



Debating Deflation: Why the U.S. is unlikely to repeat Japan's 10-year slump

The sharp rally in many global stock markets in October provided a welcome contrast to the misery of the preceding months. However, many commentators continue to dismiss the market's reversal in October as nothing but a "bear market rally" as they look for renewed misery ahead.

A favoured explanation for why more misery lies ahead can be summed up in one word: deflation. Consumer and producer prices in the United States fell in late 2001 and pricing power has remained weak since then. Many

investors have looked at Japan's boom/bust experience since the late 1980s (Chart 1), and are concerned that the United States could be headed for its own decade-long deflationary slump.

rate of nearly 15%. Not coincidentally, that is precisely when discussions of possible U.S. deflation began to be taken seriously.

But are these parallels sufficient to argue that the U.S. faces a Japanese-style deflationary slump that will last for the next decade or longer? We hardly think so. Our reasons for thinking that Japan's experience is likely to be a poor guide for predicting what will happen in the U.S. are fairly simple. First, the Bank of Japan let deflation take root and offered little resistance. In our opinion, the U.S. Federal Reserve is unlikely to follow its example. Second, Japan's economic problems go far beyond the deflation issue. Fortunately, America's economic system is far more dynamic and tends to deal relatively quickly with major problems.

We believe these concerns are largely unwarranted. Yes, there are some eerie parallels between Japan's experience in the 1980s and the U.S. experience in the 1990s and the early part of this decade. Both nations experienced a massive rally in stock prices followed by a major economic and market slump. Both nations saw a buildup of household and business debt during the boom years that created problems during the slump. And, like Japan, the United States has recently experienced significant deflationary pressures. These were most pronounced in the autumn of 2001, when producer prices declined at an annual

JAPAN'S DEFLATION TAKES ROOT

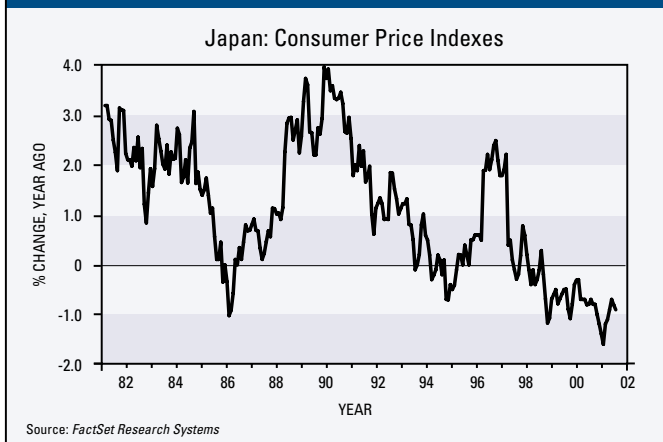


Chart 1: Japan's consumer prices have been falling since 1998, as deflation has become a way of life.

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Was Japan's Deflation Intentional?

Economists generally agree that persistent deflation can be as damaging in its effects as inflation. When coupled with high levels of business and consumer debt, falling prices lead to massive bankruptcies, rising unemployment and dismal stock markets. The longer deflation is allowed to go on, the more problems it creates, and the harder it is to control. Accordingly, it is widely believed that central banks should aim for general price stability, avoiding extremes of either inflation or deflation.

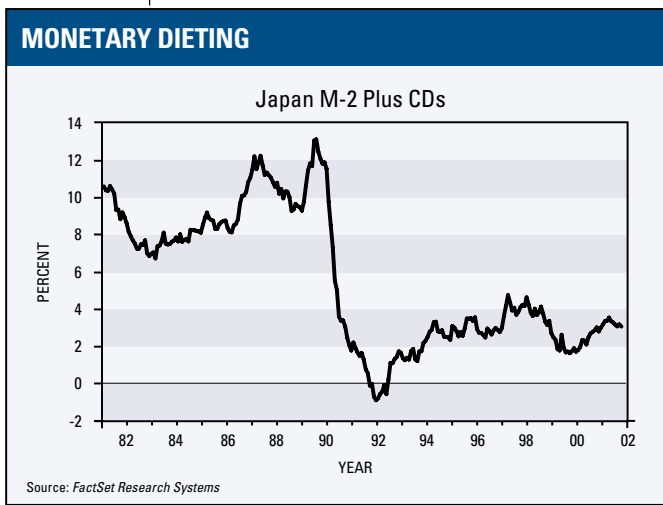


Chart 2: The Bank of Japan effectively put the Japanese economy on a monetary starvation diet in the 1990s, as it permitted the rate of money growth to fall by 60% from the 1980s.

Against that backdrop, the willingness of the Bank of Japan (BOJ) to passively stand by while deflationary pressures took root in recent years is somewhat of a mystery to most analysts outside of Japan. To put it bluntly, foreign economists have been baffled by the Bank of Japan's Nero-like approach of fiddling while deflation intensified.

As one of America's pre-eminent Japan scholars, Adam Posen, recently put it: "There is good reason why no one outside of the BOJ supports its policies. They are misguided, harmful to Japan and to the world economy, and without economic foundation."

Although the Bank of Japan has frequently acted as if the nation's deflation was out of its control, Posen and other experts view that as patent nonsense. Even if interest rates go to zero, as has happened in Japan, central banks can take other measures to boost money growth, including direct purchases of equities, corporate bonds or foreign bonds.

