Inflation, Deflation, and a Potential Second Stimulus

The Obama administration is pushing for a second "stimulus" package as the amount of money flowing in the U.S. economy contracts at a pace not seen since the Great Depression, according to international news reports.

Citing "British and European monetarists," the U.K.'s *Telegraph* reported last week that American M3 figures — basically the broadest measure on the amount of money available in the U.S. economy — started shrinking last summer. The contraction in the money supply has accelerated in 2010 to an annual rate of almost 10 percent.

"It's frightening," International Monetary Research founder Tim Congdon told the *Telegraph*. "The plunge in M3 has no precedent since the Great Depression." He blames regulators pushing banks to raise capital asset ratios for the crunch as well as the failure of the U.S. economy to "properly" recover. "The US has just tried the biggest fiscal [stimulus] experiment in history and it has failed," he said, referring to the original $800 billion "recovery and reinvestment" package.

The Federal Reserve stopped publishing M3 numbers in 2006, arguing that the costs "outweigh the benefits," but various institutions still produce estimates based on central bank data. The Fed does still produce the more narrow M2 figures, and the annual percentage change is plunging. But what the figures really mean is still being debated among economists. In the short term at least, some fear deflation.

The decline in the available money supply seems counterintuitive, since monetary central planning authorities at the Fed have kept interest rates at virtually zero percent while printing and pouring trillions into the economy through bank bailouts, Treasury bond purchases, and other methods. But despite the massive inflation of the total money supply, the velocity of money remains very low as banks hesitate to lend (except to government) while businesses and consumers shirk from borrowing and take their money out of banks.

"All the signs around us point to deflation. The money supply is being pumped up on an unprecedented scale, but all it does is push on a string," wrote monetary scientist Dr. Antal Fekete in a guest column for *The Daily Bell*, noting that while the central bank may rule over quantity of money, "the market firmly controls" the velocity of circulation. "[W]hy is it that the inordinate money creation by the Fed is having no lasting effect on prices? It is because the Fed can create all the money it wants, but it cannot command it to flow uphill." For now, it's all going to the bond market, he concluded.

Due to these factors, the multiplier effect of fractional reserve banking has not yet had the opportunity to dramatically expand the total available money supply. Much of the newly created currency remains parked at the Fed paying interest to banks, or with the banks themselves to insulate them from further anticipated losses on commercial real estate and other debt. A lot has been plowed into U.S. Treasury bonds, providing what is considered a risk-free (albeit, unproductive) return to bankers at taxpayer expense.

Of course, the federal government borrowed and injected an unprecedented amount of “fiscal stimulus” into the economy (read government-favored projects) through the American Recovery and Reinvestment Act. But the fact that it has not worked is prompting Keynesian economists in the Obama administration to demand more of the same.

Alleged fears of deflation and a sputtering “recovery” led National Economic Council Director Lawrence Summers to propose yet another “stimulus” package to Congress last week. “"We are nearly 8m jobs short of normal employment. For millions of Americans the economic emergency grinds on," he explained, arguing for at least another $200 billion. “I cannot agree with those who suggest that it somehow threatens the future to provide truly temporary, high-bang-for-the-buck jobs and growth measures … Spurring growth, if we can achieve it, is by far the best way to improve our fiscal position.”

But if too much debt and central bank “funny-money” caused the collapse, why would the government borrowing even more money solve the problem? It won’t, in the long run. But the monetary system in the U.S. and around the world is essentially a debt trap — as soon as the first Federal Reserve Note is borrowed into the economy, more money is owed on that debt note than actually exists, because the Fed charges interest but never created the money necessary to pay it back. If new borrowers can’t be induced to borrow ever greater sums to pay off the impossible-to-pay interest, the system collapses. That’s really the crux of the argument for more stimulus, government obfuscating not withstanding.

As it stands now, the Fed has created gargantuan sums of new debt money in recent years, ostensibly to bail out the bankers and prevent an even bigger crisis. But despite all the fresh cash, prices have not really gone up thus far because the new debt money has not truly entered circulation. If it never does enter the circulating money supply, America could very well be faced with deflation. But if and when banks start to lend again, the result will undoubtedly be hyperinflation as the massive new supply of debt notes chases ever fewer goods and services.

Legendary investor Marc Faber, publisher of the famous Gloom Boom & Doom Report, believes that inflation is in the cards, even if deflation arrives beforehand. “Eventually we’ll have much higher inflation rates because if deflation comes first, they’re going to have even more stimulus packages and even more [money] printing,” he told Yahoo! Finance in an interview. “It’s crazy to even suggest additional stimulus, but that is what the Keynesians believe is the right thing to do. And that will bankrupt Western governments — not just in the U.S., but everywhere.”

Deflation in the sense of falling prices is not in and of itself bad. If the central bank were not constantly expanding the supply of money — or if a gold standard limited the supply of money — deflation would be a natural consequence of increased production, efficiency and capital investment. There would be more goods and services available and the money supply would remain relatively constant. But the underlying system responsible for the deflation that may be coming is different.

“When the Federal Reserve (the Fed) is pushing the rate of interest down to zero (insofar as it needs pushing), wholesale destruction of capital is taking place unobtrusively but none the less effectively,” wrote Dr. Fekete, explaining his “Black Hole of Zero Interest” theory. “Deflation is the measure of wealth in the process of self-destruction — wealth gone for good.”

Fed chief Bernanke recently discussed sucking back up some of the new money created over the course of the crisis. But central planning has already proven itself to be a failure, and nobody can claim to truly know what the “optimal” supply of Federal Reserve Notes should be. And no matter what the Fed does, create inflation or spur deflation, the economy is still in big trouble.

The Consumer Price Index is the government’s way of tracking prices. Currently it claims “inflation” is very low to non-existent, hence the lack of a “cost of living adjustment” for Social Security recipients. But while the calculations used to reach the CPI conclusions are highly flawed, recent results point to a possible onset of deflation in the near future.

But to solve the problems, America does not need more “stimulus” packages, money creation, or money destruction. Whether inflation or deflation rampage through the economy, the results will be disastrous for the economy as wealth is continually pumped toward the banking cartel and away from average Americans. No matter what Bernanke and his fellow central planners do, the real problem is systemic. What is needed to fix the problems once and for all is sound monetary and banking systems. To accomplish this, Congress can simply look to the Constitution (which is notable for granting Congress the power to "coin" — not print — money) as the best solution.