MONEY, MACRO & MARKETS

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Part I: Japan

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DRAWING AN OMIKUJI: The Outlook from Japan

In a striking testimony to just how much we have all been spoiled by the past eight years of increasingly desperate and ever more impatient central bank intervention, the latest Wheeze from the Bank of Japan – something it grandly calls 'QQE with Yield Curve Control' – was greeted – if not exactly with a yawn - then certainly with a loud grumble of dissatisfaction.

By forgoing any immediate push further into negative territory for short-term rates and by simultaneously pledging to peg long-term yields at around zero, the Bank seemed instead to be paying attention to the plight of its banks and insurers who have complained that they are being starved of a way of to make ends meet.

At first blush, then, this shift seemed to signal an end to the fireworks which have been routinely set off by one of the world's most devilishly ingenious monetary authorities these past few years.

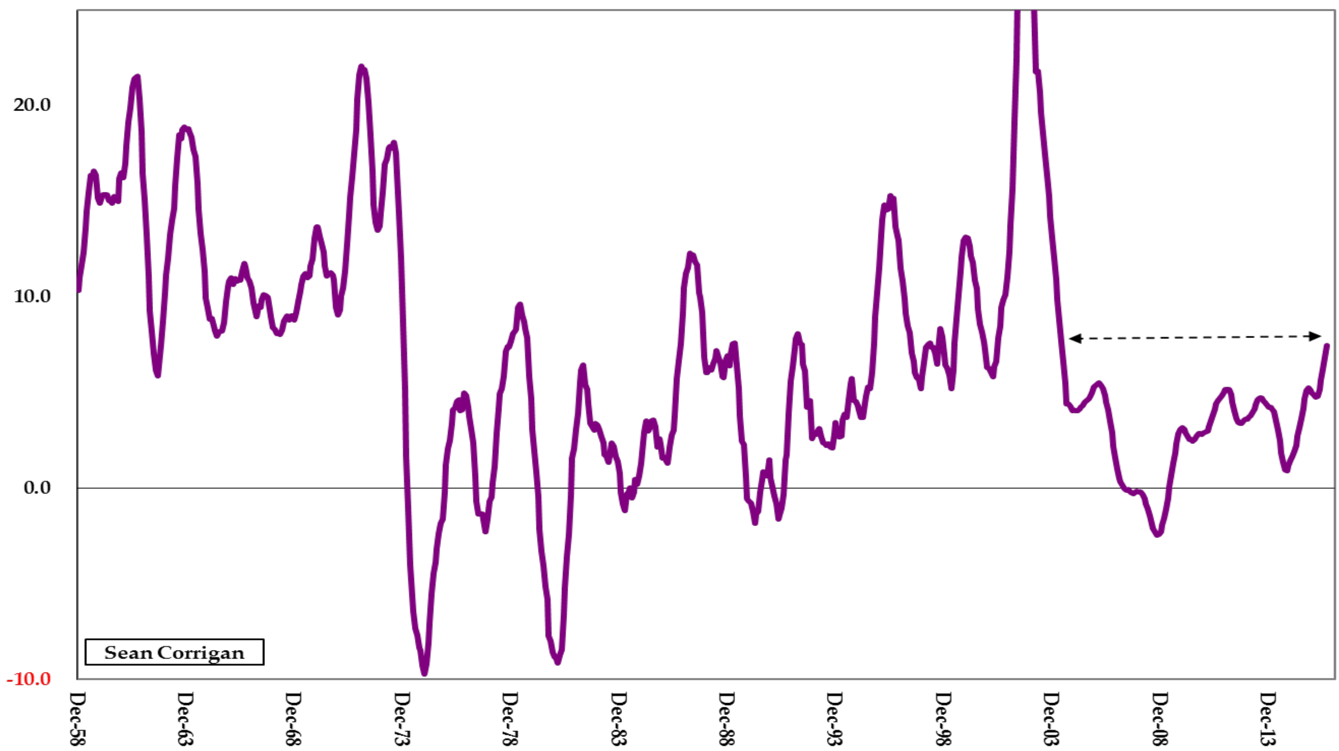
But that rush to judgement may be a little too precipitate: for the action – and especially the accompanying rhetoric – also bear the construction that what this nest of unshakeable monetary cranks has done here is to light what is possibly a slow-burning fuse, but which is nonetheless one which leads directly to a very densely packed powder-keg.

The Bank, you see, by setting fixed-price reverse auctions, has effectively pledged unlimited sums of freshly printed money to keep yields from ever going appreciably above zero - even, in exceptional cases, for maturities out as long as 20 years. In order to afford itself even more room for manoeuvre, it has also rescinded its own average maturity guidelines for the bonds it allows itself to buy, as well as now standing ready to provide, upon demand, fixed term finance for *ten* years at a stretch, rather than for just the prior one.

