THE CASE FOR DEFLATION: CENTRAL BANKS & PRINCES OF THE YEN

DR. JAMES THORNE

MARKET INSIGHTS - AUGUST 2021

"Central banks have the power to create economic, political and social change."

— *Princes of the Yen*, 2003.

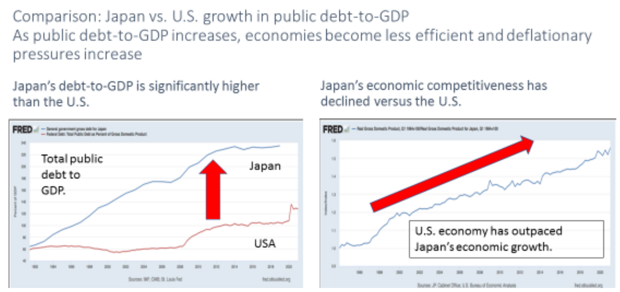
In his book, *Princes of the Yen*, Richard Werner warns us to never underestimate the central bank's ability to achieve its agenda.[1] He follows the actions of the Bank of Japan in the post-WWII Japanese economy, emphatically noting that central banks can expand their balance sheets without inflation. Instead, it is the supply of credit to Main Street and the willingness of banks to lend that create inflation. This was evident in the late 1980s, when the Bank of Japan's "window guidance" forced money center banks to lend to Main Street, creating an inflationary bubble that would precede the stagnant "lost decade," in order to force structural change.

Today, the media reverberates with talk that an inflationary era is now upon us. However, as we emerge from an unprecedented year, let's not forget that inflation is a lagging indicator and current figures have been measured against a period in which economies were completely shut down due to the pandemic. Instead, we suggest that deflationary forces have not gone away, and, as in Werner's view, the actions of the central banks will pave the road for possible inflation — or deflation/disinflation[2] — as we look ahead.

This Time is Not Different: Deflationary Forces Still Exist

For many decades, we have been sheltered from any threat of significant inflation. Perhaps the turning point occurred back in 1997 when the equilibrium level of growth for the U.S. economy began to slow. Before 1997, the economy grew at an approximate rate of 2.2% per year. After 1997, the growth rate slowed to 1.7%.[3] Many suggest that the excessive level of debt in the economy had reached its tipping point, and incremental debt had now resulted in a diminishing rate of economic growth. As the debt-to-GDP ratio increases, the productivity or effectiveness of debt in increasing GDP declines. In fact, a similar situation occurred in many nations globally, some more pronounced than others. A period of disinflation, and even deflation, started to grip many nations, starting in Japan and spreading to Europe.

As Public Debt-to-GDP Increases, Deflationary Pressures Increase



Traditional monetary theory suggests that all one needs to do is lower interest rates and economic growth will accelerate. After all, basic business cycle theory says that when interest rates tend to be low, production increases, inflationary pressures increase and the economy grows. Policymakers in Japan started the trend by taking interest rates to the zero bound and the rest of the world followed. However, the major western economies would soon realize that they had entered a unique phase in which traditional monetary policy had lost its effectiveness. Simultaneously, the world was rapidly evolving from analogue to digital and globalization had ushered in a wave of cheap goods from Asia. All of these forces combined to create an intense deflationary cocktail.

Actions of Central Bankers: Until Now, Deflationary

When Ben Bernanke became Chairman of the Federal Reserve in 2006, he was known as an expert on the effects of the deflationary forces that high levels of debt had in

---

[1] "*Princes of the Yen: Japan's Central Bankers and the Transformation of the Economy*," Richard Werner. Routledge, 2003, page 46.

[2] When we refer to deflation, we suggest that it may be a more temporary period or "disinflation." *Disinflation: the temporary slowing of the pace of inflation. Deflation: a general decline in the price level of goods and services.*

[3] St. Louis Federal Reserve Data.

causing the so-called lost decades of growth. Yet, he was unable to implement what he suggested was the optimal policy in dealing with the debt deflation crisis of 2008. He engaged in fits and starts of quantitative easing (QE) to increase the money supply in the economy.

However, QE in practice does not increase the money supply in the real economy, it only changes the composition of the assets. With QE, the central bank buys a bond and that collateral changes to cash that must be reinvested. QE leads to asset price inflation, but not inflation on Main Street. And, contrary to what we hear from many economic pundits, asset price inflation does not affect all assets equally. A simple exercise of dividing the price of assets by the size of the Federal Reserve balance sheet reveals that the assets preferred by Millennials benefit the most.

