

On Sticky Wages

What Happens When Inflation is No Longer an Alternative

Over the past weekend, on his blog on nytimes.com Paul Krugman published a piece entitled "[Lessons from Europe](#)" in which Prof. Krugman approvingly cites a (Oxford economics professor) Kevin O'Rourke article on the EU summit, in which Prof. O'Rourke lays out a very correct argument as to why internal devaluation will not work in the Eurozone periphery.

O'Rourke is spot-on, but Prof. Krugman then goes on to emphasize the Keynesian notion that nominal wages are sticky and extremely resistant to reduction - with high unemployment being the more likely outcome of attempts at internal devaluation (Ireland being the offered example). But nominal wages can be reduced under certain circumstances, without suffering massive unemployment/underemployment and actually reducing it - more about that in a bit, below.

It is very much the case that nominal wages are sticky and that internal devaluation will not work in the southern Eurozone. Suffice it to say that in the current macroeconomic climate the distressed economies of the Eurozone are in no position to endure the German prescription. It is one thing for Germany to have shown fiscal restraint during the rapidly growing global environment that predated the crisis - but something altogether different amidst global deleveraging, excess global supply and insufficient relative demand.

Were austerity actually to be effected throughout southern Europe, the results would be intolerable given the continuation of global supply/demand imbalances. The years of slow, painful rebalancing - that internal devaluation is meant to produce in the periphery - will most certainly challenge the periphery's ability to repay its creditors. Growth from internal devaluation, even if it occurred without rending the social fabric of those countries, will not occur fast enough to avoid enormous challenges to repayment/refinancing of creditors.

Here's the problem we have with Prof. Krugman's short post: It needs to be explained that nominal wages can be unstuck - without the advent of a Keynesian deflationary spiral - in an environment of falling prices, provided that the pace of price and wage deflation is managed AND the currency and fiscal policies of the country experiencing moderate wage and price deflation is allowed to respond accordingly. The latter would be impossible in the GIIPS.

"Internal devaluation" is, to our way of thinking, merely deflationary pressure with no fiscal counterweight and no cheapening of import prices that arises from a currency strengthening with new-found internal purchasing power (the latter, of course, requiring that the country in question makes stuff that folks outside it want to buy - a potential problem with Greece, not so with Italy and Spain). It is the most austere form of "Austrian" economics.

The diametrical alternative is - not surprisingly - Japan. Say what you will about cultural peculiarities and captive bondholders (both canards in our view), Japan has endured wage and price deflation, suffered from (exports) and

benefited from (imports - read, oil) a currency on steroids, has low-ish unemployment and is spending as necessary to avoid the "austerity trap," and it boasts the lowest cost of funds on the planet.

Many will love to point out at this juncture that the Japanese - sporting the highest debt-to-GDP ratios in the world - have not been hit by bond vigilantes only because "Mrs. Watanabe" is there buying JGBs by the bucket-full day in and day out. Consider, however, that Japan is the only major economy today that is not offering up financial repression (interest rates below the rate of domestic inflation) on its bond menu. Investors buy JGBs because they have every financial incentive to do so....positive real yields. Ditto the reason for the strong Yen - it buys more than it did domestically and is hence worth more than it was when it bought less.

So, *despite its strong currency and high debt*, Japan has not only been able to employ more of its people, but it has been able to narrowly maintain surplus current account status. It is working for less, paying less, and its assets are worth less - all measured in Yen. But in real terms, wages have been roughly flat domestically, and are actually up measurably in US\$ terms.

Japan, unintentionally perhaps, used the dreaded "third transmission mechanism" to manage its imbalances and its excess debt (the other two mechanisms being inflationary protectionism and currency devaluation). This certainly doesn't make its internal debt any more repayable - in fact, less so. But it does make it absurdly cheap, in nominal terms, to carry - and creditors outside the country have made a bundle on the currency side.

