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The Central Bank's Battle against Pessimism and Skepticism

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The battle has started

With Haruhiko Kuroda in charge of the Bank of Japan, the target of the central bank's upcoming battle is now clear to everyone: pessimism and skepticism. Before the appointment of Mr. Kuroda, the BOJ was merely a bystander or referee that had a neutral viewpoint. From now on, though, the BOJ will be a veritable military commander (or political activist) with the aim of destroying pessimism and skepticism. This is a very powerful commander that will probably annihilate pessimism and skepticism with no difficulty. The reason is that the BOJ has an unlimited supply of ammunition. By issuing massive amounts of money, the BOJ will support risk-takers and fuel the animal spirit of investors. However, people who shun risk (pessimists and skeptics) have no ammunition. Surrendering is their only choice because they have so little power. As a result, investors will probably start buying a massive volume of risk assets. By the end of 2013, the Nikkei Average may be in the ¥16,000 to ¥17,000 range and the yen may fall to about ¥105 to the dollar.

All of the beliefs of pessimists and skeptics are a fatalistic standpoint based on the conviction that the current situation must be accepted because it cannot be altered. There are many examples of this thinking: monetary measures alone cannot end deflation; ending deflation alone will not make Japan better; excessive monetary easing fuels asset bubbles; excessive monetary easing leads to hyper-inflation; and tight-money policies must be used to kill the deflation zombie. The majority of people in the academic and media sectors viewed the BOJ under Masaaki Shirakawa as a believer in fatalism. The BOJ masqueraded as simply an observer. However, the bank was actually a supporter of investors who sold off and brought down financial markets. The people of Japan, the Japanese government and the Kuroda BOJ have all rejected the dark world that was at the end of the path of pessimism and skepticism.

The new direction of the BOJ's new governor

BOJ governor Haruhiko Kuroda made a definitive statement that Japan was unable to break away from deflation because strategies were implemented only in stages. He went on to say that "I am confident that we are currently taking every measure that can be considered necessary." The BOJ is embarking on a new policy centered on massive government bond purchases in order to enlarge Japan's monetary base. Furthermore, the BOJ is clearly determined to achieve its inflation target of 2% within the next two years. There are three main elements. First is doubling the monetary base by raising the base from ¥138 trillion at the end of 2012 to ¥200 trillion at the end of 2013 and ¥270 trillion at the end of 2014. Second is raising the average remaining maturity of Japanese government bonds held by the BOJ from the usual period of almost three years to about seven years. Third is purchasing listed investment trusts (ETF, market value of ¥4.4 trillion) with the goal of increasing the BOJ's holdings by about ¥1 trillion each year (the BOJ will study ways to make purchases that are effective at supporting stock prices).

The following is from *Strategy Bulletin No. 79* issued on September 20, 2012.

Central Banks vs. the Black Swan – The BOJ Falls Behind

Fed Chairman Ben Bernanke and ECB President Mario Draghi have started using an unlimited supply of bullets to kill the "black swan" (the predilection for currency). "Don't fight the Fed" is a well-known rule among investors. This is why investors probably will not be able to go against the risk-taking trend. However, BOJ Governor Masaaki Shirakawa, who is hesitant and has identified no enemies to fight, still has no clear plan for ending Japan's position as the world's only loser (strong-yen deflation).

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The unlimited ammunition of the Fed and ECB

The Fed announced the start of QE3 on September 13. This will involve open-ended purchases of $40 billion of MBS every month. Obviously, the Fed's intent is to achieve sustained growth in employment and the economy by raising prices of assets. Two factors clearly differentiate QE3 from the preceding QE1 and QE2. First, the amount of assets purchased was fixed for both QE1 and QE2. This time, there is no limit. Second, the primary objective of QE1 and QE2 was to protect the United States from becoming mired in deflation. But the Fed is implementing QE3 even though the risk of deflation has been sufficiently reduced. As you can see in the figure 1, QE1 and QE2 took place during a steep drop in U.S. expected inflation (10-year Treasury note yield – yield of 10-year Treasury Inflation-Protected Securities). But QE3 is starting when expected inflation is climbing at an adequate rate. Consequently, QE3 is not a passive measure meant to shield the United States from deflation. Instead, this is an offensive action aimed at stimulating a recovery in jobs. Benefits will most likely first emerge in the form of recoveries in housing demand and home prices.

