Japan, Paper Money and Certainty of Abuse (13/03/18)

“The emitting of paper money by the authority of Government is wisely prohibited to the individual States by the National Constitution. And the spirit of the prohibition ought not to be disregarded by the Government of the United States. Though paper emissions under a general authority might have some advantages not applicable, and be free from some disadvantages which are applicable to the like emissions by the States separately; yet they are of a nature so liable to abuse, and it may even be affirmed so certain of being abused, that the wisdom of the government will be shown in never trusting itself with the use of so seducing and dangerous an expedient. …If it should not even be carried so far as to be rendered an absolute bubble, it would at least be likely to be extended to a degree, which would occasion an inflated and artificial state of things incompatible with the regular and prosperous course of the political economy.”

Hamilton clearly wrote in a very different era. It was an era following massive issuance of paper currency to fight the War of Independence and the population was all too aware of the consequences. In a land where only male, white landowners could vote - 6% of the population got to cast a vote in the Presidential election of 1789 - it was not surprising that Hamilton could garner support for restraints on the issue of paper money. Any such vestige of restraint died in the Nixon administration with the collapse of the Bretton-Woods agreement.

Since 2009 we have seen what is possible when “restraint” is a word unknown to central bankers. Indeed, it may now be a word only attributed to those who Timothy F. Geithner famously describes in his book “Stress Test” as the ‘Old Testament’ crowd; those whose apostasy is to believe in the need for bankruptcy to assure that capital allocation is a job well done. So with restraint practised only by those who have learned nothing in the past 2,000 years, according to the book by Timothy, it must be in short supply indeed. To this age of unrestraint comes a Federal Reserve launched finally upon a policy of restraint, at least of its own balance sheet. Readers will be aware that The Book of Revelations is a book of The New and not The Old Testament.

The Solid Ground has long discussed how our modern ‘emitting of paper money’, through the purchase of liquid assets from savings institutions, has created a form of money that ricochets around the asset markets without very materially impacting the markets for goods and services. However, QE did act to keep interest rates low and thus acted to create economic growth, albeit through the creation of ever more debt. The limited direct impact on economic activity from this form of money emission was all but admitted on the launch of QEII, when the Federal Reserve discussed how it would act to force asset prices higher and generate a positive wealth effect.

Thus twelve people, the members of the Federal Open Market Committee, were tasked with determining the correct artificial price for assets to produce a non-artificial nominal growth in the economy! Now the twelve are tasked with reversing policy to create a lower artificial price for assets to slow the growth of the economy

and inflation. While debt is an ally in inflating asset prices, it is an enemy of economic stability when asset prices fall.

Perhaps if wealth was more equally distributed, QE could indeed have had such a positive economic impact rather than just pushing asset prices higher. Indeed, it was during QEII that your author discussed the efficacy of monetary policy with a lady sitting outside the Boston Federal Reserve holding a sign bearing the slogan ‘Don’t piss on me with your trickle down economics’. She seemed unconvinced of either the efficacy or the morality of the policy and with today’s surging debt levels and crashing money supply growth, she looks more right by the day.

She at least seemed to be in the right place at the right time, unlike the Bostonian clutching a banner reading, ‘Give Ireland back to the Irish’. Perhaps because of this rather diffuse approach to its goals, the Occupy Wall Street movement fizzled out and QEII became QEIII and the ECB and the BOJ joined the party by the emittance of this peculiar form of paper money aimed at inflating asset prices. While the emittance of a paper currency may have then happened in concert, that concert has now ended; the discordance that will follow is the true subject of this Fortnightly.

You might think that Hamilton is cited above to prepare the way in this Fortnightly for a critique on the ‘artificial state’ of the US economy. That is tempting, particularly as your analyst listened to Larry Lindsey last week explaining that we are now in the biggest of the three bubbles the Fed has created in two decades. That’s an important ‘artificial state of things’ but perhaps not the most urgent ‘artificial state of things’.

The most urgent is the artificial state of a contraction in the Fed’s balance sheet, while the expansion of the balance sheet of the BOJ seems very likely to accelerate. The combined expansion of the balance sheet of the Fed, the ECB and the BOJ created a great global distortion, particularly in asset markets. However, at least the three were all abusing the paper money standard at the same time. What now matters for investors is that this co-ordination has ended. The result should be a major decline in the Yen/USD exchange rate.

While the BOJ has made noises about exiting its policy of emitting money, the Fed has announced that it will reduce the size of its balance sheet by US$380bn this year. So as not to offend Timothy F. Geithner, perhaps we can restrict our observations to The New Testament and particularly Matthew 7:16, ‘by their fruits you will know them’. The BOJ proffers only words, but the Fed’s balance sheet contraction has begun.

The new quarterly report (Q1 2018 “Crowding Out: Higher US Real Rates and Lower Inflation”) looks at the actions of the Fed and the other shifts that are forcing real rates of interest higher in the US. The consensus view fails to see such a shift, preferring to see the rise in US nominal rates as a precursor to higher levels of inflation. Of course, time will tell, but your author remains highly skeptical of this view, given the dramatic global monetary tightening due to the major slowdown in the growth of broad money. Anyway, whatever your view on the respective course for US and Japanese inflation, let us acknowledge that there has been a major shift in US nominal yields relative to Japanese yields. With the BOJ still targeting a JGB yield curve at 0% all the way to the ten-year maturity, the yield on the US ten-year Treasury has risen by 140bp from its low in July 2016.