Like a petulant schoolmarm, the Bank went on to bemoan the '*entrenched*' and '*backward-looking*' attitude of the uncomprehending dunces in its charge – each of them stubbornly trusting to their own experience and resisting the adoption of the 'expectations' which the BOJ wishes them to have about the bright new world which awaits them if only they will finally come to believe -and rejoice! - that prices are henceforth to rise, not fall.

Not content with merely castigating them for their recalcitrance, the Bank decided to whip them into line by means of its new '*inflation overshooting commitment'*. Under this head, every failure to cause prices to rise by the desideratum of 2% p.a. *now* will be punished by a spell of indeterminate length on the naughty step of greater than 2% in-

Real Japan M1 yoy: ***Source - BOJ***



creases *in future*, this to last until such time as the BOJ feels its will has been done, even if in a highly retrospective - and hence largely symbolic - manner.

Not that this abomination is something unique to the BOJ. Indeed, Draghi himself mused about such an approach back at his post-meeting press conference in March, telling his interlocutor then:-

'…our mandate is defined as reaching an inflation rate which is close to 2% but below 2% in the medium term. Which means that we'll have to define the medium term in a way that, if the inflation rate was for a long time below 2%, it will be above 2% for some time.'

As ever, the wildest ideas of the claque of monetary madmen who hover, whispering, at the elbows of today's Sanhedrin of central bankers are initially treated by the more politically-constrained among them as no more than guilty, lubricious temptations – though ones to which they are all too happy to give longing voice in public, by way of an *ex cathedra* endorsement of what they *would* do if only circumstances permitted.

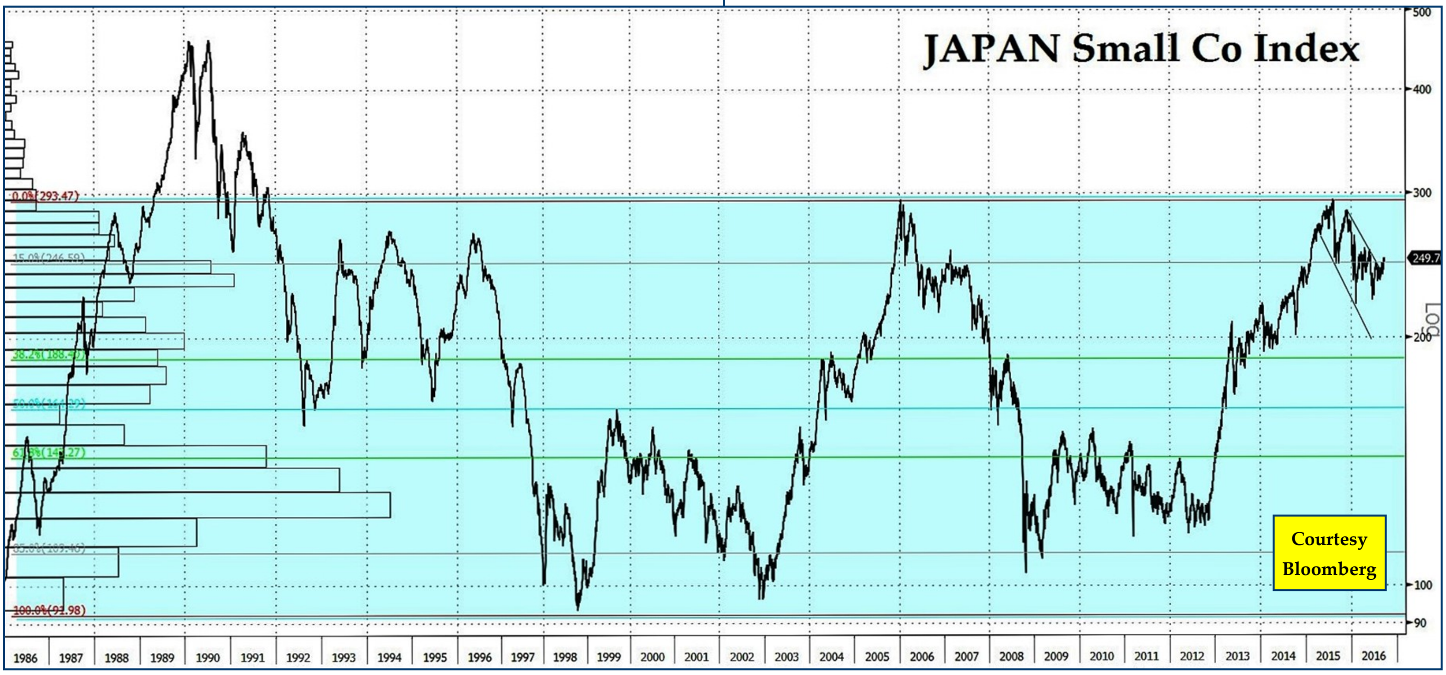
It most often falls next to the eager experimenters at the BOJ to throw such affronts to both common sense and established practice into actual operation, safe in the knowledge that their ultimate boss, Shinzo Abe, will only approve of their boldness as a diversion from his own failure to craft, much less fire, his vaunted 'third arrow' of economic reinvigoration

