The Law of Unintended Consequences

WINDHAVEN INVESTMENT MANAGEMENT

Taking stock of monetary easing in Japan

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Key Points:

- Cheap money might encourage households to borrow and invest in real assets like real estate
- Low-interest rates penalize savers who might need to save more to achieve financial goals
- Japan's negative interest rate policy (NIRP) might have hurt growth and inflation by incentivizing a higher savings rate

On the way to NIRP

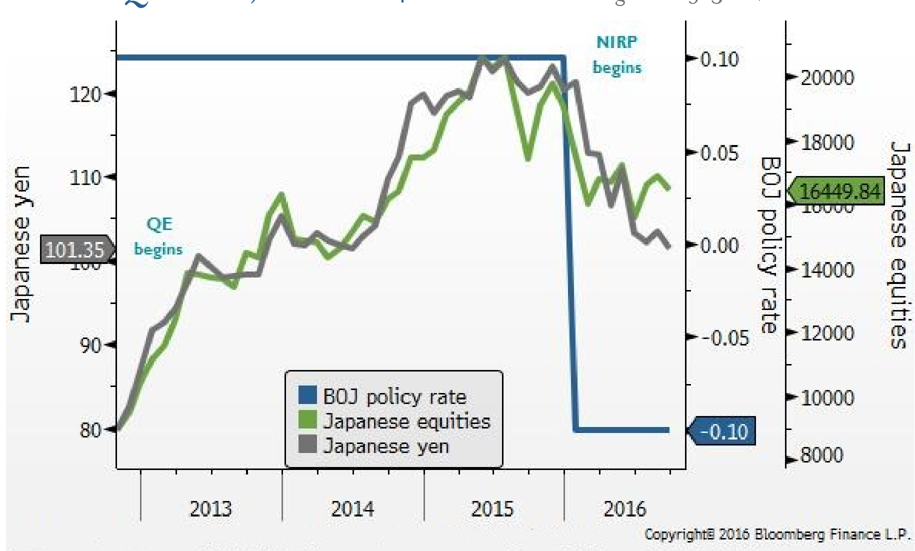
The intention of aggressive monetary policy easing in Japan was to create an environment of ultra-easy financial conditions making capital more widely and cheaply available. The explicit intended consequence was to incentivize households and businesses to borrow, consume and invest. The non-explicit intended consequence was to give a boost to stock markets and thereby create some positive wealth effect, as well as to weaken the local currency, increasing competitiveness.

Did it work?

Let's take a look at the NIRP experiment in Japan where it is relatively fresh but quantitative easing (QE) in the context of Abenomics is over 3 years old.

The charts following might offer some insight. The beginning of quantitative easing (QE) in early 2013 was met with enthusiasm by markets. In the following twenty-four months Japanese equities, as shown by the NKY index (chart 1 – green line), surged. Inflation, shown by the consumer price index (CPI) (chart 2 – green line), reached over 3.5%. Gross domestic product (GDP) (chart 3 – gray line) accelerated in 2013, during the early days of Abenomics, only for the economy to fall into contraction territory in 2014 (after falling into recession six times in the last thirty years).[1]

Chart 1: QE's boost; NIRP bust | Source: Bloomberg as of 9/30/2016



The key takeaway is that the boost to inflation that came during the first year of Abenomics, in the attempt to ultimately reach the 2% target set by Bank of Japan (BOJ), was unsustainable and damaging because it was not followed by a rise in real income (chart 2 – blue line); one reason behind that is the fact that much of the inflation boost came in the wake of a value-added tax (VAT) hike in 2014. Therefore, the boost to inflation likely ended up hurting consumers, whose purchasing power declined with the rise in inflation and the weakening of the yen (chart 1 – gray line). The economy ended up in recession, which was not what policy makers hoped for.

Two sides to every story

Then came NIRP: on January 29, 2016, the BOJ introduced their version of NIRP by applying a negative interest rate of -0.1% to current accounts that financial institutions hold at the BOJ.[2] The goal was to ease further and provide yet another boost to economic activity and sentiment, given that QE had not hit the mark. While QE is now considered text book policy, NIRP is unchartered territory. When we wrote about NIRP back in March [The More Things Change, The More They Stay the Same – Q&A on NIRP] we expressed concerns about the potential for central banks to contribute to market volatility with their unorthodox policies, rather than boosting sentiment. Chart 1 shows how NIRP was met unfavorably by the market. When the BOJ policy rate was brought to negative 0.1% (charts 1 & 3 – blue line), Japanese equities began a downward trend and inflation continued to trend down and is now back into deflationary territory.

