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

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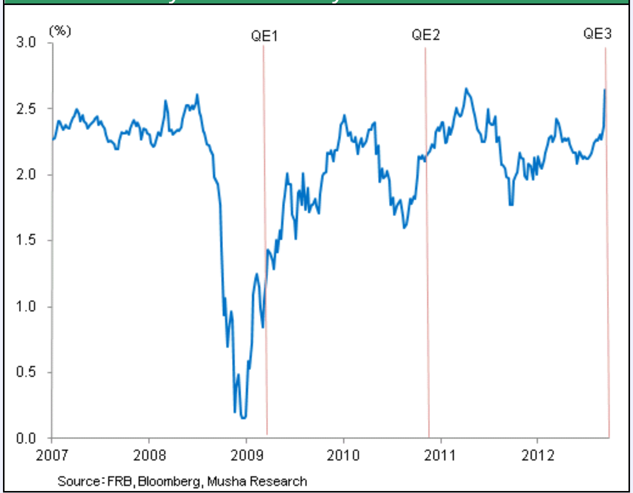
Chairman Ben Bernanke and ECB President Mario Draghi have started using an unlimited supply of bullets to kill the "black swan" (the predilection for currency). "Don't fight the Fed" is a well-known rule among investors. This is why investors probably will not be able to go against the risk-taking trend. 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).

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.

Figure 1 : Break-even spread* and imposed QE
*10-year TN – 10-year TIPS



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.

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.