The Surprising Effects of Quantitative Easing on Different Assets

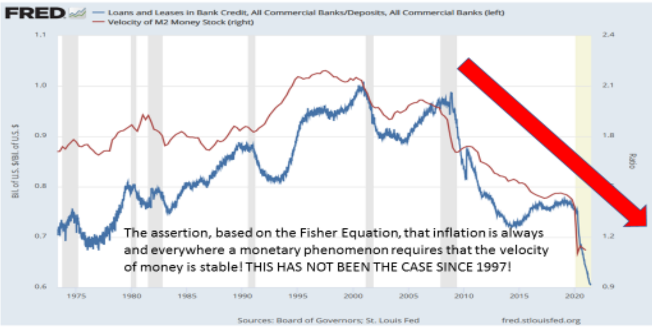
In fact, money center banks, through loan creation, are the ones who really increase the money supply to Main Street, and who can potentially create inflation. Simply put, this loan creation moves money quickly through the system (a higher money velocity) to businesses who borrow and consumers who spend.

It wasn't until the threat of the current pandemic that significant central bank intervention was again needed. Chairman Powell was forced to take a more rigorous approach to counter the economic impact of the pandemic. Unlike Bernanke, he proactively responded to the deflationary crisis with aggressive monetary expansion that was front-end loaded, not the incremental quantitative easing approach of the past. In March 2020, he invoked section 13-3 of the Federal Reserve Act, to work in concert with the U.S. Treasury, and implemented an emergency lending program. While the policy response to Covid-19 resulted in economic recovery and significant appreciation of certain asset prices, it massively expanded the level of debt in the economy and created longer-term deflationary forces. The Fed's Main Street Lending Program — which had the potential to issue up to $600 billion to Main Street — ended up lending only a very small fraction of these funds, around just 3%.[4]

Why have the deflationary forces remained dominant? Indeed, the monetary policy transition mechanism is broken. In order to create inflation, banks must increase their lending, but recent earnings results from the money center banks suggest that loan growth is not accelerating. Instead, what they have tended to do is buy back stock and increase dividends. As Mark Carney stated in a recent speech at the BIS,[5] banks are not an "*ends*" in themselves but a "*means to an end*." The banks are the critical transition mechanism to get money and credit to Main Street.[6] One might even suggest that there appears to be a relationship between that lack of loan growth and the velocity of money.

[4] bloomberg.com/news/articles/2021-02-09/fed-s-main-street-program-ends-with-just-17-5-billion-in-loans.
[5] Mark Carney, "*The art of central banking in a centrifugal world*." Presented at the Bank for International Settlements, June 28, 2021.
[6] Bank of England: *Money Creation in the Modern Economy*. Quarterly Bulletin, Q1 2014.

Inflation: Cannot be Dominant when Velocity of Money Declines



Milton Friedman once famously said: "*Inflation is always and everywhere a monetary phenomenon*." But Friedman's assertion was wrong. Inflation has no foundation when the velocity of money is rapidly falling. Otherwise, Japan would not have been marred by decades of deflation.

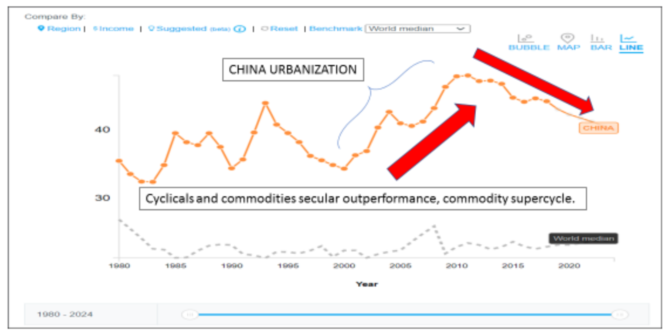
China: Continuing Deflationary Forces

The deflationary forces will continue to be fueled by China. It is very likely that as the global economy continues to open, cheap goods from Asia will eventually recapture most of the market share lost during the pandemic. The threat of supply chain nationalization globally, away from low-cost China, is highly unlikely.