That Japan is not the Eurozone is a given. The problem with the zone is, in fact, the Euro itself - currency and common market. The voluntary currency union makes true devaluation impossible...first strike. The European Union makes protectionism illegal...second strike. But strike three is that the currency used in the southern tier economies can't directly respond to deflation there and can't be unilaterally printed to enable internal fiscal spending, both of which buffer and slow, respectively, internal wage and price declines in Japan.

We say this not to hold up Japan as a paradigm of anything wonderful economically (albeit, wonderful country and people); not to state the obvious about the European situation; and not even just to take issue with Paul Krugman (although that is fun, because he's a Nobel Laureate and all). We are pushing this point because of its relevance to the situation in the United States.

The U.S. is also in a currency union (involuntary as it is) with a major surplus nation - China - which has the means to assert its *de facto* peg between the RMB and the dollar. Protectionism is also a push in our situation - who wants to break it to the emerging markets that since globalization didn't work out so well for us, we're sorry we pushed it and we're taking it back?

But unlike Europe, and more like Japan, the U.S. prints its own currency and - even more so than Japan - appears to be able/is condemned to maintain the relative value of its currency even when it resorts to extraordinary, helicopter-like, monetary intervention to try to tank it.

Arguably, upward pressure on the dollar is building with the Euro-crisis and the attendant (or perhaps **not** causal) global slowing. The reduced inflation in the emerging markets, in part engineered internally and in part due global demand issues, is reversing earlier appreciation of the "four R's" RMB, Rupee, Ruble and Real (although the Ruble's decline is more complex) against a U.S. dollar that is sharply stronger as measured by the DXY index.

It is possible, and we view it as increasingly more likely each day, that the United States will shortly find itself facing the triple deflationary forces of (i) debt deleveraging; (ii) excess global supply of pretty much everything (labor/capacity/capital), and (iii) a very strong dollar, especially relative to the Euro, which today plunged to levels not seen since the beginning of the year and threatens to sink further as the zonal morass deepens.

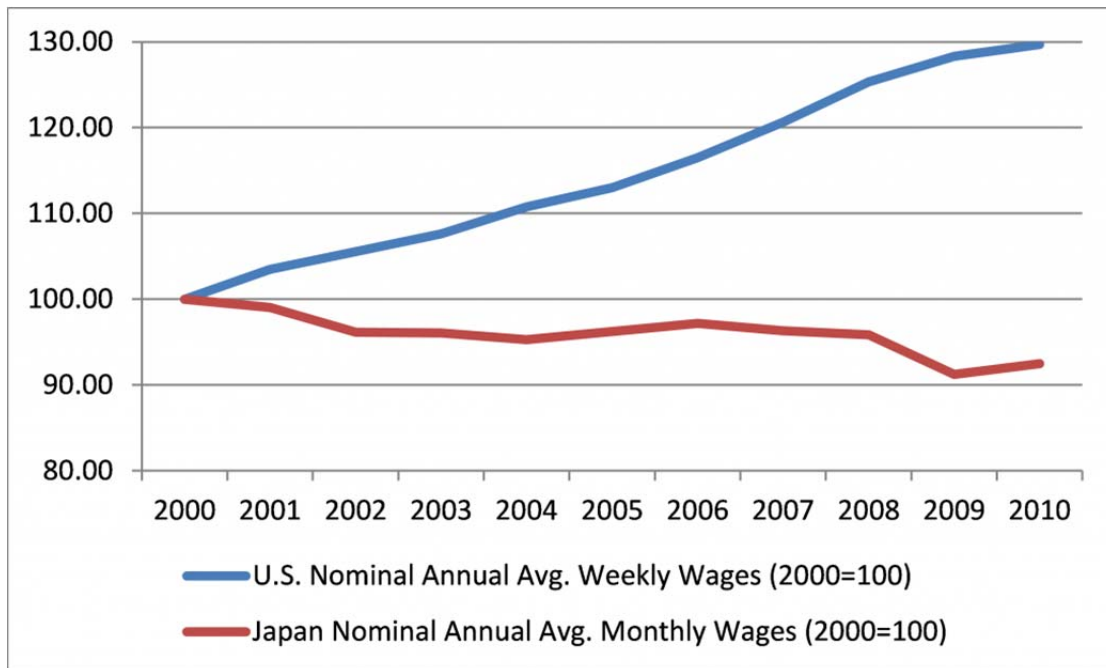
What this would mean is that pressure would build for all of the extraordinary monetary (and, yes, eventually special fiscal) actions that characterized the last 15+ years in Japan - if only to buffer and moderate the foregoing deflationary pressures. And if, we are reading the global tea leaves somewhat accurately, **the effect of such actions will be more to offset the dangers of a deflationary spiral and less to actually stimulate growth at the level of economic potential.**

