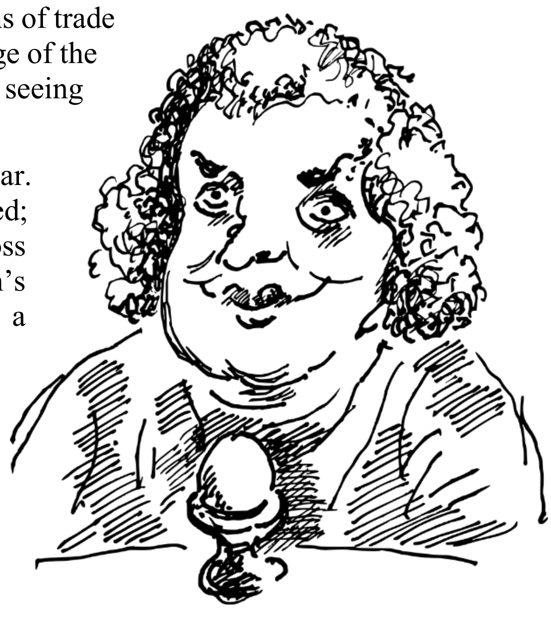
This review is more ambitious in scope than many quarterly offerings from Ruffer. It will cover more ground than is perhaps wise, and the reason for doing this is that we are looking at the many elements which will determine whether we face a deflationary crisis (to which the answer is a near-certain 'yes'), and whether the response of the central authorities will result in our long-predicted high inflation coupled with low interest rates (our answer to this is 'indubitably'). These seemingly inconsistent conclusions arise from our long-held understanding that both inflation and deflation are manifestations of the same thing: monetary instability.

The fall in the CPI inflation figure is important only if it's a herald of true deflation. Ignore talk of 'good deflation' and 'bad deflation', and the far-fetched idea that with deflation running at 0.1% a year, consumers will hold off buying stuff until it has dropped in price – presumably by a penny per £10. The issue is whether it is a messenger of mischief to come: the albatross of the Ancient Mariner, the receding of the tide before the tsunami: a harbinger – not the real thing. It does not need publication of a low CPI inflation figure to establish that there are powerful deflationary forces at work in the world's economies. Where there are deflationary forces, falling asset prices are never far away, and if central bank response to deflationary forces has driven them to high levels ahead of it, then the reversal of this becomes hard to avoid.

We may look back and see that the present phase in the worldwide economy is in a cross-current: the deflationary forces offset by the exuberance engendered by rising asset prices. Remove the latter, and you are left not only with existing deflationary forces, but also with the superimposition of the migraine imposed by financial pressures and thwarted hope. This can be seen in historical example. The fall in Wall Street in October 1929 is the best example of it. The Wall Street Crash was indeed the cause of the Great Depression – something which was obvious to its victims, but which was declared 'wrong' in the rewriting of its causation when viewed through monetarist eyes a generation later. Well, here we are again; it's not a theological debate. It is a matter of deep concern.

This is certainly the way the central banks themselves see it. They are far from complacent about the fall in inflation, concerned that it might be worrisome in its own right, and that they 'let it happen', even though they had been at great pains to seek to avoid it. The idea of quantitative easing was a resounding success for policy management, but it was more than six years ago. The cadre of economists feel it is time for another triumph, but are split on a solution and are proposing increasingly radical and divergent solutions.

Prices go down for two separate – indeed, opposite – reasons, something observed by that fine economic expert of the eighteenth century, Dr Johnson. On a trip to the poverty-stricken Shetlands, he found that eggs there cost only a ha'penny, rather than the going-rate of a penny on the mainland. He observed that the reason for this was not the abundance of eggs, but the shortage of ha'pennies. This is a crucial distinction, since a falling price can come from a change in the terms of trade either through a glut of the commodity for sale, or through a shortage of the money to acquire it. Without this distinction, one can end up seeing opposites as the same thing.



In the days when money held its value, the distinction was clear. Throughout the Victorian age, prices fell as industrialisation occurred; we see the same process today in digital cameras, in cars, and across a wide range of computer and other technologies. This is Dr Johnson's abundance of eggs. But there are times – and places – when a fundamental lack of prosperity is the driver: I see it at first hand in County Durham, where I am striving to lift spirits, lift economic activity and to lift prices. Why can one buy a four-bedroomed house in Bishop Auckland for two-thirds of the price of a two-bedroomed Oxford flat? The answer is the shortage of ha'pennies that comes with economic prostration. Across the globe, there are many economic deserts which have nothing to do with abundance, and everything to do with shortage.

