10 Seconds Into The Future

The low inflation and low interest rate environment that we experienced in the last 20 years was only possible as inflation was exported away to low cost producer countries. This is equivalent to offshoring production capacity. It must therefore lead to a trade deficit, if it is successful. We know on hindsight that it has been successful.

A weak CNY allowed the cheap repatriation of offshored finished goods and services. Therefore a weak CNY was tolerated. And indeed was associated with the trade deficit.

The acceptance of vendor financing was also a contributor to the accumulation of the trade deficit.

Low inflation coupled with low interest rates allowed the US to fund negative savings rates through cheap credit.

A rising housing market provided the assets available as collateral to enable the credit creation used to finance consumption.

The low interest rates and the low savings rates precipitated a bubble in the housing market and over leverage in the structured credit market leading ultimately to their collectively implosion.

The policies enacted to address this implosion have not all been ill advised. It was necessary at the point of implosion to apply credit and liquidity support measures, increasing the central bank's balance sheet by multiples. It was necessary to replace the deficiency in demand from the private sector households and firms with fiscal stimulus. It was convenient and elegant to fund the latter with the former in what has come to be known as quantitative easing.
It is now some 2 years since the financial crisis of 2008. Are the policies pursued today relevant and efficient?

Absent a liquidity of financial crisis it is not rational to solve a problem created by over leverage with the application of more leverage or credit.

Fiscal policy is effective to a degree but the multiplier effect has become attenuated from weak labour markets and the aftershocks of the crisis.

The price of fiscal policy in terms of sovereign borrowing requirements is therefore exorbitant.

The objective is to revive output growth, employment with price stability.

There are many potential solutions but most of them are problematic.

The US seeks a repricing of CNY and other emerging market currencies, effectively repricing the stock of debt held by its foreign creditors. It also seeks to improve its trade competitiveness through this repricing. This strategy is trivially unpopular with the US's creditors.
All net debtor nations will be motivated to create inflation. This is already underway in most developed nations except possibly in the US where arguably inflation is being under-measured by the CPI for technical reasons.

The effect of inflationary policies in net debtor nations can have inflationary impact on creditor nations as can be seen in the current dynamics between the developed world and emerging markets.

In order to be more effective, inflation leakage needs to be reduced and targeted at domestic markets.

The big picture is that the paradigm of controlling inflation through exporting productive capacity to lower cost producers needs to be reversed or rebalanced.

One perspective, and possibility, is that the reversal of this process will create elevated inflation and low output growth, a most unpalatable combination, for as long as necessary for the imbalances to be reversed. This would be the case if for example the USD was weak and thus commanded weak external purchasing power while US savings rates remained elevated. A protracted fiscal deficit is politically and financially unsustainable. The US economy would have to rely on exports. Is it conceivable that the US could be the world’s sweat shop? It is highly unlikely that the US would prefer a strong USD with domestic prices adjustmenting since this would imply deflation.

The problem of high domestic savings rates in emerging markets is a narrow specification of a wider issue. The problem is one of low per capita output and income. Income levels need to be raised. The problem of low savings in developed markets is currently being corrected. This is as it should be. However, it presents problems for growth in developed markets. With government balance sheets under considerable stress the burden will fall on investment and trade. An efficient solution will address these issues.

The realized solution unfortunately will not necessarily be the rational solution but the politically expedient as well as strategically available solution. Also individually rational strategies may not be collectively efficient.

Ideally emerging market economies will grow not only from their comparative advantage in demographics but from significant advancements in technology as well. Evidence from patent filings in emerging markets indicates that this is underway at least in some form.

Emerging markets need to democratize their capital and currency markets. There are grounds for caution and a measured execution of opening markets but markets need to be more open. Here we refer to markets for all inputs, outputs, and capital.

Markets for information and intellectual property are included in the above definition.

Developed markets need to operate open markets in each of the above input and output markets as much as emerging markets.

Whether this can be achieved lies in the hands of the politicians.

The path of least resistance will see all nations beginning with debtor nations but extending by strategic response to creditor nations, debasing the internal and external purchasing power of their respective currencies. This is a race to the bottom.

By implication, the value of real assets, from real estate to natural resources, and very possibly future claims to the same assets must increase in nominal terms.

The discount rate for future claims on fiat currency must rise. However, short term interest rates are likely to remain low.

The risk for trade protectionism is significant. With the US becoming more reliant on exports and emerging markets unused to non-export driven growth, the path of least resistance is mercantilism and trade protectionism. This can easily escalate to the more serious issue of nationalism. At this point rationality in policy making becomes subordinated to more political objectives.

Mass competitive devaluations will lead to market mispricings and bubbles. Unfortunately the dynamics of such policies and their implications will not be recognized by markets until a point of extremity is reached and there is a discontinuous repricing. This can come from a loss of confidence in one of the major currencies. Inflation may be a monetary phenomenon, but hyperinflation is always born of a crisis of confidence. Conversely, less intuitively, and therefore more dangerously, a superinflated real asset (such as iron ore, copper or silver) may lose its independence on risk and become primarily a risk asset. This happens when an inflation hedge, for example, becomes too widely utilized as a hedge so that the correlation is introduced by the actions of the holders and hedgers, and dependence on the other assets in the hedgers’ portfolios is suddenly introduced.