheless convinced that it will be a "good deflation" and "nothing to fear." On financial television, another analyst (who apparently equates deflation with falling prices) quips, "Don't worry about deflation. All it does is pad profits." A banker calls any episode of falling oil prices "a positive catalyst [that] will put more money in consumers' pockets. It will benefit companies that are powered by energy and oil, and it will benefit the overall economy." Others excitedly welcome recently falling commodity prices as an economic stimulus "equivalent to a massive tax cut." A national business magazine guarantees, "That's not deflation ahead, just slower inflation. Put your deflation worries away." The senior economist with Deutsche Bank in New York estimates, "The chance of deflation is at most one in 50" (apparently up from the 1 in 10,000 of a couple of years ago). The President of the San Francisco Fed says, "The idea that we are launching into a prolonged period of declining prices I don't think has substance." A former government economist jokes that deflation is "57th on my list of worries, right after the 56th — fear of being eaten by piranhas." These comments about deflation represent entrenched professional opinion.

As you can see, anyone challenging virtually the entire army of financial and economic thinkers, from academic to professional, from liberal to conservative, from Keynesian socialist to Objectivist free-market, from Monetarist technocratic even to many vocal proponents of the Austrian school, must respond to their belief that inflation is virtually inevitable and deflation impossible.

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## **“Potent Directors”**

The primary basis for today’s belief in perpetual prosperity and inflation with *perhaps* an occasional recession is what I call the “potent directors” fallacy. It is nearly impossible to find a treatise on macroeconomics today that does not assert or assume that the Federal Reserve Board has learned to control both our money and our economy. Many believe that it also possesses immense power to manipulate the stock market.

The very idea that it *can* do these things is false. Last October, before the House and Senate Joint Economic committee, Chairman Alan Greenspan himself called the idea that the Fed could prevent recessions a “puzzling” notion, chalking up such events to exactly what causes them: “human psychology.” In August 1999, he even more specifically described the stock market as being driven by “waves of optimism and pessimism.” He’s right on this point, but no one is listening.

The Chairman also expresses the view that the Fed has the power to temper economic swings for the better. Is that what it does? Politicians and most economists assert that a central bank is necessary for maximum growth. Is that the case?

This is not the place for a treatise on the subject, but a brief dose of reality should serve. Real economic growth in the U.S. was greater in the nineteenth century without a central bank than it has been in the twentieth century with one. Real economic growth in Hong Kong during the latter half of the twentieth century outstripped that of every other country in the entire world, and it had no central bank. Anyone who advocates a causal connection between central banking and economic performance must conclude that a central bank is harmful to economic growth. For recent examples of the failure of the idea of efficacious economic directors, just look around. Since Japan’s boom ended in 1990, its regulators have been using every presumed macroeconomic “tool” to get the Land of the Sinking Sun rising again, as yet to no avail. The World Bank, the IMF, local central banks and government officials were “wisely managing” Southeast Asia’s boom until it collapsed spectacularly in 1997. Prevent the bust? They expressed profound dismay that it even happened. As I write this paragraph, Argentina’s economy has just crashed despite the machinations of its own presumed “potent directors.” I say “despite,” but the truth is that directors, whether they are Argentina’s, Japan’s or America’s, *cannot* make things better and have *always* made things worse. It is a principle that meddling in the free market can only disable it. People think that the Fed has “managed” the economy brilliantly in the 1980s and 1990s. Most financial professionals believe that the only potential culprit of a deviation from the path to ever greater prosperity would be current-time central bank actions so grossly stupid as to be beyond the realm of possibility. But the deep flaws in the Fed’s manipulation of the banking system to induce and facilitate the extension of credit will bear bitter fruit in the next depression. Economists who do not believe that a prolonged expansionary credit policy has consequences will soon be blasting the Fed for “mistakes” in the present, whereas the errors that matter most reside in the past. Regardless of whether this truth comes to light, the populace will disrespect the Fed and other central banks mightily by the time the depression is over. For many people, the single biggest financial shock and surprise over the next decade will be the revelation that the Fed has never really known what on earth it was doing. Make sure that you avoid the disillusion and financial devastation that will afflict those who harbor a misguided faith in the world’s central bankers and the idea that they can manage our money, our credit or our economy.