In our Q&A on NIRP piece, we discussed the potential for NIRP to hurt market sentiment by signaling the need for the BOJ to venture into uncharted and very unorthodox territory. In that piece, we also discussed how NIRP could end up damaging banks' net interest rate margins (a major source of earnings for banks – chart 4 shows the negative reaction of bank equity prices to NIRP) in an economy where the banking sector provides the bulk of credit intermediation. What we did not discuss was the potential fallout for households: the unintended consequences.

As is often the case, there are two sides to every story, including this one, about low

Chart 2: The boost to CPI inflation in the early days of Abenomics ended up eroding real household income given that it was not accompanied by wage inflation | Source: Bloomberg as of 8/31/2016

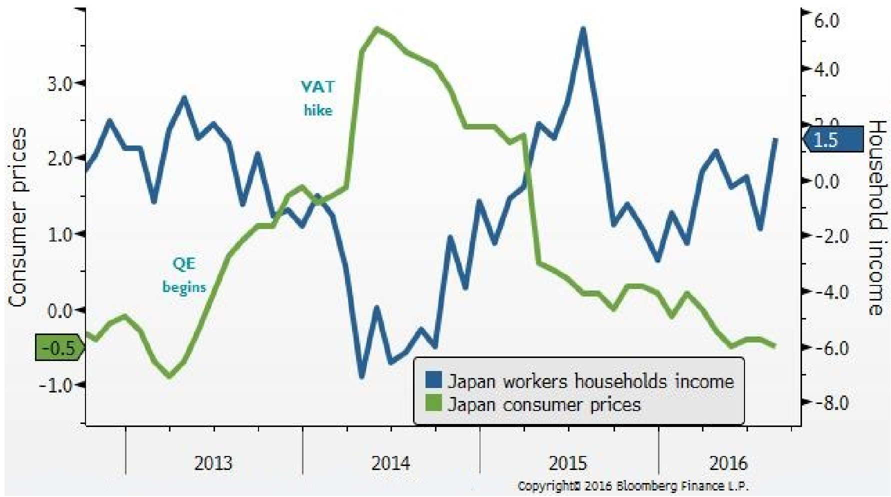


Chart 3: Inflation & GDP reverting | Source: Bloomberg | GDP as of 6/30/2016 | BOJ policy rate as of 9/30/2016 and consumer prices as of 8/31/2016

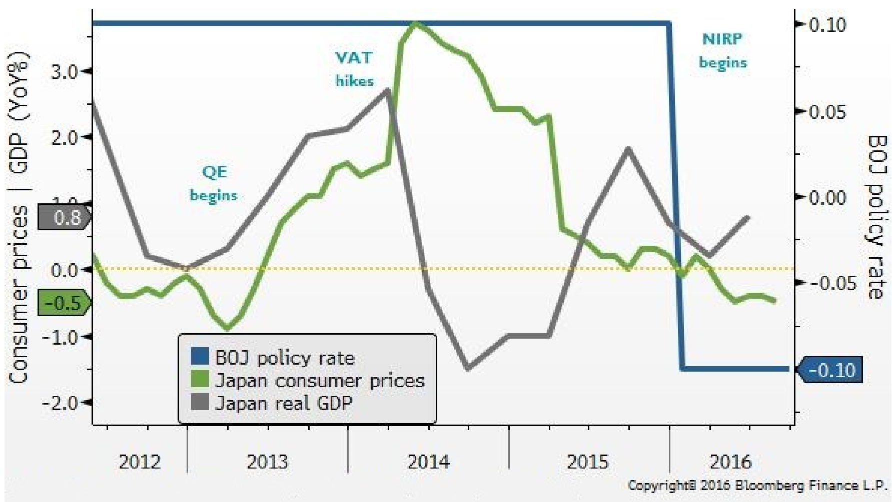
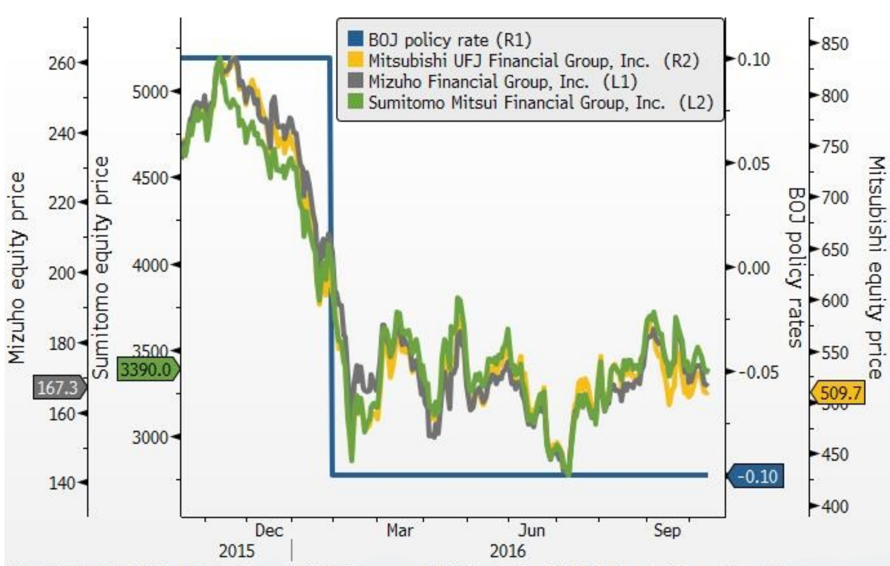


