Is the U.S. Headed for Japanese-style Deflation?

In the wake of a collapsed real estate bubble in the 1990s, Japan experienced more than a decade of weak growth, price deflation and abysmal returns on invested capital. A reasonable question among many investors is whether the U.S. is headed for a similar fate.

Although Japan in the 1990s and the U.S. today share the common scourges of collapsed real estate and stock values and impaired banking systems, we strongly doubt that Japan's experience offers much guidance to the fate of the U.S. economy in coming years. This has to do with some key differences involving both demographics and economic policy responses.

Japan's Demographic Headwinds

The demographic difference is straightforward: Japan faces demographic headwinds to economic growth since its population growth has slowed sharply over the past decade and is currently negative. In contrast, the U.S. continues to experience relatively robust population growth of about 1% per annum (See Chart 1).

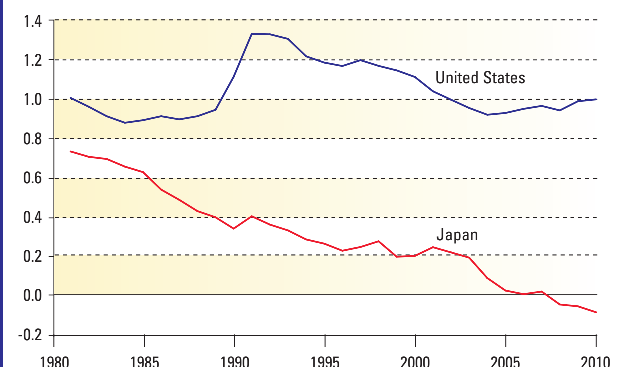
This means that much of the slowdown in Japan's growth over the last decade can be attributed to demographics. When labour force growth stagnates, economic growth has to come entirely from enhanced productivity, which tends to be challenging to achieve with a rapidly aging work force.

The rapid aging of Japan's society may also help explain its policymakers' preference for extremely low inflation, since low inflation helps preserve the purchasing power of retirees who are living on fixed incomes. In his academic days, the current governor of the Bank of England coined the colourful term "inflation nutters" to describe central bankers who pursued price stability regardless of its other costs. It is not clear if he intended the term be applied to Japan's authorities, but it appears to come up frequently in discussions about Japan's monetary policy choices.

Taking Aim at Deflation

Perhaps reflecting the different demographic backdrop, policymakers in the U.S. have been far more aggressive in fighting deflation than were their counterparts in Japan. This is almost certain to continue under the leadership of current Federal Reserve Chairman Ben Bernanke or anyone who might replace him when his term expires in 2010 (Larry Summers?).

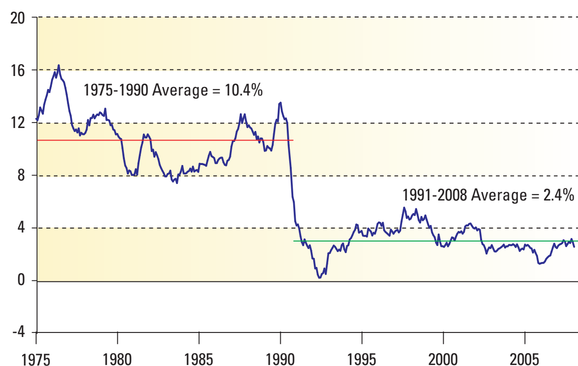
Population Growth is Robust in U.S., Stagnant in Japan (%)



Source: International Monetary Fund/Haven Analytics

Chart 1: Japan's population growth turned negative in 2006 and is likely to remain negative for years to come. U.S. population growth is relatively robust.

Japan's Money Supply Growth Never Recovered After 1990: Year-on-Year Growth of M2 Plus CDs (%)



Source: Bank of Japan, Haver Analytics

Chart 2: After Japan's "bubble economy" peaked in 1990, Japanese monetary policymakers permitted monetary growth to remain anemic for many years.

There are three critical ways that the U.S. monetary policy response differs from what was observed in Japan: (1) The speed of the response; (2) the scope of the response; and (3) the mindset of policymakers.