## **The Fed’s Final Card**

The Fed used to have two sources of power to expand the total amount of bank credit: It could lower reserve requirements or lower the discount rate, the rate at which it lends money to banks. In shepherding

reserve requirements down to zero, it has expended all the power of the first source. In 2001, the Fed lowered its discount rate from 6 percent to 1.75 percent, an unprecedented amount in such a short time. By doing so, it has expended much of the power residing in the second source. What will it do if the economy resumes its contraction, lower interest rates to zero? *Then what?*

### **Why the Fed Cannot Stop Deflation**

Countless people say that deflation is impossible because the Federal Reserve Bank can just *print money* to stave off deflation. If the Fed's main jobs were simply establishing new checking accounts and grinding out banknotes, that's what it might do. But in terms of *volume*, that has not been the Fed's primary function, which for 89 years has been in fact to foster the *expansion of credit*. Printed fiat currency depends almost entirely upon the whims of the issuer, but credit is another matter entirely.

What the Fed does is to set or influence certain very short-term interbank loan rates. It sets the discount rate, which is the Fed's nominal near-term lending rate to banks. This action is primarily a "signal" of the Fed's posture because banks almost never borrow from the Fed, as doing so implies desperation. (Whether they will do so more in coming years under duress is another question.) More actively, the Fed buys and sells overnight "repurchase agreements," which are collateralized loans among banks and dealers, to defend its chosen rate, called the "federal funds" rate. In stable times, the lower the rate at which banks can borrow short-term funds, the lower the rate at which they can offer long-term loans to the public. Thus, though the Fed undertakes its operations to influence bank borrowing, its ultimate goal is to influence public borrowing from banks. Observe that the Fed makes bank credit more available or less available to two sets of *willing borrowers*.

During social-mood uptrends, this strategy appears to work, because the borrowers — i.e., banks and their customers — are confident, eager participants in the process. During monetary crises, the Fed's attempts to target interest rates don't appear to work because in such environments, the demands of creditors overwhelm the Fed's desires. In the inflationary 1970s to early 1980s, rates of interest soared to 16 percent, and the Fed was forced to follow, not because it *wanted* that interest rate but because debt investors demanded it.

Regardless of the federal funds rate, banks set their own lending rates to customers. During economic contractions, banks can become fearful to make long-term loans even with cheap short-term money. In that case, they raise their loan rates to make up for the perceived risk of loss. In particularly scary times, banks have been known virtually to cease new commercial and consumer lending altogether. Thus, the ultimate success of the Fed's attempts to influence the total amount of credit outstanding depends not only upon willing borrowers but also upon the banks as *willing creditors*.

Economists hint at the Fed's occasional impotence in fostering credit expansion when they describe an ineffective monetary strategy, i.e., a drop in the Fed's target rates that does not stimulate borrowing, as "pushing on a string." At such times, low Fed-influenced rates cannot overcome creditors' disinclination to lend and/or customers' unwillingness or inability to borrow. That's what has been happening in Japan for over a decade, where rates have fallen effectively to zero but the volume of credit is still contracting. Unfortunately for would-be credit manipulators, the leeway in interest-rate manipulation stops at zero percent. When prices for goods fall rapidly during deflation, the value of money rises, so even a zero interest rate imposes a heavy real cost on borrowers, who are obligated to return more valuable dollars at a later date. No one holding money wants to pay someone to borrow it, so interest rates cannot go negative. (Some people have proposed various pay-to-borrow schemes for central banks to employ in combating deflation, but it is doubtful that the real world would accommodate any of them.)

