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The Age of Quantitative Easing

The revival of “Superpower America” and the end of economic pessimism

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My book titled The Age of Quantitative Easing – The Revival of ‘Superpower America’ and the End of Economic Pessimism (Nippon Jitsugyo Publishing) will go on sale June 1. This bulletin presents the introduction and afterword sections of this book.

Introduction

Four years have gone by since the Lehman shock. The facts have now been gathered for determining exactly what happened. Putting together these facts reveals that the widely accepted thinking that influenced economic views during the past four years were fundamentally wrong.

During the global financial crisis (from the subprime loan crisis to the Lehman shock) that lasted from 2007 to 2009, stock and bond prices plunged over an 18-month period on the same magnitude as during the Great Depression of the 1930s. People were convinced that the economic system was collapsing and that the future would be dark. This belief was particularly strong in Japan.

Japan’s economy has been lackluster since the asset bubble burst in 1990. From the standpoint of a country that fell behind, it was natural for Japanese observers to think that the U.S. was about to go down the same path after the collapse of Lehman Brothers. In Japan, pessimism and fatalism dominated the thinking of academics, journalists and economists. This resulted in a general sense of resignation among the people of Japan. Basically, people thought that the end of the bubble and the financial crisis were the natural consequences of mistaken prosperity, speculation and economic behavior of the past. A dark future is coming as payback for these events. As a result, the general belief was that using economic measures would be futile and wasteful. Everyone should simply accept the fact that the future would be dark. No matter how loftily these opinions are expressed, this is the essence of all these beliefs in simple terms.

But this is not what actually happened. The fatalism and resignation of the pessimists’ position was fundamentally rejected by the steady recovery of the U.S. economy and revival of ‘superpower America’. The U.S. economy did not become mired in deflation and paralysis as Japan’s economy did since the 1990s. Instead, the U.S. economy returned to a solid growth trajectory and stock prices began rising to new all-time highs.

Why was the United States able to avoid the prolonged lack of growth that is referred to as Japan’s lost 20 years? Use of the proper policies is the biggest reason. Quantitative easing overseen by Fed Chairman Ben Bernanke brought financial markets back from the brink of collapse. Risk-taking and the animal spirit, both of which had been near death, came back and the U.S. economy returned to a normalcy.

The highlight of this quantitative easing was the rapid threefold increase in the Fed’s balance sheet in order to boost prices of securities after markets plummeted. The Fed abandoned its neutral stance in financial markets to become a determined buyer. Purchasing assets after prices had plunged restored order to the financial system. The risk premium, which had become greater than even during the Great Depression, returned to normal. Moreover, stock prices, which had dropped 60% over 18 months, about the same as during the Great Depression, doubled over the next two years. This returned stock prices to the pre-Lehman shock level.

There was a firestorm of criticism as people called the decision to push up prices of securities by printing money as fast as possible an extreme example of alchemy. However, there is no doubt that another Great Depression would have occurred without this action. Consequently, the U.S. decision to use a forbidden method that exceeded previous boundaries for central bank behavior was absolutely necessary to achieve a U.S. economic recovery.

Nevertheless, everything about this reckless ultra-easy-money stance cannot go well. The simple statement that "this sounds too good to be true" is persuasive. There was a belief that everything would go well if ultra-easy-money policies altered the expectations of the public. But can this belief withstand criticism based on simple views like "easy money is like taking a narcotic that creates the illusion of ecstasy" and "the reality of a difficult economic situation is still the same?"

Market interventions based on ultra-easy-money as well could fail if they are not accompanied by an improvement in the real economy. Central bank intervention in the bond market can temporarily lower the risk premium. But even if this happens, the risk premium will surge if the economic downturn deepens and bankruptcies continue. This would make bonds worthless and saddle the central bank with non-performing assets.

Ultimately, the operation of Chairman Bernanke succeeded because financial markets had been distorted more than the real economy. The bond market had factored in an unprecedented level of bankruptcies and the stock market had factored in the complete disappearance of earnings. However, there was no rotting at all in the real economy so the Fed's bold move was successful. Therefore, this accomplishment was the result of Chairman Bernanke's accurate powers of observation that enabled him to conclude that the real economy was not as bad as the market thought.

So why did a bubble form and then burst to produce a steep market downturn and global financial crisis even though the economy was still sound? Contrary to common belief, there were multi-layered causes of the Lehman shock. The direct cause was the collapse of financial markets and mispricing. But another cause was the emergence of a housing bubble along with the immoral financing that supported the bubble. Looking even deeper reveals an even more significant fundamental cause: the surplus of people (rising unemployment) and capital (unprecedented drop in interest rates) since the end of the IT bubble in 2000. These surpluses were absorbed by the housing bubble until 2007 and fueled even more economic growth. But when the housing bubble burst, surplus labor and capital that had temporarily been absorbed by the housing sector once again surfaced. In other words, surplus labor and capital were the true sources of the Lehman shock.