First, with respect to the speed of the response, the difference is remarkable. The Japanese stock market peaked in December 1989 and land prices peaked around the same time. If one takes that date as the peak of Japan's "bubble economy," it took over six years for the Bank of Japan to establish negative real interest rates – i.e., short-term interest rates that are lower than the rate of inflation. By that time, a deflationary dynamic had become well established, making conventional monetary policy ineffective. When prices are falling, it does not matter if interest rates are low because borrowers become reluctant to take on debts that will be difficult to service if prices keep falling.

As one measure of the effect of Japanese monetary policy, consider statistics on money growth. Based on data from the Bank of Japan, the growth rate of Japan's broad money supply (M2 plus certificates of deposit) averaged 10.4% from 1975 to 1990. However, after the collapse of the bubble, growth in the money supply was allowed to languish for many years, with an anemic 2.4% growth rate from 1991 to 2008 (See Chart 2).

The Bank of Japan did not establish zero nominal interest rates until February 2001 – more than a decade after the collapse of the bubble – and did not move toward quantitative easing of monetary policy until the following month. In addition, fundamental reforms of the banking system were delayed for more than a decade as well, which kept many insolvent banks and their insolvent companies afloat for years. The result was a proliferation of "zombie" companies, which were perpetually on the edge of bankruptcy and in no position to grow.

In contrast, the U.S. stock market peaked in October 2007 and just over a year later, U.S. policymakers have established negative real interest rates, taken the official interest rate to almost zero, and begun a process of quantitative monetary easing. Although much remains to be done, there have already been massive reforms in the structure of the financial system, with all of the nation's major investment banks having either been acquired by traditional banks, allowed to fail, or changed into ordinary banks subject to much more stringent regulation.

Unprecedented Scope of the Fed's Measures

With respect to the scope of the response, there is also almost no comparison. Although the Bank of Japan finally adopted quantitative easing in 2001, the policy was limited to force-feeding the banks with unwanted reserves. Those measures did little to increase lending activity or broad measures of the money supply. As *Financial Times* economics editor Martin Wolf observed recently, "I don't think we can learn anything useful from Japanese experience, because, to put it bluntly, the policy of quantitative easing was so incompetently implemented. There are myriad ways of using the printing press to influence the economy. Among those ways, just about the least effective I can imagine is to pile up reserves in a banking system that is either undercapitalized or has undercapitalized borrowers. This is pushing on a string, to use Keynes' celebrated words."

In other words, not all forms of quantitative easing are created equally. With its numerous "alphabet soup" policy initiatives like the TAF, the TALF, etc., U.S. policymakers are adopting a far broader range of quantitative easing measures that have the potential to be far more effective in preventing a deflationary dynamic from being established – even though they are not likely to bring an immediate end to the recession.

Since the Lehman Brothers bankruptcy filing in mid-September, the Fed has expanded its balance sheet from around US$900 billion to $2.2 trillion dollars and has announced plans that will take its balance sheet to nearly $3 trillion by early 2009 (See Chart 3). Although the Bank of Japan announced that it was embarking on "balance sheet monetary policy" in 1996, its balance sheet continued to consist of mainly Japanese government bonds and it took nearly seven years to post growth in assets of 170%.

In contrast, the Fed's balance sheet will grow by more than 330% in less than six months, with the Fed moving substantially beyond its traditional "lender of last resort" function to establishing itself as a key intermediary in many critical markets. The Fed's recent announcements that it will buy $600 billion in debt and mortgages from government-sponsored enterprises and finance $200 billion in asset-backed securities is another reflection of the massively broader scope of its activities than anything seen in Japan during its "lost decade" of deflation. In fact, it is fair to say that the massive speed and scope of the Fed's balance sheet growth has no precedent in U.S. or global central banking history.

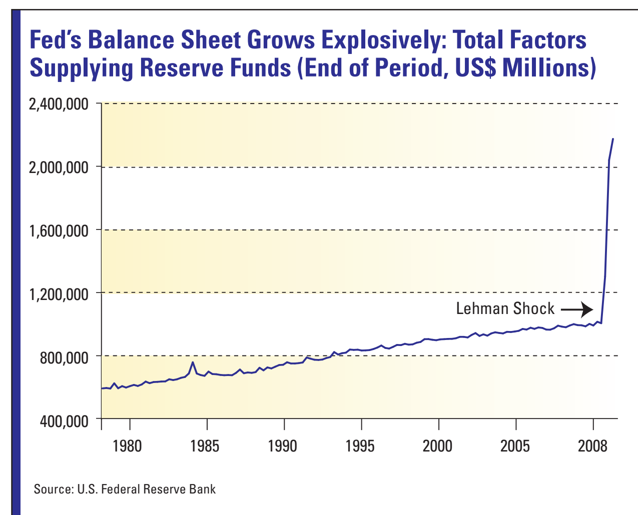


Chart 3: In the wake of the Lehman crisis, the Fed expanded its balance sheet aggressively. With recent commitments, it should more than triple to about $3 trillion by early 2009.

