Musha Research Commentary

MR Musha Research

1 February 2016

Strategy Bulletin Vol.156

Will Kuroda's Initiative Save the World?

– Monetary easing on January 29 may become a key turning point for the market

Musha Research Co., Ltd.
President
Ryoji Musha
Direct ＋81-3-5408-6821
musha@musha.co.jp
http://www.musha.co.jp

901 Renai Partire Shiodome
2-18-3 Hiagshishinbashi,
Minato-ku, 105-0021 Tokyo

(1) Kuroda's initiative puts Japan ahead of other countries

The first signs of the bottom of the global fall in stock prices
In the wake of the sharp worldwide drop in stock prices in January, the world's central banks may be about to advance to a new stage of collaboration to quell the crisis. This cooperation will lead to even more monetary easing on a global scale. Furthermore, there is reason to expect faster economic growth in developed countries as benefits of low oil prices start appearing in the spring. A strong worldwide bull market may begin as a result, prompting investors to start searching for attractive investments. Once this happens, Japanese stocks will gain recognition as one of the most appealing targets of all for these investors.

The Kuroda initiative is like no other
The actions taken by Bank of Japan Governor Haruhiko Kuroda stand out among the numerous global crisis management programs now under way. First, the Bank of Japan eradicated the belief that it has become ineffective with the surprise move of setting a negative interest rate. Moreover, Japan is at the forefront of global monetary easing measures. Second, Mr. Kuroda is advocating the establishment of capital controls in order to prevent the flight of capital from China from gaining momentum.

Deflation is still the greatest risk for the global economy due to the crisis in China. Everyone can see that preventing deflation is the most important mission of the central banks of developed countries. Naturally, the leader of the deflation fight should be Japan, which suffered from the world's most severe deflation and has the most inflation-fighting experience. Mr. Kuroda should be commended for his bold actions backed by a firm resolve. He believes that deflation is the cause of many evils. Deflation must be suppressed regardless of the amount of sacrifice required. He is focused on this goal and taking reasonable actions. The vote approving a negative interest rate was 5 to 4. But relentless risk-taking is a spirit that Mr. Kuroda wants to share with financial markets. This is a characteristic that is demanded of a wartime commander for the fight against deflation rather than a trait needed in a normal economic environment.

(2) Quantitative easing with a negative interest rate
– Will this be Columbus' egg?

The negative interest rate policy has produced criticism
The Bank of Japan's monetary easing measures mark the first time that a developed country central bank has attempted to block market sales by speculators that started in the second half of 2015. Next, the ECB and Fed will probably adopt a cooperative monetary easing stance. ECB President Mario Draghi has indicated that additional easing will start in March. This will probably force the Fed to suspend for now its plan to raise interest rates.

Many people are critical of a negative interest rate. In their editorials, Mainichi Shimbun said that negative interest rates will be an adventure of despair, Sankei Shimbun said that we must not forget the limits of reliance on the Bank of Japan, Asahi Shimbun asks if a negative interest rate will produce results, and Nikkei Shimbun asked for joint measures to stabilize markets without relying on the Bank of Japan. Only Yomiuri Shimbun had a positive view, publishing an editorial titled “negative interest rates show the Bank of Japan’s resolve for more monetary easing and ending deflation.”

Mr. Kuroda himself rejected a negative interest rate until only recently. At the announcement, he did not talk about the effects of a negative interest rate. Instead, he placed emphasis on an explanation aimed at altering the mood of the financial sector. “The people of Japan do not have to have a complete understanding of financial policies for these policies to be effective,” he said. “The key point is making progress with reversing people’s view of deflation by showing that we will do whatever is needed.” The Financial Times praised this stance with an article titled “Kuroda reasserts deflation fight stance.” Many people are critical because they think financial initiatives (quantitative easing) alone are not enough to achieve an economic recovery and eliminate deflation. Now the Bank of Japan has gone back to its basic position of refusing to recognize this criticism.

A negative interest rate may work better than expected

Although this may be like Columbus’ egg, a negative interest rate could produce much greater benefits than anyone can foresee.

The first benefit will be to push money out of Bank of Japan current account deposits, the safest asset category of all. Until now, monetary easing was criticized chiefly because of the belief that supplying more money when no one wants to borrow money (due to a lack of confidence about the economic outlook) is pointless. We cannot deny that monetary easing has not progressed as initially planned in some respects. The original hope was to generate a virtuous cycle driven by portfolio rebalancing. The Bank of Japan would buy government bonds from investors and financial institutions. Then the proceeds from these sales would be shifted to assets and loans with a higher return. As money flows into assets with risk, investments and asset prices will increase, resulting in a greater expectation for inflation.

However, several events have altered the environment. Examples include the lack of growth caused by the consumption tax increase, the crisis in China, the global drop in stock prices and expectations for a stronger yen. As a result, investors are not shifting their money to assets with risk. Proceeds from sales of government bonds are sitting idle in Bank of Japan current accounts. But imposing a negative interest rate on these accounts is likely to push money into assets with risk and loans.

