# Dr. Lacy Hunt: The Road Through Deflation Toward Eventual Hyperinflation

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***Erik***: Joining me now is Dr. Lacy Hunt, chief economist for Hoisington Investment Management Company.

Dr. Hunt, I'm so looking forward to this interview. I've been thinking about you for weeks and weeks as we're navigating this very interesting time in markets. You've been just fantastically prescient and fantastically right. We've interviewed you several times over the last few years. You've always stuck to essentially the same core thesis, and it has proven correct for all of this time.

I strongly encourage any newer listeners who didn't hear those prior interviews to listen to those past interviews. Just type "Lacy Hunt" into the search box at macrovoices.com and you'll see the previous interviews.

Dr. Hunt, for those newer listeners, please just briefly restate the core thesis of your view on interest rates and why we are where we are today.

***Dr. Hunt***: Well, we closed 2019 in very vulnerable condition, both domestically and globally. United States and the world suffering from a massive debt overhang, core discretionary spending had only risen by a 1% annual rate since August of last year. There was no increase in capital spending last year.

The global economy was even much weaker. Germany, Italy, Japan, a number of other countries around the globe were either in recessions or quasi-recessions.

Perhaps the best indicator is what happened to the volume of world trade last year is a very critical indicator. Typically, world trade grows about 5% per annum or about double the rate of increase in GDP.

Last year, world trade volume declined by about 0.5%. That's only the third decline since 1980. And the other two were in the deep recessions of 1982 and 2009.

So we came into 2020 in a very weak condition. And then we had the coronavirus. And we're now experiencing a recession that has all the looks of being the worst one since 1945, assuming the virus is contained in time for a resumption of normal activities by the end of the year.

There will be some recovery in GDP, but in the fourth quarter, perhaps in the second half of the third quarter.

But even under that assumption, we're going to close 2020 with a massive output gap. In fact, an unprecedented output gap.

And, given the frailties of the economy and the inability to achieve much growth, we're going to stagger out of the recession. And it's going to take us six to seven years, maybe even longer, to restore the output gap to where it was at the end of last year.

And so this recession is actually going to produce deflation. And that result is that we're going to press the interest rates down to the zero bound. And they're going to be stuck there for a considerable period of time.

That's sort of a thumbnail sketch of my current views.

***Erik***: I want to pick up on the last part of what you said, because you've been just remarkably accurate for as long as I've been interviewing you in saying, look, some people were saying the Treasury rates would never go below 3% and then 2% and then 1%.

You've been very consistent saying, hey, they're going lower because of this debt overhang. The fundamentals are just too strong.

Well, now we're at that zero bound.

So to what extent is the zero lower limit really a limit? And to what extent is it just a number along the way to negative interest rates?

***Dr. Lacy***: Well, there is a constraint on the zero bound. And it's the overnight rate that the Fed has control over. As long as the Fed holds the federal funds rate at zero or slightly positive, which is what we currently are witnessing, then the rest of the curve will just pile in to the zero bound.

The curve will be very, very flat. And it will remain mired there.

Now, the issue of whether the Federal Reserve could take the overnight rate is in doubt. I'm somewhat familiar with the Federal Reserve Acts. I've studied them.

As a graduate student, monetary economics was one of my fields and I've stayed abreast of the clogs in the Federal Reserve system as an economist in the early part of my career, back in the days when William McChesney Martin and Arthur Burns was chairman of the Fed.

And in my view, it is not clear that the Fed has the authority to take the overnight rate into negative territory.

And if you look at the statements that past and current chairmen of the Fed have made, it's clear that there is a split opinion there. Chairman Bernanke thinks that the Fed does have that capability. Janet Yellen and the current Chairman Powell do not believe the Fed has the authority.

It's clearly a murky area.

It might be possible for the Fed to claim that there is a servicing cost for the deposits that the banks have at the Fed. Of course, these are electronic deposits, but they could perhaps claim that they need to allocate their overhead to these electronic deposits and charge the banks a servicing fee of 25 or 50 basis points.

