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EIR Economics

Deflation Or Hyperinflation? The Two Have Paired Up

by Jonathan Tennenbaum

For passengers on a sinking *Titanic,* it were of rather secondary interest to know which end of the ship is going to hit bottom first; the important thing is to get into lifeboats as soon as possible. But today, with the global financial system in the process of disintegrating under our feet, we witness a heated debate, among "experts" and "insiders," about whether the fundamental danger facing the United States and other leading economies, is *deflation* or *inflation*.

The anti-hero of this discussion is U.S. Federal Reserve Chairman Alan Greenspan, desperately attempting to control an ongoing collapse (deflation!) of financial asset prices, by unleashing the most uncontrolled monetary expansion (hyperinflation!) since Weimar Germany 1923. That circumstance by itself should demonstrate, that the two apparent opposites—deflation and inflation—are in this case actually combined in symbiosis. A paradox exists only for those, who, instead of rushing for the lifeboats, choose to stay behind in their *Titanic* cabins, deciding what to do with their money. Most of these "market players" are going to lose in any case: wiped out in the collapse of asset prices, or, if enough of them succeed in converting their assets into liquid money quickly enough, they will soon find that money itself worthless.

This is the essential polemic I developed in an October 2000 article, "Hyperinflation Ahead?" published in a German-language special report by *EIR*. At that time, there were clear signs of an onset of *commodity price inflation:* The gigantic inflation of financial asset prices, resulting from the liquidity-pumping operations of Greenspan and the central banks since 1994, was beginning to spill over from the financial sector into the real economy. I pointed to the near-tripling of oil prices, from September 1998 until October 2000, together with sharp increases in other basic commodity prices and services in Fall 2000, as evidence for the onset of this spill-over process.

This was soon followed by a severe energy crisis in many parts of the United States, with an explosion of electricity and natural gas prices to the consumer. My whole analysis had been inspired by Lyndon LaRouche, who had sounded the warning in 1999 that a critical point had been reached, where the rate of expansion of monetary aggregates now exceeded the rate of increase in financial asset prices. This, he said, marked the point at which a further continuation of Greenspan's liquidity-pumping policy, would lead toward a "Weimar 1923-style" hyperinflationary blowout of the financial system.

The Other Twin

In the meantime, a gigantic wipe-out of financial asset prices has begun—beginning with the collapse of the "New Economy" bubble of so-called high-tech stocks, and now continuing with a drastic downturn in the level of corporate profits, trade, and production, in the United States and most of the world. As global demand shrinks, prices have begun to drop in many categories, including the recent, dramatic fall in oil prices. Warning cries of "deflation!" are beginning to be heard, recalling the horrors of the Great Depression. In this situation, some acquaintances are asking: "Where is the hyperinflation you were predicting? Isn't the opposite happening? After all, everybody knows that in a depression, you get deflation."

There is no doubt we are plunging into a depression, as LaRouche has long warned. But before being misled by analogies to the post-1929 "Great Depression," look at implications of the sheer insanity with which Greenspan and other leading

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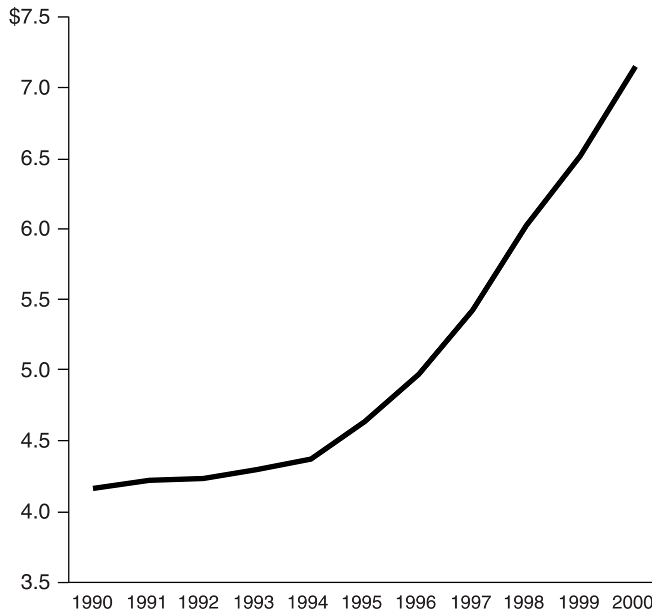
FIGURE 1
U.S. Money Supply, M3
(Trillions $)



Source: Federal Reserve.

