Japanese Past Performance Predicts Future Results

There are two aspects of human existence where the correct answer is supposed to be, "It doesn't matter." As absolutely nobody believes the second, let's focus on the first, and that is whether past performance can be used to predict future results.

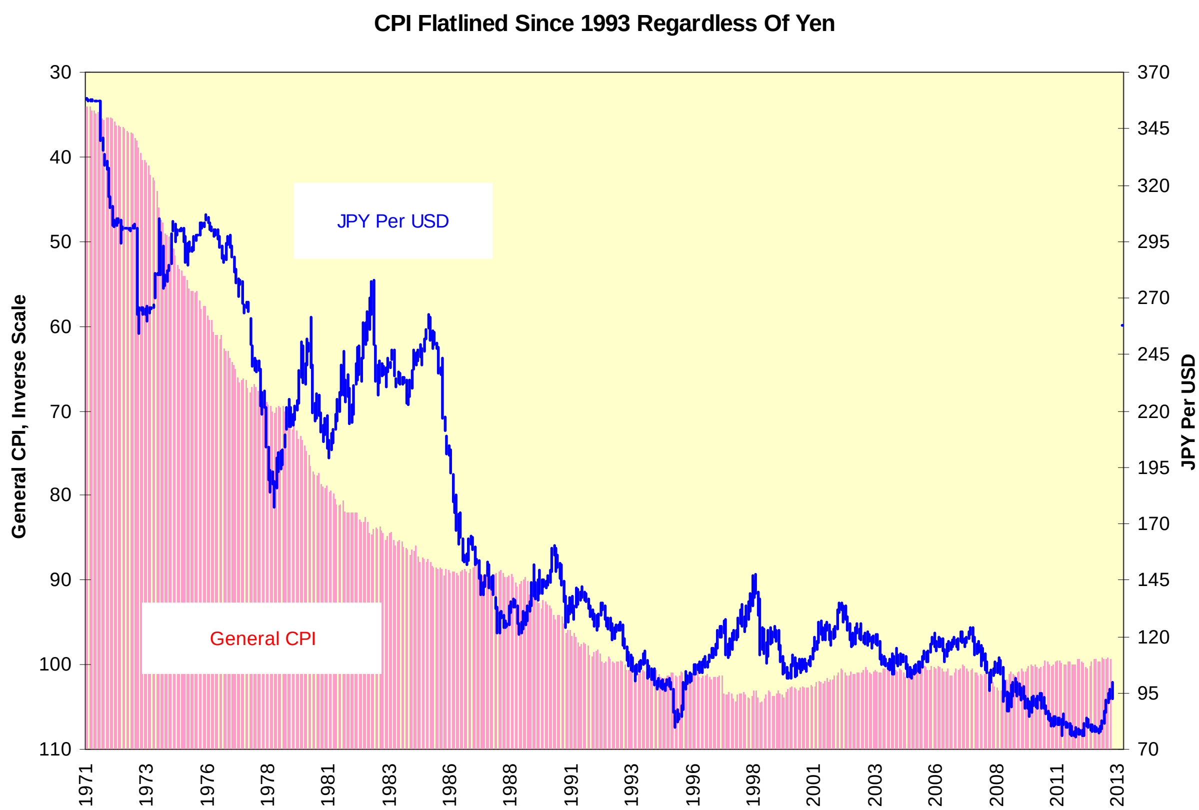
If the answer was an absolute, "No," we could and indeed should abandon all forms of technical analysis, managerial performance analysis and the ocean of statistical minutiae supporting industries ranging from Big Data marketing to fantasy football. But while every study of investment management has shown chasing last year's winning trades and last year's hot managers is not a good idea that does not mean the forces of mean-reversion will rescue every bad idea.

Japanese Policy: Repeat Regardless Of Results
Blue Oyster Cult understood the concept perfectly in their 1977 camp classic, Godzilla:

"History shows again and again
How nature points out the folly of men"

And yet policymakers in Tokyo, the large angry lizard's tableau, have undertaken a policy to break deflationary forces in Japan via two channels, massive expansion of the monetary base and a deliberate devaluation of the yen. Neither mechanism will work going forward for the very straightforward reason they have not worked in the past.

