The 3 Faces of Inflation

by Martin A. Armstrong

Inflation is something that most people perceive as a single dimensional force with its cause and effect one and the same. But inflation is far from such a simplistic explanation of money supply and its relationship to prices. While the studies of Milton Freedman captured the Noble prize for its demonstration of inflation's causes being linked to monetary policy, much has transpired in the 30 years that have past.

The monetarist's view of economic history is unfortunately a tainted one built upon a case study of 100 years of data which ended during the 1960s. The very definition of money supply has drastically been altered by the advent of credit cards, electronic transfers and most of all, the floating exchange rate system itself.

During the 100 years between 1860 and 1960, for the most part, the history of the United States was a history of the gold standard. Gold was money and budgets were mostly balanced. When the supply of gold was increased due to major new discoveries, the money supply increased often by chance rather than be design. The value of the dollar was fixed to gold and as such it was not subject to wild fluctuations in the international marketplace as it is today under the floating exchange rate system. As a result, if the supply of gold increased, money supply increased which would lead to a rise in prices. Life was simply then, as was the world economy. There were but two variables - the supply of money and the price of goods and services.

With the dawn of the floating exchange rate system in 1971, a new variable was introduced into the equation that would forever alter our understanding and definition of inflation. Perhaps no other period in US economic history would demonstrate this change in inflation than the period between 1980 and 1985. Here we look at a period where the national debt virtually doubled by $1 trillion, money supply rose by 400% and yet we called this period the age of deflation! According to our old definition of inflation being caused by a rise in the supply of money, the period of 1980 to 1985 should have been one of the most inflationary periods of this entire century. How could deflation emerge when economic theory suggests that inflation should have taken place?

The answer to this riddle is quite simple. The value of the dollar rose by some 40% during this period offsetting any inflationary pressures that would have otherwise been set free. As the dollar rose in value on world foreign exchange markets, currencies like the British pound crashed falling from $2.40 to $1.03. The yen, dmark and even the mighty Swiss franc wilted under the pressure of the rising dollar. Therefore, the pressure within the

system which would have otherwise been transferred into rising prices, resulted in the rise in value of the dollar instead.

In the new floating exchange rate era, inflation has become largely 3 dimensional. Inflation can arise from labor demands, raw material shortages, and overall changes in both the supply and value of the dollar. Nevertheless, inflation fails to conform to any one single definition of cause preferring to remain a multiheaded dragon capable of lunging forward with any single head or a combination attack of two or more simultaneously.

WAGE-PRICE SPIRAL

The 1960s was a period known as the Wage-Price spiral. It was a period during which a legitimate scarcity in skilled labor resulted in escalating wages. That period produced the highest gains in the American standard of living, which, to this day, have not been exceeded. This period of the 1960s was called the Wage-Price spiral because wages moved higher first forcing prices to follow in a lagging relationship. As wages drove the cost of production higher, those cost eventually passed through the system causing consumer prices to rise. It was perhaps this first cycle in wage increases that set the tone for what was to come later during the 1970s.

PRICE-WAGE SPIRAL

The 1970s was a period that became known as the Price-Wage spiral. Spearheaded by oil price increases by OPEC and shortages in agricultural commodities due to drought, prices in most sectors began to rise first leaving labor in a lagging battle to maintain parity. As a result, labor fought for CPI increases during the 1970s in an effort to keep up with rapidly rising price inflation, which in turn prompted the Federal Reserve to over-react. The sharply rising prices due to OPEC and natural events in weather, could not be overcome through artificial intervention. Nevertheless, the Fed raised the discount rate to 17% in its battle with the Price-Wage spiral setting the stage for phase three.

AGE OF DEFLATION

The over-reaction of the Federal Reserve to the inflationary cycle of the 1970s, created a nightmare that would forever change the course of American life. The excessively high interest rates caused interest expenditures of the government to also rise substantially. During the Reagan administration, the national debt doubled despite the fact that revenue and spending were actually balanced. The doubling of the national debt by $1 trillion was caused not by Reaganomics, but by the fact that interest rates rose so high that the interest expenditures during Reagan's term amounted to $1 trillion alone. This massive expansion in the national debt sucked capital from the private sector causing a deflationary impact for the economy while the government sector expenses exploded.

THE AGE OF CURRENCY INFLATION

Following the Plaza Accord of September 1985 and the birth of the first G5 (Group of 5 nations), a new dawn of currency inflation was born. European fears that the US debt expansion had been so massive as to threaten a default, caused vast capital flows shifts internationally. The Euro- dollar deposited dropped by 50% between 1980 and 1985 as Europeans scrambled to move their dollar deposits to domestic US dollar deposits. The more bearish the Europeans became of the fate of the dollar, the greater the shift of deposits from Europe to the United States. The net effect of this massive capital injection into the US economy drove the money supply up significantly as well as the value of the dollar thus forcing deflation in US dollar denominated assets domestically.

This massive rise in the dollar made US exports very uncompetetive and forced American labor costs to record highs from an international perspective. The G5 attempted to intervene by forcing the value of the dollar down on world markets. This trend had a negative impact on foreign investors within the United States which ultimately led to the 1987 Crash.

Japanese investors were enticed by the significantly lower dollar to buy US assets, namely real estate. With the dollar down by 40%, the Japanese perspective of US real estate was something like a one day fire sale. Real estate prices began to soar due to substantial foreign buyers based solely on currency. The inflationary spiral that emerged had been prompted not by shortages in labor or raw materials, but by a sharp and sudden decline in the value of the US dollar.

The same trend emerged in Britain following the sharp decline in the value of the pound to $1.03 in 1985. Scores of American investors swamped the real estate markets of London driving prices through all time record highs with the typical over-reaction by the Bank of England who plunged the nation into a deep recession with excessively high interest rates.

Inflation, therefore, is far from our dimensional definition of money supply and prices. Inflation has several faces and has struck in different forms from one decade to the next. The 1990s, however, will be a period of not merely record volatility, but a new age of record global inflation as well sparked by all three forms of inflation, labor, shortages in raw materials and above all sudden changes in the value of our underlying currency.