When banks and investors are reluctant to lend, then only *higher* interest rates can induce them to do so. In deflationary times, the market accommodates this pressure with falling bond prices and higher lending rates for all but the most pristine debtors. But wait; it's not that simple, because higher interest rates do not serve only to *attract* capital; they can also make it flee. Once again, the determinant of the difference is market psychology: Creditors in a defensive frame of mind can perceive a borrower's willingness to pay high rates as desperation, in which case, the higher the offer, the more repelled is the creditor. In a deflationary crash, soaring interest rates for bonds mean that creditors fear default.

A defensive credit market can scuttle the Fed's efforts to get lenders and borrowers to agree to transact at all, much less at some desired target rate. If people and corporations are unwilling to borrow or unable to finance debt, and if banks and investors are disinclined to lend, central banks cannot force them to do so. During deflation, they cannot even *induce* them to do so with a zero interest rate.

Thus, regardless of assertions to the contrary, the Fed's purported "control" of borrowing, lending and interest rates ultimately depends upon an accommodating market psychology and cannot be set by decree. So ultimately, the Fed does not control either interest rates or the total supply of credit; the market does.

There is an invisible group of lenders in the money game: *complacent depositors*, who — mostly by default — have been letting banks engage in whatever lending activities they like. Under pressure, bankers have occasionally testified that depositors might become highly skittish (if not horrified) if they knew how their money is being handled. During emotional times, the Fed will also have to try to maintain bank depositors' confidence by refraining from actions that appear to indicate panic. This balancing act will temper the Fed's potency and put it on the defensive yet further.

In contrast to the assumptions of conventional macroeconomic models, people are not machines. They get emotional. People become depressed, fearful, cautious and angry during depressions; that's essentially what causes them. A change in the population's mental state from a desire to expand to a desire to conserve is key to understanding why central bank machinations cannot avert deflation.

When ebullience makes people expansive, they often act on impulse, without full regard to reason. That's why, for example, consumers, corporations and governments can allow themselves to take on huge masses of debt, which they later regret. It is why creditors can be comfortable lending to weak borrowers, which they later regret. It is also why stocks can reach unprecedented valuations.

Conversely, when fear makes people defensive, they again often act on impulse, without full regard to reason. One example of action impelled by defensive psychology is governments' recurring drive toward protectionism during deflationary periods. Protectionism is correctly recognized among economists of all stripes as destructive, yet there is always a call for it when people's mental state changes to a defensive psychology. Voting blocs, whether corporate, union or regional, demand import tariffs and bans, and politicians provide them in order to get re-elected. If one country does not adopt protectionism, its trading partners will. Either way, the inevitable dampening effect on trade is inescapable. Another example of defensive psychology is the increasing conservatism of bankers during a credit contraction. When lending officers become afraid, they call in loans and slow or stop their lending no matter how good their clients' credit may be in actuality. Instead of seeing opportunity, they see only danger. Ironically, much of the actual danger appears as a consequence of the reckless, impulsive decisions that they made in the preceding uptrend. In an environment of pessimism, corporations likewise reduce borrowing for expansion and acquisition, fearing the burden more than they believe in the opportunity. Consumers adopt a defensive strategy at such times by opting to save and conserve rather than to borrow, invest and spend. Anything the Fed does in such a climate will be seen through the lens of cynicism and fear. In such a mental state, people

will interpret Fed actions differently from the way that they did when they were inclined toward confidence and hope.

