Is The U.S. Becoming Japan?

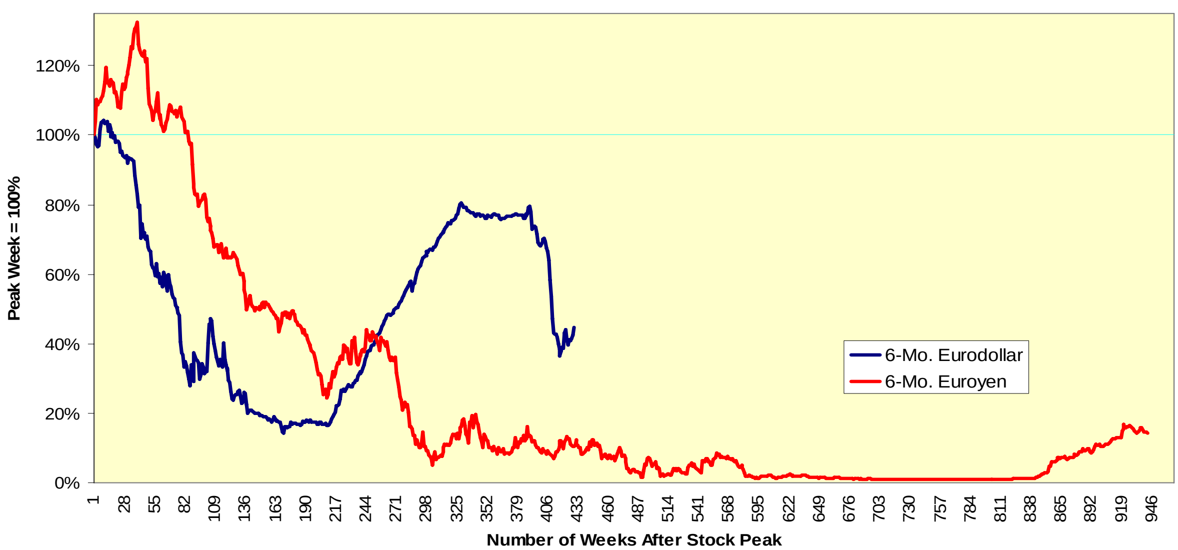
Inevitability lay at the essence of classical tragedy. A protagonist had a flaw, his destiny was predetermined, often by some ethylene-besotted priestess at the Oracle of Delphi, and that was that. We like to believe we have moved beyond such cute gibberish. How many times did you hear in your economic education a replay of some calamity such as the Great Depression or even the Great Inflation of the 1970s was impossible because we had policies in place to prevent such recurrences?

The tragedy was worse if a protagonist was aware of what was in store and had all means available to prevent it. Federal Reserve Chairman Benjamin Bernanke made his academic reputation by mastering the history of the Great Depression and all the policy errors behind it. As an aside, the stock market crash of October 1929, a truly spectacular affair, was only a minor contributor to all that followed, but that is a topic for another day. Bernanke also drew parallels between Japan's various policy errors in the 1990s and the Great Depression; his knowledge led him to argue persuasively for the still-Greenspan Federal Reserve to cut its target federal funds rate to one percent in May 2003 to forestall a Japan-style deflationary recession.

How tragic, then, that Bernanke is at the helm while a course parallel to Japan is underway. Let's compare the paths of U.S. and Japanese six-month LIBOR and ten-year government interest rates with both markets re-indexed to their respective bull market peaks of December 1989 for Japan and March 2000 for the U.S.

We can see in Chart 1 Japan's initial policy error following the collapse of its dual stock and real estate bubbles at the start of 1990. The Bank of Japan kept raising short-term interest rates; it was not until mid-1991 did six-month yen LIBOR fall below December 1989 levels. The Federal Reserve acted far more swiftly and decisively in 2000, and by late 2002 we could see how six-month dollar LIBOR had fallen further and faster than its Japanese parallel.

