Inflation Lessons From Japan

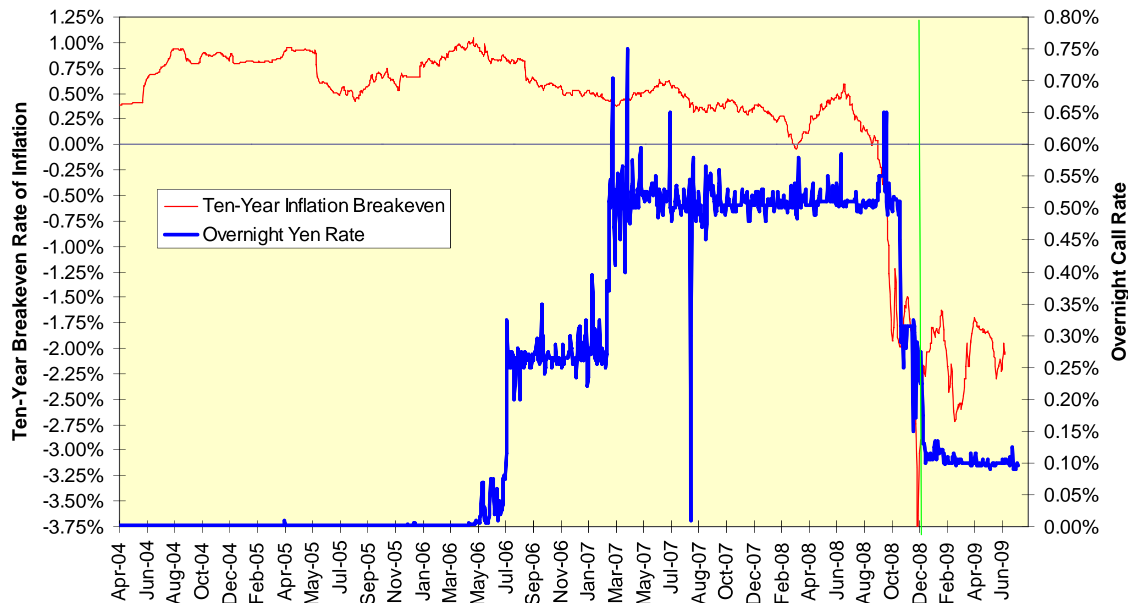
Japan has had minuscule interest rates for nearly fifteen years; it went to a zero interest rate policy in February 1999 and quantitative easing in March 2001. After a brief and failed attempt to raise interest rates and end quantitative easing in 2006 and another brief foray in that direction in August 2007, the Bank of Japan sat on the sidelines until December 2008, when it resumed quantitative easing on the very day the Federal Reserve dropped the target federal funds rate to 0-0.25%.

With all of this printing of money, Japan still does not have an apparent inflation problem. Note the word, "apparent." If we expand our definition of inflation to include asset valuations in addition to price indices, we can find the missing inflation easily: It was transmitted from Japan to the rest of the world, emerging markets especially, via the yen carry trade. The same carry trade mechanism has operated for other low-interest currencies, including both the dollar and the Swiss franc.

Money For Nothing, Downticks For Free

First, while we can debate whether we are in inflation or deflation at present, a pretty incredible statement to make, or whether if we are in deflation now we are cruising for an inflationary bruising later, the issue is settled in Japan. Their year-over-year CPI numbers are -1.1% and -1.5% for the general figures and Tokyo region, respectively, and their most recent ten-year breakeven rate for their inflation-linked bonds is -2.04%. Moreover, while our dive in TIPS breakevens was a short and sharp affair at the end of 2008 and early in 2009, their breakevens have not recovered at all.

