THE Strategic View
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Hoovernomics versus Inflationomics; We Suggest Learning from the Past

For much of the past 50 years, economists have fiercely debated which economic policies would be most helpful in attempting to prevent another Great Depression. The Keynesian School, founded by British economist John Maynard Keynes, advocates stimulating the economy through large spending increases and tax cuts that are financed by large budget deficits. By contrast, the Monetarist School, founded by US economist Milton Friedman, believes that overly restrictive monetary policy caused the Great Depression; therefore, aggressive money printing by central banks would be the best antidote to economic depression.

If current policy trends continue, economists may get a chance to resolve this debate, because a controlled policy experiment is being conducted by three major economic blocs. Over the past decade, the United States, the United Kingdom, and most of developed Europe pursued economic policies that encouraged borrowing to finance excessive consumer spending. All three economic blocs now face a painful adjustment process away from debt dependency. They have all bought time to implement needed adjustments by running unprecedented peacetime budget deficits, but their policy prescriptions for the next several years could not be more different. Europe is ignoring both Keynes and Friedman's advice by refusing to provide either fiscal or monetary stimulus to its troubled PIIGS (Portugal, Italy, Ireland, Greece, and Spain). The US, with the recently enacted tax and spending compromise between President Obama and Congressional Republicans, is going full bore on both types of stimulus. Finally, the UK is combining aggressive monetary stimulus with a credible, specific plan for deficit reduction. Judging by prior instances of excessive debt in the US, we think that the UK's policy is likely to prove most successful.

Europe: ***Hoovernomics***

We believe that Europe is following policies similar to those that ultimately led the US into the Great Depression; (i.e., tight monetary and fiscal policy [Hoovernomics]). The PIIGS have no choice but to cut their budget deficits, because markets are refusing to provide additional financing and the terms of the European bailout fund require that these countries put their financial houses in order. However, the European Central Bank (ECB) is not providing sufficient monetary stimulus to help offset the deflationary pressures caused by these budget cuts. Since Germany is growing faster than the rest of Europe, a monetary policy that achieved modest inflation across the entire euro bloc would produce above-average inflation in Germany. Since Germany refuses to tolerate such an outcome, the ECB is imposing deflation on the weaker European economies. Restrictive monetary and fiscal policies, combined with the PIIGS' high debt levels, risk inducing a deflationary spiral similar to Japan since the mid-1990s and much of the global economy in the 1930s.

We believe that domestic political pressures will force the ECB to adopt a more accommodative monetary policy in 2011. Average unemployment rates across the PIIGS are rapidly approaching 20%. An increasing likelihood that more countries will need bailouts and the growing costs of these bailouts is undermining political support in Germany (the only European country that can credibly fund such bailouts). Rather than allow the euro block to fall apart, we think the ECB will likely cease acting like Germany's central bank and begin acting like the central bank for all of Europe. Aggressive money printing and government bond purchases by the ECB (a policy known as quantitative easing, or QE) could ease economic pressure on the PIIGS just as it has done in the US and UK. This would be bullish for local equity markets but could prompt renewed declines in the euro. Bond prices in weaker economies would rally as default fears are eased, while German bonds would fall due to rising inflationary expectations.