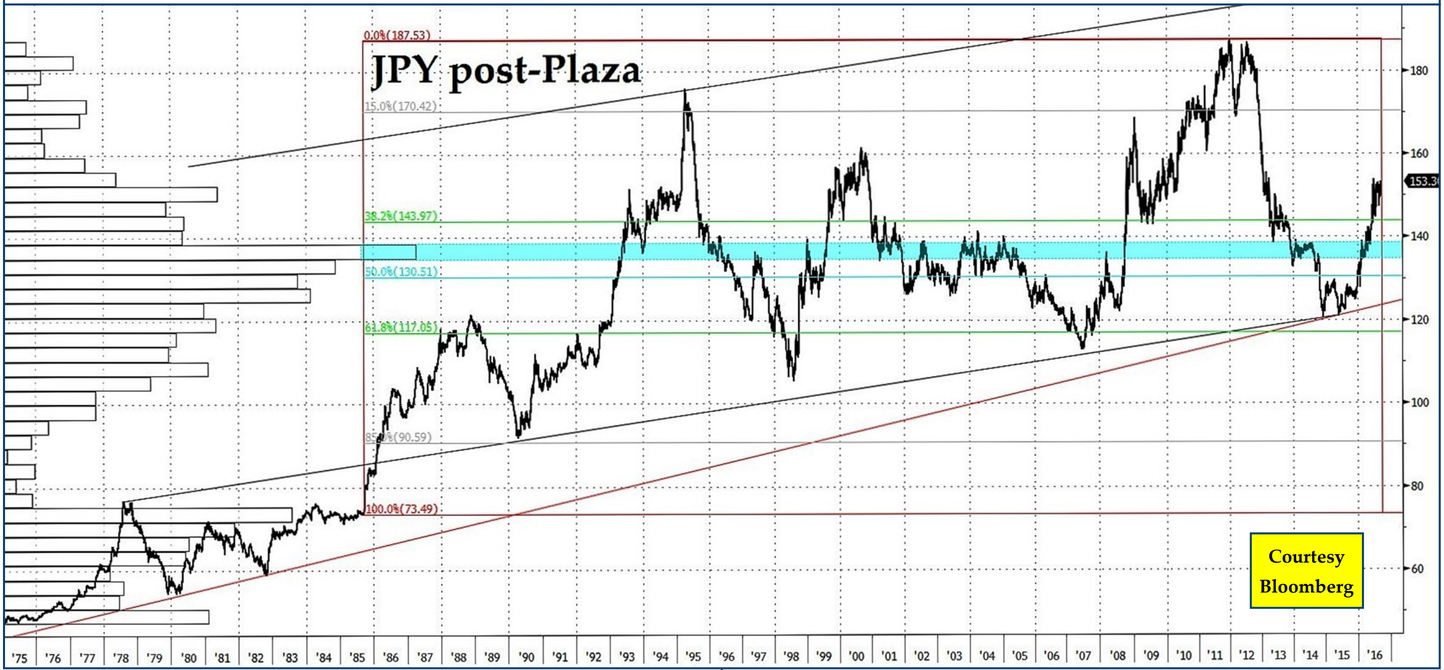
Henceforward, now that they have a working precedent to which to point, the others, too, can indulge their fantasies and so redouble their ongoing attempt to bludgeon the masses into conformity with the esoteric calculus of their economic 'models'.

It is all too easy to mock Haruhiko Kuroda for his descent into Peter Pan whimsy when trying to explain why it is *so* crucial to the MIT Macromancers that 'expectations' be hammered into the required shape. But consider, too, that such twisted, cart-before-horse ratiocinations prevail in the inner sanctum of the ECB, too.