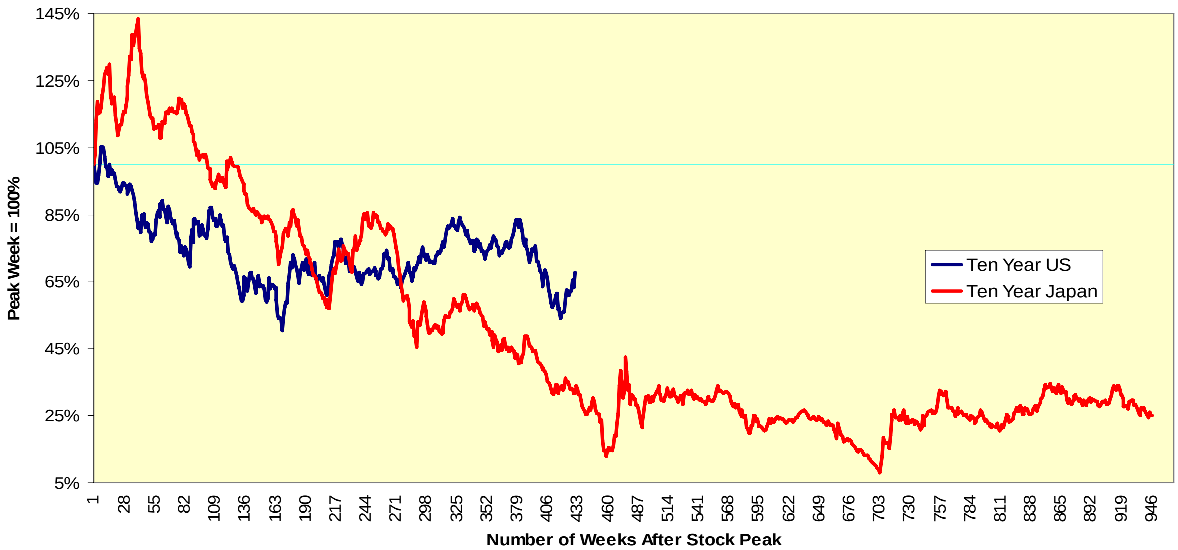
Chart 1: Short-Term Rate Parallels



By mid-2004, the Federal Reserve started to raise short-term rates, and the analogy to Japan appeared broken. But the Oracle had spoken, and by September 2007, the Federal Reserve was in a full-fledged panic mode. Nothing in the Japanese experience was at all parallel to the sudden and violent collapse of short-term interest rates seen between September 2007 and March 2008 in the U.S.

What about ten-year government bond rates? As we see in Chart 2, Japanese bond yields rose sharply in 1990 before commencing their long fall. U.S. government bond yields fell quickly in 2000, and once again had fallen further and faster than did their Japanese counterparts by 2002. Interestingly, they never rose that much after they bottomed in 2003, and by late 2007 were falling at a pace faster than Japanese yields did at a similar point in time.

Chart 2: Long-Term Rate Parallels



Japan and the U.S. also find themselves in the unenviable position of having the two worst-performing stock markets relative to the Morgan Stanley Capital International World Free index since its inception in May 2001. The length and depth of Japanese underperformance is shocking; by February 2008, the Nikkei 225 was at levels first reached in July 1985. That is a quarter-century of going nowhere; we should note the Dow Jones Industrial Average did not recover its 1929 high until 1954.

No American reading this should feel too smug; it is quite likely you will not see the NASDAQ Composite reach 5,000 for at least a similar period, and the total return on the S&P 500 since March 2000 has been about one-twentieth of that on three-month Treasury bills.