The banks would probably contest that. I don't know how the courts would rule, personally. That's a legal issue.

The reason they would contest it is, first of all, the banks are not in good shape. And their capital position is going to be considerably eroded by the events. And they would have to pay that safekeeping fee or servicing fee to the Fed.

And so it's not clear.

But let's say that the Fed was able to take the federal funds rate to negative territory. Then I think you would see a good portion of the curve also into negative territory.

And the main motivating factor here is the key determinant of the long Treasury yields, which is the Fisher equation, a pillar of macroeconomics, which says that the longer-term bond yields are equal to the real rate plus expected inflation. The real rate has been dropping now for 20 years as growth has underperformed. It will continue to go lower.

And, since we're going into deflation, the inflationary expectations will also move lower. And so we're going to experience a pileup along or close to the zero bound.

And we'll pierce the zero bound if the Federal Reserve is able to and decides that they are willing to engage in a dogfight with the bankers over their ability to do that.

***Erik***: In our past interviews, we had significantly positive interest rates. You made a very strong and persuasive argument that they would be moving lower. And that led to a conclusion that duration risk was the trade. So a lot of people benefited from price appreciation in longer-dated Treasury securities as a result of following your advice.

Now it sounds like we're not really saying the trend is to move to substantially lower rates. You're saying it's go to zero and stay there.

So is that probably not an argument for duration risk? What do you do as an investor in this environment?

***Dr. Hunt***: Well, that's a very good question. So the long Treasuries are around the 1.25 level, fluctuating quite violently from day to day. I think we're going to go to something like a deflation rate of about 2%.

Let me explain that.

The three worst recessions of the post-war period reduced the inflation rate by about 430 basis points. But we're starting with an inflation rate of 1.7%. So we're going to go into a deflation, mild deflation.

So the tendency will be to keep pressing the longer rates down. And, of course, they're going to be interfering with the structural restraint of the Fed action there, with regard to the overnight rate.

But if we were to go down to 50 basis points from here on the long bond over the next several years, then that would be a capital gain in excess of 20%. Plus you get the coupon.

And in a deflationary environment, there is another kicker: If you invest a dollar today and the inflation rate falls 2%, then you're going to get paid back at the end of the year in purchasing-power dollars that are worth $1.02.

Now, the Treasury rates will decline somewhat further. But in deflation, the critical private borrowing rates are probably not going to decline. And deflation, you'll see decline in wages, something we haven't experienced for a long time. The risk premium on mortgages and corporate bonds will go up. And so the Treasury yields are going to outperform the so-called spread product.

The spread product will not do well. This is what happened in Japan in the last 30 years. This is what happened in the Great Depression. It's very, very difficult for borrowers to maintain profitability and sustain margins when you have even a mild degree of deflation such as we're looking at.

***Erik***: Now, Dr. Hunt, you've just made an excellent argument for deflation. I agree with you.

I think the coronavirus recession is going to last longer than some people are seemingly assuming. But, at the same time, the government reaction to it has been just unprecedented both monetary and fiscal stimulus to the tune of, literally, it seems like for a while there it was every week it was another $2 trillion stimulus bill being contemplated. A couple trillion here, a couple trillion there. Before you know it, you're talking about real money.

At some point, does all of this government reaction overcome or change that deflation and create a stagflation? Or how do you see the results of the government's reaction to this affecting your thesis?

***Dr. Hunt***: Remember, debt is an increase in current spending in exchange for a decline in future spending, unless you generate an income stream to repay the principal and interest. And we're borrowing astronomical sums.

But the funds are going to maintain daily living needs of people to put food on the table, pay their rent. A humane activity, politically popular. But it will not generate an income stream to repay principle and interest.

And one of the key points that I've made for a long time is that when you use the economy's production function, what the debt is doing is it's triggering diminishing returns. And the production function, GDP is determined by technology interacting with the three factors of production: land, labor, and capital.

And the production function states that if you begin to overuse one of the factors of production, let's say borrowed capital, initially the GDP will rise. But, continue to make overuse of that same factor of production, the GDP levels out. And further overuse leads to a decline in GDP.

