

The Outlook: May 29, 2020

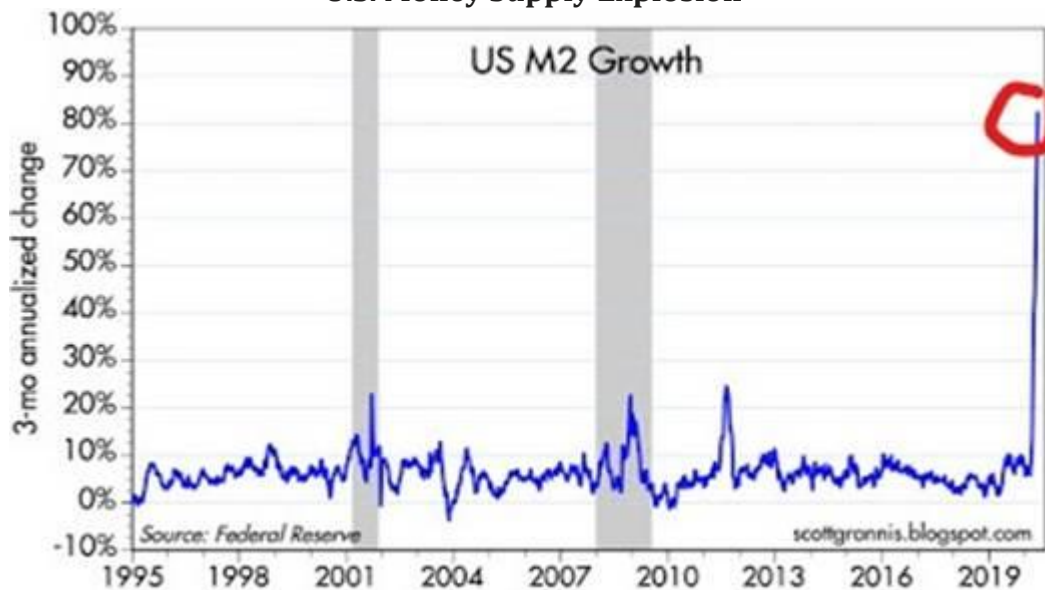
Inflation: learning from Mr. Lenin

"Inflation will run rampant!" is pretty high among the possible long-term consequences of the "Shutdown Calamity of 2020." Economist Scott Grannis neatly captured the Inflation Nightmare possibility with these 2 charts:

Argentina's Money Supply Explosion



U.S. Money Supply Explosion



Argentina's 10-year inflation rate has been in the 20% to 30% range, and Mr. Grannis thinks it'll head toward 100% now, with that "rocket to the moon" expansion of the money supply during the Shutdown Crisis. That sounds like a Nightmare for the U.S., all right, when we see the same moon-rocket spike in the supply of dollars. But charts and statistics can be just as misleading as a politician's speech. Notice the left-hand scale in the 2 charts. On top, Argentina has been printing 20% - 40% annual mountains of new pesos for 10 years. On the bottom, though, the U.S. has only added 5% to its money supply for the past 25 years, on average. 5% very roughly matches the annual growth in the U.S. economy, before adjusting that growth for annual inflation. So our 1% to 3% inflation rates, most of this time, make basic sense.

But that moon-rocket spike to an 80% money growth rate is a possible Nightmare, regardless of how well-behaved inflation has been, looking backwards. Will the Nightmare come to pass?

Here is Outlook's answer: "We don't know yet. We can't know, yet." Why not?

With great hesitation, and with apologies to Outlook's readers in advance, let's glance at the simplest and most understandable "explanation" for inflation. It goes back to freshman economics, and like a lot of things from freshman economics it's much more useful than most of the heavy thinking from sophomore-to-senior economics, and graduate school economics.

$$MV = PQ$$

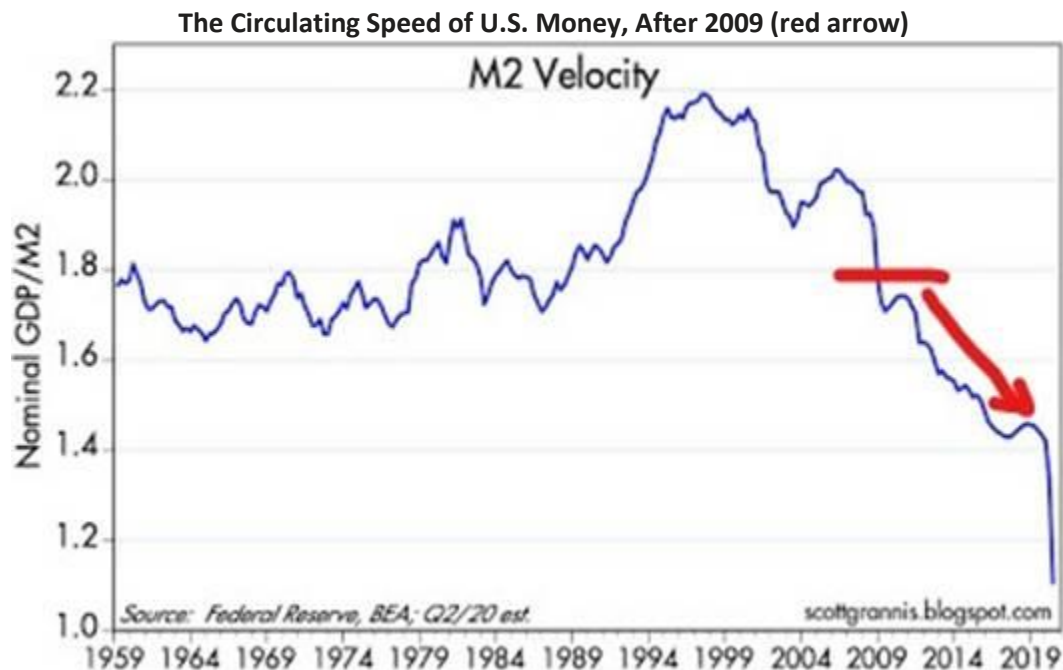
The "supply of money" times the "speed of money's circulation in the economy" (velocity) = the "general price level" times the "quantity of goods (and services) produced." Are we lost? No problem, that means we have normally-functioning brains. They will clear up if we look at a real-life event in history: the Russian Revolution of 1917 and what came next.

