the fleet sheet's final word friday edition

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The coming deflation

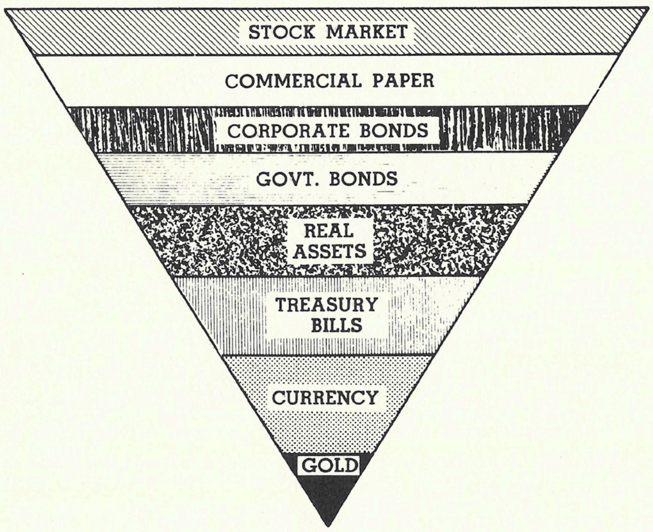
No, that's not a typographical error in the title of today's analysis. This is about the coming *deflation*, not inflation. Everyone is already talking about inflation, so it's time to talk about what comes next.

We wrote last week that we are being manipulated in the Global War on Covid by subtle changes in the meaning of words: "Healthy" in some cases now means potentially dangerous to others, while the guaranteed EU right of free movement is to be reserved for those with a covid passport.

The subtle change in the definitions of inflation and deflation occurred over a longer period, and the new meanings are accepted by nearly everyone. Inflation at its base is an increase in the money supply that leads to a rise in prices, but it is now generally considered to be the increase in prices itself, regardless of whether this is caused by an increase in the money supply or instead by supply and demand.

Likewise, deflation at its base is a decrease in the money supply, and falling prices are either a result of it or are due to supply and demand. In common usage, the idea of deflation as a decrease in the money supply is generally considered a relic of the past.

When the Czech National Bank devalued the crown on Nov. 7, 2013, it cited the risk of deflation as the reason: At first, falling prices mean that people can buy more with their income and savings. However, if this continues for a longer period, they might lose this income and consequently their savings, because in a "deflationary spiral" the economy goes into a downturn, and firms have to lay off and/or cut wages. People and companies might start to delay their major purchases and investments in anticipation that prices will fall even further. Thus, although money is gaining in value due to falling prices, it is becoming increasingly "idle" in the economy, with savings not being translated into investment. This forces companies to cut prices and costs at the same time, by reducing the number of employees and wages. And this further limits consumer demand, and people find that the price of their apartment or house is suddenly lower than the mortgage they have to pay. This can threaten the stability of the banks that have made the loans. And so on, and so on. Households can easily (and perhaps paradoxically for some) become poorer as a result of falling prices. This is nothing to be desired.



The Upside-Down Pyramid of Credit
The above graph is qualitative and illustrative only and represents the author's concept of safety.

From *The Coming Deflation: Its Dangers - and Opportunities*, C.V. Myers, 1976

That's a near-verbatim explanation by the CNB from 2013 of what deflation can do. The CNB's answer to the threat then was to devalue the crown by printing new money. Inflating the currency was its answer to the threat of a decline in prices and an increase in the value of money.

When the CNB acted against price inflation this week, it didn't reverse the inflationary process of 2013. It didn't use the foreign reserves that it had bought then to remove the excess crowns that are now "causing" inflation; it instead raised interest rates. This will eventually slow the increase in credit creation and monetary inflation, but not reverse it.

Tomáš Havránek, a former adviser to the CNB, was one of the few analysts to recall the devaluation this week. The CNB could use its foreign reserves to fight price inflation, he said, but this is almost unheard of. The CNB did not even do it, he said, in the two greatest crises of the past 30 years, the financial crisis of 2008 and covid crisis of last year. The current situation is much less serious, he said.

C.V. Myers, a long-deceased investment adviser, wrote in his 1976 book *The Coming Deflation* that we can't know when the excessive creation of money - inflation - will become so great that credit collapses. There are signs that it is imminent, he wrote then, but he explained that inflation comes in waves that gradually, one cycle after another, bring us closer to deflation. No western financial crash since he wrote his book has been of the magnitude he was expecting. His hand-drafted diagram, now known as Exter's Pyramid, was meant to serve as a guide of where to head as the warning signs of deflation increased.

This year is the 50th anniversary of the dollar as we know it. On Aug. 15, 1971, Richard Nixon took the U.S. off the gold standard. He was not devaluing the dollar, he said, but "if you want to buy a foreign car, or take a trip abroad, market conditions may cause your dollar to buy slightly less." We hear similar things today as the global money supply explodes. The Fed has doubled its balance sheet in the past 20 months.

In its Global Wealth Report this week, Credit Suisse wrote that the low interest rates of central banks probably had the greatest impact on a surge in household wealth last year and a widening of the wealth gap. "There are inflation implications in the longer run and also questions related to future rises in interest rates. However, these are relatively unimportant compared to the more immediate economic challenges," the bank said.

Myers would disagree. The first and foremost question, he said in 1976, is whether we are faced with another inflation wave, or whether deflation is on its way. And by deflation, he meant a decline in the money supply and a gradual move down Exter's Pyramid, as risk increased.

At some point, there will be a scramble for cash, because the greater the inflation, the greater the eventual deflation. It will be a game of musical chairs, and many people will be left with no seat to sit on.