In other words, the overuse of debt triggers a nonlinear reaction. Up GDP first, flat, then down.

And when the growth rate falls, then that pulls the inflation rate lower. This is what explains, clearly, what's been happening.

At the end of last year, government debt was 107% of GDP, which was an all-time record. The three bills that have just recently passed – the Family First Act, the CARES Act, and then the bill just passed yesterday that provides an additional $400 billion for the Payroll Protection Plan – account for about 16% of GDP, based on last year's GDP.

But, of course, the GDP is declining.

And in addition to that, the social security payments are going up, the unemployment payments likewise. And income tax collections are going down, both corporate and personal.

And so the government debt-to-GDP ratio by the end of the year or early next year is going to be somewhere around 125-130%.

Now, let me explain how diminishing returns is working. There is a large number of econometric studies that indicate that when government debt reaches about 50% of GDP, there is a deleterious effect on GDP.

And when it goes to 60%, the effect is more intense. There is a greater loss in growth against trend at 70%. At 90% debt to GDP, an economy loses about a third of its growth rate against trend.

We're going into territory that we've never been before. But diminishing returns are at work.

And so the programs, while they are popular and certainly understandable from a humane standpoint, they are going to weigh the economy down. And the net result is that it's going to produce very poor economic growth going forward. And that's going to drive the inflation rate lower, not higher.

This is the path that Japan has taken in the last 30 years. Government debt-to-GDP rate has risen from 60% to 225%. And it's been combined with all types of monetary policy manipulations as well. And the Japanese economy has become progressively weaker.

And that's the path that we're following.

So this is really not stimulus. It gets us by. It helps people out. It's probably necessary, absolutely necessary. But it's going to retard growth for a very, very long period of time.

***Erik***: Let's talk a little bit more about the effects of national debt overhang.

You just talked about Japan some. Something I've been perplexed by for as long as I've been interviewing you, you know, you've made this very, very clear argument and it's been proven right time and time again, which is, look, the problem here is we've got too much debt. And as a result of having too much debt, interest rates have to stay super-low because there is just no way for the system to service the debt at any higher interest rate.

That makes logical sense.

But at some point, when you get to a point where a borrower is insolvent, normally what happens is interest rates or yields go up dramatically because the market realizes it's mathematically impossible for that borrower to ever service the debt.

So I have to believe that, instead of talking about $25 trillion of national debt, if we were talking about $500 trillion of national debt at our current GDP, the market would conclude, okay, Treasury paper is worthless because there is no way to service it. And yields would go up.

So is there some threshold or event? How do you know when you get to the point?

***Dr. Hunt***: No, there is no threshold. In other words, you're going to continue to oppress down the right-hand side of the elliptical relationship that is the law of diminishing returns. More is not more. It's less. Economic activity will become progressively weaker.

And let me just make a couple of points here.

One of the most important concepts in economics is the circular flow, which says that what we produce equals what we spend equals what we earn. Everyone accepts that.

But, out of the circular flow, there are certain platinum-solid propositions that hold. And one of them is that physical investment must equal saving out of income. And saving out of income has three components: private, government, and foreign.

Okay. So as we closed 2019, net national saving as a percent of net national income was just 2%. Historically we run 6.5%.

Now, that 2% was comprised of private saving of 8.4% and government dis-saving of 6.4%. But the government dis-saving, we're going to run a deficit in excess of $4 trillion, versus a little bit more than $1 trillion last year.

And so as a consequence, net national saving is going to go to minus 12 or 14%.

Now the private saving rate will probably go up. People, I think, will conclude that they cannot operate as tightly as they have in the past, that they need to have rainy-day funds. We'll see some increase in the private saving rate.

But we're going to have a net national dis-saving of somewhere between 10 and 15%. which means there can be no physical investment. There are no resources.

And without physical investment, you cannot increase GDP. You cannot increase the standard of living. The debt will just make you weaker and weaker and weaker.

And one of the problems is that as Europe, the United States, China, Japan have pursued these debt policies over the last 30 years, one of the other elements in the production function has deteriorated. And that's the demographics.