The urbanization of China ushered in a secular growth period where value and commodity stocks benefited from the strong cyclical forces that were unleashed. The investment export-led growth model that allowed China to become a middle-income economy was revisited in 2020 when massive credit creation financed commodity-intensive investment and real estate projects, expanding areas in the Chinese economy that already exhibited overcapacity. We expect these policy measures to reverse, leading to a possible growth scare as witnessed back in 2010. China has been slowly evolving their economy to focus on consumption and high value-added manufacturing. More recently, the Chinese Communist Party has made it clear that Chinese tech companies need to focus on compliance, suggesting that the phase of hyper-growth for these companies is over.

Few recognize that this structural shift in China's growth also ushered in a commodity bear market. Without a large secular theme that is financed, commodity prices could eventually fall back to pre-Covid-19 levels. As the evolutionary process in China continues, investors need to keep an eye on the massive credit bubble that funded the many years of expansion, as well as supported China through the pandemic. Typically, as a nation evolves from having a low-income to a middle-income economy, a credit crisis occurs. This has yet to happen in China. With US$50 trillion in debt, and growing, the popping of China's debt bubble would have significant global ramifications. But for now, China's efficiency of debt is deflationary and its growth is no longer highly commodity intensive.

China: Investment as a Percentage of GDP



WORLD BANK

Looking Forward: Inflation or Deflation?

We suggest that the longer-term path for inflation — or deflation — will be dependent on the actions of the central banks. As they say, do not fight the Fed; but what will the Fed do? The key question remains: will policymakers continue to be proactive as they have demonstrated with their policy response to the Covid-19 pandemic or will they revert to the old incremental reactive policy stances? Over the past few months, we've heard contradictory statements coming from Fed officials.

Our long-term thesis still holds. However, it is dependent on the future actions of central banks and politicians to act on their proclamations to remedy today's twin existential threats: income inequality and climate change. This includes a dedicated focus on building a new green economy. We are anchoring off the post-WWII reconstruction period, where central banks and policymakers worked in tandem to rebuild and retrain the workforce of the western economies. Modern monetary theory (MMT) will be used to finance this reconstruction period. The "build back better" inclusive green economy would be akin to the urbanization of China, providing a secular growth impetus that would ironically be commodity intensive and financed out of deficits as policymakers embrace MMT. But given the reactionary and entrenched forces that are focused on deficits, a period of deflation prior to a period of any significant growth should be expected.

At the same time, we will not be naïve by neglecting to recognize that the great promises of a new regime can often fail to materialize. To be clear, if we do not see these significant changes in our economy and society and we instead maintain the status quo, inflation fears will be misplaced, forces of secular stagnation will be stronger and interest rates will continue to fall. To wit, the populist forces will continue to strengthen, social unrest is likely to intensify and the Federal Reserve would have made a baseless promise about entering a new era of monetary policy focused on social issues.

Where to for Investors?

As we enter the second half of 2021, investors should expect economic growth, inflationary pressures and monetary stimulus to slow. Remember that the common measure of inflation is the annualized percentage change in the general price level. Basic math suggests that by this measure, the inflation rate should decline as we lap the deflationary months of 2020 when the global economy was completely shut down. We believe that most of the reflation trade is over and that we have pivoted from early cycle to mid cycle.

With growth, inflation and interest rates all declining, will we get the policy response needed to counteract these structural deflationary forces enhanced by the response to Covid-19? Richard Werner reminds us that "*central banks hold significant, yet little understood, powers*."[7] Investors need to understand that money is not just a neutral medium of exchange, for the creation of money by the central bank is not neutral. It can be earmarked investment credit, stimulating productive investment and economic growth; or, it can be speculative credit, forcing asset and land prices up and resulting in a subsequent misery-creating recession, with the possibility of the central bank not engaging in necessary credit creation that can end these types of depressions.

Deflationary forces are still strong and need to be respected. With the velocity of money continuing to decline, the expansion of the central bank balance sheet is not in itself inflationary. Banks need to lend to Main Street for this to happen and, given the current earnings release by money center banks, this is not happening.

As such, portfolios need to be prepared for potential deflationary episodes, as well as potential inflationary episodes. As always, flexibility and proactive rebalancing continues to be key in the ever-changing investing world.

James E. Thorne, Ph.D.

[7] *Princes of the Yen*, Directed by Michael Oswald. Queuepolitely, 2014 (at 1:28:38).