money

Why Deflation Will Not Happen

How many people do you know who bought gold around $103? Sold out in December 1974 at the height of the boom? Bought stocks when the Dow bottomed and sold them when the Dow was over 1000?

Not many, I'd bet. The majority of people, especially when entering markets for the first time, tend to buy near the top and hold all the way down, waiting for the market to turn. The psychology of the market, grounded in good old human optimism, is the reason. When prices are going up, people expect and want them to keep rising. When prices are going down, people want them to go up, but believe they are going to keep going down.

The theory of contrary opinion is based on this simple observation: Sell when the public buys; buy when the public sells. That, in a nutshell, is the way to make money in markets.

Of course, you need to know a lot more than that. Timing is all important, and beyond the scope of this column. But whenever you are considering investment, always keep in mind what I call *The Market's Law of Gravity:* Everything that goes up, must come down; and everything that goes down, must come up.

Such a simple rule has a host of exceptions. If a company goes bankrupt, its shares are never going to come out of that down phase. Prices can move sideways rather than up or down. Keeping this rule in mind will guard against being caught in the feverish atmosphere surrounding the top of any bull market—and from missing out on the bargains at the bottom of the bear.

Such straight-line thinking about the future is an easy trap to fall into in any area of prediction. I think it accounts for the increasing numbers of people in hard-money circles who are predicting deflation, rather than runaway inflation, as the ultimate consequence of the current monetary crisis.

If we remember back to 1973-74, predictions of imminent runaway inflation were a dime a dozen. When inflation subsided, so did the fear of an inflationary collapse. Now many people are afraid of deflation and depression, a fear based on the current enormous level of pyramiding debt, with the prospect of a credit collapse.

Certainly, the level of debt is a cause for concern. So is its poor quality, with so much lent to Third World countries. Their shaky economies would guarantee a default in times of stable money. Or the borrowings of communist nations, who sell less than they buy in the West, and have little or nothing left to pay back the interest, let alone the capital.

John Exter, former Citibank executive, is possibly the most well-known proponent of deflation as the most probable future for the United States. Many others are appearing in growing numbers.

The crux of their argument is that many of these shaky debtors must default sometime soon. Since much of this debt is held by the top US banks, such a widespread default will render these banks illiquid. They will be unable to pay out their depositors, resulting in a run on the banks; and the nation will be gripped in a banking panic like that of the 1930's.

There are many flaws in the arguments of the deflationists (those predicting deflation). Exter, for example, doesn't understand what deflation *is*: namely, a reduction in the money supply. His definition—falling prices—presupposes a falling or stable money supply. As the government isn't about to change its policy of printing money, a deflation could only happen as a result of a banking collapse.

In the absence of a government policy of deflation, the likelihood of that banking collapse is about zero. New York City provides us with a perfect example of the deflationist scenario. Banks like Citibank and Chase Manhattan have upwards of 50 percent of their assets in New York City and State paper. New York City declares a moratorium on interest payments. The market for New York City bonds drops to zero. Big New York banks suddenly find a substantial part of their assets worthless. If they've invested in W.T. Grant, Penn Central or Lockheed paper as well, they've got a few more problems.

But neither Citibank nor Chase closed its doors. No run eventuated. And it wasn't as though the Fed or Washington raced to the rescue. Far from it. Then-president Ford made it clear he wasn't about to bail out New York—though Congress eventually came through with some assistance. Why didn't a run develop? Why didn't depositors line up to get out their money when it was known the big banks could be in trouble?

One reason is that people are so thoroughly bamboozled by the government and the banks, they're not aware that fractional-reserve banking means all banks are technically bankrupt *now*. No bank can pay out all its depositors on demand, because they only keep 10-15 percent of the depositors' money on hand (or at the Fed). The rest they loaned to New York City, the Soviet Union, Zambia and Peru. Not to mention Pan Am, Lockheed, and a few sound risks as well. The myth of the FDIC helps, of course, as does the belief (correct in my opinion) that the government, in its Federal Reserve clothing, stands ready to print unlimited dollars to stem any widespread bank run.

More importantly, New York's moratorium on interest payments didn't affect the banks' day-to-day operations. All they lost was some income, and only temporarily. Banks make their money from *interest*. So long as this keeps coming in, it doesn't matter too much if the capital is never repaid. If one of their borrowers is in trouble, especially one as big as New York City, the banks will reschedule repayments by postponing the date when the *capital* has to be repaid.

Providing the borrower can make the interest payments, the day of reckoning will be postponed indefinitely. Only when the borrower goes *bankrupt* do the banks have to write the loan off their books. If it's a borrower as big as New York City, then the banks would be in real trouble.

The temporary loss of interest income, even on a large part of a bank's assets, does not create cash flow problems at the tellers' windows. Since the amount is so small relative to the bank's total liabilities to its depositors, it can always borrow a little more from the Fed to tide it through until the interest starts rolling back in.

If New York City's default didn't start a bank run, how could a default by Peru or the Soviet Union? Neither country—or any other borrower—owes as much to the big US banks as New York City or New York State.

I'd be the first to agree this continual rolling over of loans is very poor banking practice. But it is only one of the many effects of inflation on debt the deflationists ignore completely. For example, inflation reduces the *real value* of any debt. Thus, if New York City—or you—manage to postpone repayment of a debt, you'll be able to pay back a debt contracted in 1976 with 1978 or 1980 dollars.