Last year, worldwide population growth was the slowest in about three-quarters of a century at about 1.2%. In the United States last year, population growth was .48%, which, ironically, was the lowest since 1918, the year of the Spanish flu.

But, in Europe, population growth was only .2%. Population was (we'll call it) zero in China. It actually declined slightly. And in Japan, the decline was even greater.

But, of course, this year the demographics are going to deteriorate further.

So if you look at the production function, because of the debt overhang when we closed 2019, public and private non-financial debt was, for every dollar of new public and private debt, was generating only 40 cents of GDP growth. In Europe it was in the high 30s. In China it was in the low 30s. In Japan it was in the mid-20-cents range.

By within 12 months, more or less, the United States number is going to be 25 cents, down from 40. But there are going to be even greater collapses in Europe, Japan, and China. The Chinese have undertaken a $5 trillion program this year. Massive. And they are subject to diminishing returns.

Everyone has a production function. It doesn't matter whether you are command and control or not. If you overuse that factor of production, you are dealing with a non-linear relationship. And a lot of folks don't want to deal with that. They think that this is accounting. It's not.

Economics is not accounting.

And so we know two of the elements of the production function: The marginal revenue product of the debt is at low levels and it's going lower, and the demographics are at low levels and they're going lower.

And so when we come out of this, there will be a pent-up demand recovery. But the major economies of the world are going to be very hard pressed to generate even a 1% real growth rate in per capita terms.

So the production function doesn't work for us. And the lack of saving to fund investment does not work for us.

And, ironically, there have been some pretty smart minds over the years that have looked at the indebtedness problem.

One of the first was by the great David Hume, writing in 1752. My professor, Ingrid Rama said that the Enlightenment could not have occurred without David Hume. Adam Smith, who was mentored by Hume, said that he was the greatest intellect of the age. And Smith knew Voltaire. He knew Ben Franklin. And Hume was the greatest.

Hume, in his *Treatise on Human Nature,* discussed the physics topic of time and space, to which Einstein attributed the inspiration for the theory of relativity.

In 1752, Hume wrote a paper called "Of Public Credit," which I recommend you read. You can get it on the internet easily. It's only about 20 pages. It's not in modern English, but it's very understandable.

And he looks at these cases that were available up until the time of 1752. He looks at Mesopotamia and Rome and a number of lesser cases that have long been forgotten.

And this is what he says. He says when a state has mortgaged all of its future revenues, the state by necessity lapses into tranquility, languor, and impotence. And today, we know that it triggers diminishing returns and an insufficiency of saving to generate physical investment.

So there is no level, in my opinion.

And if the politicians pursue the idea that if $2 trillion doesn't work, we should try $4 trillion. And if $4 trillion doesn't work, we should try $8 trillion or $10 trillion or $12 trillion. Then they're working in a linear world and they're trying to ignore the reality that we have non-linear relationships coming through the production function.

More is not more. It is less, Erik.

***Erik***: I think that you are absolutely brilliant, Dr. Hunt. And I think that your reference to Hume is brilliant as well. The thing is, politicians don't listen to the brilliant economists like yourself. They listen to whoever gives them something they can tell the voters that they want to hear.

And it seems to me that at the moment it seems like the resistance that existed toward modern monetary theory and simply monetizing a lot of government spending, that resistance, even from the political right, seems to be waning in this coronavirus crisis.

We've gotten to the point – was it Nixon who said we're all Keynesians now? It seems like in this coronavirus we're all – not you and I, but the politicians, certainly – are all MMT-ers now.

***Dr. Hunt***: Well, we haven't adopted MMT yet. The advocates are raising their voice now. But we haven't done it. The Federal Reserve Act is very explicit. The writers of not only the 1913 act but the more critical legislation that was passed during the '30s wanted to give the Federal Reserve broad powers to make loans and provide liquidity.

But they did not give the Federal Reserve the ability to spend.

Today, when the Fed buys government and agency and other securities, when that transaction clears, the net result is that the sellers of the government debt give up a maturity of securities that have an average life of about seven years. And at the end of the transaction, the banks and their holdings of overnight deposits at the Federal Reserve go up.