By way of an example, as the culmination of an exposition on this very theme which its Chief Magus – sorry, *Economist* – Peter Praet was delivering, back in April, he offered up this classic exercise in reversed causation, wishful thinking, special pleading, and utterly unsubstantiated, historical speculation as a justification for the bent of the Bank's current policy:

'Indeed, Eggertsson and Pugsley show that, in a fragile post-crisis situation where monetary policy is sustaining the recovery, any perception that the central bank is adopting a greater tolerance towards a future regime of lower inflation can have very negative effects. Looking at the Great Depression period, they argue that ***the return of the US economy to recession in 1937 resulted from a perception that the Fed had abandoned its commitment to reflation****, creating pessimistic expectations of future growth and inflation that fed into both expected and actual deflation.'*





'The economy then became caught in an equilibrium of "contractionary beliefs [emphasis added].'

Now it is true that this is an episode about which, almost 80 years on, controversy still rages with regard to whether it was a mistake of the Federal Reserve, committed as it was seeking to quell an incipient inflationary episode with a modest monetary tightening; whether it was an inadvertently large adjustment to fiscal policy carried out by an uncomprehending Roosevelt administration; or whether – as your author has argued at some length in *'The Ghost of '37'* [available on the *True Sinews* website] – it was as much about the mounting of an ideologically-motivated, two-pronged assault on owners of capital and judicial independence which led to a somewhat Randian 'strike' on the part of the productive classes.

No matter which of these various contentions the reader might find more convincing – and, as with all such cases, no verdict can be definitive since no single cause can ever be isolated from amid the complex interplay of real-life events and irrecoverable contemporary attitudes - what he will *not* find among them is any trace of Praet's and Kuroda's almost quantum mechanical mysticality whereby an entire society becomes *so* convinced that bad things *might* be about to happen that they act in precisely the manner best judged to give their phantasms immediate, concrete form.

Nor can one escape the bitter irony that the very people whose 'forward expectations' have become 'de-anchored' - and so slipped into a spiral of self-defeating morbidity which is based on their 'adaptive' reaction to events of the past several years - are the central bankers themselves – what, with their 'savings gluts', their lowered 'real equilibrium interest rates', their rehashed phobias of 'secular starvation', and all the rest of their intellectual baggage!

That, alas, is where we do find ourselves today, however.

Dragon head, snake tail

As a result, the BOJ now wants to reinforce its determination to reach 2% p.a. in CPI increases by bruiting abroad its willingness to exceed that target over some not inconsiderable horizon.

Given that the very lack of success it has encountered in achieving the first objective has necessitated its adoption of the second, ostensibly more challenging one, this has met with a certain degree of derision from the commentariat. We, however, for all our scorn of the pretensions of central bankers would not be quite so quick to dismiss its import.

Firstly, it might not be the ordinary man and woman whose 'expectations' and calculations it is that the BOJ is really aiming to reformulate, but the managers of financial assets and the wielders of trading leverage instead.

Consider now their conundrum. The Bank wants to keep a minimum *positive* spread between the overnight rate and the bonds they own and will tailor its bond buying to achieve this. It will try, it avers, to keep 10-year JGBs hovering around the zero percent mark while also maintaining the overnight rate at -10bps for the time being.

The fact that its ability to fix the slope of the yield curve might be compromised by its more pressing wish to buy around Y80 trillion a year of these instruments, at a time when the government is only scheduled to issue around Y20 trillion of them gross, is a conflict regarding which we all await further clarification.