US: ***Inflationomics***

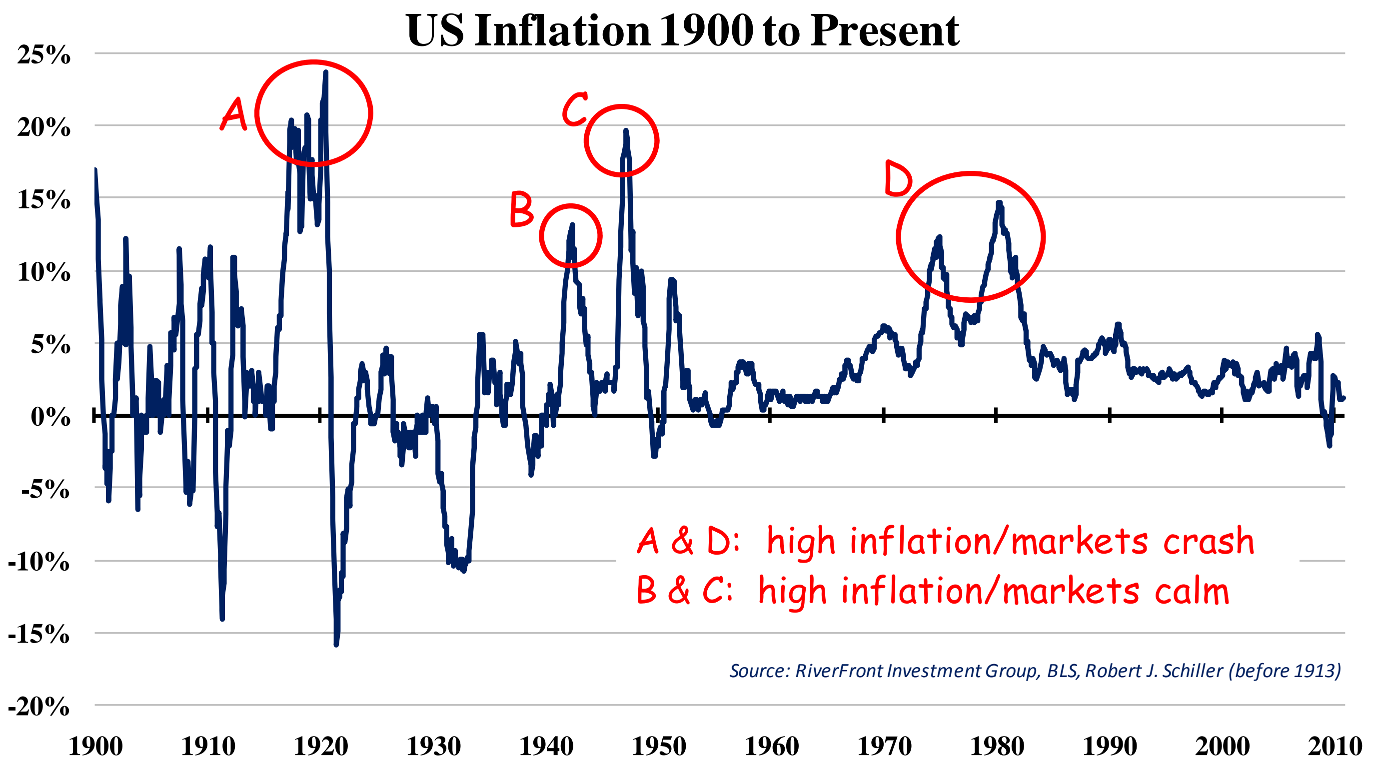
Over the past two months, the Federal Reserve has committed to another round of QE, and Republicans and Democrats have "compromised" on a tax and spending plan that gives both sides policy victories at the expense of even greater budget deficits. Large budget deficits financed by aggressive money printing has historically led to inflation (Inflationomics). High unemployment and the ability of the US to import excess capacity from China will help mute inflation in 2011. However, we expect aggressive QE will force China to allow the yuan to rise during 2011. If we are correct then, contrary to market expectations, we believe that inflationary pressures will quickly surface in 2012 absent painful reversals in either fiscal or monetary policies.

Assuming the Fed can keep inflation between 2% and 4%, the stimulative fiscal/monetary policy combination would have the effect of transferring wealth to borrowers from savers and investors. Since the US is heavily indebted and much of that debt is held overseas (especially China and Japan), a transfer of wealth from lenders to borrowers would be a net long-term benefit to the US economy.

More printed money coursing through the banking system, combined with a fiscal policy backstop on the overall economy, could fuel additional lending. However, most new loans would likely be devoted to stock buybacks and/or acquisitions. Such financial transactions are generally good for stocks but are unlikely to create many new jobs. Thus the aggressive, reflationary policies pursued by the US are supportive of the equity market, in our view, and will remain supportive unless inflation expectations rise above approximately 4%. However, the inflationary potential of big deficits financed by printed money could be disastrous for high-quality bond investors.

UK: ***Learning from the Past***

We think the UK is pursuing the best of the three policy combinations. The Bank of England's aggressively accommodative monetary policy ensures that the UK will not slip into a deflationary spiral, in our view. Furthermore, additional money circulating in the banking system makes it easier for the UK to fund large budget deficits and relieves the strain of high debt levels on UK consumers. More British pounds flooding global markets have depressed the currency's value and helped stimulate accelerating UK export growth.



The UK does not share the US commodity pricing advantage — agricultural and energy commodities are traded in US dollars almost universally around the world. As a result, printing money to finance large budget deficits has already pushed UK inflation above 3%. We believe that UK financial markets have remained calm despite rapidly rising inflation because the UK has a credible, aggressive plan for reducing its budget deficit to manageable levels over the next four to six years. The market appears to believe that the budget cuts' deflationary impact will counteract current inflationary trends.

We believe that the UK essentially wants to engineer an outcome similar to that of the US following both World War II and the Korean War (learning from the past). Aggressive money printing by the Fed helped to finance both of these wars and produced significant inflation after wartime price controls were lifted (see the chart on previous page). However, uniquely during these periods, the US received the benefits of high inflation without incurring the costs. Double-digit inflation helped inflate away the wars' crippling debt levels, yet financial markets remained calm and asset prices stable despite the inflation. We believe this is because there was confidence that the inflation would be short lived due to the planned return to a gold standard and massive planned cuts in wartime deficit spending. By contrast, markets and the overall economy were severely hurt by the inflationary episodes of 1916 to 1921 and the 1970s.

By combining short-term monetary stimulus with long-term deficit restraint, the UK appears poised to enjoy the "best of both worlds" scenario of the US after World War II and Korea. UK policymakers have inspired confidence that fiscal and monetary policies will return to noninflationary levels over the next few years. In the US, the recent budget compromise and its "stimulus for everyone" approach could undermine confidence in future US policy. Without credible action on the budget deficit, we believe that by 2012 the US risks repeating the World War I and 1970s experiences as investors anticipate sustained inflation above 4%.

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