The Governing Council of the ECB decided on September 6 to use outright monetary transactions (OMT) for indefinite purchases of government bonds of southern European countries. One requirement for these purchases is a request by a government for European Stability Mechanism (ESM) aid. Taking this action eradicated the underlying cause of the euro crisis: the black swan scenario (the possibility of a collapse of the financial system due to growing panic). Market sentiment is expected to undergo a fundamental shift as a result. The euro crisis that started in 2010 is linked to the imbalance between southern and northern Europe and the reckless economies (low productivity, large budget deficits) of countries in southern Europe. But this is not all. Another cause was the effective paralysis of financial market functions (a widespread predilection for currency) triggered by investors who decided a collapse of the euro was inevitable. OMT is aimed squarely at this problem.

The battle against the Black Swan Scenario

Market participants adopted an extreme risk-avoidance stance following the collapse of Lehman Brothers. The risk-avoidance bias (predilection for currency) was so excessive that investors were effectively anticipating a once-a-century Black Swan Scenario to occur every year. Doing nothing about the predilection for currency would inevitably lead to an economic collapse. The Fed and ECB positioned this bias as their primary enemy and began taking numerous actions to combat the problem.

The timing was perfect. After the Greek elections in June, a summary rally has unfolded that defied the expectations of the majority of investors. Measures to fight the Black Swan Scenario started when the market was in a bull phase. True to the saying "don't fight the Fed," investors will probably be unable to challenge central banks, which have an unlimited supply of bullets. Stock markets staged a summer rally from June to August even as pessimism became more widespread. Although stock indices are up by 10% to 15%, hedge fund returns are far behind at only a few percent. One reason is that hedge funds have lost their superiority. These funds are no longer superior in terms of collecting information, market access and the use of financial technologies. But even more significant is most likely that how investors view the market has been far off target. Investors have been exaggerating tail risk. A black swan comes once every century, not every year. Even so, there was a consistent pessimistic bias among investors who expected frequent black swan events. However, these pessimists were overlooking the fact that a Black Swan Scenario can be avoided if central banks issue unlimited volumes of currency.

A new era of central bank policies has started. First, during a financial crisis, central banks no longer serve as lenders of last resort to provide a safety net. Now the central banks are buyers of last resort. Second, central banks no longer use bank loans to supply liquidity. Instead, they create purchasing power by boosting market prices (lowering the risk premium). Third is a shift in the transmission mechanism for financial initiatives. Central banks now emphasize the wealth effect and consumer sentiment effect that occur when asset prices increase. Since central banks can take these actions by expanding their balance sheets, they have an unlimited amount of ammunition even though interest rates are virtually zero.

Even so, why has Fed Chairman Bernanke has been so determined to take these actions, no matter what? The reason is probably his beliefs as a researcher. He is responding to two changes in the financial environment: (1) the unprecedented volume of excess capital and labor and (2) the growth of direct financing and shadow banking. Idealistic criticism rooted in the defeatist view that deflation is unavoidable is not an option for a policy-maker with the mandate of producing economic growth.

- Continued from *Strategy Bulletin No. 79* issued on September 20, 2012

A clear difference compared with the stance of the wishy-washy BOJ

On September 19, the BOJ announced a ¥10 trillion increase in its asset purchases. When unveiling this new monetary easing measure, BOJ Governor Shirakawa said "I believe that the BOJ is not inferior to Europe and the United States with respect to its boldness or aggressiveness." However, the BOJ is still much more timid with respect to the inability to use unlimited ammunition as well as the inability to target the black swan (predilection for currency) as the primary enemy. I must conclude that the BOJ's awareness of the seriousness of several issues is woefully inadequate. One example is the evils of the strong yen coupled with deflation. The BOJ also has an insufficient awareness of how statistics do not fully evaluate Japan's deflation ('The urgent need to improve the accuracy of price statistics' by Tokyo University Professor Tsutomu Watanabe, September 13, Economics Classroom, Nihon Keizai Shimbun). Furthermore, the BOJ must recognize that Japan's financial markets have completely stopped functioning because of excessive risk avoidance (the largest-ever risk premium). With measures to terminate Japan's strong yen-deflation progressing slowly, the upturn in Japan's asset prices as well will probably be inferior to price increases in the United States and Germany