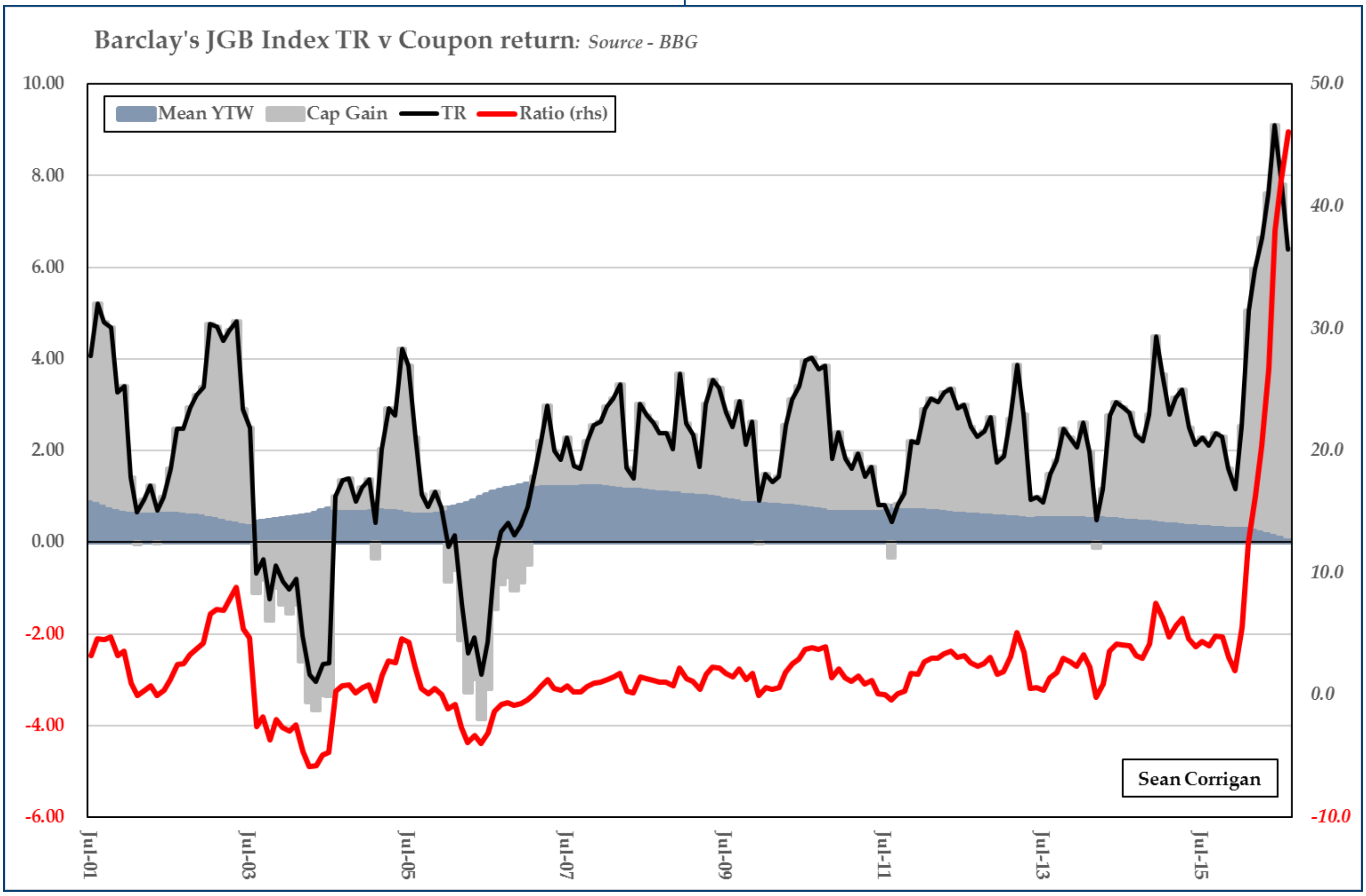
Ostensibly, then, the change is intended to lessen the plight of those banks and insurers who have been denuded of earning assets – and, in particular, of those deemed 'safe' by their regulators. This the BOJ hopes to do by preserving for them at least some residual reward for undertaking the pivotal process of 'maturity transformation'.

Pending the success of this latest adjustment, NIRP had been threatening to place banks in the somewhat paradoxical situation wherein they would henceforth be expected to earn their vital net interest margin (the bedrock of their business model, no less) by charging their depositors more to look after their cash than they, the banks, would then have to *pay* their own borrowers to relieve them of it!

In Japan's case, any such alleviation would be more than welcome, given that the sheer ferocity of the BOJ's interventions caused a spectacular collapse in bond yields in the first half of the year, flipping the 10-year JGB from +30bps to -30. Even more spectacularly, the heat generated by all this led to the almost complete evaporation of the 150/60bps which the supra-longs had been commanding just before Christmas.

The combination of their already long duration and the Gadarene rush down to the scanty few basis points of YTM which was left to them at the start of July produced some stunning increases in their quotations in what was arguably one of the greatest bond bubbles of the modern era.

For example, the No.8 40-year rallied no less than 57% (sic) in just seven months. For a dollar-based buyer, the yen's concurrent strength would have pushed that already breath-taking gain to just over 90%, while a sterling holder would – thanks to *his* currency's post-Brexit slump – have



racked up a startling 125% profit in that same interval!

No wonder the MOF rushed to impose a capital gains tax on the instruments.

Since then, something of a classic, post-mania reaction has set it in, it is true. Prices have fallen by up to a sixth and so have wiped out almost half of the prior capital appreciation. Make no mistake, however, this breaking of the fever still leaves the returns achievable on the bonds preternaturally reliant on a renewed slide in the greatly-depressed yields of 55bps which now prevail on the longest of them all.

Therein perhaps, lies the crux of a policy which has otherwise perplexed the legions of teenage scribblers who have commented upon it; to a man unable to fathom how the BOJ can hope to make its new 'symmetrical' CPI target stick when the 20%-plus fall in import prices has temporarily reduced the measure to the negative column once more.