It Should Not Be

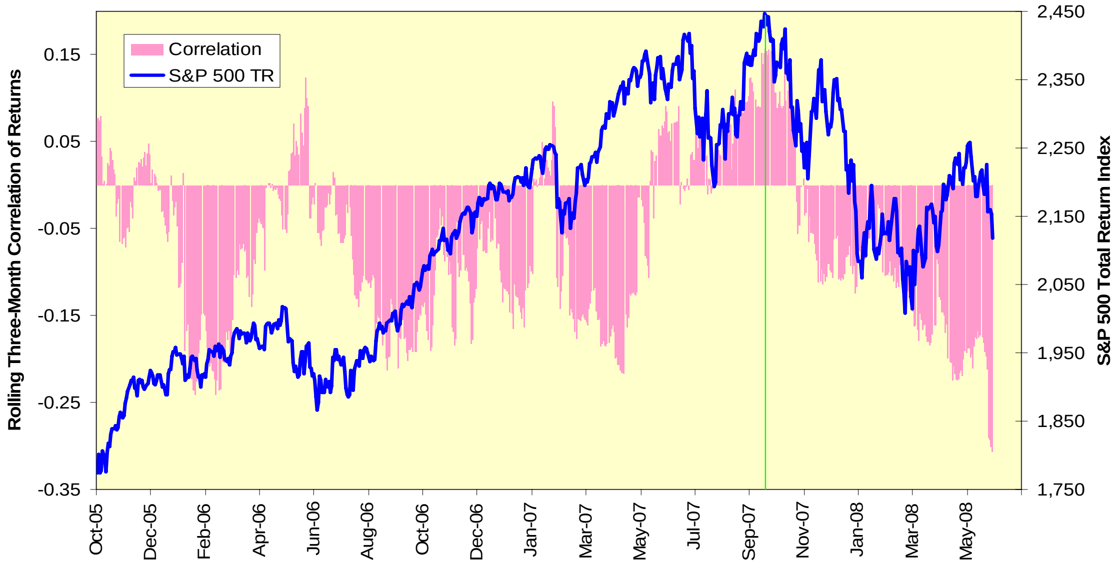
There are a number of reasons why these parallels should not exist:

- As mentioned above, Japan's dual bubbles popped simultaneously; our stock and real estate markets peaked in 2000 and 2006, respectively;
- Japanese business culture tried to prevent banks from writing off bad loans and consolidating weak banks into strong banks; U.S. banks began to write off bad debt quickly and in multi-billion dollar chunks by late 2007;
- Japan's core export business faced withering external competition, first from Taiwan and South Korea and later from China, and several of its key Asian customers got clobbered in the 1997-1998 Asian crisis. The U.S. not only encountered no such losses, but was the engine of global growth between 2002 and 2007;
- Japan raised its national sales tax in 1997; the U.S. lowered taxes in 2003;
- Japan's national debt as a percentage of GDP is almost two and one-half times as great as the U.S. national debt;
- Japan remained vexed with deflation even after its various rate-cutting operations; by early 2008, it was apparent the Federal Reserve's rate cuts were contributing to a surge in inflation; and
- Japanese are fanatic savers; Americans are fanatic spenders

The Chinese Connection

If China's ascendance as a global economic powerhouse derailed Japan, are there any parallels to the U.S? Yes, and in a most roundabout fashion. Just as Japan raised its national sales tax right in front of the Asian crisis, the U.S. imposed a consumption tax on itself in the form of a stronger Chinese yuan. China had been allowing the yuan to revalue slowly from July 2005, but under pressure from U.S. protectionists, it allowed a much faster revaluation starting in October 2007, marked with a green line in Chart 3. October 2007, as fate would have it, was when it began to dawn on many the mortgage-related credit crunch was not a minor and contained macroeconomic problem.