The record of Fed Chairman Greenspan's terrific monetary expansion since 1994—and during 2001, the curve has gotten much steeper, reaching an annual 21% rate. How can this co-exist with the "deflation" into which the U.S. economy has now supposedly fallen?

representatives of the "financial community" are reacting to the unfolding demise of their entire system.

Exemplary is a commentary in the latest isue of Germany's weekly *Die Zeit* by economist Robert von Heusinger, with the curious title: "The Curse Of Too Much Money." Referring to Greenspan's tenth reduction of interest rates within a single year, Heusinger says, "One has to be a historian, to find a period of such drastic interest rate reductions. That period was the years of the world economic crisis of 1929-1931." Then he asks, "Is Greenspan's maneuver pure actionism, as the growing number of his critics are saying? Or is the U.S. economy really in such bad shape?." "The latter is the case," Heusinger says. "Not inflation, but deflation is the problem today. And the only thing that helps is lowering the interest rates."

But Greenspan should be careful in doing so, Heusinger warns, because the United States might fall into what he calls the "liquidity trap": That, as he describes, is the situation in which "even though the central bank pumps more and more money into the economy, demand does not grow. Business won't invest, consumers won't consume. Growth rates and prices fall." Even worse, "deflation is poison for all who are indebted. . . . Companies cannot repay their credits, and finally the banks collapse due to excessive bad loans." Japan, he says, has been experiencing exactly this sort of situation ever since the collapse of the Japanese "bubble economy" in 1989. (We could add, that the United States corporate sector is showing the signs of the "liquidity trap" during 2001.)

Therefore, Greenspan should reduce interest rates even further, Heusinger demands. But if that doesn't work, and the "liquidity trap" is sprung, then "the last, radical measure is to reflate the economy. The central bank purchases stocks, bonds and real estate from private holders in unlimited amounts [!], until private investors realize there is an excess of money in the economy, and inflation is on its way." Then consumers will begin spending and companies will start investing again. To back up their expectations, the Fed "should commit itself to do nothing to stop the ensuing inflation."

Weimar 1923, here we come! From 1994—when LaRouche in his "Ninth Forecast" declared the financial system to be already unsalvageable—until the financial asset collapse of the last 12 months, Greenspan has created the most gigantic monetary bubble in world history. To prop up the already bankrupt financial system, the Fed inflated U.S. broad money supply (M3) from roughly $4.3 trillion in October 1994 to $7 trillion in October 2000. Seeing the asset collapse set in during the past year, Greenspan has accelerated the monetary expansion even further, pumping in another trillion dollars over the last 12 months alone. Still the outcry is for more, more, more!

Worse Than 1929

It is worth pointing out, that nothing remotely comparable to this hyperinflationary insanity occurred in the lead-up to the 1929 collapse and ensuing Great Depression. From the end of 1925 until the end of 1929, broad money supply (M3) increased in the United States by only 10% (compared to 41% in the four years from end-1995 to end-1999, and 21% annual rate now). Furthermore, the degree of indebtedness of the United States, both internally and externally, was incomparably less. In 1929, America was a net creditor; today it is the biggest net debtor in world history. In 1929, the ratio of total debt to GDP was about 1.6, whereas today it is more than double that. And there are many other notable differences:

- In 1929, America had no trade deficit at all; in 2000, its official trade deficit was nearly $500 billion,
- In 1929 (before the crash), U.S. citizens were saving at a high rate. Today the rate is negative.
- In the immediate period up to 1929, there was essentially no inflation in the United States. Up to the recent downturn, inflation has been more than 3%, and "hidden inflation" much larger.

Most important, the United States was a flourishing industrial economy when the Great Depression hit. Its currency was backed up by gigantic productive capacities and the

world's most productive workforce. Today, most of the U.S. economy is a "post-industrial" scrap heap, the result of 30 years of systematic dismantling and "downsizing" of her in-depth industrial and infrastructural base, and "dumbing-down" of her population. When Franklin Roosevelt came into office, there were vast idle capacities and qualified manpower that could be set into motion, practically instantly, to bring about a recovery. Today, the internal resources for recovery are relatively much less.