If yields *are* to be confined to a few basis points either side of zero, not only will there be no income to accrue, but no scope for further capital gains either – at least, on the assumption that the BOJ can (much less will) act to prevent another rush into the assets. That should be enough, the Bank may well imagine, to encourage a greater appetite for, say, USD assets, which – even with the hurdle of a 70bp adverse basis swap to overcome for those who insist on hedging their forex risk - still offer a sizable premium over the homegrown variety.

Now it may be asking too much of Mrs Watanabe to suddenly fear that the purchasing power of her *hesokuri* nest egg will begin to erode as rapidly as Kuroda-san might wish her to do though it may not matter overmuch since she invests barely 1% of her savings *directly* in JGBs, in any case.

But the manager of her salaryman husband's life assurance might not be so sanguine and *he* is the man whose opinion counts, alongside that of his banker, his credit co-operative representative, and the fellow at Japan Post, since these four between them dispose of around 85% of the domestically-owned bonds not already in possession of the BOJ and so hold an amount approximately Y85 trillion larger than does that last august institution itself.

This man is one who, in his professional capacity at least, might be more amenable to taking Kuroda's threats in earnest. *He* might therefore begin to reckon up the potential effect on future real returns of the Bank's new idea of balancing today's sub-par price rises with a slew of supra-normal ones tomorrow. This would, after all, be a neat way of allowing the same long-term price *level* to be reached, if by way of a less even trajectory than would be followed if the 2% target had already been attained.

Even without this apprehension, now that the passing of the frenzy in the bond market has again allowed our trusty steward of his clients' capital means the time for reflection, he might become mindful once more of the awful fiscal arithmetic which confronts him as he tries to discharge his fiduciary duty.

Dust piled up becomes a mountain

For the sobering truth is that Japan has for too long been a country where the citizens would rather not finance what their government pays out to them in benefits and boondoggles by way of taxes taken from them, but would instead prefer to bridge the chronic shortfall caused by this reluctance by *lending* it back the money it has first showered upon them.

The problem with such a system is twofold. Firstly, it predisposes them to cling to the dangerous illusion that such already expended resources still remain as 'savings' upon which they can draw down. Secondly, it entangles the mediators of such 'savings' in a web of legal obligation which cannot be honestly discharged.

That Japan is not alone in such fostering such confusion in its social accounting is true, but Japan *is* (for now) fairly unique in how viciously this interacts with its rapidly greying population. If you listen closely, you can hear the evil spirit of Keynes cackling at the consequences of people failing to think clearly about what happens when, 'in the long-run', we are all dying out.

As Professor Keiichiro Kobayashi of Keio University outlined in a recent paper for the Canon Institute, the government itself effectively admitted it is doomed in the reference material compiled for the Public Finance System Subcommittee of the Fiscal System Council, back in April 2014, as part of a presentation entitled, *'A Long Term Estimate of Japan's Finances'*.

This depressing document showed that, should matters continue to stand as they now do, by the end of this decade, the national debt would begin a catastrophic divergence from its present, already parlous course, going on to reach a putative - though, of course, practically insupportable - 500% of GDP by mid-century.

In order to stave off the disaster entailed by entering even into the early stages of such a process, the Committee's experts calculated that a fiscal adjustment of no less than 14% of GDP would be required if the debt were to be instead reduced – and then over a forty-year horizon, no less – to a mere 100% of GDP.

That, Professor Kobayashi was quick to point out, would require some combination of slashing outlays and raising taxes to the tune of some Y70 trillion – such as could be achieved, for example, by raising the consumption tax to as high as 30%. Given the fall-out occasioned by 2014's piffling 2% rise in that levy to its present, hardly-swingeing 5%, it is all too apparent that this is politically, if not economically, a non-starter.

