For Professional Investors

# CHOPPER WARS

## The implications of monetary and fiscal stimulus in Japan - - 26/07/2016

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## INTRODUCTION

We believe that Japanese policymakers are likely to announce a significant monetary and fiscal stimulus package in the near future. We think that the package will involve *at least* a modest rate cut and an expansion of the asset purchase programme on the monetary front and *at least* a ten trillion yen package on the fiscal front. We think that the risks are skewed to the upside – a bigger and bolder package is more likely than a modest package. However, we are not sufficiently confident that the Japanese will move the monetary goalposts and temporarily or permanently raise the inflation target. Given the current state of the Japanese economy, the scale of the public debt burden and the stock of government debt already sitting on the central bank's balance sheet we believe that Japan has already been engaging in 'stealth helicopter drops' and another major stimulus package should be considered a helicopter drop in all but name. Indeed, investors are likely to view additional monetary stimulus as a helicopter drop, particularly if it coincides with the release of new information on the government's fiscal priorities that would create the impression of close policy coordination between the Bank of Japan and the Abe government.

This note sets out our thinking on the size and scope of that package, the likely macroeconomic impact and the ramifications for global asset prices. Key for asset prices is the extent to which investors see coordinated stimulus in Japan as reflationary. In this event, we would expected nominal bond yields to rise (particularly at longer maturities) even as the BoJ expands its QE; risk assets to rally and the yen to weaken.

## WHY NOW ?

One might reasonably ask why the Japanese would be launching a(nother) stimulus package – and in particular *why now?* Our answer is in three parts.

First, the timing is right. Prime Minister Shinzo Abe has just earned a renewed electoral mandate to press ahead with reforms. The elections for the upper house of Japan's parliament have delivered Abe a super majority in both houses.

Second, the economic case for action is compelling. Whilst some measure of reflation has been achieved, the economy has not achieved escape velocity and the price stability target of 2% remains out of reach. If the acid test of QQE was this year's wage round then the current package has failed. Moreover, there is scant evidence of any material improvement on the supply side. The third arrow of Abenomics (structural reforms) has not hit the target – if it was ever even fired. Abe has pledged to tackle Japan's demographic problems of low birth rate and an ageing population head-on, but has yet to deliver the measures that could solve those problems.

The third and perhaps most compelling reason for expecting the imminent announcement of a fresh stimulus package is that Abe has promised a 'bold' action. In the immediate aftermath of his election victory Abe promised: ***'We are going to make bold investment into seeds of future growth'*** and noted that ***'We have to accelerate Abenomics to meet the public's expectations'.*** Likewise, he was crystal clear about the need to press ahead in comments around a meeting with Bernanke earlier this month: ***'We are only halfway to the exit from deflation, we want to be steadfast in accelerating our breakaway from deflation'***. It is unclear why Abe would deliberately and consistently raise expectations of a major stimulus package which he has the parliamentary muscle to implement if he did not intend to deliver.

## THE TIMELINE

Although we expect the authorities to announce additional monetary and fiscal measures in the near future and we believe these two elements make sense as a part of a single stimulus package we do not expect the authorities to announce those measures together. Instead, we expect the fiscal and monetary authorities to stick to the existing timetables.

The timeline for announcing fiscal policy is inherently fuzzy. Work on calibrating the size, design and financing of the package is clearly already underway and may continue for the next month. It is unlikely that the finished article – in the form of a supplementary budget – will emerge before September and may not pass into law until the October. The peak impact of these measures on demand is therefore unlikely to be felt until 2017, although asset prices and activity may start to react as soon as the broad parameters of the package are known. Still, we expect that information about the intended size and contours of the program will become clearer in the weeks ahead.

The timeline is more straightforward on the monetary side. There are Bank of Japan policy meetings slated for the 29 July and 21 September. If the Bank of Japan wants to wait until the precise details of the fiscal package are known then we should not expect fresh monetary stimulus to be announced until the September meeting. However, we presume that Governor Kuroda is already familiar with Abe's broad intentions on size. In any case, there is already a strong argument for fresh monetary stimulus and failure to deliver may weaken investors' confidence in the Bank of Japan's stomach for the fight to achieve price stability, which could lead to a counterproductive tightening in financial conditions. As one of Abe's economic advisers recently commented about the July decision: ***'I will really want to know why if there is a decision not to do anything. Markets will react and the yen will probably strengthen.'***

## FISCAL POLICY

We think that there are three key issues around the looming fiscal stimulus: the overall size of the package; the design of the package; and the likely macroeconomic impact.

