36 South views by Richard "Jerry" Haworth

It's time to swing, baby!

The current economic playbook is like something out of the next Austin Powers movie. Both severe deflation and inflation (Dr Evil and Austin Powers) have been cryogenically frozen for thirty years. But they are unfrozen and back to play out their respective roles.

Dr Evil is threatening to destroy the world by deflation and pricking the global debt bubble, Austin Powers is trying to thwart him by keeping the economy growing by partying all day and all night!

It's time to swing, baby!

Austin Powers has the antidote... it is called 'shagflation', a Frankenstein hybrid of both nominal inflation and real world deflation. The net result of the misguided attempt to fight deflation with inflation. Average Joe is 'shagged' whatever '-flation' we get.

It is like a company who, fearing they are going bankrupt, lowers their prices by 50% to get some sales inflation! You end up with higher sales, lower margins, greater net losses and higher debt. You get the negatives of BOTH.

Austin Powers has coined this new term to correctly reflect what stagflation does to the majority of the population.

In a movie it could be light entertainment but in the real world the consequences of stagflation are anything but.

A major credit bubble started in earnest after the 1987 crash as Greenspan correctly predicted he could avert the negative consequences of the crash by lowering interest rates and making large amounts of liquidity available. Even then, if the credit bubble had unwound, a nasty depression would have ensued. Ditto 1994, 1997, 1998, 2000, 2001 and 2008.

By inflating the money supply and lowering interest rates, we have unwittingly perpetuated the credit bubble to the extent that the consequences of an unwind are probably catastrophic for the whole financial system as opposed a home-grown, common, garden-variety depression.

Thus central bankers are stuck. The only tool left at their disposal after interest rates have gone to zero is quantitative easing or inflating the money supply base. Anyone who thinks that even semi-permanent negative interest rates are a possibility has never tried to sell a negative carry strategy!

And so they pursued this QE strategy. To be honest it is impossible not to win, at least in nominal terms, and to a large extent they have in US. But they are now victims of their own success. Rampant equity markets/art markets/property markets (everything the rich already own) point to the need to raise interest rates, but therein lies the rub. The real economy cannot withstand any significant interest rate rises and neither can the government quite frankly, which is now habituated on burgeoning deficits at low or zero interest rates.

It is not fanciful to predict that they will try to engineer a pop in the equity markets downwards to try and downscale the current animal spirits. The last thing central banks need now is a runaway equity market or property market.

But why is stagflation such a problem? Why will people suffer whatever happens?

Well, if central banks get behind the eight ball, like nearly happened in Europe and might be happening in China, deflation could easily snowball out of control resulting in commercial and then social collapse. The potential debt spiral is just too big.

If they contain deflation but stoke inflation, you get a real economy working at stall speed, spluttering along, but nominal prices moving ever higher and worse, social inequality rising exponentially as this antidote favours the rich and people close to the money spigot. The lower and middle classes get nominally richer but actually poorer. The illusion of increasing property keeps the majority of people in a boiling frog syndrome for a while – the water is getting hotter and hotter, and they won't notice until it's too late. To make matters worse, politicians actually believe if you give them more money (increase debt), they will fix the problem and thus potentially irrational government spending starts to crowd out private investment.

Thus we may avoid the deflationary collapse only to hurtle at warp speed to an inflationary collapse, aided and abetted by misguided government spending.

Average Joe is forced to abandon prudent savings guidelines and jump into the overvalued asset markets, preferably leveraged with debt if he has any chance of keeping pace with the rise in nominal asset prices. If he is wrong, he is wrong with the whole herd and the resultant illiquid stampede out of the asset abattoir will make 2008 pale in comparison. If he is right, he will be right with a smaller and smaller percentage of the population, the rest being polarized by their 'unfair treatment'.

They might just want to overturn this "social contract" so average Joe ends up being wrong again.

As Austin Powers said, "it's time to swing, baby".

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