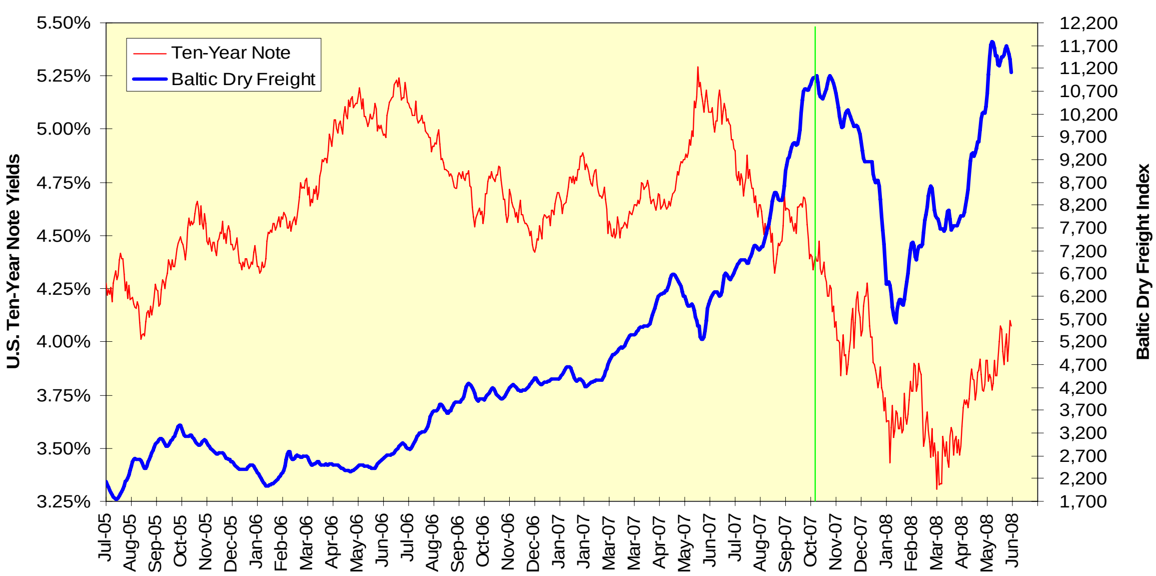
Chart 3: U.S. Stocks And Yuan During Revaluation Era



The effects of revaluation, a de facto tax on imports, were immediate and negative. Not only did the U.S. stock market break from a nominal all-time high, the rolling three-month correlation of returns between the yuan and U.S. stocks turned negative. In fact, the correlation of returns between the yuan and U.S. stocks had been negative but for a brief window between June-October 2007 since revaluation began in 2005. This was, per our theme of classic tragedy, a self-inflicted wound.

Moreover, the revaluation of the yuan hurt China and China's suppliers, too, at least initially. The Baltic Dry Freight index measures demand for bulk carriers of cargoes such as cement, ores, coal and other commodities; in reality, the index is most sensitive to cargoes going from Australia to China. Once the accelerated revaluation of the yuan began in October 2007, the Baltic Dry Freight index plummeted, as seen in Chart 4. Combined with the financial crisis and the Federal Reserve's aggressive rate cuts, this sent U.S. ten-year note yields down to levels not seen since 2003. Both freight rates and ten-year note yields rebounded after the March 2008 rescue of Bear Stearns.

Chart 4: Pain From The Rising Yuan



Insisting on a more expensive currency from one of your major suppliers is a protectionist policy error affecting both the U.S. and China, and in another tragic parallel, it is similar to the disastrously high Smoot-Hawley tariff of 1930.

The U.S. and others had badgered Japan to revalue the yen throughout the 1980s, and the Japanese eventually acceded in an effort to cool their domestic economy and rising inflation. They raised interest rates and tightened lending standards, just as China began doing in 2007. In both cases, the government had to engage in what is called currency sterilization. They printed their own currency, bought dollars from their exporters and then issued bonds to soak up their domestic currency.

The result in Japan was a deflationary recession. China has yet to reach that point, but it clearly is at risk of making its own policy error via its continual tightening of credit. If the Chinese economy goes into recession, the world will notice it for sure.

And what might be the final tragic outcome for the U.S? If Japan tried to stimulate its own economy through ever-lower interest rates until such time as zero was not low enough and then began a policy of “quantitative easing” in 2001, the U.S. might do the same. In the Japanese case, their monetary policies led to the yen carry trade, a global financial engine where the yen was borrowed, sold and then lent elsewhere. Everyone but Japan benefited. The final parallel would be for a dollar carry trade to flourish, one where excess dollars finance growth everywhere but in the U.S.