We no longer live in a world where money is an absolute. When a pound sterling was made of gold, it was easy to tell whether prices were really going up or down: the rise or fall in the cost of living gave the answer. But when sterling is a token, made of paper, or by a computer entry on a bank screen, there are two moving objects. Prices have two opposite forces in a modern recession: a tendency to fall because of the economic malaise, and a tendency to go up because there is more paper money in circulation. As times get harder, the 'more paper money' overwhelms the economic malaise. That is clearly manifest in Russia: low oil prices, a flight of confidence, of capital, are all symptoms of hardship, of shortage. But the rouble is being created in big volume, so there is inflation in Russia, although the forces are exclusively deflationary. At least Russia is able to create new roubles – the essential problem for Europe is that Greece, Portugal and many other countries suffer the deflationary forces of a widespread loss of confidence, but have the euro, which they cannot manipulate downwards, as they would have done with their own currency in the last century.

Pausing there, we see deflationary forces throughout the world, which are being scarcely held at bay by the bull market in assets, itself the result of a rush from safety by conservative investors despairing of getting an adequate return on their money. The bull market is now a fundamental part of the health of the world economics, as a bear market would be – will be – if it comes about. And then the world's economics will darken quickly.

In this circumstance, the question is: will the central banks at the centre of the world's economy follow Russia and allow the partial default of their currency? In this world, the deflationary shortage of ha'pennies masquerades as an abundance.

Quantitative easing was such an initiative and it has been a resounding success – largely due to a fluke. We described in the last investment review that the money-creation was voucher-like, in that, acting as money, it transformed the balance sheet of the financial system, but it was a voucher not usable by the consumer or corporation for spending on goods and services. The inflation was seen, therefore, in asset prices, not retail prices. It bought time for those central banks, but the time has run out – will they create consumer demand with CPI-sensitive money, as a reprise?

It is an important question. If we see inflation, it is the saver who suffers. If we see deflation, it is the borrower. There is a lot of debt about following the debt explosion which came to an abrupt end in 2008. The ensuing years have seen a re-arranging of that debt – basically from the financial world to governments – but it is pretty much as high as it has ever been. There is a huge asymmetry of risk between an inflation (one less holiday a year for the victims with savings) and deflation, which threatens to bankrupt every debtor, beginning with governments. It will be inflation which will redistribute the wealth away from the saver, and keep stable the equilibrium of the borrower.

The surprise – it shouldn't have been – is that the creation of 'somewhat inflation' by the 'somewhat destruction' of a nation's currency isn't as easy as it sounds. This observation would have created hollow laughter in the days of high inflation a generation ago, but the reality is that once a trend is in place – Japan since 1995 – it is very hard to reverse. But there's an increasing realisation that the only way of extinguishing the amount of debt in the world is to penalise savers – the same dynamic, of course, as subsiding borrowing rates. Thus, when RPI peaked at 5.2% in Britain in 2011, base rates were already down to 0.5%. Now that inflation has disappeared, that subsidy has disappeared, but it tells investors what we could only surmise (as we did) a few years ago, that the solution which governments will choose is interest rates much lower than the rate of inflation. While asset prices hold up, deflation is a paper dragon. Central bankers will worry, but the rest of the world will go happily or unhappily about its business. If asset prices fall, and fall seriously, the phoney war will be over, and we will indeed be facing true deflation: a deflation which is one step on this journey to currency-compromised inflation. If that happens, expect the central authorities to respond. Expect them to target inflation. Expect them to learn from the old Japanese experience that a desire to replace deflation with a bit of inflation with some vague attempts at monetary expansion, is like attacking an enemy with a pair of scissors. Currency destruction – partial, of course, as in the UK during the 1970s and 1980s – is achieved through fiscal profligacy. In these extreme circumstances, that is the course which they will adopt. We expect to see interest rates up to 4% in the next cycle – when inflation is 10%. The next boom, on the back of prostrated savers, will be a mere five years after that.

Jonathan Ruffer
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