Gonzalo Lira: What Hyperinflation Will Look Like In America

I usually don't do follow-up pieces to any of my posts. But my recent longish piece, describing how hyperinflation might happen in the United States, clearly struck a nerve. It was a long, boring, snowy piece of macro-economic policy speculation, discussing Treasury yields, Federal Reserve Board monetary reaction, and the difference between inflation and hyperinflation—but considering the traffic it generated, I might as well been discussing relative breast size in the porn industry. With pictures.

Essentially, I argued that Treasury bonds are the New and Improved Toxic Assets. I argued that, if there was a run on Treasuries, the Federal Reserve—in its anti-deflationary zeal, and its efforts to prop up bond market prices—would over-react, and set off a run on commodities. This, I argued, would trigger hyperinflation.

The disproportionate attention my post garnered is indicative of people's current fears. As I've said before, people aren't blind or stupid, even if they often act that way. People are worried—they're worried about the current state of affairs: Massive quantitative easing, toxic assets replaced by the full faith and credit of the U.S. government in the shape of Treasuries, fiscal debt which cannot possibly be repaid, a second leg down in the Global Depression that seems endless and only getting worse—people are scared. Many readers gave me quite a bit of useful feedback, critiques, suggestions and comments on the piece—clearly, what I was discussing touched on a deeply felt concern.

However, there were two issues that many readers had a hard time wrapping their minds around, with regards to a hyperinflationary event:

The first was, Where does all the money come from, for hyperinflation to happen? The question wasn't put as baldly as that—it was wrapped up in sophisticated discussions about M1, M2 and M3 money supply, as well as clever talk about the velocity of money—the acceleration of money—the anti-lock brakes on money. There were even equations thrown around, for good measure.

But stripped of all the high-falutin' language, the question was, "Where's all the dough gonna come from?" After all, as we know from our history books, hyperinflation involves people hoisting bundles and bundles of high-denomination bills which aren't worth a damn, and tossing them into the chimney—'cause the bundles of cash are cheaper than firewood. If the dollar were to crash, where would all these bundles of $100 bills come from?

The second question was, Why will commodities rise, while equities, real estate and other assets fall? In other words, if there is an old fashioned run on a currency—in this case, the dollar, the world's reserve currency—why would people get out of the dollar into commodities only, rather than into equities and real estate and other assets?

In this post, I'm going to address both of these issues.

Apart from what happened with the Weimar Republic in the 1920's, advanced Western economies have no experience with hyperinflation. (I actually think that the high inflation that

struck the dollar in the 1970's, and which was successfully choked off by Paul Volcker, was in fact an incipient bout of commodity-driven hyperinflation—but that's for some other time.) Though there were plenty of hyperinflationary events in the XIX century and before, after the Weimar experience, the advanced economies learned their lesson—and learned it so well, in fact, that it's been forgotten.

However, my personal history gives me a slight edge in this discussion: During the period 1970–'73, Chile experienced hyperinflation, brought about by the failed and corrupt policies of Salvador Allende and his Popular Unity Government. Though I was too young to experience it first hand, my family and some of my older friends have vivid memories of the Allende period—vivid memories that are actually closer to nightmares.

The causes of Chile's hyperinflation forty years ago were vastly different from what I believe will cause American hyperinflation now. But a slight detour through this history is useful to our current predicament.

To begin: In 1970, Salvador Allende was elected president by roughly a third of the population. The other two-thirds voted for the centrist Christian Democrat candidate, or for the center-right candidate in roughly equal measure. Allende's election was a fluke.

He wasn't a centrist, no matter what the current hagiography might claim: Allende was a hard-core Socialist, who headed a Hard Left coalition called the Unidad Popular—the Popular Unity (UP, pronounced "oo-peh"). This coalition—Socialists, Communists, and assorted Left parties—took over the administration of the country, and quickly implemented several "reforms", which were designed to "put Chile on the road to Socialism".

Land was expropriated—often by force—and given to the workers. Companies and mines were also nationalized, and also given to the workers. Of course, the farms, companies and mines which were stripped from their owners weren't inefficient or ineptly run—on the contrary, Allende and his Unidad Popular thugs stole farms, companies and mines from precisely the "blood-thirsty Capitalists" who best treated their workers, and who were the most fair towards them.

Allende's government also put UP-loyalists in management positions in those nationalized enterprises—a first step towards implementing a Leninist regime, whereby the UP would have "political control" over the means of production and distribution. From speeches and his actions, it's clear that Allende wanted to implement a Maoist-Leninist regime, with himself as Supreme Leader.

One of the key policy initiative Allende carried out was wage and price controls. In order to appease and co-opt the workers, Allende's regime simultaneously froze prices of basic goods and services, and augmented wages by decree.