With these thoughts in mind, let's return to the idea that the Fed could just print banknotes to stave off bank failures. One can imagine a scenario in which the Fed, beginning soon after the onset of deflation, trades banknotes for portfolios of bad loans, replacing a sea of bad debt with an equal ocean of banknotes, thus smoothly monetizing all defaults in the system without a ripple of protest, reaction or deflation. There are two problems with this scenario. One is that the Fed is a bank, and it would have no desire to go broke buying up worthless portfolios, debasing its own reserves to nothing. Only a government mandate triggered by crisis could compel such an action, which would come only *after* deflation had ravaged the system. Even in 1933, when the Fed agreed to monetize some banks' loans, it offered cash in exchange for only the very best loans in the banks' portfolios, not the precarious ones. Second, the smooth reflation scenario is an ivory tower concoction that sounds plausible only by omitting human beings from it. While the Fed could embark on an aggressive plan to liquefy the banking system with cash in response to a developing credit crisis, that action itself ironically could serve to aggravate deflation, not relieve it. In a defensive emotional environment, evidence that the Fed or the government had decided to adopt a deliberate policy of inflating the currency could give bondholders an excuse, justified or not, to panic. It could be taken as evidence that the crisis is worse than they thought, which would make them fear defaults among weak borrowers, or that hyperinflation lay ahead, which could make them fear the depreciation of all dollar-denominated debt. Nervous holders of suspect debt that was near expiration could simply decline to exercise their option to repurchase it once the current holding term ran out. Fearful holders of suspect long-term debt far from expiration could dump their notes and bonds on the market, making prices collapse. If this were to happen, the net result of an attempt at inflating would be a system-wide reduction in the purchasing power of dollar-denominated debt, in other words, a drop in the dollar value of total credit extended, which is deflation.

The myth of Fed omnipotence has two main countervailing forces: the bond market and the currency market. With today's full disclosure of central banks' activities, governments and central banks cannot hide their monetary decisions. Indications that the Fed had adopted an unwelcome policy would spread immediately around the world, and markets would adjust accordingly. Those adjustments could not only negate but also *outrun* the Fed's attempts at undesired money or credit expansion.

The problems that the Fed faces are due to the fact that the world is not so much awash in money as it is awash in *credit*. Because today the amount of outstanding credit dwarfs the quantity of money, debt investors, who always have the option to sell bonds in large quantities, are in the driver's seat with respect to interest rates, currency values and the total quantity of credit, which means that they, not the Fed, are now in charge of the prospects for inflation and deflation. The Fed has become a slave to trends that it has already fostered for seventy years, to events that have already transpired. For the Fed, the mass of credit that it has nursed into the world is like having raised King Kong from babyhood as a pet. He might behave, but only if you can figure out what he wants and keep him satisfied.

In the context of our discussion, the Fed has four relevant tasks: to keep the banking system liquid, to maintain the public's confidence in banks, to maintain the market's faith in the value of Treasury securities, which constitute its own reserves, and to maintain the integrity of the dollar relative to other currencies, since dollars are the basis of the Fed's power. In a system-wide financial crisis, these goals will conflict. If the Fed chooses to favor any one of these goals, the others will be at least compromised, possibly doomed.

The Fed may have taken its steps to eliminate reserve requirements with these conflicts in mind, because whether by unintended consequence or design, that regulatory change transferred the full moral responsibility for depositors' money onto the banks. The Fed has thus excused itself from responsibility

in a system-wide banking crisis, giving itself the option of defending the dollar or the Treasury's debt rather than your bank deposits. Indeed, from 1928 to 1933, the Fed raised its holdings of Treasury securities from 10.8 percent of its credit portfolio to 91.5 percent, effectively fleeing to "quality" right along with the rest of the market. What actual path the Fed will take under pressure is unknown, but it is important to know that it is under no *obligation* to save the banks, print money or pursue any other rescue. Its primary *legal* obligation is to provide backing for the nation's currency, which it could quite merrily fulfill no matter what happens to the banking system.

### **Local Inflation by Repatriation?**

Other countries hold Treasury securities in their central banks as reserves, and their citizens keep dollar bills as a store of value and medium of exchange. In fact, foreigners hold 45 percent of Treasury securities in the marketplace and 75 percent of all \$100 bills. Repatriation of those instruments, it has been proposed, could cause a dramatic local inflation. If in fact investors around the world were to panic over the quality of the Treasury's debt, it would cause a price collapse in Treasury securities, which would be deflationary. As for currency repatriation, if overall money and credit were deflating in dollar terms, dollar bills would be rising in value. Foreigners would want to hold onto those remaining dollar bills with both hands. Even if foreigners did return their dollars, the Fed, as required by law, would offset returned dollar currency with sales of Treasury bonds, thus neutralizing the monetary effect.