The surpluses of labor and capital were the result of an unprecedented increase in productivity that was driven by the IT revolution and globalization. These two events made it possible to produce more goods in a shorter time. Fewer workers were needed and the cost of manufacturing declined, too. In this environment, earnings at companies increased amid an excess of labor and capital.

During the history of capitalism and even mankind, higher productivity has always been a driving force behind economic progress. If this is true, then the formation and destruction of bubbles is collateral evidence of rising productivity. So we should regard this formation and destruction process as milestones along the path to more economic progress.

Consequently, the ultra-easy-money policy of Chairman Bernanke was a success because of the large increase in surplus labor and capital caused by rising productivity. We now know that the general conviction that reckless ultra-easy-money measures cannot succeed is not applicable in this type of environment. This thinking is also the basis for the belief that the ultra-easy-money initiatives on a new dimension by Bank of Japan Governor Haruhiko Kuroda are proper and can succeed.

A new era triggered by the Lehman shock is beginning to emerge. The revival of "superpower America" will produce renewed global economic growth. Chairman Bernanke's quantitative easing will utilize surplus labor and capital to create new demand that will establish a path for long-term economic growth.

Until just a short time ago, almost everyone was convinced that the era of the industrialized countries was ending with a shift to the BRIC countries. But now this is becoming an outdated view. This belief was nothing more than an intermission as a series of crises occurred in the United States: the 2000 collapse of the IT bubble, the 2007 subprime loan crisis and the 2008 collapse of Lehman Brothers. The many economic abnormalities behind the emergence of the Chinese economy and the difficulties in sustaining growth of this economy need no explanation. But strong economic growth in Russia and Brazil was also in large part a reflection of China's ravenous economy. The economic clout of Russia and Brazil is certain to decline as economic weakness in China causes prices of natural resources to fall. From now on, the emerging countries at the center of global economic growth will not be large countries like the BRIC countries that want to establish a global order. Instead, the key players will most likely be ASEAN countries and other small and midsize emerging countries with an affinity to a global order based on Western European-style democracy.

What will be the new center of new demand for the global economy to replace the BRIC countries? The answer can only be more improvements in the quality of life in the United States and other industrialized countries. The industrialized countries will enter an age in which surplus labor and capital is used to make living standards even higher. I believe that the drivers of this progress will be the United States followed by Japan and Germany.

Afterword

My job is economic research. You could call me an analyst or a strategist. My job involves analyzing current and past events in order to create accurate forecasts. My role differs from that of people in the academic sector, who focus on creating principles and theories, and commentators and journalists, who explain information to the public. Even though the forecasts of scholars, commentators and journalists are seldom accurate, these inaccuracies are probably often overlooked because these people do not specialize in creating forecasts. But for me, inaccuracies are obviously not allowed.

Research and hypotheses can be used to raise the accuracy of forecasts to a surprising degree. The end of Japan's asset bubble and subsequent economic problems, the resurgence of the U.S. economy in the 1990s and the end of the IT bubble in 2000 could all be forecast far in advance. I made these forecasts in my reports even though I was one of very few people who made these predictions. Signs of the rapid recovery from the Lehman shock and revival of 'superpower America', which I have discussed in this book, started becoming visible four years ago. This is the product of research and hypotheses.

The hypothesis that I believe is most important of all is "what comes around goes around." Neither good fortune nor bad fortune will last forever. Empty successes will fall apart and meaningful failures will be rewarded. My job is to look for instances where there was a success for no legitimate reason and where there was no success even though there should have been a favorable outcome. I examine the balance between actions and results by looking at the two key economic inputs: the providers of labor and providers of capital. I can determine whether or not each provider is receiving a return that is commensurate with the benefits of the input. If the return does not match the benefit, the corresponding activity cannot be justified and will eventually undergo a correction.

To perform this research, the most important data are the unit labor cost (wages divided by productivity) and the risk premium. Are workers receiving compensation that matches their contributions? The only way to answer this question is to determine if the benefits of labor are properly reflected in wages. This can be determined by using the unit labor cost.

To ascertain if providers of capital are receiving a suitable return, the stock risk premium is the best indicator. A high risk premium shows that even though capital invested in a company is producing sufficient earnings, shareholder value (in the form of the stock price) is low. As a result, the high return on equity is not passed on to shareholders. This signifies that the stock is undervalued and has significant upside potential.

The revival of 'superpower America' as well can be proven based on data because of the significant potential for corrections in the unit labor cost and the stock risk premium.

The country with the potential for the largest corrections in the unit labor cost and stock risk premium is Japan. This is why a powerful resurgence of the Japanese economy is expected to occur. In Europe, this resurgence is expected to take place in Germany. Revivals of the economies of the United States, Germany and Japan will probably become a major economic trend over the next several years.