At first, this measure worked like a charm: Workers had more money, but goods and services still had the same old low prices. So workers were happy with Allende: They went on a shopping spree—and rapidly emptied stores and warehouses of consumer goods and basic products. Allende and the UP Government then claimed it was right-wing, anti-Revolutionary "acaparadores"—hoarders—who were keeping consumer goods from the workers. Right.

Meanwhile, private companies—forced to raise worker wages while maintaining their same price structures—quickly went bankrupt: So then, of course, they were taken over by the Allende government, “in the name of the people”. Key industries were put on the State dole, as it were, and made to continue their operations at a loss, so as to satisfy internal demand. If there was a cash shortfall, the Allende government would simply print more escudos and give them to the now State-controlled companies, which would then pay the workers.

This is how hyperinflation started in Chile. Workers had plenty of cash in hand—but it was useless, because there were no goods to buy.

So Allende’s government quickly instituted the Juntas de Abastecimiento y Control de Precios (“Unions of Supply and Price Controls”, known as JAP). These were locally formed boards, composed of loyal Party members, who decided who in a given neighborhood received consumer products, and who did not. Naturally, other UP-loyalists had preference—these Allende backers received ration cards, with which to buy consumer goods and basic staples.

Of course, those people perceived as “unfriendly” to Allende and the UP Government either received insufficient rations for their families, or no rations at all, if they were vocally opposed to the Allende regime and its policies.

Very quickly, a black market in goods and staples arose. At first, these black markets accepted escudos. But with each passing month, more and more escudos were printed into circulation by the Allende government, until by late ’72, black marketeers were no longer accepting escudos. Their mantra became, “Sólo dólares”: Only dollars.

Hyperinflation had arrived in Chile.

(Most Chileans, myself included, find ourselves both amused and irritated, whenever Americans self-righteously claim that Nixon ruined Chile’s economy, and thereby derailed Allende’s “Socialist dream”. Yes, according to Kissinger’s memoirs, Nixon did in fact tell the CIA that he wanted Chile’s economy to “scream”—but Allende did such a bang-up job of fucking up Chile’s economy all on his own that, by the time Richard Helms got around to implementing his pissant little plots against the Chilean economy, there was not much left to ruin.)

One of the effects of Chile’s hyperinflation was the collapse in asset prices.

This would seem counterintuitive. After all, if the prices of consumer goods and basic staples are rising in a hyperinflationary environment, then asset prices should rise as well—right? Equities should rise in price—since more money is chasing after the same number of stock. Real estate prices should rise also—and for the same reason. Right?

Actually, wrong—and for a simple reason: Once basic necessities are unmet, and remain unmet for a sustained period of time, any asset will be willingly and instantly sacrificed, in order to meet that basic need.

To put it in simple terms: If you were dying of thirst in the middle of the desert, would you give up your family heirloom diamonds, in exchange for a gallon of water? The answer is

obvious—yes. You would sacrifice anything and everyting—instantly—in order to meet your basic needs, or those of your family.

So as the situation in Chile deteriorated in '72 and into '73, the stock market collapsed, the housing market collapsed—everything collapsed, as people either cashed out of their assets in order to buy basic goods and staples on the black market, or cashed out so as to leave the country altogether. No asset class was safe, from this sell-off—it was across-the-board, and total.

Now let's return to the possibility of hyperinflation in the United States:

If there were a sudden collapse in the Treasury bond market, I argued that sellers would take their cash and put them into commodities. My reasoning was, they would seek a sure store of value. If Treasury bonds ceased to be that store of value, then people would invest in the next best thing, which would be commodities, especially precious and industrial metals, as well as oil—in other words, non-perishable commodities.

Some people argued this point with me. They argued many different approaches to the problem, but essentially, it all boiled down to the argument that commodities and precious metals have no intrinsic value.

Actually, I think they're right. In a strict sense, only oxygen, food and water have intrinsic value to human beings—everything else is superfluous. Therefore the value of everything else is arbitrary.

Yet both gold and silver have, historically, been considered valuable. Setting aside a theoretical or mathematical construct that would justify the value of gold and silver, look at it from a practical standpoint: If I went to a farmer with five ounces of silver, would he give me a sack of grain? Probably. If I offered him an ounce of gold for two or three pigs, would he give them to me? Again, probably.

Where there is a human society, there is a need to exchange. Where there is a need to exchange, a medium of exchange will soon appear. Gold and silver (and copper and brass and other metals) have served that purpose for literally millennia, but then they were replaced by paper.

Right now, there are two forms of paper currency: Actual dollars, and Treasury bonds. One is a medium of exchange, the other a store of value.

