

Quarterly Critique

1 July 2009

Markets for a wide range of assets have risen in the past quarter. US leaders such as Obama and Bernanke have coined the phrase 'green shoots' to convey a view to the public that government stimulus is positioning economies around the world for recovery. Of course, people in government are unlikely to subscribe to the notion that their intervention may be counterproductive. In Australia, there is much backslapping around the handouts that have boosted the retail sector, with David Jones notably issuing a significant profit upgrade. But is it responsible government to take on debt to finance consumption by voters, when too much consumption is part of what got us into this mess?

Australia has been the lucky country to date, outperforming its OECD counterparts. One might think that somehow our economic structure is superior, not suffering the debt excesses of many other countries. Our financial system is considered more robust than most, although this has not been without government support in the form of deposit and funding guarantees and a ban on short selling.

Interestingly, our banks typically need to fund about half of their loan books from wholesale sources as deposits only fund half the level of advances. This is reflective of Australia's lack of saving, also expressed through our external deficit. By contrast, HSBC and Standard Chartered, both of which have a strong presence in a variety of emerging markets, have deposits *in excess* of their loans (around 125%). Surely emerging markets, which are younger in their economic

development progression, can more sensibly borrow to fund development. People in more advanced economies have come to believe it is acceptable to keep expanding their borrowings, even though much of it simply funds consumption rather than an investment that is likely to generate a return to repay the debt.

The financial system has come to dominate to such a degree that many institutions are considered "too big to fail". This has led to some questionable outcomes. After ploughing taxpayer money into US investment banks there was public outrage at the bonuses being paid. Predictably, it seems employees will be looked after without the public being explicitly informed – anecdotally many local employees at Citigroup and Morgan Stanley have received base pay increases of about 50%.

The possibility of a renewed bout of inflation is getting a lot of press. Merrill Lynch's notorious internet stock analyst during the tech bubble, Henry Blodgett, opined in a June 10, 2009 *Business Insider* column titled "Here comes Hyperinflation" that "Arthur Laffer [has joined] the chorus of economists predicting that the Fed's massive stimulus will lead to hyper-inflation." The US based National Inflation Association has recently posted a video "documentary" called "Hyperinflation Nation" featuring Jim Rogers and other luminaries on YouTube. Within 36 hours, the clip had twenty-five thousand views.

The gold price should at least double, according to many gold bugs. People like to compare the

stock market index (say the Dow Jones Industrial average) to gold. They cite how few ounces of gold the stock market index (in \$ terms) used to buy, and how many it now does, suggesting some sort of necessary reversion to a supposed mean level. The infatuation with gold is reflected in a new public fascination with the metal. A German entrepreneur intends putting vending machines selling small gold coins in railway stations in central Europe to satisfy the public's demand for gold. This demand will no doubt be fuelled by advertising that suggests hyperinflation is nigh, and hence the commuter's only hope of being able to pay for his train ticket and other expenses in the future is to have some shiny gold under the mattress. Naturally, for the privilege a premium of about 30% to the market price of gold will be charged!

In my experience, when the proverbial 'man on the street' develops an interest in a particular financial asset, it is time for conservative investors to look for an exit.

Prices do not appear to be increasing very much, so why worry about inflation? It was announced overnight that Euro-area headline inflation went negative for the first time ever, at -0.1% in the year to June. Interestingly, the bond market is not particularly concerned about the coming hyperinflation we are being warned about. Yields on thirty year US government debt have only moved up modestly to 4.4% from very low levels, despite the prospect of ballooning supply. Often thought to reflect inflation concerns, the gold price itself is well below the highs it reached in March 2008. Reported inflation figures in many countries are negative, particularly when fuel and energy costs are included. Although these are high by historical standards, the oil price is half its bubble peak level. Using figures from the Economist magazine, consumer prices fell in the year to May or June in countries as diverse as the USA, Japan, China, France, Thailand and Taiwan.

Paul Krugman, with whom I would normally not agree, noted on May 28 in the New York Times:

"Much of the current inflation discussion calls to mind what happened during the early years of the Great Depression when many influential people were warning about inflation even as prices plunged. As the British economist Ralph Hawtrey wrote, "Fantastic fears of inflation were expressed. That was to cry, Fire, Fire in Noah's Flood." And he went on, "It is after depression and unemployment have subsided that inflation becomes dangerous.""

The reason for the inflation fears is that central banks around the world have embarked on 'quantitative easing'. In effect this is a way of printing money, usually by buying government debt rather than requiring the private sector to do so. This expands the money base, and dogmatic monetarists would hold that expanding the monetary base is tantamount to unleashing inflation.

The US Federal Reserve president, Ben Bernanke, appears to believe that his predecessors were somehow inept and allowed the Great Depression to happen by not easing monetary conditions sufficiently. Ergo, when he provides a flood of liquidity he will save the day.

Since deflation is widely considered to be devastating for economic performance, a little inflation is thought to be a good thing. Of course, this may reflect a flawed notion of causation; it could be that severe economic weakness is accompanied by deflation rather than deflation itself being the cause of woe.

I believe the authorities have failed to understand the problem, in part because they fostered it. They seem to think that the bursting of the credit bubble they nurtured with easy monetary policies and lax financial regulation can be solved by encouraging people to borrow again. There seems to be a Keynesian notion that what the world lacks is sufficient demand, leading to populist

handouts and stimulus packages. This is reinforced by feted economists such as Paul Krugman, a Nobel Economics Prize winner, who blames our current parlous state, at least in part, on a savings glut, especially in Asia. The idea that savings allow for investment in the capital stock of nations, fostering sustainable long term growth, has been discarded in an orgy of consumerism financed by debt.

Armed with the flawed intellectual premise that recent high levels of consumption were appropriate (however parlously funded), governments seem intent on restoring these spending and demand levels. One of the ways to do this is to discourage people from saving and to encourage them to spend. While people are naturally trying to reduce their indebtedness from exceedingly high levels, the authorities are trying desperately to counter this with low interest rates (discouraging saving and encouraging borrowing) and possibly by fanning inflation.

Inflation may not be as easy to foster as monetary authorities think. Although the monetary base is expanding exponentially, broader monetary aggregates are not expanding much at all. Banks are unwilling to lend; after all in tough times the people who really need a loan are the least likely to get one because they may never be able to repay it. Even creditworthy customers are being squeezed. In the USA, American Express offered customers \$100 to close their accounts and presumably cut up the cards. Brokers and banks are also less willing to lend to hedge funds and private equity. Borrowers who can repay debts are doing so. Overall credit is more likely to shrink than grow; as long as this is the case it is more likely there will be deflation than inflation.

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