In other words, it's just a reduction in the average maturity of the government debt held by the private sector.

Now, the banks can make use of the reserves. And many people assume that they will. But that assumption is not valid. Because the banks, to take advantage of the reserves, have to have the capital to put at risk. And they have to be able to make an assessment that they will cover the risk premium. In other words, the likelihood of default.

And the banks are very weakened. And, moreover, this flat yield curve will further undermine the profitability of the banks.

And, moreover, not only do the banks have to find making loans attractive. The borrowers have to also be willing to put their capital at risk.

And they have to be able to make a calculation that the funds can be profitably used, which will be increasingly difficult if we go even into a mild deflationary environment.

Now, I would recommend that you listen to the webinar that Chairman Powell gave there in early April, when they took the latest round of measures to facilitate on a lending basis various components of the fixed-income market. And Powell made it very clear that the Federal Reserve has the authority to lend but it does not have the power to spend.

For them to do that, the Federal Reserve Act will have to be rewritten. Now, that could be done. And perhaps we will go in that direction.

And it's important to note that the Bank of England, just recently, this month, has crossed the Rubicon. Or if they haven't crossed the Rubicon, they've certainly waded into the Rubicon.

And the Bank of England made a direct advance to the British Treasury of approximately a half a trillion dollars. Now, they said it was temporary. And we certainly hope that it is.

But the United States Federal Reserve does not have that authority. And it would require a change in –

The key writer of the revision to the Federal Reserve Act was a Virginia politician by the name of Carter Glass. And you may know that name. He was also author of the Glass-Steagall Act. And he went to the two leading monetary theorists of the time, Irving Fisher of Yale and Charles Whittlesey of the Wharton School.

And he said, how do we construct the Federal Reserve Act so that the Fed has liquidity powers but not the power to spend? We don't want the Federal Reserve to turn the country into a banana republic. And if you give the Federal Reserve that ability, then the inflation rate would take off.

But, unfortunately, what would happen is the inflation rate would rise very rapidly and Gresham's Law would be triggered: The bad money chases out the good money. People would not want to hold paper assets. They will try to convert their paper assets into commodities that either can be consumed or can be traded for other commodities that they might need. You'll force a return to barter.

And in that case we would make everybody's lives miserable.

In other words, to go down the road of giving the Federal Reserve the ability to spend, you would basically destroy the system by trying to save the system.

***Erik***: Dr. Hunt, you make excellent points. But I want to push back just a little bit because the Federal Reserve Act is very, very clear in that it says that the Federal Reserve can only buy debt securities which are backed by the US government agency securities.

And, very recently, they literally reinterpreted that to say, well, if we put this little special-purpose vehicle in between and pretend that the Treasury is a party to this transaction, we can call junk bonds – literally junk bonds, the ETF full of junk bonds – sort of kind of a government security. And we'll use the Federal Reserve to literally bail out the junk bond market. Which has happened.

So it seems to me like we're in a political climate where, I don't know what you want to call it, a loose interpretation of the Federal Reserve Act by regulators is being tolerated. Nobody is questioning that in court now.

So isn't it true that they are effectively spending money to bail out the junk bond market and just kind of pretending that junk bonds are government bonds because they've created this little special-purpose vehicle mechanism, which to me seems like they're just trying to undermine the intention of the law?

***Dr. Hunt***: Well, they are providing liquidity financing to debt that has already been issued. They are not providing additional funds for new debt.

Now, the fact of the matter that they are stretching the Federal Reserve law does not change the fact that this does not constitute money printing. But there is a major economic effect.

The firms that are seeking the Fed's help are doing so because they weren't prepared for the shock to the system. The corporate sector was massively over-indebted. In fact, it was more over-indebted at the end of last year than at any time in our history.

And one of the reasons that they were so over-indebted is that corporate profits, as we closed 2019, were basically unchanged from 2012 and down slightly from the peak in 2014. And those are after profits, which were benefited from a significant corporate tax cut.