If Treasuries—the store of value—were to collapse in price, and the Fed—as I predict—tried everything in its power to at least initially prop up their prices, would those sellers who managed to get out of Treasuries in time then turn around and invest in even dodgier bits of paper, like stocks? Or REIT's? Or even precious metal ETF's?

No they would not: They would get out of Treasuries—supposedly the "safest" investment there is—and get into something even safer—something even more tangible: Actual commodities. Not ETF's, not even futures (or anything else that entails counterparty risk)—sellers of Treasuries would get into actual, hard commodities. Because if suddenly even the safest of all investment vehicles is now unsafe, do you really want to get behind the wheel of

an even more unsafe vehicle, like stocks or corporate bonds or ETF's? I mean, c'mon: If Treasuries crash, what else might crash?

That's why people in a Treasury panic would buy commodities. This ballooning of non-perishable commodities would be as a means to store value. Because that's what people do in a panic—they batten down the hatches, and go into what's safest. When the stock markets tanked in the Fall of '08, where did all that sellers' cash go? To Treasuries—because it was then considered the safest store of value. Commodities suffered in comparison—gold took a bit of a hit, as did the other precious metals—but Treasuries ballooned as the equities markets tanked.

But if Treasuries—the ultimate store of value—now tanked? If the last sure-thing in paper-based stores of value took a hit, where would people go to both store value, and have ready access to that value?

Commodities. And this rush to commodities, I argued, would trigger hyperinflation.

Now, I said I would answer two questions—one was why commodities would outpace all other asset classes in a Treasury panic and subsequent hyperinflation. The other question was, "Where's all the dough to feed my fireplace gonna come from, in a hyperinflationary event?"

The first wave of dollars in a hyperinflationary event will come from people's savings accounts.

If Treasuries tank, and the markets all barrel into commodities, then prices will rise for regular consumers—this should not be a controversial inference. What would consumers do, with suddenly much higher gas prices, and soon much higher food prices? Simple: They'll bust open their piggy banks, whatsoever those piggy banks might happen to be: 401(k)s, whatever equities they might have, etc.

But if the higher consumer prices continue—or become worse—what will happen to the 320 million American consumers? They'll start buying more gas now, rather than wait around for tomorrow—and the market will react to this. How? Two way: Prices of commodities will rise even further—and asset prices will fall even lower.

Again, the man in the desert, the diamonds, and the water: If American consumers are getting hit at the gas station and the supermarket, they'll start selling everything so as to buy gas, heating oil (most especially) and foodstuffs. The Treasury panic will thus be transfered to the average consumer—from Wall Street to Main Street by way of $15 a gallon gas prices, and $10 a gallon heating oil prices.

All other consumer prices would soon follow the leads of gas, heating oil and food.

In the above bit of Chilean history, I described how the Allende government printed up escudos to make up for the shortfall in nationalized businesses that was produced by their policy of hiking wages, while at the same time fixing prices.

This is a completely different way to hyperinflation than the way I envision it for the American economy—but once the American economy gets there, the effects of hyperinflation will be exactly the same: People will try to get out of assets in order to get hold of

commodities. To get all eccy about it, money velocity would approach infinity, as money supply remains (at first) fixed, yet in the panic over commodities, aggregate demand as measured by aggregate transactions goes vertical.

Would there be Federal government intervention of some sort? Most definitely—people would be screaming for it. Would food rationing be implemented? Probably, and probably by way of the current Food Stamps program. Troops on the streets, protecting gas stations and supermarkets? Curfews to prevent looting? Palliative dollar printing? Yes, yes, and very likely yes.

That last bit—palliative dollar-printing: That's the key. When palliative dollar-printing happens, it will be the final stages of hyperinflation—it's when sensible people ought to realize that the crisis is almost over, and that a new normal will soon appear. But this stage will be fucking awful.

Palliative dollar printing will take place when the Federal government simply runs out of options. Smart economists will get on CNBC and argue that, "The velocity of money is destroying the economy—we must expand the currency base!" It'll sound logical, but palliative money-printing will be a policy option born out of panic. The final policy option. It won't be done for evil conspiratorial reasons—always remember Aphorism #6 ("Never ascribe to malice what can be explained by incompetence."). It'll be carried out because of fear and panic.

A whole boatload of fools in Washington, on seeing this terrible commodity-driven crisis unfold, with consumer prices shooting the moon, will scream for dollars to be printed—and their rationale will be perfectly reasonable, I can practically hear it now: "We've got to get cash into the hands of the average American citizen, so he or she can buy food and heating oil for their families! We can't let Americans starve and freeze to death!"

Palliative money-printing will take place—hence the average American family will likely be using bundles of $100 bills to fire up the chimney that hyperinflationary winter.

Hoo-Ah.

