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Downunder Daily

Pop It Or Mop It?

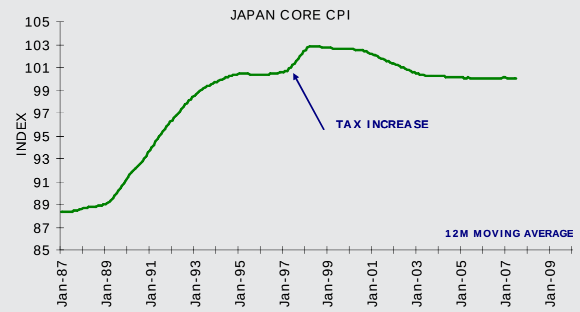
When Ben Bernanke was anointed Alan Greenspan's successor, Stephen Roach commented that new Fed Chairmen often have been confronted by problems they were ill-trained to deal with (*Transition Curse*, 7 October 2005). However, I think the end-game of the next recession is likely to be a deflation scare, which suggests that Dr. Bernanke, who established his reputation studying the Depression and Japan, is the right man for the job. Re-reading some of Dr. Bernanke's speeches prompted the following thoughts:

First, one Bernanke comment resonated: "the best way to get out of trouble is not to get into it in the first place." This suggests that a Bernanke Fed is a break from the bubble-blind Greenspan Fed. The Greenspan dictum that a central bank couldn't tell what an asset bubble was, but stood ready to counteract the effects of one popping (we-can't-pop-'em, but-we-can-mop-'em), always struck me as irresponsible, in two ways:

First, one of the common features of severe recessions in developed-world economies (with the possible exception of the early 1970s) has been an overlay of asset price boom and bust, which typically led to financial sector stress. Second, making difficult judgement calls is a necessary part of forward-looking policy setting. To put asset prices in the too-hard basket seemed arbitrary at best, and potentially reckless given that they have often increased the amplitude of economic cycles.

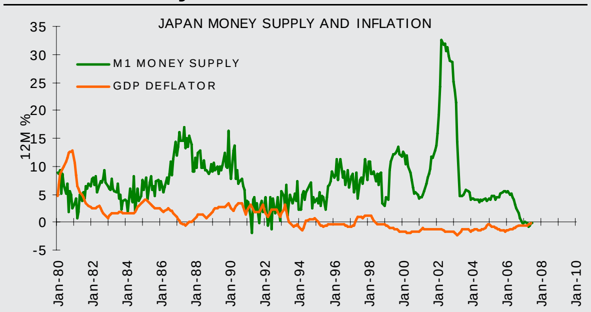
My second thought is that if "the best way to get out of trouble is not to get into it in the first place" then I think America is already in trouble. There are already two imbalance measures – economy-wide leverage and household sector dis-saving – that I think have in part been created by asset price booms that are now at multi-decade extremes. (As an aside, America is not alone in this predicament.)

Exhibit 1
That's Not Deflation



Source: DataStream, BoJ; Morgan Stanley Research

Exhibit 2
Lots Of Money…



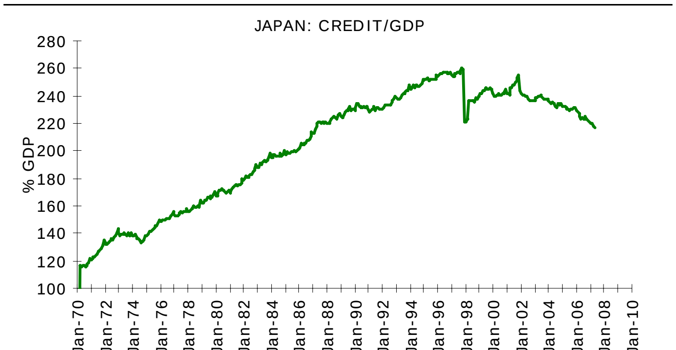
Source: DataStream, BoJ; Morgan Stanley Research

Third, much of Dr Bernanke's comments on historical deflation episodes focus on monetary policy mistakes made at the mop-it-up stage. The tone, almost Greenspanatic, is that there are financial tools that can cope with almost any financial problem. Perhaps so, but, in my humble opinion, that misses one central feature of the current imbalance: that the household sector consumes more than it produces. That is a real-economy problem, although that excess spending has to be financed (hence the financial overlay and the link to asset prices which facilitated that financing).

As I see it, it is hard to see any type of financial jiggery-pokery that will prevent an adjustment in that real economy imbalance causing economic pain. The obvious risk is that an initial cutback in activity feeds back to employment weakness, with all that implies when accumulated debt, encouraged by rising asset prices, is so high. In short, once there is pain in the real economy, the financial imbalances will potentially deepen the adjustment problem.

Fourth, while I don't expect the US to see a Depression, or even a Japanese-style lost decade, I think the Japanese experience does hold some lessons for the US. But I'm not convinced that people have taken the correct lessons from the Japanese experience.

Exhibit 3
…That No One Wanted



Source: DataStream, BoJ, Morgan Stanley Research

For a start, there's too much focus on Japan's 'deflation'. In my view, deflation did not cause Japan's problems. That's in part because Japan hasn't seen deflation: it's seen price stability (the CPI has averaged 0.1% over the 14 years to 2006, with the core CPI falling by no more than 1% over any 12 month period). Exhibit 1 shows the core CPI index (as a rolling 12 month average because the data are not seasonally adjusted). Japan has simply been a deleveraging story. The problem was not that prices were too low, but that debt was too high.

Conventional policy has been ineffective breaking this deleveraging process. This is not, in my view, due to critical policy errors. Yes, the Bank of Japan may have been initially slow to respond to the downturn, but the fact is that narrow money supply growth has been super-plentiful for a decade (Exhibit 2). Yet credit continues to contract (Exhibit 3). While real rates stayed positive, they hardly seemed prohibitive.

Moreover, the credit contraction didn't appear to be due to a supply-side constraint: Japan's ailing banks were famously willing to lend to their ailing corporate clients. The simple fact was that households and (quality) corporates didn't want to borrow, even at ultra-low rates. Conventional policy proved ineffective when the private sector aimed to reduce leverage.

Finally, it may be that in Japan the correct solution would have been 'the technology': the central bank printing cash and giving it away. Certainly, Japan's experience shows that low rates don't work if the lender still expects repayment of the loan. But it's a moot point whether 'the technology' would be a painless option for America. First, there's the issue noted above, that there is a real economic adjustment required: bringing household consumption back in line with income. Japan, as a positive saving nation, didn't have to make that adjustment.

The second America-specific problem with the printing press option relates to the external deficit, or more specifically America being the world's largest debtor. If Japan, the world's largest creditor, wants to utilize the reflating technology of a printing press, then its debtors have no issues: the currency of their debt is being debauched. But if America tries the same trick, its creditors get annoyed. In that setting, the economic adjustment could be imposed on America if foreigners refused to finance the excess spending. That's quite easy to do: start invoicing export sales in euros or yen.

This is a debate about a risk that hasn't yet unfolded. But, as I see it, the current imbalances seem to have some intractable characteristics that suggest to me the next downturn will be difficult. More to the point, I'm not sure that some of the lessons – or at least, the correct lessons – from the past have been learnt.

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