In effect, Japan's descent into deflation appears to have resulted from active choices made by the Bank of Japan not to use measures

that could have prevented deflation. A look at Japan's rate of monetary growth over recent decades illustrates the point (Chart 2). Growth in the nation's money supply averaged 9.1% per annum in the 1980s, and then slipped to 3.6% per annum in the 1990s. It is as if the nation's body politic were put on a monetary starvation diet in the 1990s. Not surprisingly, Japan's economy not only shed fat as a result of this strict regime, it became downright gaunt.

Is the U.S. Federal Reserve likely to force the same kind of restrictive monetary diet on the U.S. economy in coming years? We doubt it. One reason for optimism on this score is that the Fed has extensively analyzed Japan's experience as a prime example of what not to do when deflation is a threat. This June the Federal Reserve Board issued a paper entitled "Preventing Deflation: Lessons from Japan's Experience in the 1990s." It argues that Japan could have avoided deflation had it adopted sufficiently aggressive monetary policies.

According to the Fed paper: "We draw the general lesson from Japan's experience that when inflation and interest rates have fallen



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close to zero, and the risk of deflation is high, stimulus, both monetary and fiscal, should go beyond the levels conventionally implied by baseline forecasts of future inflation and economic activity." Translated from FedSpeak, that simply means that when deflation is a major risk, fight back with everything at your disposal.

That leads directly to another reason for optimism that the U.S. will not follow in Japan's deflationary footsteps: The Fed already has been far more aggressive than the Bank of Japan in easing monetary policy in response to the stock market slump. Consider Table 1, which shows the state of different monetary indicators a bit more than two years into each nation's respective stock market slump – September 1992 for Japan and September 2002 for the United States. At this point in Japan's slump, money and credit growth had slowed to zero versus the 10% rates seen in the U.S. Japan's discount rate was 1.5% higher than the U.S. Fed funds rate. Housing prices in Japan at that point had plummeted, compared to the generally strong current condition of the residential real estate market in the U.S. These are clearly major differences.

Japan's Problems – Not Just Deflation

Before jumping to the conclusion that the U.S. is destined to repeat Japan's decade-long economic slump, it is also important to bear in mind that Japan's economic problems have gone far beyond the failure of the Bank of Japan to prevent deflation. A short list of these problems would include (1) the failure of the nation's effective one-party political system to undertake any fundamental economic reforms; (2) the failure of the bank-led financial system to allocate capital effectively; (3) the relatively low rate of new business ventures in a regulatory and financial climate that has stifled entrepreneurship; (4) the increasing reliance on growth based on government spending projects with low returns on investment.

Several excellent books have dealt at length with these system-wide problems. One highly prophetic book was *Japan: The Coming Collapse*, written in the early 1990s by Brian Reading, a former editor of *The Economist*. One of the memorable lines from that book was that "Japan is not capitalism with warts, it's communism with beauty spots." His point

MONETARY POLICY COMPARISON

3-month Percent Change, Annualized

	Japan Sept. 1992	U.S. Sept. 2002
M2	-1.9	10.6
Liquidity	0.4	9.1
Bank Loans	0.6	10.6
Central Bank Rate	3.25	1.75
10-Year Bond Yield	4.8	3.78

Source: ISI

Table 1: In response to economic weakness and slumping equity markets, the U.S. has eased much more aggressively than Japan. The result has been stronger growth in money and credit.

was that Japan suffered from many of the same symptoms of central planning and excessive government involvement in the economy that had undermined the Soviet Union and other East Bloc nations. Fortunately, Japan had allowed enough free-market activity in the small business sector to become far more successful than the Communist nations. Unfortunately, the substantial wealth that was created may have been responsible for permitting Japan to take a much more relaxed attitude toward economic



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reform, which contributed to the “lost decade” of economic stagnation in the 1990s.

Another book published in the late 1990s did an outstanding job of analyzing the economic problems created by Japan's “Iron Triangle” of politicians, bureaucrats and corporations. *Japan – The System That Soured*, written by economist and long-time Japan observer Richard Katz, chronicles the rise and fall of the Japanese economic model. The model was effective in the immediate postwar years in channeling the nation's resources into a few key industries like autos and steel that would become major global players. However, the model broke down in the late 1980s and early 1990s when uncompetitive sectors that should have been liquidated were instead protected by the government to such a degree that they became a drag on the overall economy and financial system. Even now, Japan finds it nearly impossible to pull the plug on dozens of major firms – the so called “zombie companies” that would have disappeared years ago without political support.

In contrast, the U.S. economy clearly appears to be a case of “capitalism with warts,” but capitalism nonetheless. Yes, we have seen excessive investment and corporate governance scandals. But the U.S. has moved quickly to shift resources away from unprofitable firms and industries and to boost accounting and corporate governance standards in the wake of recent scandals. In late October, an influential group of communications analysts and business executives urged the Federal Communications Commission to let failing telecom companies fail, and “fail fast,” instead of trying to prop up businesses that technological progress has made obsolete. Such voices have seldom been heard in Japan or, for that matter, Europe. The ability to tolerate failure and to move on is a key strength of the U.S. economic system that argues forcefully against a scenario of Japanese-style stagnation. So too does phenomenally good U.S. productivity data, that reflects labour market flexibility and improving profit margins.

For investors, how the deflation debate is resolved is likely to be of crucial importance. If the U.S. is headed for 10 years or more of deflation and economic stagnation à la Japan, then bonds are likely to remain the asset class of choice for years to come. However, if you think that the Fed will be successful in fending off deflation and that the U.S. economy will resume a path of more normal growth, equities are likely to trounce bonds in performance in coming years.

We think it's clear: the comparisons to Japan are overdone and misleading at best. Don't underestimate the resilience of the U.S. economy and financial markets. The time to be bearish was a couple of years ago, not now.

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