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Domestic Credit by David Goldman

Deflation confirms EIR's warning

In the 1930s, they called it "pushing on a string"; today, it would more appropriately be: "dangling on a rope."

Executive Intelligence Review's *Quarterly Economic Report* for Spring 1986, entitled, "The Deflationary Collapse of the Western Banking System," begins with the following statement:

"In our December 1985 *Quarterly Economic Report,* we concentrated attention on two features of the global financial crisis: the spiralling collapse of commodity prices, and the bubble in global financial markets. We predicted that the 10% decline of commodity prices would turn into a decline of at least 20% during 1986, with disastrous consequences for commercial-bank creditors of energy-producing nations and corporations; and, secondly, that the bubble in the foreign exchange and futures markets would become the epicenter of the global financial crisis."

Alarm bells should have rung in the Reagan administration when the International Monetary Fund reported this June, that commodity prices fell by about 4% during April and May, after an apparent stabilization earlier in the year. That is a 24% annual rate of decline, about the same as *EIR* projected in its December 1985 *Quarterly Economic Report.* The decline occurred across the board: Coconut oil, a staple export item for African and Asian exporters, declined by 60%, for example.

For the first time since the trend became obvious late last year, something of a public debate has erupted concerning the fear of 1930s-style deflation. Prices in world trade fell by roughly half between 1929 and 1934. They have already fallen by that amount since 1984, if the collapse of the U.S. dollar is taken into account: The International Monetary Fund's index of world commodity prices has fallen by 20% in the past two years, while the dollar has fallen by 30% against other currencies.

On one side of the debate stands Rep. Jack Kemp (R-N.Y.), who hopes to blame the Reagan administration's economic disaster on the Federal Reserve Board in the course of his campaign for the Republican presidential nomination. Kemp and his economic advisers demand that the Federal Reserve print more money, to raise prices. Gerald Ford's economic adviser, Alan Greenspan, disagrees. "Any marked decline in the general price level would almost certainly be countered by a flood of money creation by the world's central banks. This, in turn, would bring any disinflation to an end," Greenspan told the *Washington Post* June 22.

"Inflation is too much money chasing too few goods," they deduce. "Therefore, if we print more money, it will chase prices up." No syllogism in the history of Aristotelian logic has done more damage than this idiocy.

Both sides agree on the minor premise, that more money should be set to chasing after goods, in order to solve the problem. Sometimes, it takes one's breath away, to consider what the academic study of economics can do to the brain of the victim.

The "general price level" to which Greenspan refers has, of course, gone up, not down, as every consumer knows—despite the fall in pump prices for gasoline, and despite the collapse of commodity prices. There is an ugly reason for that: America's trade deficit accounts for one-sixth of all our physical consumption. That is, our physical production at home falls short of meeting the requirements of our current spending power by one-sixth, and we make up the difference with a subsidy from foreign producers. If we compare the rate of increase of Gross National Product (the dollar value of sales), to the rate of increase of U.S. physical output, our inflation rate has exceeded 15% per year since President Reagan took office. The collapse of commodity prices on the international markets, in the short run, enabled the United States to buy this subsidy at a fraction of its true production cost. The overvalued U.S. dollar (since much fallen) did the same thing.

Eventually, the parasite destroys the host, as Mexico is now attempting to explain to its choleric bankers. The collapse of commodity prices wipes out the victim's capacity to repay debt to the banks, destroying the banks' capital, and the banks' capacity to lend.

If the borrowers are bankrupt, and the banks are insolvent, no one will borrow or lend. That is more or less the present state of affairs. If anyone lends, the money will merely refinance debt service, i.e., go from one teller to the next; not a penny will come within hailing distance of an actual commodity.

Back in the 1930s, the last time the Federal Reserve tried to print money against a general deflation, the problem was called "pushing on a string." In the interest of originality, why not change the phrase to "dangling from a rope"?

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