The second benefit of a negative interest rate is a dramatic increase in the number of ways to achieve more monetary easing. Quantitative easing appears to be nearing its limit because the Bank of Japan now holds more than 30% of all government bonds outstanding. In asset categories other than government bonds, like ETFs and REITs, the Bank of Japan has massive holdings in relation to the size of the markets for these securities. It is like dropping a whale into a small pond. The negative interest rate will start at 0.1% but there is no limit on how much the rate can be raised. The result is a big increase in the feeling of intimidation due to the unlimited ammunition that a central bank has.

The third benefit is an automatic shift in the structure of interest rates. Since this influences the earnings of investors, quantitative easing may become much more effective. The fourth benefit is to significantly induce investors to take on more risk. Investors will be confident because of Mr. Kuroda’s bold actions that show no fear of failure or side-effects. As long as the Bank of Japan, with its unlimited ammunition, clearly retains its resolve, risk averters will have no choice other than to reduce their current positions.

The monetary base will shrink if negative interest rates lead to a withdrawal of funds from current accounts and will weaken anticipation of higher inflation. In that case, purchases of government bonds will have to be stepped up. Negative interest rates will work more effectively only if they are accompanied by quantitative easing.

(3) Kuroda's first remarks about capital controls point to measures to end China's crisis

Capital controls for crisis management in China

At the Davos World Economic Forum, Mr. Kuroda broke the rules by saying that China should use capital controls to protect its currency (January 28, 2016 Financial Times). When IMF Managing Director Christine Lagarde was asked if she agrees, she avoided a direct reply but said that China should not use up its foreign exchange reserves in order to prop up the yuan (January 28, 2016 Financial Times). At Davos, the governor of the Bank of Mexico and some researchers stated that capital controls and other emergency measures are needed in emerging countries when a crisis occurs.

Mr. Kuroda's position is based on a commitment to deregulation, a transparent currency, responsible management of foreign exchange reserves and respect for market principles. However, to end a crisis like the recent global financial crisis, capital controls are effective as part of a contingency plan. Of course, an awareness of the increasingly severe capital outflow crisis in China is underlying Mr. Kuroda's stance.

On January 12, Reuters reported that the Bank of Japan and Bank of China were in negotiations concerning a currency swap agreement. It was unclear which side originated this idea. The first yen-yuan swap agreement was in 2002, which was after the Asian currency crisis. But the agreement expired in 2013 as relations between Japan and China soured. This report indicates that the Bank of Japan is working out of sight on a way to support China.

At the Davos forum, George Soros said that a hard landing in China is inevitable. He also said that he is selling the yuan, Hong Kong dollar and other Asian currencies. China retaliated by stating in the People's Daily, the official newspaper of the Communist Party, and government-owned New China News Agency that there will be no hard landing and selling the yuan will end in failure. This looks like a replay of the give-and take between Malaysian Prime Minister Mahathir and George Soros during the 1997 Asian currency crisis. But this time is different. If speculative sales of the yuan succeed, there could easily be a global financial crisis because of the massive scale of China's economy and its more than $4 trillion of foreign debt.

The yuan market is currently quiet because of interventions by Chinese authorities and limited capital controls. But expectations for a weaker yuan will continue to climb unless China can halt the rapid decline in foreign exchange reserves and the rapid growth in capital outflows. China has failed to slow the drop in foreign exchange reserves, which peaked in June 2014. In fact, the decline is accelerating. The largest monthly decline ever was recorded in December 2015 when these reserves fell $107.9 billion. China's monthly current account surplus is now an average of $20 billion. Therefore, the net outflow of capital was roughly $130 billion. During the 18-month period from June 2014 to December 2015, China's foreign exchange reserves decreased by $660 billion, falling from $3.99 trillion to $3.33 trillion. The current account surplus was an estimated $400 billion, so the total capital outflow was more than $1 trillion. Several factors may be responsible for these outflows: (1) the growth of China's direct overseas investments, (2) the recovery of investments in China by foreigners, and (3) the shift by Chinese investors of capital to other countries. Factors two and three are probably the most important reasons. In other words, we are seeing the start of a rapid flight of capital from China.

The accelerating downturn in stocks (asset prices) and the currency along with capital outflows in China are precisely the three components that triggered the 1997 Asian currency crisis. There is an urgent need for emergency measures (a contingency plan) in order to avoid an international financial crisis originating in China. This is why there are big expectations about the upcoming role of Mr. Kuroda's Bank of Japan.

Introduction of even more radical capital controls and establishment of systems to contain the China Crisis in earnest is difficult given the difficulty of overcoming the high hurdles in China's domestic politics. As mentioned in my previous report it is still uncertain whether China will stop spreading the "poison. It would be wise to keep your seatbelts fastened.