'Abenomics'. This Time Is Different. Japanese Economic Recovery and Central Banking

‘Abenomics’ isn’t particularly innovative. Keynesian spending funded by central bank debt monetization was popularized by the Bank of Japan as an ineffective tool to raise output since before every Western Central bank and its accessories multiplied their balance sheets post 2008, with some surprising success. Japan has tried this before with little success, so is this time different? Yes and no. Past attempts at QE by the BoJ were sterilized so that while on the one hand it was buying assets, on the other it sold to maintain a moderate balance sheet expansion. You cannot have a semi-responsible central bank. Irresponsibility is best overdone if one decides to do it. In previous QEs, the current account and the JPY strengthened confounding efforts. Today we see the reverse. So large is the scale of asset purchases by the BoJ that the JPY has lurched down while the current account has deteriorated. Good job!

The liquidity infusion and the improvement in market sentiment has caused the stock market to surge. Most foreign investors are naturally skeptical after two and a half lost decades. Domestic investors, normally the more morose of the two, surprisingly, are the more upbeat. Th current mood and liquidity are such that a continued rally in the stock market is not only possible, it is probable. This, however, is a trade and not a secular trend. Still, such a trade can last a good 12 months or more. 3 to 5 years down the road, the picture is very unclear and rather concerning. For now, however, the trade balance has improved on an accounting basis from JPY weakness, it remains to be seen if the terms of trade will have a more leasing effect on trade flows, consumer sentiment has surged, and the JPY has been allowed to weaken and will be given more latitude by trading partners. That the BoJ has lagged it's Western counterparts in balance sheet expansion has bought it some forbearance as it eases policy and weakens its currency.

An inflation target if 2% is laudable since Japan has been mired in chronic deflation. However, this deflation is a consequence of demand deficiency in large part due to a rapidly aging demographic, and not productivity. Since Japan is heavily dependent on imports for its energy, oil and gas, a sufficiently devalued JPY will provide cost push inflation, even without a recovery in demand. Is like building a nuclear reactor for the radiation but without the power.

Second, how will Japan pay off its massive debts? The government is accumulating debt faster than it can repay. With a slow economy and an aging demographic Japan will run out of domestic savings to fund itself. A weak JPY will further discourage foreign lenders. It will be left to the BoJ to monetize Japan's debt as it refinances itself into the future with no end in sight.

Now lets take a detour into the truly unconventional (never never land). I don't much like central banks for their meddling in the money market, unilaterally declaring short term interest rates and more recently trying to manipulate the entire term structure. So for me, seppuku, is the preferred path for a central bank. What would happen if a central bank made the ultimate sacrifice and destroyed itself? It's quite unthinkable and quite frankly, if private commercial bank deposits and reserves with the central bank were not protected we would quite quickly descend into barter and social chaos. However, a slightly less chaotic route would be to create a bad central bank and a good one. Before this happens the central bank will make its ultimate sacrifice. The sovereign would issue special bonds at negative nominal interest rates for purchase by the central bank and any other self destructive investors (there are always a few). The government would receive positive income the more it issued and help its fiscal position. The central bank would face guaranteed losses which it would fund out of money printing. At some stage the central bank would become insolvent but given its ability to print money this is not an obstacle. Appoint of acute stress would no doubt come when the central bank would have to reorganize itself and hive off a bad bank holding these ridiculous negative coupon bonds with just enough capital at it would simply amortize to thin air in a finite time frame. But here is the thing, if you we’re trying to get 2% inflation, it is likely that this little stratagem will decimate your currency and deliver you several thousand % inflation. Would you call that a rip roaring success?