Mr. Lenin and his Bolsheviks took power in Russia in October of 1917. Mr. Lenin's aim was to "create a new form of mankind." That plan called for a great many interesting action steps, among them the abolition of money, which Mr. Lenin and his friends saw as the root of all evil, and the root of the capitalist system (same thing.) Despite having a vast crowd of intellectuals at their disposal, all of them philosophically opposed to money, the Bolsheviks weren't quite sure how to proceed.** But in the meantime, they badly needed money, so they used the dregs of Russia's vanishing gold reserves to buy great quantities of paper and ink from overseas, and spare parts for Moscow's printing presses, and proceeded to print so many rubles over the next 3 years that inflation reached 10,000% or so. During the same 3 years, every measure of industrial production fell from 50% to 90%, as did the supply of food, due to some of the other interesting action steps Mr. Lenin was carrying out—abolishing private property, private wealth, and a few million individuals who didn't like the new system . . . including everyone who knew anything about running businesses, factories and farms.

Back to $MV = PQ$. So from 1918 – 1921 Russia's "Q" (production) plunged 80% or so; and Russia's "M" (money supply) rose 10,000% or so. So if Russia's "V" (the velocity, or speed of circulation of all those rubles) stayed very roughly the same, then Russia's "P" (general price level) had to take a rocket ride toward the moon. It did, by 10,000% or so. It wasn't merely "too much money chasing too few goods." It was a Pacific Ocean of new money, chasing a vanishing amount of goods. The result was astronomical inflation, which made the ruble as worthless as a random piece of colored paper . . . so the Bolsheviks, in the end, got the result they had theoretically wanted: the abolition of money. (Standing in 1921 and

facing the consequences, Mr. Lenin rewrote everything he'd said about money in 2018 and blamed the mess on zealous Bolshevik bunglers who had misinterpreted his meaning, back then, but were making up for it by working voluntarily on turnip farms in Siberia.)

Here we are in 2020, a hundred years later, and we have an 80% explosion in “M” and a 30% plunge in “Q,” most likely. Looks like a guaranteed explosion in “P” (inflation), doesn't it? Much more money chasing sharply fewer goods. And that is exactly what must happen . . . but only if “V” stays about the same—just as it did 100 years ago in Russia. But 11 years ago, the last time the Federal Reserve spiked up the money supply, “V” didn't stay the same at all. It did this.



Money was spent, loaned or otherwise changed hands much more slowly, after the Calamity of 2008 – 2009. That red arrow shows the remarkable, historic plunge in that “velocity of money.” Why? As Outlook has noted once or twice, for a very simple reason: U.S. consumers and businesses had an almighty fright during the Calamity, so they acted like normal human beings for the next many years: namely, with great caution. They didn't spend or borrow with anything like the same confidence. Instead they built up their liquidity and general financial strength.

If we focus on the blue “Velocity” line in 2019, just before the cliff-diving plunge of 2020, we can see a little upturn. That might have been the very beginning of a return toward “normalcy” in the kind of business and consumer confidence needed for money to circulate faster. It didn't get a chance to show us, did it? Along came the “Shutdown Calamity of 2020” and we've all held onto our money for dear life, hence the shocking further plunge in Velocity.

We can't know the answer to the “Future Inflation Nightmare?” question, yet, because nobody on earth can guess which force might be stronger: moon-rocket money growth, or cliff-diving circulation plunge. We can say this: “Caution” will certainly rule, for a good while, so Velocity (money circulation speed) will certainly stay down there somewhere toward the bottom of the cliff. That ought to rule out Argentina's double or triple-digit flavor of inflation. But there's a lot of room between 2% inflation, our

former flavor, and 20% inflation—Argentina’s flavor. Outlook’s best guess is this: the old 2% flavor will be out of stock for the next few years or more. It’s easy to imagine 3%, 4%, or 5% inflation developing—or even something more—as we climb steadily through the next decade. That’s not a good thing, but it’s no growth-killer either. It will give us another entry on our constant list of worries, as the U.S. economy and business sector do their usual determined job of picking up the pieces, putting the wheels back on the bus, and driving steadily ahead.

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** Historian Richard Pipes had an insight into the point of view of those Russian intellectuals: “They had no money, and they had no wish to earn money. But they dearly loved the influence and gratifications which money can bring.”