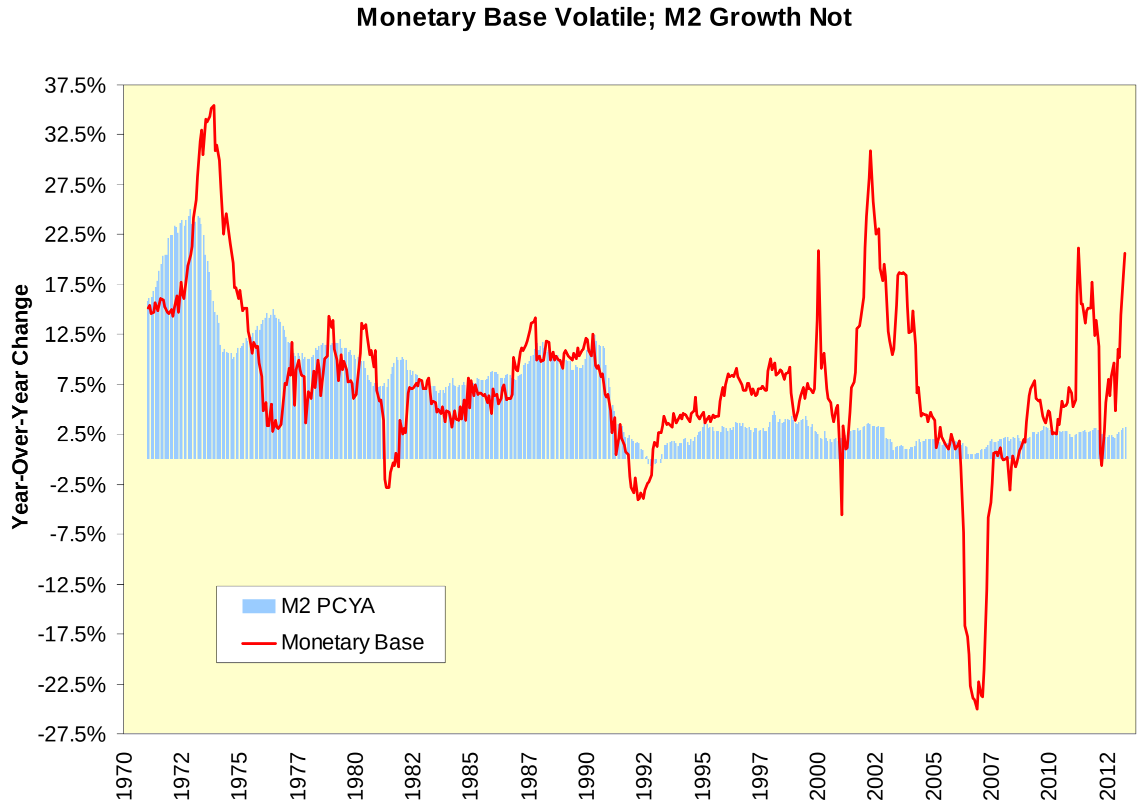
Japan's general consumer price index has been incredibly constant since 1991 regardless of the yen's ups or downs. It has ranged from 98.2 to 104.5 since October 1991 and has increased at an average annual rate of -0.028%. The U.S. CPI, in contrast, has increased at an average annual rate of 2.423%. The yen's long rally between 1971 and 1995 did little to arrest a rising CPI in Japan; then an average annual gain in the yen of 4.84% was matched by an average annual CPI increase of 5.12%.



Japan was part and parcel of the global inflation of the 1970s, and its rising yen was part of its leading role in global trade at that time. No one suggested then what Japan needed to break inflation was an even more rapidly appreciating yen.

Off Base
What about Japan's plan to expand its money supply by expanding the monetary base? Here again I defer to the data; the rate of M2 growth in Japan after 1991 peaked at 4.9% in February 1998. Year-over-year changes in the monetary base, which includes cash plus current account balances at the Bank of Japan, has ranged from 30.9% in April 2002 to -25.1% in November 2006.

The fractional-reserve banking mechanism for converting the monetary base into credit is even more broken in Japan than it is in the U.S. or the Eurozone. All of the Bank of Japan's lurching back and forth may have given it the sensation of control or even some other sensations, but it had little effect on the rate of change in the money supply.



Given the track record of global central banks in arresting the inflation of the 1970s, we should be grateful they have been unable to create higher levels of inflation. Here is one area where past incompetence probably predicts future incompetence: Why a group of institutions who failed collectively at arresting deflation, at foreseeing and preventing asset bubbles and their bursting and at providing macroeconomic stimulus via money-printing should be trusted to arrest any inflation they may yet ignite is beyond me.