And so the effect of helping these folks out over the near term, it maintains their viability. But there is an economic offset. It means that scarce capital is absorbed to sustain zombie corporations, or failing corporations. And this increases the mal-allocation of capital.

And in the final analysis (as I told you), to have physical investment, the Fed's role is irrelevant. You have to have saving out of income. And we don't have saving out of income. We're going to have net negative saving.

So the Fed's action is basically standing-in-place motion. And the way that you will be able to verify this is that we will see massive declines in the velocity of money.

The presumption [is] that if the Fed is able to increase the money supply that it will have important influences on economic activity and on the inflation rate. But GDP is determined by money and velocity.

Now, velocity is a very complex variable. There are a lot of things at work there. But the most important of which is the marginal revenue product of the debt.

And as the marginal revenue product of the debt has come down since the late 1990s, the velocity of money has declined. And at the end of last year, velocity was about 1.42 down from almost 2.2 in 1997 – almost a straight line down. There were a few bouts upward.

And when the data comes in for the first quarter, I think velocity will drop down to 1.32. And then we'll have another massive decline in the second quarter.

For the velocity of money to rise, the increase in the money that the Fed manages to engineer in the short run will only be viable if it generates an income stream to repay principal and interest.

And this kind of lending will not do that, on the grounds that I have just explained. And the velocity of money will fall.

And that will usher in weaker growth and economic activity in the midst of high money-supply growth. And the inflation rate will also go into negative territory in spite of it.

***Erik***: Let's talk more about how this plays out over the next several years. Because it seems to me that coronavirus crisis is going to lead to lots and lots of accommodation, both monetary policy and fiscal policy, fiscal spending, and so forth.

Now, a lot of the critics have said they think that that's going to lead to runaway inflation.

You're making a very good argument for why it will not lead to runaway inflation because of the stronger dynamics that are in place. If you're right, I would say that that just gives more ammunition to the people who want to do much more of that what you've described as counterproductive stimulus, stimulus that's not really stimulus.

It seems to me that, even though you and I agree it's a bad idea, what we're really talking about is a setup here which is going to give the proponents of those policies ammunition. Look, it didn't lead to runaway inflation. We should just keep doing more of it. We should provide much more – more, more, more, more, more.

Would you agree that the politics are kind of set up that way? And if the more, more, more,

more, more happens, what happens?

***Dr. Hunt***: The politics are set up that way. But unless the – I mean, the increase in the debt will not itself produce better growth and inflation. If we give the Fed the ability to spend, which they do not have that authority now.

That will generate inflation but it will not generate growth. And it will make everyone's lives miserable. And it is possible that we will go in that direction. I'm not saying that we won't.

But I'm telling you this: Hyperinflation is going to make 99% of us terribly miserable. It will be a far worse outcome than mild deflation. There is no government lever that can solve this problem.

Now, we have some outstanding research that's been done on the matter, by McKinsey Global Institute which is the think tank of McKinsey and Associates. And it's a 2010 paper. And they looked at 24 advanced economies for the time in the period from 1900 through 2008 that became extremely over-indebted. And they measured the buildup of debt to the panic year or multiple panic years and then the ultimate solution.

And they found in all 24 of these cases that the indebtedness problem had to be solved by an extended period of austerity. And they defined austerity as a significant rise in the saving rate.

In other words, if you think of indebtedness as living beyond one's means, we have to – to solve an indebtedness problem, you have to live within one's means.

Now that's a very unappealing solution. So in that regard you are right. Because people do not like the alternative. And that does raise the risk.

And you're correct to say so, that we change the Federal Reserve Act and we let the Federal Reserve print money. That's a real risk. And it's a risk that I am extremely cognitive of.

But let me tell you this, we're going to make everyone extremely miserable in very short order. There are numerous cases of this.

This was tried by Chiang Kai-shek in the 1930s, Germany in the 1920s. This was tried by Yugoslavia and Hungary at the end of World War II. There was a famous Bolivian case in the 20th century. And, basically, it was the path that was taken by the Bourbons of France. And the Romans and the Mesopotamians.