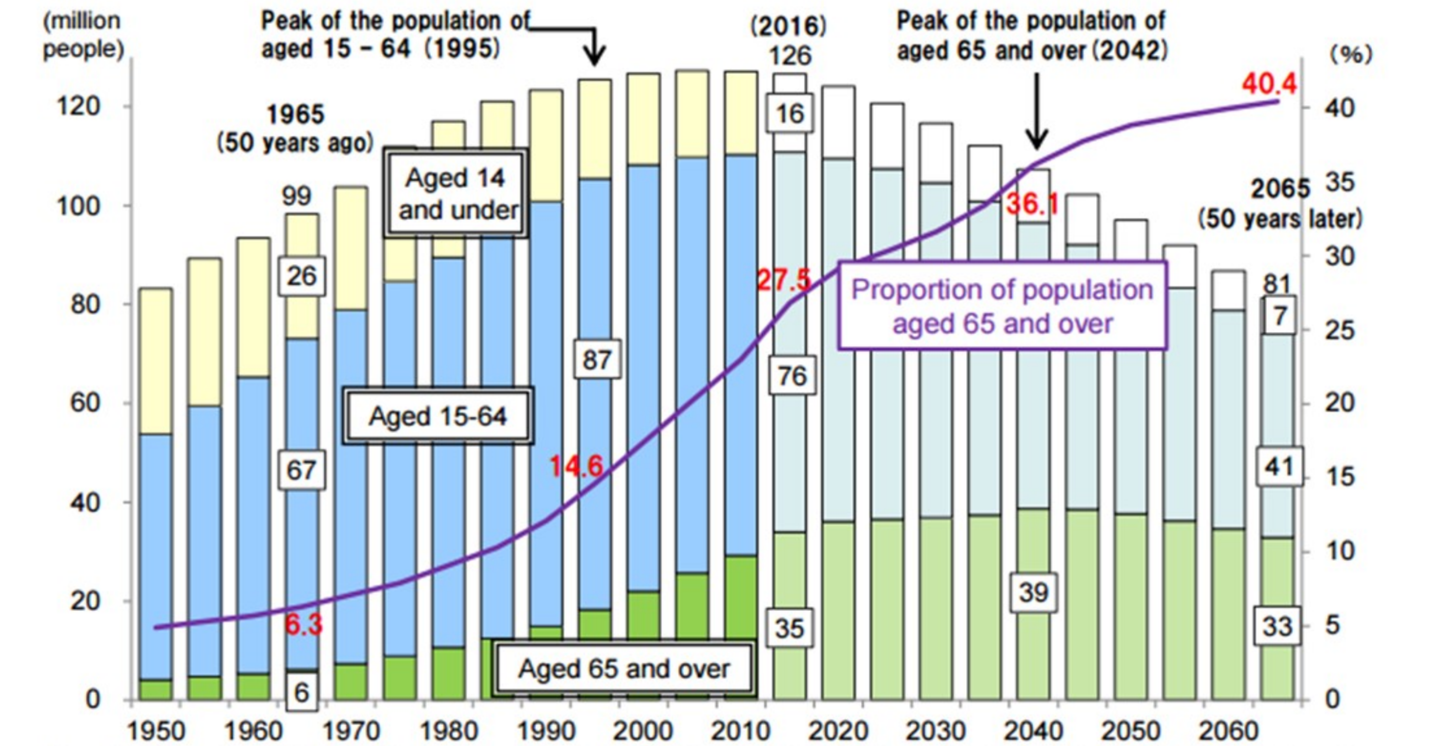
Conversely, primary budget expenses – i.e. those not involving debt service – currently stand at a not wholly incomparable Y73 trillion a year, so the problematical nature of enacting economies of the requisite Y70 trillion along *that* particular axis should need no further elaboration either.

Here, those of a suspicious bent might notice that the monstrous sums currently being conjured up out of thin air by the BOJ are conveniently something of a match for this projected shortfall, comprising Y80 trillion per annum, as they do. Moreover, given contemporary debt service costs of Y23 trillion (in principal and interest payments), the least contentious quarter of the existing budget has already been paid for by means of the BOJ's seignorage. This means it has effected one-third of the prescribed reduction by stealth. Nor should one overlook the fact that NIRP itself is nothing more than the imposition of yet another unconstitutional tax with which to further fill the hole.

Though there is, of course, a distinct measure of chicken and egg in the mix, the experience in the eight years since the GFC shows JGBs in issuance rose Y292 trillion as part of a Y364 trillion increase in total government debt.

To show for all that gargantuan outlay, Japan now generates Y28 trillion in extra GD; an adverse marginal debt/income ratio of 13:1. Fortunately (or otherwise), the BOJ's helicopters absorbed Y326 trillion, or 90%, of that debt directly and chipped in an additional Y18 trillion contribution to the coffers of its potential buyers via its other interventions. That left only Y20 trillion of what amounted to a 60-point surge in the ratio of debt:GDP for everyone else to cover out of pre-existing or privately-created monies.

Adding to the concerns, primary (non-debt related) ex-



(Sources) Ministry of Internal Affairs and Communication "National Census" and "Population Projection", National Institute of Population and Social Security Research, "Japan's Demographic Composition in the Future (estimation as of January 2012)", Ministry of Health, Labor and Welfare "Vital Statistics"

penditures outside of social security were essentially unchanged over this period, meaning that the entirety of the roughly Y10 trillion in extra outlays which did eventuate arose as part of a near 50% rise in their social security component.