In terms of the overall size of the package we see the economics and the politics both pointing in the direction of a sizeable package – of *at least* 10 trillion yen, with a package double that size being perfectly plausible in our view.

We note that there have been three occasions in the past decade where 10 trillion yen packages have been unveiled. As we will go on to discuss we think that the common objective for the monetary and fiscal authorities is to shock expectations about the economic outlook – in particular around the inflation outlook but also around productivity and implicitly around the willingness of policymakers to do what it takes. We believe that in this, size matters: that the chances of shocking expectations increase more than proportionately with the size of the package, so it would be a mistake to drip feed 20 trillion yen worth of stimulus in a sequence of small announcements spread over several years.

The design of the package is likely to be geared towards the stated objectives of Abenomics. On that basis we would expect to see consumption vouchers that are geared towards boosting labour force participation, for example vouchers for child and elderly care. An increase in benefits tied to the number of children in the household is also plausible given the stated aim of boosting the birth rate. Infrastructure spending, potentially tied to preparations for the 2020 Olympics, is also plausible. However, the larger the package, the more likely it is that it will also contain more conventional forms of stimulus (like tax cuts) – there is only so many childcare vouchers you can distribute or bullet trains you can purchase.

When it comes to the macroeconomic impact of the package we think it is important to distinguish between aggregate demand and aggregate supply.

Starting with aggregate demand we believe that the features that really matter are the size of the package and how Japanese households and companies expect the scheme to be financed. How the money is spent only really matters if the stimulus is directed towards those who are on low incomes and credit constrained and who are therefore most likely to spend any income boost. Instead, expectations about how the package is *financed* matter because even if we don't believe in the extreme parable of Ricardian Equivalence (where fiscal stimulus is impotent) we think its plausible that households may save more in response to the government borrowing more if those households expect to pay higher taxes in the future to finance that stimulus. It follows that one way to increase the impact of whatever fiscal package Prime Minister Abe unveils is to signal that current cohorts of workers will not pay for the stimulus through higher taxes (or lower public services) and instead the package will be financed by printing money. As we will go on to discuss, the problem with this approach is that it calls into question the independence of the central bank.

When we turn to the question of aggregate supply our answer is turned on its head: now the design of the package does matter. In theory, vouchers which reduce the costs of labour supply for those who currently devote a significant fraction of their time to caring for children or the elderly could have a material impact on labour supply. However, it seems hard to believe that these measures could have a transformative impact on the supply side. The best case scenario is that these measures engineer an increase in labour force participation rates, which in turn implies a modest increase in the level of potential supply. Likewise, an increase in infrastructure investment could engineer an increase in the capital stock and a marginal increase in potential supply. A one-off increase in the level of potential supply is a worthy objective – however, it should not be confused with an increase in the trend growth rate, which is much harder to achieve.

## MONETARY POLICY

When it comes to monetary policy the questions are *how?* and *how much?*

The Bank of Japan's three dimensional mantra on monetary easing is well understood: there is the interest rate dimension; the quantity dimension (relating to the expansion of the monetary base); and the quality dimension (relating to the mix of asset purchases).

These alternative dimensions of monetary easing are clearly not perfect substitutes in terms of in their impact on financial markets. A rate cut deeper into negative territory is not equivalent to an increase in purchases of ETFs.

We expect the Bank of Japan to adjust both the price and quantity of money – that is, cut the policy rate (the lowest of the three key interest rates) further into negative territory by *at least* the 10 basis points (that is more or less priced in) *and* expand the stock of purchases by *at least* 30 trillion Yen.

Once again we see the risks here as being skewed to the upside – that is, we think that Governor Kuroda is more likely to over-deliver than under-deliver. Although some question whether the Bank of Japan has reached the point where further monetary stimulus is counter-productive, especially where negative interest rates are concerned, we note Kuroda's recent comment that there is not any significant limitation to further easing if it is needed and that all three dimensions are still on the table. The BoJ may feel obliged to take steps to cushion the impact of more negative rates on the banking sector, perhaps mimicking the ECB's TLTRO-II programme which Kuroda labelled : ***'extremely bold and unique.'***

We also believe that a key consideration in calibrating the monetary stimulus will be the outlook for the currency. If the ultimate objective of the combined stimulus package is to shock inflation expectations higher then it might not be wise to trigger an appreciation of the yen which will tend to depress inflation in the short run. However, a stimulus package which is heavy on fiscal and light on monetary runs the risk of doing precisely that. This is why we believe that the purchase of government obligations (JGBs or guaranteed agency bonds used to finance infrastructure projects) will at least equal the size of the fiscal stimulus package.

