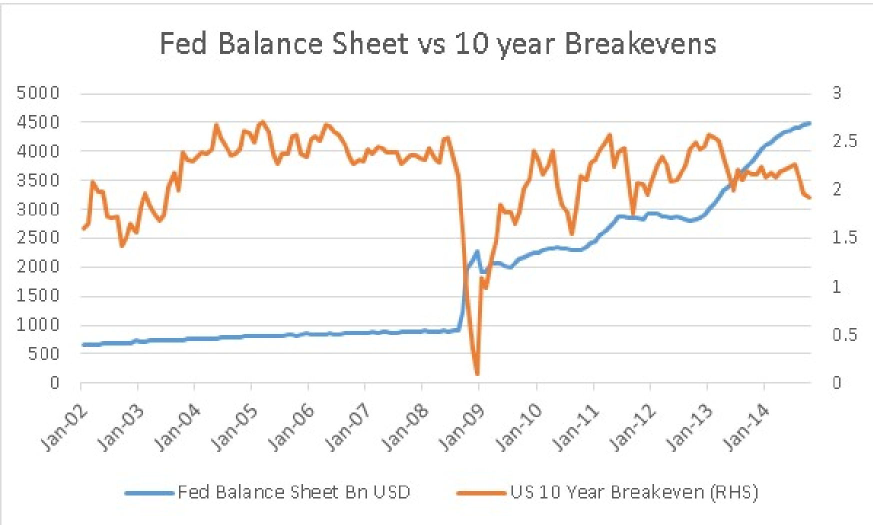
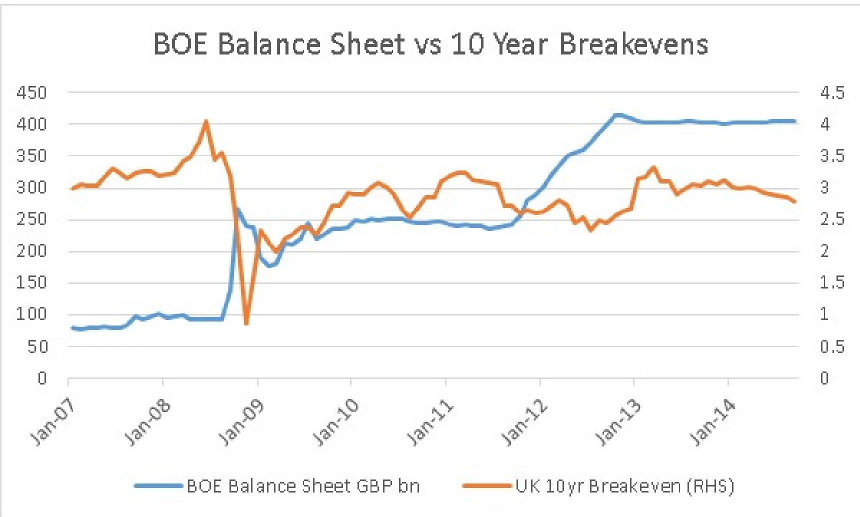
WHY QE IS NOT CAUSING INFLATION BUT MIGHT CAUSE DEFLATION

Critics and supporters of the QE program often state that increasing the money supply inevitably leads to inflation. Commonly they quote Milton Friedman, "Inflation is always and everywhere a monetary phenomenon". The critics claim it will lead to high or even hyperinflation, while the supporters of QE claim that we need inflationary monetary policy to avoid deflation.

So far the actual evidence of QE seems to offer no support to Milton Friedman's claim.



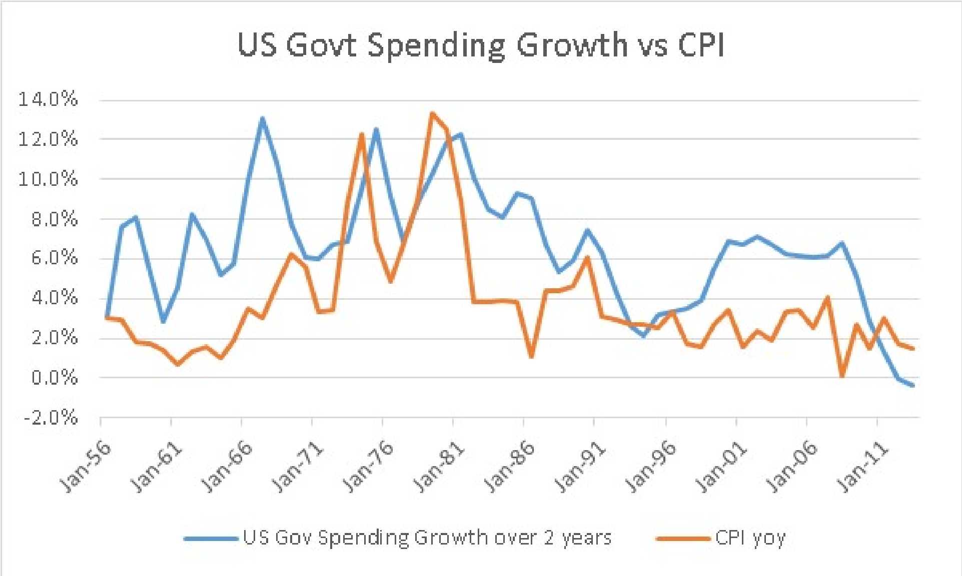
The Federal Reserve has increased its balance sheet by nearly 4 times, and yet 10 year breakevens (a market measure of inflation expectations) imply even lower inflation than before the financial crisis.



