

# How The Bubble Bursts

## Understanding inflation and deflation.

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Now that we're getting a taste of what deflation is, it's easier to talk about. Before, I tried to describe what to expect and how to deal with it, but in a way that was difficult for the average person to understand - especially when the government, the Fed, and Wall Street continue to misrepresent it.

Now that we've seen the beginning stages of deflation, it's becoming clearer what's going on and what's important: to conserve capital. To save.

So let's review what inflation and deflation really are.

The traditional definition of inflation (rising prices) and deflation (falling prices) don't make sense in today's world. That's why people are confused. Ironically, the Fed wants you to be this confused, because it's actually they who create inflation - which plants the seeds for eventual deflation.

Inflation's just the expansion of the money supply, almost always through the expansion of debt. This is what the Fed does: They create debt out of thin air and pass that debt on to the banking system by extending credit; banks then extend it to consumers.

From 1993 to 2006 the Fed created massive inflation by creating massive debt, keeping real interest rates negative and supplying plenty of credit to keep them there. This was particularly true from 2001 to 2006; in 2006 alone the Fed expanded the money supply by creating \$4 trillion in new debt.

People who had no business borrowing took money from people who had no business lending. This drove the prices of the cars and house they bought with that money up, while the debt drove the value of the currency down. This doubles the pressure on the prices of things we get from other countries - like oil.

So it isn't hard to convince people that inflation means rising prices, because rising prices almost always occur when the money supply's inflated with debt.

In 2007, we reached a point where there was just too much debt; no one could take on any more. This is where the Fed's inflation machine breaks down: If no one can borrow or lend on the credit they offer the banking system, the money supply stops expanding. In fact, as people try to pay off all that debt (retire it) or default on it (destroy it), the money supply, bloated with debt, begins to shrink. Hence deflation.

What does the Fed do then? Why, they buy that debt themselves, to try to keep the money supply from deflating. This leads to those TAF (term auction facility) auctions you've heard about, where the Fed exchanges new capital (t-bills) for bad debts with banks.

Despite these efforts, the money supply has probably deflated by the amount of write-offs -- by now, approximately \$400 billion -- that banks have incurred. Strict measures of money supply, like M3, haven't fallen - but that doesn't include the most important broad sources of new money, like derivatives and securitized loans. As the money supply deflates, people borrow less and spending goes down. The deflation thus feeds on itself, because lower spending means lower income and debt becomes even harder to support. Prices in stocks begin to fall as the money supply dwindles.

Central banks are powerless to stop the money supply from deflating unless they take on the debt themselves. If not, it will be systematically destroyed by defaulting, and the money supply will shrink even more.

As central banks fight this by taking on debt (as in TAFs and the Bear Stearns bailout), taxpayers will be called upon to make up the losses. Ironically, the Fed's attempts to keep the money supply inflated are much worse for the average person, who suffers from a declining dollar and higher taxes in the long run.

Why doesn't this happen all the time, you ask? It does - it just usually happens in smaller increments. What's happening now is different only in terms of magnitude: The money supply has been so debt-inflated for so long that the reversal is very significant. Over the years, it just adds up: Few realize just how much debt's still out there.

When a bank takes a write-off, debt gets smaller - but we still have a long way to go. How long? Well, the level of debt's currently four to five times greater than is normal for our economy; the natural level of income and savings aren't enough to support the debt. Debt will get destroyed -- and the money supply will deflate -- until debt and actual savings are more balanced.

If you understand inflation and deflation in this way, our current crisis makes more sense. Now we're seeing deflation (a shrinking money supply and lost liquidity), which is causing havoc in markets.

We're still seeing prices rise on certain scarce commodities as various competing forces work their way through the system; but that's to be expected, because those rising prices are caused by more debt, which will eventually make the debt untenable as income goes down.

We're seeing formerly powerful financial institutions destroyed by even these first stages of deflation. That's because their only power came from franchise - from being able to

take out high-risk spreads. So they actually had very little capital to support vast amounts of debt when things began to sour.

High risk has been rewarded in the past by government (easy monetary policy), legislation (the repeal of Glass-Steagall, now clearly a mistake), and the markets (the Wall Street marketing machine). Those rewards fall away quickly when you see that you have built your house built on sand.

For decades, but especially over the last seven years, central banks have “solved” any and all market dips, slowing economies, and financial problems by creating debt. If the stock market declines, just make it easy to borrow, so people can buy stocks. If the economy slows, just make it easy to borrow, so people can consume more. This methodology may work on occasion, but doing it systematically leads to crisis.

Central banks can't fix this problem: They can only create more banking debt or transfer its risks onto taxpayers via TAF auctions or nationalization - which will only stabilize the banking system long enough for banks to dilute themselves massively by suckering investors into buying stock. More debt isn't the solution.

So stay the course. Stay out of the way. Bottom feeders keep coming up empty. There will be rallies in stocks. Some will be quite vicious, but that doesn't mean we're in a bull market. The GDP's going to go way down, but will eventually come back when debt is wiped out to a point where those with savings want to lend or invest again.

We have a long way to go, though - and risk is high.