

Why Lost Money Isn't Lost

Before you get too excited, I'm not about to reveal a way of getting back money you've lost in investments, or money that's dropped out of your pocket, or that's been lost down the back of the sofa.

Rather, I'll try and put paid to a theory that is already resulting in higher interest rates, and will soon reveal the consequences of higher inflation.

You may have seen the argument in the press or on TV. It goes that because asset prices have fallen so much during the last eighteen months, there is less 'money' in global economies and therefore any stimulus from the government is filling the gap vacated by the consumer and business.

But it's not the only argument used by mainstream economists and commentators to argue that fears of inflation are over-blown. They also tell us about Japan, where the government set interest rates to zero and gave trillions of Yen to the banks in an attempt to stimulate their economy.

This didn't work and Japan had its 'lost decade' where there was very little inflation and very little asset price growth.

While we won't claim Japan is perfect - it clearly isn't with the amount of debt it issued - it should be remembered the Japanese central bank issued new money in a different type of economy.

It was issued to a saving economy rather than a spending economy. It's one of the reasons why Japan holds so much US debt. Rather than the additional Yen being spent it was simply used to take advantage of the carry trade.

The borrowed Yen was sold, converted into US dollars and held in US treasury bonds. This naturally had a weakening effect on the Yen, keeping it low and therefore keeping its exports strong.

It isn't a particularly good idea, and because of it, Japan shouldn't be viewed as a leading light of free markets. They've manipulated their own economy just as much as the US has. That means there's just as much change the Japanese economy will suffer for it as well.

In fact, the mistake mainstream economists and commentators make is to think Japan won't suffer from future inflationary pressures. They assume the story is over - that Japan printed lots of money, it didn't cause inflation and therefore other central banks can do the same thing.

But they forget a couple of things. The first is that Japan has a higher savings rate. That means there is a demand for investments rather than spending. Therefore the debt was easily 'soaked up' by the market as there was ample demand.

That's why Japan has been able to keep its interest rates low. It hasn't had to increase them in order to attract savers. They have willing savers.

The other side is that Western nations, mainly US, UK, Australia and Western Europe have lower savings rates and are more inclined to spend. And what did they spend their money on? Imported goods from Asia.

As we have seen, it is already causing interest rates to rise, as central banks have to offer more attractive rates as the amount of debt increases.

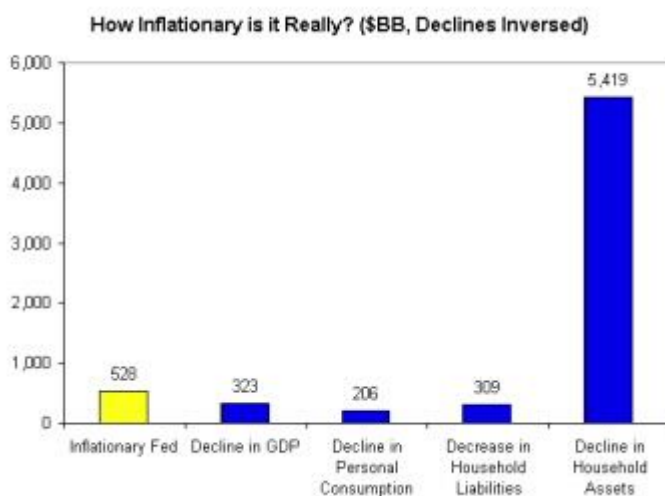
Therefore it is foolish to use the experience of Japan to argue that it is good to pump more money into the economy to stimulate it.

At some point the Japanese economy will also suffer from excessive inflation. That it hasn't done so yet doesn't mean it won't. The high savings level just means the spending is pent up, waiting to be released.

And it will either be released in the form of direct consumer spending or the private sector borrowing to invest in capital or goods. Either way it will filter through to increase the cost of living for the Japanese citizen.

Perhaps it already has. Odds are that Japan's deflation would have been greater if it wasn't for their stimulus.

But it isn't just the Japanese that are being used to make excuses for increased spending and printing money. We came across this gem of a graph on the internet...



It illustrates how the "money printing" by the US Federal Reserve is tiny when compared to the fall in household asset values. It's like a "drop in a bucket" in comparison.

We've seen a similar argument used by analysts on the business channels over recent months. They claim that because so much value has been lost on financial markets, any stimulatory spending by governments or money printing by central banks could not possibly be inflationary as it is only replacing a fraction of the money that has been lost from investments.

This reasoning is flawed. But let's take a closer look at what they mean.

What they're trying to say is because share prices of say, Citigroup, General Motors, Bank of America and Lehman Brothers have fallen so much, billions and trillions of dollars has been wiped off the 'balance sheet' of individuals.

So, because their investments have declined by so much it means if they cashed in on these investments they would get back much less money and therefore have much less to spend.

Therefore, if governments decide to give these people a handout or spend the money on infrastructure it cannot be inflationary.

Have you spotted the flaw? If you have, you've done better than most of the boffins that would have you believe that inflation is not a concern.

They mistakenly equate an investment with money. It isn't. When the share price of Macquarie Group fell from \$99 to \$20, it may have wiped several billions of dollars off the 'value' of Macquarie shares, but it did not alter one cent the amount of dollars in the economy.

And that's where these boffins are making the error when they argue that new government spending won't have an inflationary impact. It will.

It's quite simple. If we take a share trade as an example, when you buy shares you are exchanging your cash for ownership of shares. From that point you no longer have cash. The investor you bought the shares from holds the cash.

That means, if say, the shares went to zero there hasn't been any loss of money from the system. It is still there, only it is the person who sold the shares to you that is holding it rather than you.

It is even the same if leverage is involved. It makes no difference. The money is still there, only it is being held by someone else other than the shareholder.

Look, that may be stating the obvious, but it's amazing how many excuses and 'reasons' the mainstream commentators are coming up with to deny the threat of inflation.

But it's not only the commentators. Policymakers have been acting in precisely the opposite way to how they should. Instead of trying to prop up the value of assets or investments, it is the value of cash/money that needs to be increased.

And that should be done through higher interest rates and/or decreasing the money supply.

You see, the current global bout of low interest rate policies is actually discouraging real investment. Instead it is encouraging speculation.

The correct course of action would have been to keep interest rates at previous levels or in fact increase them. (Naturally, our preference would be for interest rates to be left to the market, and for no interference at all by central banks, but that's a bit too much to hope for at the moment).

Keeping interest rates higher would have encouraged more savings and therefore it would have brought interest rates down without central bank manipulation. Once interest rates had fallen, entrepreneurs and businesses would be prepared to borrow funds to invest in their businesses.

This action - if the businesses are publicly listed - would have led to companies becoming more valuable as it invests productively in its business, and therefore lead to an increase in share prices.

The way policymakers are trying to run the economy is by getting assets prices high and hoping that will lead to an increase in wealth and spending. It may very well do that, but with an added consequence of higher inflation as more money is fed into the economy from misdirected government spending.