



Invesco Insights



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Inflation or deflation ahead?

The recent global recession was much more severe – both deeper and longer – than typical post-war recessions. But why was it so different and what can we expect in the aftermath of subsequent huge fiscal deficits and massive central bank easing?

The economist who first analyzed the difference between mild recessions and deep depressions was the American economist Irving Fisher in 1933. The crucial factor, he found, was the extent of the prior buildup of debt. The more severe economic downturns of 1837 and 1873 had both been preceded by extended credit booms, as was the Great Depression of 1931-33. A prolonged buildup of credit also preceded the recent housing, equity and commodity bubble of 2003-2007.

The reason that credit expansions cause such serious downturns is that they can play havoc with household, corporate and financial sector balance sheets. When the bubble bursts, the value of the assets that borrowers have bought with the debt typically collapses. Households are then confronted with the fact that their assets are now worth less than their borrowing. Mortgage borrowers face negative equity; companies and banks may face bankruptcy. The shock or trauma induced by the bursting bubble provokes a dramatic change in behaviour. Households, companies and banks no longer wish to borrow; all they want to do is repay debt and repair their balance sheets – no matter how far the central bank may lower interest rates. In the recent bubble it was households and financial institutions that became most overextended. Unfortunately, neither group can recover quickly because balance sheet repair is a slow process and it is also inherently deflationary.

Fundamentally, there are only three ways to repair the balance sheet. First, companies or banks can raise capital (but only if their share price prospects are good), although households do not have this option. Second, assets can be sold and the proceeds used to pay down debt. But nobody likes to sell into a falling market, so they procrastinate – until the bank calls to insist on repayment, and that leads to distress sales. Third, the only other way to pay down debt – if you can keep your job or stay in business – is to cut consumption and increase savings, paying down debt slowly out of savings. Inevitably this takes years, not months.

If we look at recent case histories of countries where credit bubbles have burst, we find that the subsequent desire to repair balance sheets leads to markedly lower borrowing, lower credit growth and lower money growth in the aftermath of the bank crisis or negative equity trauma. For example, in the cases of Japan after 1989-90, the Nordic economies after 1992 and the non-Japan Asian economies after 1997-98, inflation and bond yields fell by an average of 3.9% in the decade after the bubble burst compared with the preceding decade. And this happened despite steep falls in the currency in Sweden and non-Japan Asia. Why? Because it is money and credit that create inflation, not weakness in the currency. The currency depreciation typically follows from the withdrawal of foreign funds after the bubble bursts and the lack of investment opportunities during the balance sheet repair phase. Of course, currency depreciation can be a symptom of excess supply of money and credit – and hence, imminent inflation – but in these cases it was a symptom of the steep decline in the demand for credit in the aftermath of the bubbles bursting in these countries.

What are the practical implications of these findings for U.S. and Canadian investors in 2010 and 2011? First, now that equity markets have bounced back from the post-Lehman panic that extended from September 2008 to March 2009, the ongoing balance sheet repair process means that – at least in the U.S. and contrary to the experience of most post-war recoveries – real and nominal GDP growth will be subnormal as U.S. households constrain spending and increase savings in order to pay down debt, and banks hold back on lending while they build up capital. In turn, this implies slow top-line growth for the majority of companies and only modest bottom-line growth.

Canada is in a slightly different situation since households are not de-leveraging in the same way as U.S. households and Canadian banks emerged from the recession much stronger than their U.S. counterparts. Based on the most recent data, the ratio of Canadian household debt to disposable income has continued to rise,

reaching a new all-time high of 143.3% in the fourth quarter of 2009. This probably reflects Canada's more favourable natural resource endowments in a world where demand from emerging economies remains firm, the gradual recovery in Canadian employment and relative optimism from Canadian households towards future house prices. Canadian banks, too, appear to be increasing their lending again after a pronounced period of risk aversion in 2008-2009.

Second, inflation is likely to be subdued in both the U.S. and Canada for an extended period, despite the large-scale issuance of government debt in both economies. In the U.S., money and credit growth is negligible, suggesting prolonged low inflation despite last year's depreciation of the U.S. dollar. In Canada, the prompt recovery of the currency and slow credit growth last year means inflation should remain low for most of 2010-2011.

The recent upswing in the headline CPI in both Canada and the U.S. (and elsewhere) is entirely temporary, largely an echo of the post Lehman-panic and not a portent of things to come. In the wake of the Lehman bankruptcy, consumer prices in many economies, including Canada, fell on a month-on-month basis in October, November and December 2008, in addition to January 2009 as commodity prices tumbled, shops and businesses cut prices and governments cut taxes. Since March 2009, the panic has subsided and many of these prices have returned to more normal levels. The result has been a faster-than-normal year-over-year change in the CPI as the recent year-over-year comparisons have been with the abnormally low figures of late 2008 and early 2009. Once these abnormally low base figures drop out of the comparisons, the year-over-year figures are likely to drop sharply, especially in the second half of 2010 after September.