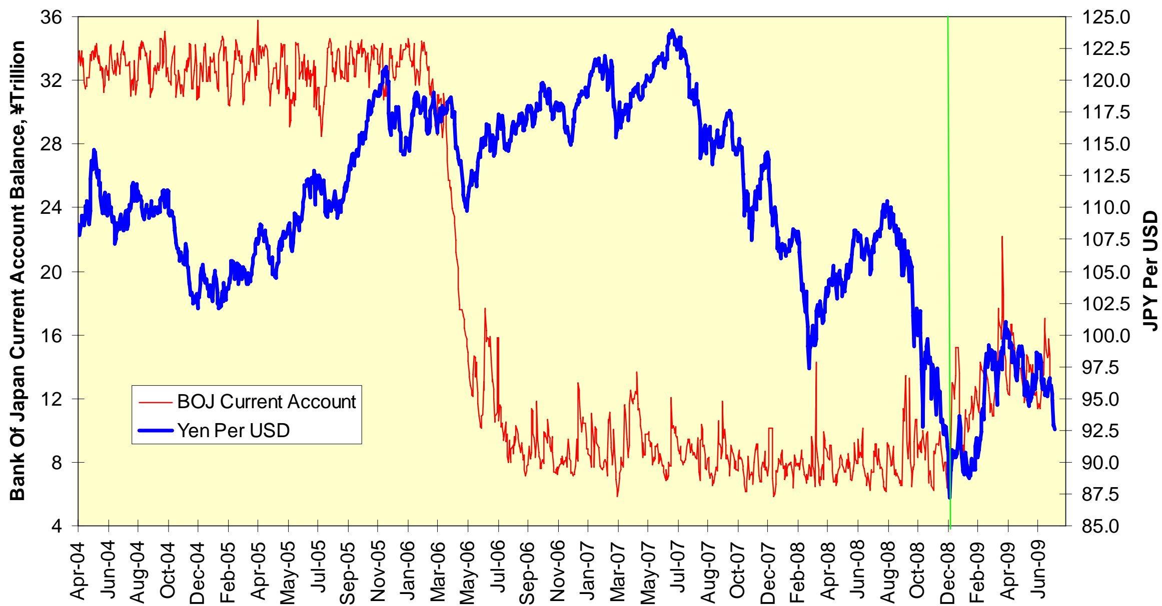
If we map their ten-year inflation breakeven against the overnight yen rate over the past five years, we see a response in the call rate to the drop in inflation expectations in late 2008, but we see no rebound in inflation expectations from cheap money later. The December 2008 re-introduction of quantitative easing is highlighted here and subsequently with a green vertical line.



The Yen Link

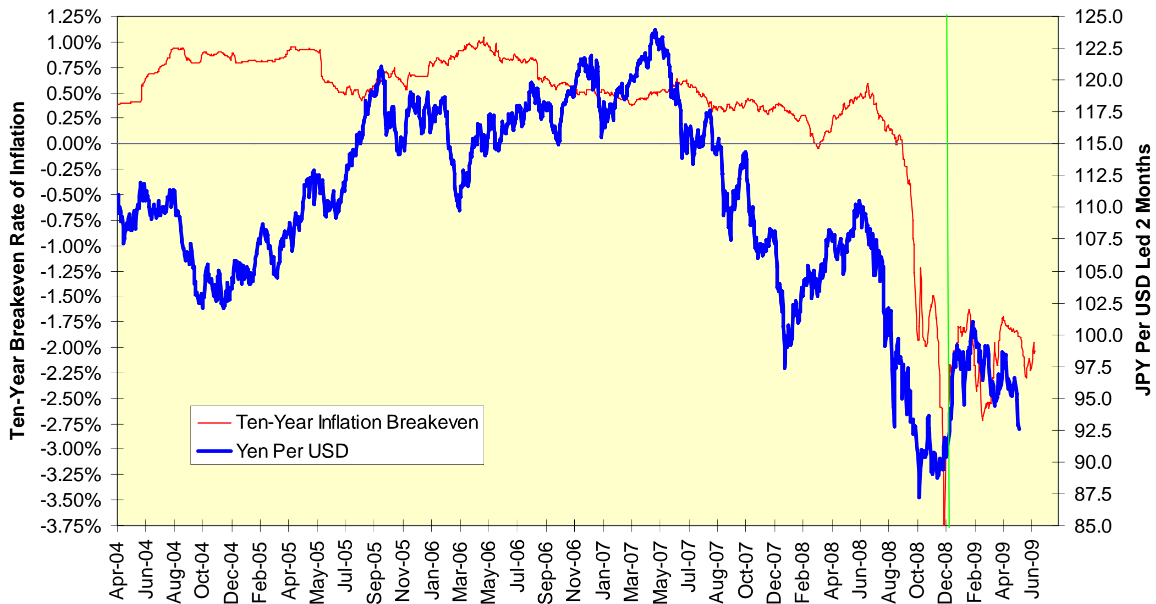
The quantitative easing propensities of the BOJ can be tracked by the excess reserves or "current account balance" they leave in the Japanese banking system, their mid-2006 withdrawal of liquidity is quite visible in the chart below. A direct link between this quantity and the exchange value of the yen began in December 2008. The yen weakened from about 87.5 to the dollar up to over 100 as the balance grew, and then rallied sharply last week as the current account balance fell and yen carry trades were being unwound globally. The subject of the euro/yen cross-rate was addressed here in December 2008; for the sake of brevity, this trade does not cause global risk reduction but rather is a perfectly circular coincident indicator of global risk appetite.