The good news, such as it is, is that moderated deflation - which will be **really dicey** from a variety of other perspectives (and will result in sizable losses to the holders of debt in the U.S.) - eventually improves competitiveness. In Japan, in our opinion, this improvement is the rock on which its on-again/off-again surplus and growth are anchored to.

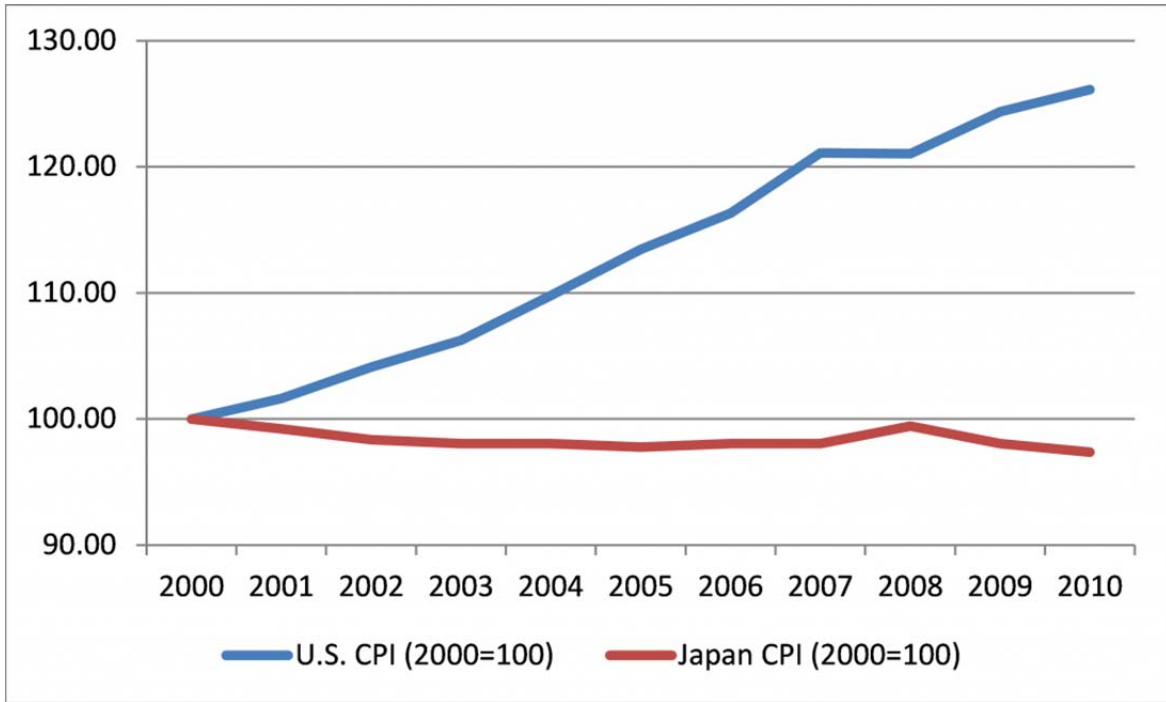
Having read this far, it is time to treat you to a few graphs illustrating some of the differences between the U.S. and Japan from 2000 through 2010. Keep in mind that Japan - its bubble having burst at the end of 1989 - had a head start in the re-balancing dodge, so don't focus so much on contemporaneous differences (although they are relevant in a limited sense), but rather the Japanese experience as potentially predictive. Nominal wages have already flattened in the U.S. and the dollar is already stronger (of course, the debt's been with us for some time).