Now, this fairly Apocalyptic scenario is simultaneously horrifying, and exciting as all get out. Hell, why do you think disaster movies are so popular? Shit blowing up is way cool! That's why Roland Emmerich gets paid the big bucks, God bless 'im.

But for sensible people, Apocalypse is a distraction—it's not the main event. For sensible people who want to be prepared, Apocalypse represents opportunities.

A true story: In '73, at the height of the Allende-created hyperinflation, an uncle of mine, who was then a college student, was offered an apartment in exchange for his car. That's right—an apartment. He owned a crappy little Fiat 147—a POS if ever there was such a thing—but cars in Chile in the middle of that hyperinflation were so scarce, and considered so valuable, that he was offered an apartment in exchange. To this day, my uncle still tells the story—with deep regret, because he didn't follow through on the offer: "That Fiat was in the junkyard by '78, but that apartment still stands! And today it's worth nearly a half a million dollars!" Actually, I think it's worth a bit more than that.

Another true story: A banker friend of mine manages the assets of a fabulously wealthy 70-something gentleman, whom I'll call Alfredo. In 1973, Don Alfredo was a youngish man, just starting out, with a degree in engineering but no money—until he inherited US$3,000 from a deceased aunt. Alfredo realized that the $3,000 were in a sense worthless: He couldn't buy anything with them, and it wasn't enough for him to leave the country and start over someplace else. After all, even then, $3,000 was not that much money.

So he took those $3,000, went down to the stock exchange, and spent all of it on Chilean blue-chip companies: Mining companies, chemical companies, paper companies, and so on. The stock were selling for nothing—less than penny stock—because of the disastrous policies of the Allende government. His stock broker at the time told him not to buy stocks, as Allende's government, it was thought, would soon nationalize these companies as well.

Alfredo ignored his broker, and went ahead with the stock purchases: He spent all of his $3,000 on buckets of near-worthless equities.

On September 11, 1973, the commanders in chief of the four branches of the Chilean military staged a coup d'état. Within a year, Alfredo's stock had rebounded about ten-fold. Since then, they've multiplied several thousand-fold—yes: Several thousand-fold. Don Alfredo has lived off of that $3,000 investment ever since—it's what made him a multi-millionare today.

He realized, of course, that either those blue-chip companies would be nationalized by Allende—in which case he would lose all his $3,000 inheritance, which really wouldn't change his fortunes very much—or somehow a new normal would arrive in Chile. Since the $3,000 couldn't buy him anything, he took a gamble—and won.

What do these two true stories tell us? Simple: Buy when there's blood on the streets.

That's Baron de Rothschild's famous line—but it hides a key insight, one which should be highlighted perhaps even more forcefully than the line itself:

Even in the midst of Apocalypse, things will get better.

That's something people don't quite seem to understand. In fact, it's why teenagers tragically kill themselves over some girl or boy: They don't realize that, no matter how bad things are now, they will get better later. To repeat:

Even in the midst of Apocalypse, things will get better.

I'm not repeating this insight as an empty comfort to my readers—I'm saying it as a trading strategy. When things are at their crazy worst, when everyone believes the Apocalypse is well nigh here, that's when thing are about to turn for the better. This applies to every situation—including and most especially in a hyperinflationary situation.

Why? Simple: Because hyperinflation—by definition—cannot last. Because people need a stable medium of exchange. So if the currency goes up in flames in a hyperinflationary fire, of course there will be a period of terrifying instability—but it will pass. Either the currency will be repaired somehow (as Volcker repaired the dollar back in 1980–'82). Or the currency will be completely and irrevocably trashed—and then be replaced by something else. Because—to insist—people need a stable medium of exchange.

If Treasuries tank and commodities shoot up so high that they essentially break the dollar, civilization will not come crashing down into anarchy. At worst, there'll be a three-four years of hell—economic hell. Financial hell. But then things will settle down into a new normal.

This new normal might well have unsavory characteristics. I tend to be a pessimist, and just glancing through history, I can see that just about every period of hyperinflation has been stabilized by some subsequent form of autocratic or totalitarian government. The United States currently has all the legal decisions and practical devices to quickly transition into an authoritarian or totalitarian regime, should a crisis befall the nation: The so-called PATRIOT Acts, the Department of Homeland Security Agency, the practical suspension of habeas corpus, etc., etc.

But as I said in my previous post, and reiterate here: Speculations about the new normal are pointless at this time. The future will happen soon enough.

What I do know is, One, a hyperinflationary event will happen, following the crash in Treasuries. Two, commodities will be the go-to medium for value storage. Three, all asset classes will collapse in short order. And Four—and most importantly—civil society will not collapse along with the dollar. Civil society will stumble about like a drunken sailor, but eventually right itself and carry on with a new normal.

During that stumble, opportunities will present themselves. I hope I have explained why.