They built up huge debts, which they could not service.

And so, take the Bourbon case, which is perhaps the most well documented. They took on a great deal of debt to finance the French and Indian War, which was really a world war. In Europe, it was called the Seven Years' War.

Then they financed the American Revolution. It cost the French more for us to win the American Revolution – it cost them more than it cost us. And then they went into high living and so forth.

And so what was the solution of the Bourbons? Well, to issue a worthless metallic coin. And eventually the inflation became extreme.

And so, going to money printing is an avenue, and it may be seized upon. But the result is social rupture and collapse of the financial – people will not want to hold financial assets. The whole world will be turned upside down, Erik.

And, in other words, at that point in time we'll make the United States the equivalent of a banana republic.

***Erik***: Okay, let's talk in more precise detail about how we get there. Because I think we're in agreement, first of all, that lots and lots of fiscal spending, so-called stimulus, is not a good idea. But we also agree that the setup is for governments to do much more of it.

***Dr. Hunt***: Well, let me just interject something there. The first-round effects may appear to be appealing. Wanting to bail people out in a time of crisis. People get a check. They think that's good.

The problem is, in economics, is that there are the unseen effects. The second-, third-, and fourth-round effects. And I don't like to use the term "good" or "bad."

But there is a little exercise that folks can do. If you graph government debt to GDP on one axis and the long-bond yield on the other axis, and you do that for the United States, what you'll see is that there is an inverse relationship. That is the government debt levels go higher, the bond yields decline.

And the logic here is that you are triggering the law of diminishing returns and you are reducing saving to weaker and weaker levels that precludes physical investment.

And, by the way, if you do that exercise, for Europe, for Japan, and now China, you'll see that inverse relationships hold.

So what we're talking about is understanding the economics. And the economics suggest that if we pursue this policy, we're going to get weaker growth and lower inflation and a prolonged period of low interest rates. Unless of course the central bank, Federal Reserve, is allowed to print money.

And in that case we will not improve the growth rate one iota. In fact, the growth rate will probably even get worse because we will have experienced a severe decline in productivity.

In extremely high inflation, people do not hold financial assets. They spend time converting the financial assets as quickly as possible into commodities. And then they trade those commodities with other people to have things that they want.

In other words, you have to have double coincidence of wants, which is extremely inefficient. And so productivity will fall and the economy will lapse into an even deeper morass than it is now.

So the money printing is the absolutely horrendous option. It may be used though. And if it does, you'll see a change in my forecast, absolutely.

***Erik***: I want to make sure I understand where that distinction is. Because what we've said so far is there is a setup for there to be a whole bunch more fiscal stimulus spending, infrastructure spending, whatever.

You've made a very good argument that it feels good in the beginning, but in the end it's not really simulative. It just drags the economy further down. But it's deflationary in the way that it does that.

It sounds like the key event – because, as you said, hyperinflation is the really big risk. That's the one that there is no way you can fight it. The only way, it sounds like, you would see us getting to hyperinflation would be if they changed the Federal Reserve Act and allowed the Fed to spend money rather than just buying assets.

***Dr. Hunt***: That is correct. That is the key. You understand your macroeconomics. That is the critical key.

Could I just go back to something? So let's just look at some fiscal actions that people are really familiar with. We had a $2 trillion stimulus in 2009 of shovel-ready projects. It was said that that was going to lead to accelerating growth in inflation and higher interest rates and the decline of the dollar. And that was a very, very popular view.

And, moreover, the Fed was engaged in quantitative easing at the same time. What we saw is maybe a couple of quarters of improved economic growth. And then the higher debt weighed on economic activity.

In 2018, there was an important tax cut. It was a $3 trillion tax cut over 10 years financed with debt. In January of 2018, this law took effect.

But by the end of January, there was also a bipartisan – I use that word, "bipartisan" – increase in spending that added basically another $3 trillion in debt. So you had the tax side and the spending side.

So what happened? We experienced about one-quarter of accelerating growth, maybe one-and-a-half quarters. And then the growth rate turned down.

