CJ Investment Mini-Lessons

Callom B. Jones, V   Investment Adviser Representative

September, 2012   From the One Hundred Seventy Seventh Issue

Mini Lesson: Capital, Money Supply, Inflation and the Financial Markets

Let's distinguish the difference between capital and money. *Capital* is wealth created through saving or from creating something new and useful. *Fiat money* (money by government edict) is nothing but a medium of exchange. Remember that fiat money only *measures* wealth; it is not equal to it. Wealth is houses, buildings, clothes, food, cars, computers, *etc*.

While not technically required, the economic definition implies the presence of a central banking system. In the US, we call this central bank the Federal Reserve Bank, or, more simply, the Fed. To my knowledge, no economist has ever *proven*, logically or factually, that a central banking system is either necessary or even the best way of dealing with an economy's money.

The framers were, almost to a man, against the notion of paper money as we have it today. When Hamilton argued that the government should create a central bank, Jefferson was alarmed and aware that such a system would break down the guards on federal power in the Constitution. The founders opted instead for money with intrinsic value, such as gold or silver, also known as *specie*. *The key point is that money, at that time, was not just a medium of exchange; it also had its own intrinsic value recognized by virtually everyone*.

Why would the government decide to use paper money and create an institution such as the Fed? Two major reasons why any government would want this *power* are:

- It makes it much easier structurally for government to finance its activities through *deficit spending*, instead of having to collect honest taxes (and deal with the voter backlash) to pay for its spending.
- It allows a government to manipulate (*control*), however crudely, the economy.

Key government words: *power* and *control*.

Deficit spending, enabled by the Fed creating US$ to purchase federal debt, is what robs wealth from the populace by creating *inflation*. To understand inflation and deflation, imagine balance scales, such as the scales of justice. In one basket is the "value" of the economy – goods and services. In the other basket is the money supply. *By axiom, the scales must balance over the long term*. Now, imagine the Fed adds money to the money supply, which doesn't change the wealth on the other side. What happens? No wealth was created, only additional measuring units (US$). Still, axiomatically, the sides *must* balance. So, the *nominal* cost of the wealth in the other side of the scale goes up – that's *inflation*. Conversely, if the money supply is reduced, when the sides rebalance, the *nominal* cost of the wealth goes down – that's *deflation*.

Note that the *actual* wealth (capital) never changed – only the measuring units did. That's why *inflation and deflation are purely monetary phenomena*. Incidentally, someone attempting to deceive could falsely call an inflationary increase *economic growth.*

Keep in mind that *we can only measure the economy indirectly through its own monetary units.* Therefore, we're trying to measure the changes in an economy with the same units with which we wish to vary with its size. This circularity creates many difficulties, not the least of which is accuracy. Knowing this, we can posit the following: ***Changes in inflation or deflation can be present in an economy without being detected via measurement statistics.***

(Continued on Page 2)

Trend Capital Management, LLC
9717 W 121 Terrace ▪ Overland Park, KS 66213 ▪ O (913) 897-7576 ▪ C (913) 568-9916
e tcm@trendcapitalmgmt.com ▪ www.trendcapitalmgmt.com

(Continued from Page 1)
Marshallian K theory states that as long as there is more money than the economy needs, the excess will migrate into financial assets. K theory also works in reverse. Therefore, detection of changes due to inflation could be further delayed for long periods, as the excess money supply would be expressed as higher prices in the financial markets. How can you tell if you are looking at asset inflation or a proper rise in stock prices due to increased wealth? A topic for another article.

At a common sense level, the government creating dollars with no real wealth to back them up is not functionally different from counterfeiting. Remember, the Constitution does not allow for a central bank or the creation of dollars as now practiced in the US through the Fed.

Additionally, the business or trade cycle *is caused by* the lowered interest rate that happens along with the increase in the money supply without backing the new money with real wealth. The cheap interest rate (cost of money) fools businesspeople into undertaking uneconomical projects (malinvestments). This happens during the boom portion of the cycle, in fact is responsible for part of the boom itself. However, when the sponsors realize the projects are uneconomic, they shut down the nonviable projects and valuable capital is lost. When enough of this happens, the economy contracts, creating the bust portion of the cycle.

Price distortions through Fed created inflation and deflation alter market activities, including hampering or preventing proper *price determination*, a primary market function. It is unconstitutional. It is immoral. It is there because politicians are more short-term afraid of losing voters than they are of the long-term consequences of not levying honest taxes for America and its citizens. *Only we, as informed voters, can stop these devastating behaviors from continuing*.