Inflation also *encourages* debt for this very reason. The rising level of debt is simply another result of inflation, as everyone tries to buy assets today and pay for them with dollars tomorrow. Thus, we've seen the troubled companies of

1974-75 becoming profitable in 1977, partly because inflation has enabled them to trade out of trouble. The same thing applies to the Soviet Union or Third World nations.

But there is also a host of international bodies like the IMF standing by to bail out any Third World nation that has trouble paying back its loans. And the bankers themselves stand ready to "re-schedule" repayments on loans which Third World nations are having trouble servicing.

To put the final hole in the deflationists' arguments, the events of the 1930's do not bear out their thesis of a credit collapse. The worst years of bank failures were 1931 and 1933—two and four years *after* the depression had begun. The bank failures resulted *from a government policy of deflation.** They were not the cause, but the *result* of deflation.

In other words, there is no way a deflation can happen now unless the government causes it to happen. What are the chances of that?

Mark Tier

* See Milton Friedman and Anna Schwartz, *A Monetary History of the United States;* or Murray Rothbard, *America's Great Depression.*

washington watch

Involuntary Treatment Banned

Sometimes if you stay with an issue long enough it becomes "noncontroversial" and you can win your points in surprisingly simple ways. An example is the issue of involuntary mental treatment for those accused of crimes and remanded to the State for psychiatric treatment.

The Senate is still trying to reform the federal criminal code. This year's bill, S. 1437 is much improved over the potentially repressive S. 1 which had civil libertarians exercised last session.

During markup sessions in the Senate Judiciary Committee, Sen. Malcolm Wallop (R-WY) slipped in an amendment which gives defendants who have been declared incompetent to stand trial, or whose competency has been questioned, the right to refuse certain kinds of psychiatric "treatment" including psychosurgery, electroshock "therapy," and forced drugging. For these techniques to be used now requires a reasonably safeguarded informed consent in writing. Sen. Wallop's amendment was passed (waved off as "noncontroversial" by Sen. Kennedy, who was presiding) and is now a part of the Senate bill, which has been passed by the Senate Judiciary Committee and will be considered by the full Senate in February.

Reforming the FBI and the CIA

Rep. Herman Badillo has introduced a bill to reform the nation's intelligence agencies, provide clear limits to FBI-CIA jurisdiction, limit abuses of power and punish deception of Congress and the public by intelligence agency officials.

H.R. 6051 (which is co-sponsored by such as Conyers, Dellums, Drinan, Clarence Mitchell, Pete Stark and Charles Rangel) would change the CIA's name to the Foreign Information Service and ban covert actions, and change the FBI to the Federal Bureau of *Criminal* Investigation and ban political and other non-criminal investigations. If the bill is passed, such activities as Cointelpro will be forbidden, the method of classifying government "secrets" would be revised, and victims of intelligence agency abuses or overzealousness would have statutory grounds for civil or criminal suits.

The FBI recently issued internal guidelines to control some of the bad-PR abuses of the recent past, but a recent Government Accounting Office report calls them vague and subject to varying interpretations, and still not followed very closely. The GAO's sample found that 73% of local preliminary investigations go beyond the 90-day limit without being reported to FBI headquarters, in violation of the guidelines. Also, only 10 of the 319 preliminary investigations surveyed by the GAO produced information useful to an eventual arrest. Any investigating agency will start investigations which turn out to be blind alleys, but this seems a little out-of-line.

Libertarian Advocate is supporting this legislation and urging supporters to write their Congressmen urging support and co-sponsorship. We don't share the sponsor's apparent faith that passing this law will end all abuses, but it seems like a constructive first step.

Write to: US House of Representatives, Washington, DC 20515.

Airline Deregulation

It remains to be seen whether Senate passage of H.R. 6010, which deregulated cargo air transportation and allowed airlines to offer special fares to senior citizens, bodes well or ill for passenger deregulation. On one hand it may indicate Senate receptivity to the more comprehensive regulatory reform measure passed by the Commerce Committee and due for full Senate consideration in February or March. On the other hand it may eliminate some interest groups (senior citizens and freight shippers) from the ranks of those pressing hard for the more comprehensive reform measure.

Even if you've written before on this issue, letters to all Senators would be helpful at this juncture (US Senate, Washington, DC 20510).

Humphrey-Hawkins and the Washington Mood

There is some serious danger that an amended version of the Humphrey-Hawkins "full employment" bill, with a few compromises and fewer mandatory or automatic actions required of the president when unemployment reaches certain levels, will squeak through. That would be disastrous. One can hardly say that we now have an economy free of government controls and manipulations, but Humphrey-Hawkins, no matter how "watered down," would institutionalize certain kinds of federal economic planning and put in place some automatic forms of control which could mark a watershed change in the relationship between government and the productive sector of the economy.

While we can't afford to relax our vigilance, especially on Humphrey-Hawkins, I sense a certain caution about new proposals for even more government controls. Carter's problems with his energy package are well-known. The House killed a new banking regulation bill as well as the old treadworn Consumer Protection Agency.

Some of these legislative fiascos are due to Carter's uncertain and abrasive leadership style, but some of them may be due to an increasing realization that the money just isn't there any more. There are precious few "surpluses" left for politicians to feed their egos and sense of power by allocating. Everybody knows Social Security is broke. Everybody agrees that taxes are too high. Most people are suspicious and skeptical about government. The existence of these attitudes does not assure libertarian victories without a lot of effort, but the time may be getting riper for innovative non-government and anti-government initiatives.

Alan Bock