There is a very fleeting transitory benefit. But the benefit fades very, very quickly.

And so these new programs that we're taking on right now, they won't even be visible, in my opinion. They'll be helpful, and they'll help get us through. They will help people that are in bad shape for a variety of reasons. But there is not going to be any income generation to repay the principal and interest.

And so the economy is going to be much, much weaker as a result of these extremely politically popular and humane actions.

I'll just make one other point with you: In Hume's paper, he made a recommendation that the best fiscal policy is the one that always runs surpluses. And his argument was that you run surpluses so that when you have a national emergency – and he was mainly thinking about a war or some type of natural disaster – that you have the ready resources to handle the problem.

As a matter of fact, Adam Smith, in *The Wealth of Nations*, followed Hume's advice. And, generally speaking, the United States followed that policy until Keynesian economics took over.

And if you think about the advice that Hume gave, this genius of a man, this towering figure, that's how successful people behave. You don't run on the margin. You have a rainy-day fund. You're prepared for an emergency so that you do not have to rely on debt, which makes you weaker.

***Erik***: Dr. Hunt, you gave me a passing grade on macroeconomics, so I'm going to try my luck with reflexivity in politics. It seems to me that what you're saying here is that right now for humanitarian reasons we've got to move forward with this stimulus, which is going to feel good to a lot of people.

The people who oppose it are saying, but the risk is inflation.

And what you're saying is they're going to be proven wrong on that. To my thinking, that just gives more ammunition to the people who want to get us eventually to change the Federal Reserve Act to allow the Fed to just literally print money. And spend it.

So it seems to me like we're in a vicious cycle that takes us, maybe by the 2024 presidential election, when they're saying, okay, it's time to just let the Fed print money.

And, because we can't keep raising taxes when there's no way to serve all of this crazy debt that we have, the Fed's got to print money.

And anybody who tries to express a voice of reason is going to get shut down and told, look, you people have been complaining about inflation for 25 years, saying it was going to happen, even since we did the first round of quantitative easing back in 2009 you've been wrong consistently.

It's time to let the Fed print money. And that's where the event happens that eventually leads us to a hyperinflationary outcome and really bad consequences.

How'd I do?

***Dr. Hunt***: You did very well. I will just make one –

***Erik***: I don't think it's very well. I think it's very bad. I think it's horrible.

***Dr. Hunt***: No, your explanation was excellent. The outcome is bad. For the Federal Reserve Act to be revised, the Federal Reserve will basically have to lead that role. In my opinion.

In other words, the Federal Reserve would have to go to the Congress and the president and say that we need to (quote) modernize, or whatever wonderful term you want to use.

Based upon the webinar that Chairman Powell gave this month, I would say that Powell would not lead that. His term will expire, and we'll get a new Federal Reserve Chairman.

But one of the risks here is if you open the Federal Reserve Act up for revision, then we're going to have to deal with a myriad of alternative ideas that people have. And some of them are really strange. And so opening up the Federal Reserve Act for revision would open a whole can of worms, unknown can of worms.

And where you go once that's started is anybody's guess.

It could be in the direction of money printing. That's certainly a possibility that we have to be aware of. But I think the Federal Reserve, Erik, has to take the role and the leadership in pushing the change through. And I don't see the Powell Fed doing that.

I think he's aware of what the risks are. That would be my reading. I may be wrong on that, but that's my reading.

***Erik***: What happens when Stephanie Kelton is the Fed Chair?

***Dr. Hunt***: I'm not going to go there. But I'm only just telling you that I don't think the Powell Fed would want to do that.

***Erik***: Dr. Hunt, I can't thank you enough for a terrific interview.

Throughout this interview, Dr. Hunt has referenced several different written works, some of which are 100 years old. Our production staff has assembled links to as many of these as we could find and inserted them into your Research Roundup email. So I encourage everyone to check your Research Roundup email and you'll find links to all of the various different writings that were discussed in today's episode. [If you are not already registered, you can do so on the MacroVoices homepage via the Looking for the Downloads? button.]

Again, thanks so much, Dr. Hunt. Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.