On this background, we need not wait for commodity prices to go up, in order to qualify Greenspan's monetary expansion as "hyperinflationary." There is literally *nothing* to back up the value of the trillions of dollars which the Federal Reserve System has created from nothing over the last half-decade—not to speak of the tens of trillions of speculative paper and debt which have been piled up on that monetary base—no real economic growth, not even the *promise* of some future generation of wealth, but only the prospect of further destruction of an already devastated physical economy. What is the worth of a currency, which is based on a bankrupt system and even worse policies? When the moment of truth arrives, it won't help much to point out, that most of the world's other currencies are in the same shape.

How 'Deflation' Feeds A Debt Bubble

Meanwhile, don't forget the crucial factor of debt. While "deflation" has wiped away trillions of dollars of fictitious financial assets, the cancerous mountain of debt has continued to grow unabated. As I emphasized in my October 2000 study, the ballooning direct and indirect costs of that debt exert a growing inflationary pressure on the economy, which has only been "compensated" by a wholesale looting of producers and workforce, outside and inside the country. Thus, nominal consumer price inflation in the United States (and industrialized nations generally) has been kept low by artificially depressing producer prices for farmers, raw material suppliers, and the Third World exporters of "outsourced" products. The difference—accruing to "middle men" and trading companies, etc.—goes into financial flows to speculation and servicing of the debt. In this process, "overproduction" serves as the pretext for ever more brutal cost-cutting. Thus, it is possible for deflationary and inflationary processes to coexist and even feed each other.

It is notable, that at the same time as commodity prices in the United States tend downward, the cost of medical and many other services, and of housing, continue to rise rapidly. These latter reflect, in my view, the gigantic inflationary pressures generated by the debt pyramid and the accelerated monetary expansion.

By the end of the 1923 hyperinflation, the total nominal national debt of Weimar Germany was worth the equivalent of a few pennies or less. Apparently, this sort of "final solution" to the debt problem is becoming more and more attractive to the loonies who run much of the world's financial system today.

State Budgets On Fire: Don't Worry, Say Experts

by Mary Jane Freeman

"Our houses are on fire!" cry U.S. state officials. "Don't worry," reply the economists, "We predict it will rain soon." That exchange summarizes recent babble, to the effect that there will be an economic turnaround by Spring, and so no need to worry about the billion-dollar revenue holes burning through state budgets. Already at the end of October, California, Florida, Michigan, New Jersey, New York, Ohio, Washington, and Wisconsin announced revenue shortfalls in the multi-billions, and many more have holes bigger than $500 million. A California headline, "State Revenue Decline Worst Since World War II," captures the reality. The high-flying revenues derived from taxation on the speculative U.S. stock market bubble and the high-tech "New Economy," on which most states relied through the 1990s, have evaporated, leaving a combustible tinderbox.

A few national economic indicators show the accelerating downturn in the U.S. real economy over the third quarter (July-September) and October. The industrial production index fell 1.1% in October, a 13th consecutive monthly fall. Three key components of the index had huge third-quarter drops: semiconductors, 24.8%; industrial machinery, 15.9%; and textiles, 16.6%. September import/export trade figures, released by the Commerce Department on Nov. 20, show exports fell by 8.5% compared to August, with capital goods dropping by $1.6 billion, and industrial supplies and materials down by $1 billion. Imports fell 14%, which makes a six-month continuous fall. The impact of the shutdown of physical economy was writ large in October's 732,000 newly unemployed, bringing the (understated) official national unemployment to 7.7 million. These national figures are not divorced from state statistics, but rather reflect economic activity in all 50 states.

This depression trajectory was long in the making, and will not be ended by Federal Reserve chairman Alan Greenspan's interest rate cuts, done to feed the voracious bubble market economy; nor by Congress' pathetic "stimulus package" tax breaks, loans and payments to select corporations, and expanded unemployment benefits coverage.

Revenue shortfalls in the states are tied to three primary tax sources: personal income (PIT), sales, and corporate taxes. **Figure 1** shows states' total tax collections, nationally, have fallen by 3.4% in third quarter 2001 from third quarter 2000. The corporate tax component of this, fell a whopping 25%. States' sales tax growth rate has declined over the last six quarters, beginning second quarter 2000. The folly of tax cuts