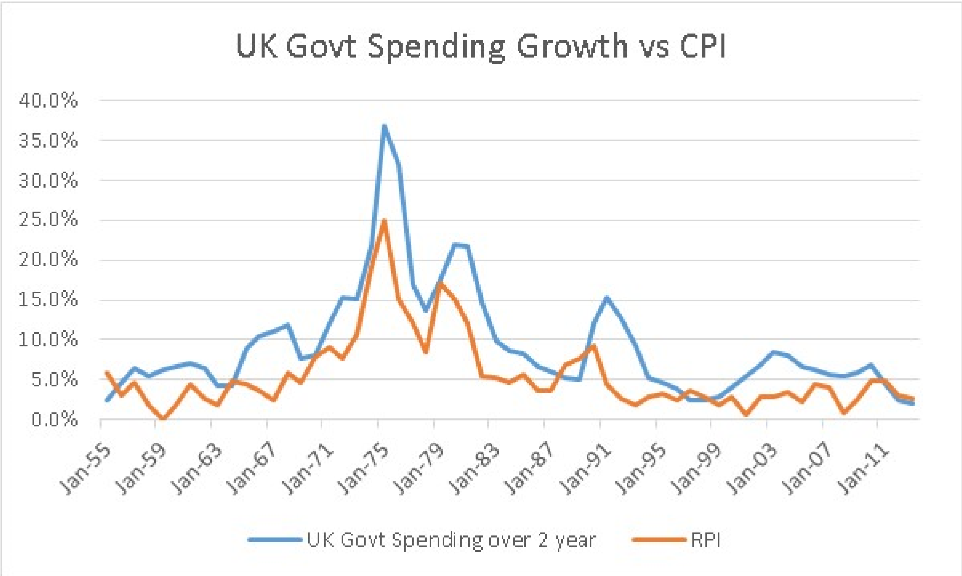
The Bank of England has also greatly increased its balance sheet, but, like the US, with little impact on inflation expectations.

This is very curious for students of economic history. Loose monetary policy was often cited as the cause of inflation both in the Western world in 1970s, but also in the Weimar Republic and Brazil in 80s and early 90s. But despite a prolonged period of extremely loose monetary policy inflation expectations remain weak.

In my view, the thought process behind loose monetary policy and spiralling inflation misses an important step. In previous cycles when central banks have had loose monetary conditions, governments have been keen to spend this money to boost growth. However in this cycle we have seen governments retrench their spending.



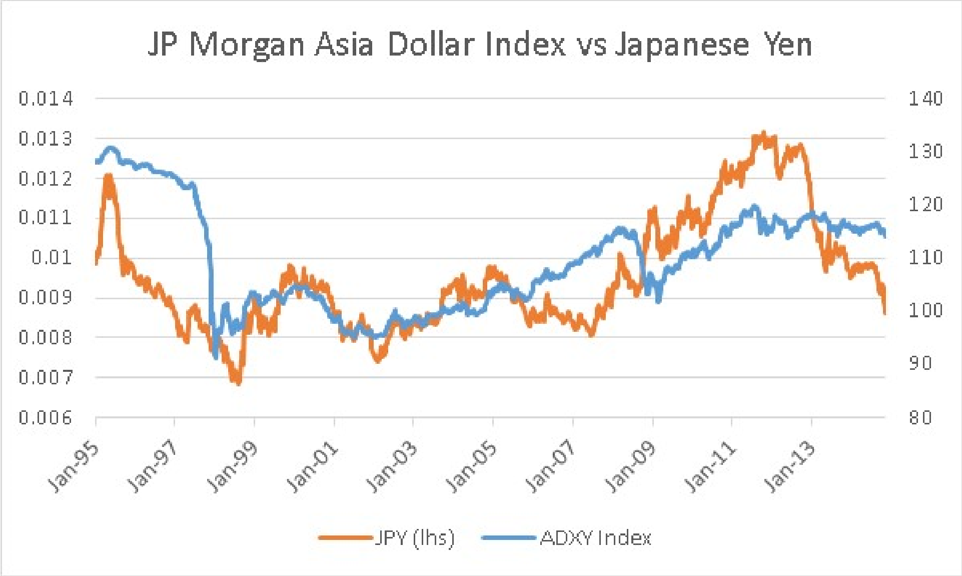
As can be seen from above, in the early 1960s the US government ramped up spending aggressively and maintained the increase for two decades. The UK shows a similar relationship.



One way that Milton Friedman could have been correct is that without QE the deflationary effects of reduced government spending would have been far more evident. Certainly in my view, QE has helped to keep the Western World currencies look cheap versus the “growth” market currencies of the world. It has also been noticeable that as QE has ended the US dollar has had a significant move against most currencies.

While QE may have helped the US avoid deflation it has also had some unintended consequences. One has been to encourage a rapid build-up of US dollar debt in Asia. The data below data is taken from BIS.

A strong dollar makes these positions more difficult to repay and can lead to a debt crisis.



The above graph shows the ADXY index (JP Morgan Asian Currency Index) versus Japanese yen. In the above graph I have reversed the way yen is usually quoted, so a fall in the graph means yen weakness. The big fall in yen in 1995/6 led to falls in Asian currencies that triggered the Asian Financial Crisis.

The BIS banks data again shows Asia has leveraged up significantly. When I combine this with the steep yen devaluation we have seen recently I think the chances of even steeper declines in Asian currencies (including the CNY) is becoming more likely. A steep fall in Asian currencies is very deflationary as it reduces growth from the most dynamic region of the world, and it reduces prices of Asian exports forcing western manufactures to cut price. That an Asian currency crisis might happen in an environment where US government spending is contracting and core inflation is at its lowest level outside of recession makes me think the US is heading for outright deflation. While it is possible that QE stopped the US from going into deflation after the crisis, one of its unintended consequences (that is a debt binge in Asia and it's unwind) could cause deflation after all.

INFORMATION

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