### **Can Fiscal Policy Halt Deflation?**

Can the government spend our way out of deflation and depression? Governments sometimes employ aspects of "fiscal policy," i.e., altering spending or taxing policies, to "pump up" demand for goods and services. Raising taxes for any reason would be harmful. Increasing government spending (with or without raising taxes) simply transfers wealth from savers to spenders, substituting a short-run stimulus for long-run financial deterioration. Japan has used this approach for twelve years, and it hasn't worked. Slashing taxes absent government spending cuts would be useless because the government would have to borrow the difference. Cutting government spending is a good thing, but politics will prevent its happening prior to a crisis.

Understand further that even the government's "tools" of macroeconomic manipulation are hardly mechanical levers on a machine; they are subject to psychology. Have you noticed the government's increasing fiscal conservatism over the past decade? Even Democrats have been voicing the virtues of a balanced budget! This is a sea change in *thinking*, and that is what ultimately causes trends such as inflation and deflation.

### **Endgame**

The lack of solutions to the deflation problem is due to the fact that the problem results from prior excesses. Like the discomfort of drug addiction withdrawal, the discomfort of credit addiction withdrawal cannot be avoided. The time to have thought about avoiding a system-wide deflation was years ago. Now it's too late.

It does not matter how it happens; in the right psychological environment, *deflation will win*, at least initially. People today, raised in the benign, expansive environment of Supercycle wave (V), love to quote the conventional wisdom, "Don't fight the Fed." Now that the environment is about to change, I think that the cry of the truly wise should be, "*Don't fight the waves.*"

## **Currency Hyperinflation**

While I can discern no obvious forces that would counteract deflation, *after* deflation is another matter. At the bottom, when there is little credit left to destroy, currency inflation, perhaps even hyperinflation, could well come into play. In fact, I think this outcome has a fairly high probability in the next Kondratieff cycle.

When a government embarks on a policy of currency hyperinflation, such as the Confederate States did in the 1860s, Germany did in the early 1920s or France did after World War II, the monetary path is utterly different from that of deflation, but ironically, the end result is about the same as that of a deflationary crash. At the end of hyperinflation, total bank accounts denominated in the hyperinflated currency are worth far less than they were, sometimes nothing at all. Total debts have shrunk or disappeared because the notes were denominated in depreciated money. In the severest cases, even the money disappears. In this sense, even with hyperinflation, the end result is the destruction of money and credit, which is deflation.

## **The Markets Will Signal Inflation**

Despite my thoughts on the matter, I recognize that international money flows are massive, central bankers can be ingenious, and politics can be volatile. Perhaps there is some way that inflation, whether globally or locally, could accelerate in the immediate future. How can you tell if my conclusion about deflation is wrong and that inflation or hyperinflation is taking place *instead of* deflation?

There are two sensitive barometers of major monetary trends. One is the currency market. If the price of the dollar against other currencies begins to plummet, then the market either fears dollar inflation or that the value of the dollar will not hold up in a climate of waning confidence. The other, which is more important, is the gold market. I hope to recommend gold at lower prices near the bottom of the deflationary trend, but if gold were to move above \$400 per ounce, I would probably be convinced that a major low had passed.

## **A High Degree of Complexity**

Stocks are not registering a Supercycle top like that of 1929 but a *Grand Supercycle* top. This means that the ultimate — if not the immediate — consequences will be more severe and more confounding than the consequences of the 1929-1932 crash. As Chapter 5 of *At the Crest of the Tidal Wave* explains, the entirety of Grand Supercycle wave (IV) should last a century and comprise two or three major bear markets with one or two intervening bull markets. My outlook for deflation pertains primarily to the first bear market. Because in some ways the financial world is in uncharted waters, this analysis may not have all the answers.



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