In addition, fully absorbing fiscal stimulus via increased central bank purchases has the added benefit of creating the impression of permanent monetary financing. This is an attractive option because legal and political considerations may make it difficult for the BoJ to specifically label their actions as a "helicopter drop". But acting in a manner that is consistent with a drop could still serve to shock inflation expectations and avoid the Ricard Equivalence trap –if taxpayers perceive that taxes will not have to be raised in the future to pay for the fiscal stimulus as a result of the BoJ financing the stimulus, then they will be more willing to increase spending.

## THE IMPORTANCE OF SHOCKING EXPECTATIONS

Japan's inflation problem does not appear to be primarily one of chronic spare capacity consistently dragging down on costs and prices. Rather, the problem appears to be one of expectations. Economics teaches us that inflation can stabilise at any rate if the output gap is close to zero. Japan's problem is that households and companies do not expect inflation so they do not get inflation. Indeed, until expectations are re-anchored on the Bank of Japan's 2% target it may be hard to achieve that objective.

This is not to say that spare capacity has no impact on inflation. A major stimulus package could give aggregate demand a significant shot in the arm and that should help drive costs and prices higher. Moreover, if households come to believe that the stimulus package will have a meaningful impact on the supply side then that could further boost demand, as people bring forward consumption.

The question then is how best to shock expectations higher. The mere fact that policymakers are taking action should help to re-anchor expectations by maintaining (or restoring depending on your point of view) confidence that policymakers are ready, willing and able to achieve their targets. But policy-makers have been taking action for years, and even with the intensification of such efforts under Kuroda, inflation expectations remain too low. Clearly, a new approach is warranted.

A more effective way to shock expectation is to shift strategy around the conduct of fiscal and monetary policy. As we have argued elsewhere (Everything you ever wanted to know about helicopter drops (but were afraid to ask)) the Japanese are already engaging in 'stealth drops': there seems little prospect of the Bank of Japan winding down its JGB portfolio in the foreseeable future so recent fiscal deficits have to all intents and purposes been permanently monetary-financed.

Any communication or design feature of the stimulus package that makes the stealth drop more explicit should make the package more effective. As already discussed, the more households and companies believe that taxes will not rise in the future to finance the stimulus because the BoJ will roll over the bonds into perpetuity the less likely it is that positive impact of the stimulus will be neutered by higher private savings.

However, providing clarity around permanence of the monetary injection is not straightforward. Conducting helicopter drops may run afoul of the legal restrictions that the BoJ operates under (the Bank of Japan Act and the Public Finance Law). Indeed, only this week comments surfaced from Governor Kuroda that there is ***'no need and no possibility for helicopter money.'***

Laws can be changed and Abe has significant political capital. However, even if Abe does have the votes to relax the legal constraints under which the BoJ operates this option would take time and could potentially undermine confidence in the independence of the central bank. At this point, the problem may switch from trying to re-anchor expectations from below to trying to prevent expectations of inflation rising above the target as investors worry that Japan will try to inflate its way out of a debt problem.

We think that one elegant solution to this problem is for the Bank of Japan to modify its price stability target, which was defined by the BoJ as 2% in January 2013. The BoJ could move the monetary goalposts in one of two ways: either switch to a price level path target (PLPT), which effectively raises the inflation target for a period of time, or permanently raise the target. The BoJ would have to announce a significant increase in stimulus alongside either change to make the new target credible, and that in turn makes it easier for the BoJ to justify what is a helicopter drop in all but name. That is, a permanent increase in the money supply (which also implies a permanent expansion in the balance sheet, and permanently financing current government spending by printing money) makes sense if you need to hit a more ambitious monetary goal, but at the same time, the new target limits the extent to which the BoJ needs to resort to helicopter drops and therefore should provide an anchor of sorts on inflation expectations.

## IMPLICATIONS FOR YEN ASSETS

To summarize our views, we expect a significant coordinated fiscal and monetary stimulus program in the near future, with the BoJ likely to announce at its July 29 meeting a 10 to 20 basis point cut in its policy rate, and additional asset purchases that at least equal the amount of Abe's intended fiscal stimulus. While a supplementary budget will not be submitted until September, we expect details on the package to become clear over the next few weeks. Fiscal stimulus will total at least 10 trillion yen and potentially closer to double that amount and will place significant weight on measures aimed at boosting potential growth, such as vouchers for child- and elderly care and spending on infrastructure.

We believe that coordinated monetary and fiscal policy will be interpreted by investors as at least mildly reflationary. As such, we would expect the yen to weaken, nominal JGB yields to rise and the curve to steepen and Japanese equities to rally, particularly once the details of the likely amount of fiscal stimulus become clearer. We doubt markets have fully discounted our base scenario, meaning that announcement effects in the wake of the BoJ meeting could still be significant.