Even the "helicopter money" option would appear to be on the table for 2009. In practice, that would mean using the Fed to finance an increased fiscal deficit that is used to transfer money directly to households in the form of tax cuts, transfer payments or spending on infrastructure.

Anti-Deflation Mindset

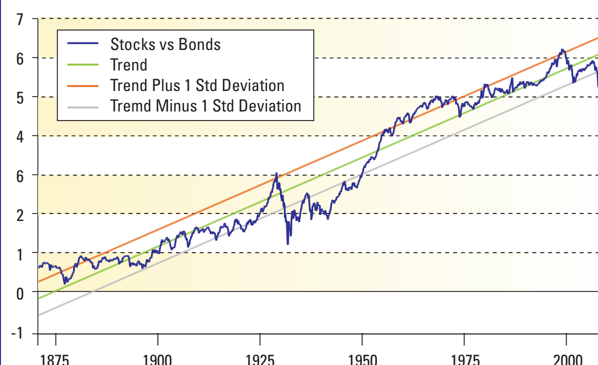
The final key way in which the U.S. policy response is likely to differ greatly from Japan's experience is simply the mindset of U.S. policy makers. By the speed and scope of their actions, they have already made it clear that they intend to fight deflation with every resource at their disposal. That is totally different from the mindset of Japan's policymakers, who moved slowly and cautiously over many years as deflationary forces became entrenched.

As Martin Wolf said, "I believe that the Japanese central bank did not really want quantitative easing to be successful. It was successful in making it unsuccessful. But that is not because it could not have been successful."

In contrast, one need only look at some of the speeches and writings of Fed Chairman Bernanke to understand how determined he is to avoid deflation. In a speech given in November 2002 entitled "Deflation: Making Sure 'It' Doesn't Happen Here," Mr. Bernanke was clear about the power of the printing press:

"U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic

Only in the 1930s Have U.S. Stocks Underperformed Bonds So Dramatically – Logarithmic Ratio of the Total Return of U.S. Stocks vs 10-Year Bonds



Source: Global Financial Data, Trilogy Global Advisors

Chart 4: The only time U.S. stocks underperformed bonds as dramatically as in 2008 occurred during the deflationary 1930s. Avoiding deflation should permit stocks to outperform.

equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

As an academic in 1999, Mr. Bernanke wrote a critique of Japan's deflation challenge that concluded by calling for "Rooseveltian resolve." His comments on Japan at that time may be highly relevant to the incoming Obama administration: "Roosevelt's specific policy actions were, I think, less important than his willingness to be aggressive and to experiment – in short, to do whatever was necessary to get the country moving again. Many of his policies did not work as intended, but in the end FDR deserves great credit for having the courage to abandon failed paradigms and to do what needed to be done."

We believe that most of President-elect Barack Obama's incoming economic advisors would likely agree with Mr. Bernanke's bias toward decisive actions to prevent deflation. With proposals for $600 billion to $850 billion of fiscal stimulus (up to 8% of GDP) apparently under consideration for 2009, it seems highly likely that active monetary policy will be complemented by active fiscal policy as well. We conclude, therefore, that U.S. economic authorities have been and will continue to be far more aggressive in fighting deflation than the Japanese ever were. And that means they will probably succeed.

If the Fed and its counterparts in other major nations succeed in generating economic recovery in the second half of 2009 – which is the clear intent – that should benefit asset classes that have sold off during this year's credit crisis and deflation scare. That includes both investment–grade and non-investment–grade corporate credit and equities alike. The only time U.S. stocks have underperformed bonds as dramatically as has they have recently was in the deflationary 1930s (See Chart 4). If policymakers succeed in avoiding deflation, as we anticipate, that should be a major factor in helping stocks recover lost ground.

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