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Is monetisation the only ammo left in the BoJ's arsenal?

Ahead of the Bank of Japan's (BoJ) next meeting, we believe that monetisation is fast becoming the only option left to ensure Japan's economy doesn't enter another lost decade.

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Bob Jolly
Head of Global
Macro Strategy

30 Minutes
Unstructured
Learning Time

Negative interest rates and quantitative easing (QE) have so far failed to breathe life into Japan's stagnant economy. Low inflation and low growth still blot Japan's economic landscape, and despite the Bank of Japan's (BoJ) best efforts, the yen has strengthened since the introduction of its latest package of measures. The BoJ is officially stuck between a rock and a hard place.

Are we approaching the point at which the BoJ will need to consider more drastic measures? At this stage, the only option left to trigger a positive shift in inflation might be a more dramatic shift towards monetisation.

What is monetisation and how will it work?

Monetisation is the issuance of cash by a central bank without the need or pretence of an "IOU".

We have long held the view that the accumulation of Japanese government bonds (JGBs) by the BoJ is really a soft form of monetisation, rather than QE.

QE and negative rates have attempted to boost final demand and drive an acceleration in both recorded inflation and, importantly, inflation expectations.

If inflation is generated, the outstanding nominal liabilities of borrowers decline in real terms. This increases the net balance sheet and the potential for demand continues to grow.

Savers will be incentivised to spend to maintain the real value of their purchases and as labour demand picks up, wage demands will rise to increase the real purchasing power of their income. Inflation expectations rise, sustainable nominal growth accelerates and companies invest and hire to meet the higher level of demand. Well, that's the theory.

QE is also, in theory, a temporary fix. The central bank will ultimately need to sell the government debt it has purchased from the market back to the market, potentially supressing inflation.

> "Monetisation would be the final roll of the dice, a truly big bazooka, but the fallout for the global economy could be unbridled."

However, in the post global financial crisis world, since QE has been introduced no developed central bank has openly gone into partnership with the government without some form of IOU.

Using monetisation in its purest form, the central bank can print a potentially infinite supply of notes and coins for the government to spend, importantly without there being an equal and opposite liability on the governments' balance sheet.

The government can spend that cash on anything from tax cuts for households and corporates to infrastructure investment. Importantly, because it doesn't create new government liabilities, the spending can continue until such time as the economy has enough demand for goods, services and labour to cause inflation and inflation expectations to rise.

Why hasn't BoJ policy worked so far?

Japan is a relatively closed economy. Using the exchange rate as a policy lever to boost inflation was never going to be an easy win and was most likely to provide only a temporary inflation boost.

Compounding the issue is the fact that Japan's export mix is among the most inelastic in terms of developed economies. A lower currency will only really boost corporate profits, rather than the final demand for goods.

Essentially, while Japan has managed to boost growth and employment, it hasn't yet succeeded in getting enough economic momentum to shift longer term inflation expectations higher.

> “ Cash in wheelbarrows is not a panacea. ”

The apparent tacit agreement between G-20 nations not to use currency as a policy lever aggravates the BoJ's position further.

Whether, like the ECB, it can explain more aggressive policy intervention as purely domestic policy which does not impact the exchange rate, I have my doubts.

Japan now runs a hefty current account surplus, so the yen may once again be seen as a safe haven currency.

This could exacerbate the Japanese challenge, especially when most commentators recognise the yen is already cheap compared to most measures of long term fair value.

What does Japan need?

Japan needs its economy to run too hot; to get to a point where inflation expectations become entrenched rather than any pick-up in inflation being seen as short-term. To achieve this, it needs the following:

- To create demand-pull inflation, which occurs when aggregate demand is growing at an unsustainable rate, leading to increased pressure on scarce resources and a positive output gap.
- For households and companies to view demand and inflation as a permanent feature, requiring more investment to meet demand, more hiring, higher wages and ultimately a virtuous cycle leading to more growth.

While the most recent shift in BoJ policy has seen long-term interest rates decline significantly, which may boost housing demand, monetary policy can’t really do much more. It is already close to its effective limits.

Fiscal policy has limits too, given the debt dynamics of the sovereign and the side effects of negative rates on the Japanese banking system.

So why hasn’t Japan used monetisation?

Monetisation targets inflation, but inflation is a lagging indicator. Just how much money does the BoJ need to print and spend?

It’s impossible to know in advance. The risk of a policy error that generates too much inflation - or potentially hyper-inflation which historical precedent suggests is the principal risk - would potentially cause:

- The yen to plummet.
- The market to pressure China / Asia to devalue to maintain a competitive position.
- After a degree of market mayhem, inflation expectations may rise globally.
- Valuations could fall. Real assets, such as property and gold, are probably the best performers in this scenario. Nominal assets such as bonds could tumble.

- The euro will likely rally substantially. While the US and UK might be willing to follow the Japanese experiment, German history suggests they would never condone the ECB printing money. This could ultimately trigger a breakup of the eurozone.

Monetisation would be the final roll of the dice, a truly big bazooka, but the fallout for the global economy could be unbridled.

Cash in wheelbarrows is not a panacea.