Importantly, although the BoJ will be expanding its QE program further, the fact that it will be aimed at absorbing new bond issuance means that it could have a very different effect on the JGB market than past QE. Since these purchases will not ultimately reduce JGB supply available to the private sector, they will not suppress the nominal term premium as prior QE rounds did. In addition, inflation expectations could also move higher if the stimulus measures are seen as boosting demand and inflation.

We do not expect the Bank of Japan to explicitly announce that additional balance sheet expansion will be *permanent* (i.e., a helicopter drop). However we see some likelihood that authorities will work to create the impression of implicit monetary financing in order to shock inflation expectations and encourage households to spend (as opposed to just boosting savings on the belief that fiscal stimulus will lead to higher taxes later). This can be accomplished by emphasizing policy coordination between monetary and fiscal authorities, for example by the Abe administration making clear its intentions for the scope of fiscal stimulus around the time of the BoJ meeting, or through a joint policy statement noting the intention of the government and the Bank of Japan to use all available tools to overcome deflation and boost potential growth. There is clear precedence for a coordinated announcement, for example the January 2013 joint statement that laid the groundwork for QQE. Any such efforts to highlight coordination increase the probability that investors will interpret QE expansion as permanent debt financing, providing an additional reflationary impulse to market pricing.[1] While not our base case, a decision to temporarily or permanently boost the inflation target would also jolt inflation expectations and could provide a substantial boost to nominal yields (particularly at the long end) and Japanese equities, while leading to significant yen depreciation.

While we expect financial markets to interpret monetary and fiscal stimulus as at least a mild reflationary shock, we appreciate that the potential timing mismatch of policy announcements complicates the market response. If the BoJ announces QE expansion next week but there is little news on the fiscal front (and no joint statement to foster impressions of coordination), JGB yields would likely decline on the announcement due to expectations of increased scarcity of bonds. We would suggest fading such a move as it could reverse once information on the size of a fiscal package becomes clearer.

We have to be alive to the possibility that the stimulus package is less impressive than we anticipate or that the market views it as 'more of the same' and doomed to fail (certainly in the absence of any clear commitment that the balance sheet expansion is permanent or any change in the definition of price stability). In this scenario, we may well see a re-run of the market response to the 29 January decision to take rates into negative territory – that is, equity investors may punish bank stocks and bond investors may re-price the term premium to reflect the new lower bound, causing long yields to fall.

[1] Investors may be misinterpreting Kuroda's recent comment that there is "no possibility for helicopter money". We see these comments as indicating that the BoJ will not *formally* adopt permanent monetary financing, but still leaves open the very real possibility that authorities will craft and coordinate policy so that investors view new stimulus as the functional equivalent of a helicopter drop.

## CONTAGION TO GLOBAL MARKETS – CHOPPER WARS ?

We see forthcoming fiscal and monetary stimulus in Japan as a potential game-changer in global financial markets. Across developed markets, central banks have leaned heavily on the stimulus pedal in recent years, but there is a growing public perception of diminished effectiveness of such measures. At the same time, there have growing calls for fiscal policy to do its part, particularly for targeted stimulus aimed at boosting potential growth. Given mounting impatience with anaemic global growth and concerns over high leverage and deflation risks, there has been growing discussion among investors about the potential benefits for many economies of coordinated monetary and fiscal policy. Seen in this light, forthcoming policy initiatives in Japan have the potential to be truly ground-breaking, as they could represent a bolder foray down the path of monetary financing (even if authorities avoid using this term). If this indeed occurs, the reflationary impulse in Japan could pressure global nominal bond yields higher and could lead to heightened volatility in currency markets, with Japan's export competitors potentially responding by easing monetary policy to prevent undesired currency strength. Currency pressures aside, risk assets could be supported in countries where Japan's moves may be viewed as a template for future efforts at coordinated monetary and fiscal policy.

A second implication is that over time, investors may categorize economies as "money printers" and "money misers" – i.e., those willing and able to engage in de facto helicopter drops, and those that are not. This theme could influence relative asset price and currency performance. As a (perhaps obvious) example, one could argue that the Eurozone is or will soon be ripe for a de facto helicopter drop, given persistently high levels of sovereign leverage in the periphery which continues to weigh on consumer spending and realized and expected inflation. But the legal constraints placed on the ECB, as well as the social compact in many core European countries, essentially precludes even the consideration of explicit monetary financing. As such, the euro could eventually bear the brunt of yen weakness stemming from a perceived helicopter drop in Japan.

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