All of the below are for the period 2000-2010 and, except for the the unemployment rates, all have been indexed for convenience and comparative purposes (2000=100). The sources for all of the charts are the U.S. Bureau of Labor Statistics and the Japanese Statistics Bureau of the Ministry of Internal Affairs and Communication.

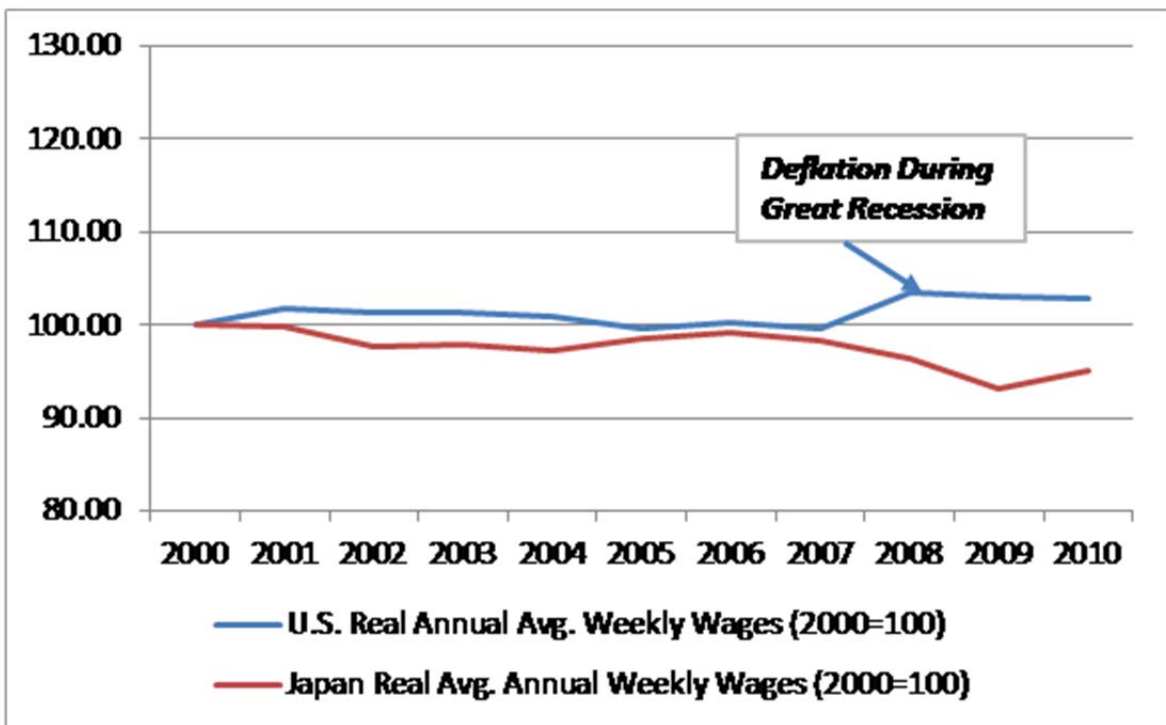
First up is a chart showing nominal wages in the U.S. and Japan. They increased steadily and significantly in the U.S. and fell moderately in Japan:



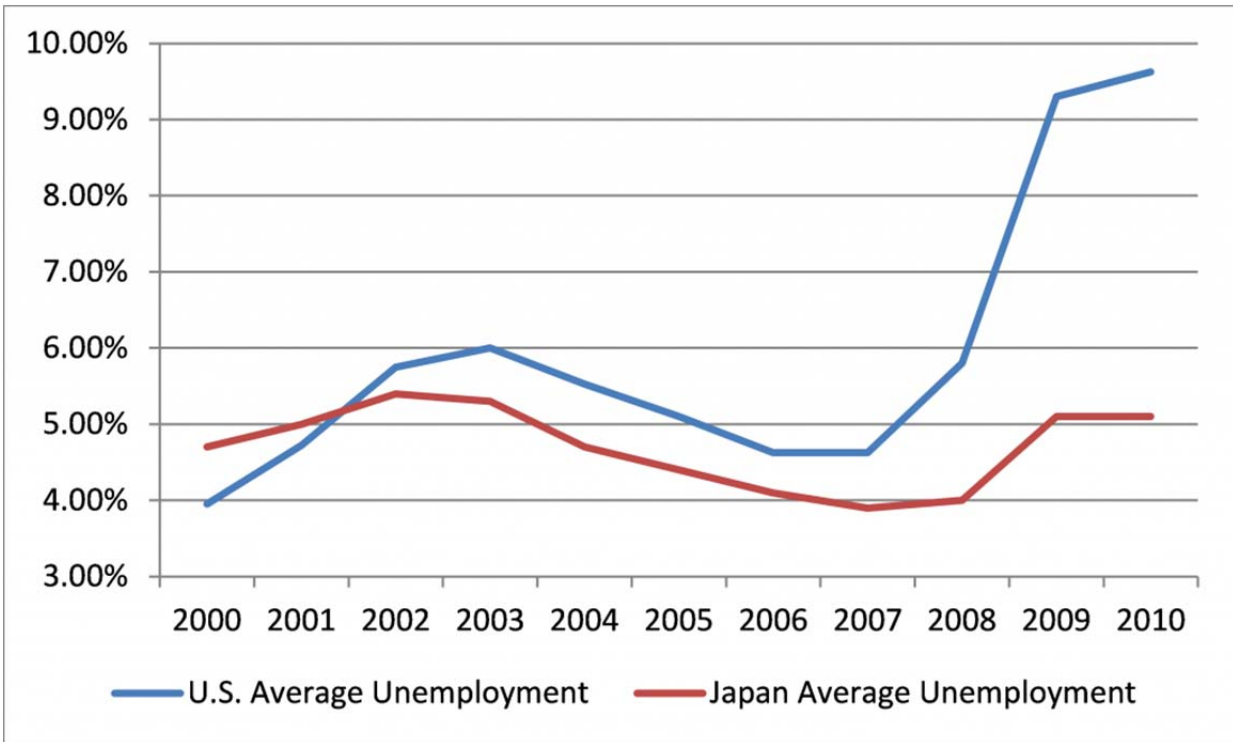
Next, let's look at inflation (deflation) in both countries during the same period. Note how it, unsurprisingly, mimics the above nominal wage chart:



Overlaying the above to data series produced real wage growth. This is where things get interesting, as real wages in both countries are pretty much flat (and in the U.S. they are only up a tad because of the period of actual deflation the U.S. already experienced during the Great Recession):



Finally, we have the issue of unemployment in both nations. I will recite the "Japan's official unemployment number is heavily engineered and unreliable because of the huge number of temporary and part time workers, and besides the Japanese just don't tolerate unemployment" line to defuse critics. But really, that's an old saw that is becoming increasingly toothless in light of the huge gap between U.S. U-3 (unemployment) and U-6 (underemployment), as well as the United States' own volume of temporary and part time workers (over 19% of those we consider employed are part time, for example):



Yes, the Japanese have not been very good at "tolerating" unemployment. The U.S. (and Europe) apparently excel at it by contrast.

The question, yet to be fully answered, is: Does U.S. unemployment merely reflect the "banking" of what will be inevitable wage deflation, so that the majority in the labor force can work at wages near, and prices don't plummet from, current levels?

We believe 2012 will begin to show us the answer.

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