Needless to say, that particular line item is not likely to decline anytime soon. Indeed, the demographics suggest there will be around 10% more (and older, more expensive to maintain) retirees by the time their absolute number (though not their highest proportion) peaks a quarter century from now, by which time there may also be 25% fewer people of working age around both to support them and to pay off the bills they ran up in the years of their prime.

Faced with the knowledge of this looming inter-generational catastrophe and now seemingly deprived of the sweetener of rapid capital gains on what are essentially non-performing loans-in-waiting, might our life assurance manager not soon find himself itching to hit the BOJ's bid, especially since he knows that same bid will not now move against him under the weight of his own sales?

Parenthetically, the new directive also means that the bulk of the last several months' windfall capital gains will now be cemented into place by the BOJ's prevention of any further price falls; such 'profits' to be variously apportioned between the state, the shareholders, and the owners' capital accounts – thereby allowing the former two to carry on spending and the banks among the latter to expand their loan books further, as and when the spirit moves them.

Once such a way of thinking becomes common – and especially if the redistribution of the sellers' monies starts to move other asset classes higher and/or the yen lower – it would not be hard to envisage a self-fuelling, even a self-accelerating process being set in train.

Oni ni kanabou: Giving the monster a stone

Outside of the financial markets themselves, this might just be enough to start edging prices higher again – particularly if the foreign exchange impact were to magnify what the *other* central banks' gross monetary irresponsibility might be on the verge of doing for commodity prices, once more.

Here is where that averaging-out of the CPI rate might come into its Mephistophelean own, especially since Kuroda is currently 18 months into a spell wherein he has missed his target by around 2% on average and so has stored up plenty of ammunition with which to defend a prolonged period of inflationary unconcern, should the chance arise.

Given his stance, if CPI *did* begin to pick up again, the plain, good folk of Japan - assuming they had not already been swept up in whatever speculative enthusiasm for other assets had meanwhile been excited – might realize that not only was the purchasing power of their deposits beginning to erode once more, not least because the BOJ was preventing them from earning any compensatory return on them, but that the Bank had declared that it would look kindly upon an acceleration of that loss well beyond its nominal 'target' rate.

The converse would, of course, be true of anyone predisposed to borrow in order to buy assets, rather than consumables. The real value of their obligations would decline, leaving them with notionally more net collateral against which to borrow and buy again. Of those borrowing specifically in order to finance consumption, let us not forget that the foremost among them, the state, would retain all of its eagerness to do so, especially as the burden of its vast social security commitments is almost guaranteed to rise with, if not faster than, the general increase in prices and so render any increase in its tax receipts less likely to transform its fortunes.

Nor would even the *nominal* rate at which they all could do this rise very much: the BOJ's efforts to hold benchmark rates near zero, combined with an avid competition among lenders for an earning asset, would surely see to that.

As this convective vortex wound tighter and began to spin faster – and assuming some future Bank of Japan governor did not entirely abnegate the policies of his predecessor (or, if it came to pass quickly enough, Kuroda his own) – liquidators, borrowers, and lenders would all find a fixed bid for their paper in whatever size it took to absorb the effort to sell. Thus, their repeated attempts to escape would simply enable the BOJ to boost the money supply further and so potentially push CPI on faster and faster until – well – KA-BOOM!

So far, all of this is in the realm of supposition where we must hope, but should not presume, it will long remain.

For all that this represents no obvious advance on the prior situation and that therefore no-one is exactly sure of how it might succeed where the old strategy failed - and for all *we* lampoon the Macromancers' fervent invocation of 'expectations' as if they were Victorian parlour spiritualists fraudulently conjuring up the ectoplasm of the dearly departed - what the BOJ *has* undeniably done here is string out a tripwire across the path of its people which it has wired to a very large IED – in this case, an *inflationary* explosive device.

Thus, in the short term, the doubters may be proven correct in their weary assertion that nothing fundamentally has changed. What they miss, however, is the *optionality* of the new framework: that if something starts to move in the BOJ's direction – however much that might be a stroke of fortune, rather than an act of will – the mechanism will magnify its impact, even, conceivably to the point where an unstoppable chain reaction could occur.

Given the Bank's implicit intent to monetize just about everything it can in Japan – whether for its professed, thaumaturgical belief in the healing powers of mild inflation or because of an insidious plot to use its balance sheet to erode the state's unpayable mountain of debt – and given, too, that the other major central banks are not exactly ready to isolate their own citizens from whatever virus may be unleashed by the mad scientists of the Nihon Ginkō laboratories - one should certainly be prepared for the worst.

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