LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

According to the National Bureau of Economic Research (NBER), our most recent recession began in December 2007—in April 2010, the NBER said it saw no end in sight. However, in September 2010 the NBER announced the recession had actually ended in June 2009.

As current debate centers around a future inflation rate, we felt it would be informative to comment on the near-term possibility of deflation. While inflationary pressures arise from the creation of debt, deflationary pressures arise from the destruction of this debt. Since the bursting of the financial bubble in late 2008, when consumers completely ran out of borrowing power, we have had a new economic theme to deal with. Debt reduction is now the real story of the American economy, just as rising debt was the real story behind the apparent *free lunch* of the last twenty years.

Just as the increase of debt over the years helped to stimulate the economy, so the reduction of this debt will contribute to contracting it. As the private sector deleverages by paying off debts and increasing savings, an enormous amount of stimulus is removed from the economy. The government has attempted to offset this decline by increasing its debt. Unfortunately, according to some economic theories, the increase in government debt does not equally offset the decline in private sector debt. There appears to be a multiplier effect in the private sector which may be as high as 1.5x. In other words, the government must issue $1.50 in debt to offset a $1.00 decline in private sector debt.

Deflationary forces can result from a drop in the money supply and credit, declining spending, or high unemployment—all of which can encourage companies to cut prices. Falling prices can make businesses and consumers reluctant to spend and invest, hurting profits and crippling the economy. In a period of deflation (or falling prices), companies can find it challenging to generate profits, putting pressure on stocks. Economists say the U.S. economy has to grow at more than 2% in order to avoid deflation. When one explores the impact of deflation on society it's no wonder that the Fed is trying so hard to *prime the pump*—to prevent its occurrence—and move the economy to 2%+ growth.

It will become obvious if the U.S. is in a deflationary environment because Federal Reserve policy will be ineffective. The Fed will be *pushing on a string*, where no matter how much money is injected into the system, the economy just will not respond because deleveraging in the private sector is not complete. Under this scenario, economic growth would continue to be weak, much like the Japanese experience from 1997 to date.

Since deflation is the opposite of inflation, one might assume the solutions to be different also. The Federal Reserve seems to believe that printing money—a technique used in past recessions—is also the solution to deflation. Unfortunately, in this recession there appears to be too much money sloshing around the system already. Adding more is unlikely to make the situation any better. Most past recessions have been caused by tight monetary policy and when that policy is eased, demand rebounds. This recession, however, was the result of a financial crisis and fiscal policy was already easy. Recoveries after financial crises are normally weak and slow as banking systems are repaired and balance sheets are rebuilt. Businesses and individuals want to decrease their debt loads—not increase them—as the Fed action is designed to work. Monetary policy, which impacts the money supply, would appear to have little impact.

So that leaves us with fiscal policy to combat deflation. One of the solutions would be for government to accelerate debt reduction. The government could encourage the cleaning up of the housing market by requiring the write down and/or charge offs of mortgages where the value of the property is below the debt owed. This would make it easier for people to move to where the jobs are and therefore help in cutting the unemployment rate. Any type of payroll tax cuts and credits to reduce the cost to small business would also help.

A huge victory for the economy would be for the government to minimize the uncertainty of their near-term policies. For example, the tax cuts currently in effect should be extended and items like the estate tax should be clarified. It is only with confidence and clarity in government policy that American enterprise can be expected to flourish.

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450 Regency Parkway, Suite 410 | Omaha, Nebraska 68114-3701 | *tel* 402.392.2606 | *fax* 402.392.2597 | www.lawsonkroeker.com