Might this additional relative yield tempt Japanese investors? If it does, who buys the JGBs they most likely liquidate to fund their Treasury purchases? If such a liquidation is triggered, the BOJ balance sheet expansion, given their yield target for JGBs, would accelerate just as the Fed’s balance sheet contracts. While there are many, indeed too many, shifting forces that determine an exchange rate, these trends in central bank balance sheets should be particularly negative for the Yen/US dollar exchange rate. So, the more the Fed acts to contract its
balance sheet, the more it could, through enticing Japanese savers to the Treasury market, force an accelerated balance sheet expansion on the BOJ. This concert party, aimed at driving up all asset prices, while maintaining relative exchange rate stability, will very clearly be over. The impacts from a decline of the Yen on the international exchanges will be profound.

Whatever course the Fed has followed in the emittance of paper money, it has now started reversing. Just how much pain for asset markets and for the economy it is prepared to endure in the destruction of central bank money, we will have to wait to see. However, what we do know is that the BOJ has not foresworn the abuse of the paper currency.

Indeed, we know that with a government debt to GDP ratio at a record high and a savings rate near a record low, the role of the BOJ in funding the government is structurally crucial. As Hamilton knew, in extremis paper money is issued to support a government that cannot access any other form of finance; in the case of the United States to win its freedom. This need to finance a government that savers cannot or will not fund is the ‘certainty of abuse’ of which he forewarned in December 1790. Investors have fretted over whether such an abuse had finally come to the US, but the jury remains out as the Fed at least attempts to destroy central bank money.

In Japan the jury is not out. The expansion of the BOJ balance sheet will not only continue but will now likely accelerate as JGBs are liquidated by savers to fund their purchases of Treasury securities. Financial history provides some guidance as to the reactions in financial markets one can expect when the unique abuse of the issuance of paper currency in Japan is finally revealed:

‘But whereas domestic prices and wages react slowly in the early years of an unexpected moderate inflation, foreign exchange rates move up more quickly and strongly, though often less than the supply of money. Exchange markets are better organised and market participants are usually better informed about changes affecting the whole economy. It follows that the beginning of a moderate inflation (if it is higher than that experienced by the main trading partners) leads to an undervaluation of its currency. Consequently, export industries benefit from prices (expressed in domestic currency) that have increased more strongly than the prices of most of their domestic inputs. Similarly, import-competing industries enjoy better competitive positions in domestic markets than before the inflation.’

‘Early in July paper marks began to show such a tendency towards depreciation that the investing classes in Germany took alarm and there was a mad rush to invest their paper in industrial and other securities before currency dropped further.’

The Fed has been contracting its balance sheet since November 2017 while the expansion of the BOJ balance sheet continues at its steady pace. So far investors have ignored this divergence.

Those seeking to time when the major dislocation of the Yen/US dollar exchange rate occurs should watch for an acceleration in the pace of the BOJ balance sheet expansion. Those not so concerned about timing can increase their exposure to Japanese equities now, remembering, of course, to hedge their exchange rate exposure. Japan’s ‘certain abuse’ of paper money to fund its government can only be revealed when other central bankers reverse and the BOJ accelerates. That time has come.

---

1 Monetary Regimes and Inflation: History, Economic and Political Relationships by Peter Bernholz
2 The Wall Street Journal, 9 September 1921.
During the US Revolutionary War the value of the paper currency of the thirteen states declined in value by 99% and effectively ceased to circulate. Hamilton was all too aware of the cost of the ‘certain abuse’ that can come from emitting paper currency to fund a government. Those who think the age of QE is over and that an ‘inflated and artificial state of things incompatible with the regular and prosperous course of the political economy’ is passing, ain’t seen nothing yet - at least not in Japan. For those who expect that Japanese policy makers have the measure of the problem, we shall leave the final words to Alexander Hamilton:

“I never expect to see a perfect work from imperfect man.”

¹ The Federalist Papers No.85, 13th August 1788
Important Legal and Regulatory Disclosures & Disclaimers

This research is for the use of named recipients only. If you are not the intended recipient, please notify us immediately; please do not copy or disclose its contents to any person or body as this will be unlawful.

Information and opinions contained herein have been compiled or arrived at from sources believed to be reliable, but Orlock Advisors Limited does not accept liability for any loss arising from the use hereof or make any representation as to its accuracy or completeness. Any information to which no source has been attributed should be taken as an estimate by Orlock Advisors Limited. This document is not to be relied upon as such or used in substitution for the exercise of independent judgement.

© 2018 Orlock Advisors Limited

Postal Address: Newbattle House, Newbattle Road, Newbattle, EH22 3LH Scotland

Registered Address: 6 Logie Mills, Beaverbank Business Park Edinburgh, Lothian EH7 4HG, Scotland

Company Number: SC36220