The Yen And Japanese Excess Liquidity



Japanese inflation breakevens lead the yen by about two months. If the problem of deflationary expectations worsens in Japan, we should expect the yen to strengthen over the summer. Given the BOJ's unwillingness or inability to ease further, we should this will be the case. If the 2006 experience is any indication, the very prospect of a stronger yen will prompt those who borrowed it to sell their yen-financed assets and repurchase their borrowed yen before they strengthen further.

Declining Inflation Expectations Lead The Yen Higher



Looking Forward

If this sounds like an unwelcome recipe for another financial panic, it unfortunately is. Our friends in Tokyo must be pretty frustrated at all this; they spend years trying to break a deflationary psychology through increasingly aggressive steps of low interest rates and monetary creation and have failed.

The implications for us are scary. Whether I agree with the Bernanke policies or not, I must agree the Federal Reserve studied what they considered to be fatal delays by the Bank of Japan in easing during the 1990s and moved

toward both zero interest rates and quantitative easing at a much earlier point in the cycle. The results have been marginally better; as I note, we can debate whether we are in deflation or not.

What if we measuring inflation improperly by not including global asset valuations in the mix? Even with some recent downturns, many emerging markets are up very smartly this year: Brazil is up 52% in USD terms, Russia 32%, the Hang Seng 23% and India nearly 40%. The entire MSCI Emerging Markets Free index has a USD total return of 31.9% in 2009. Is this based on sober earnings valuations or is it too much money chasing too few goods, the classic definition of inflation?

If the Federal Reserve and other central banks continue to focus only on price indices, they will convince themselves well after the fact inflation is not a problem. And as long as the banking system remains impaired, the securitization markets remain torpid and monetary velocity continues to decline, the expansion of the U.S. monetary base will not produced the explosion in available credit characteristic of inflation.

The central banks continue to live in a textbook world, "their father's Oldsmobile," where they controlled the money supply via reserves in the fractional-reserve banking system. That world ended a quarter-century ago with the dissolution of the Regulation Q ceilings on time deposits. They have no mechanism for assessing the total price-plus-assets consequences of their actions. As a result, they will continue to do what the Bank of Japan has continued to do, and that is more of the same.

Einstein defined insanity as doing the same thing and expecting different results. Keynes responded to a critic who questioned his changed opinion by responding, "When the facts change, I change my mind. What do you do, sir?" Had Keynes ever posed this question to an Einstein running the Bank of Japan, the results would have been entertaining, which is more than we can say for the train wreck once again looming on the horizon.