Chart 4: Impact of negative policy rates (blue line) on Japanese bank equity prices (other lines) | Source: Bloomberg as of 9/30/2016



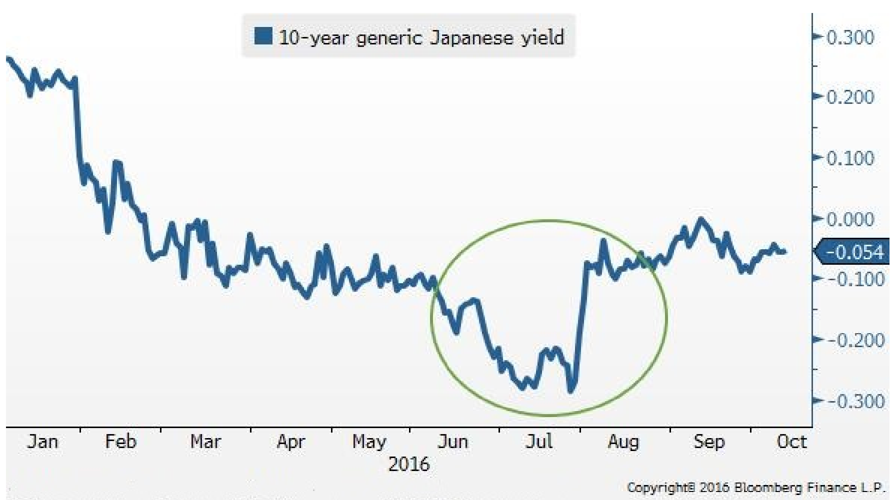
interest rate policies. On the one hand, cheap money might encourage households to borrow/leverage and invest in real assets like real estate. On the other hand, low interest rates penalize savers who might need to save more in order to achieve their future financial goals. Those additional savings and investments could come at the expense of current consumption and therefore at the expense of GDP growth and inflation. Therefore, NIRP might have boosted real asset demand as well as real estate investments; but might also have had unintended consequences: it might have hurt market sentiment by signaling the need for unorthodox policies and it might have hurt growth and inflation by incentivizing a higher savings rate and lower household consumption.

Most likely the net effects of NIRP to growth and inflation have been negative by virtue of the resulting redistribution of resources away from household consumption and in favor of residential investments. In Japan's second quarter real GDP report, private residential investments grew at an annualized pace of over 21% while household consumption grew less than 1%.[3] Unfortunately the boost to residential investments does not help much given that those account for only 3% of real GDP, while household consumption makes up for almost 60% of it. The reality is that the downside to the banking sector and to household consumption might have outweighed the upside to residential investments.

Easy policy is actually hard

At the last policy meeting, the BOJ introduced new policy measures with the goal of reinforcing their commitment to their 2% inflation target and reducing the negative effect of NIRP for the banking sector. To achieve the latter, the BOJ has introduced a yield targeting framework, called Yield Curve Control, with the objective to keep the 10-year government bond yield at 0%. The way a central bank targets a yield or a price is to buy or sell the asset in question until demand and supply clear at the desired price.

Chart 5: 10-year generic Japanese yield
Source: Bloomberg as of 9/30/2016



Targeting the 10-year bond yield at 0% in Japan means likely maintaining a certain steepness in the yield curve which would be supportive of bank net interest rate margins. However, there could be some unintended consequences. For example, in the case of external negative shocks, like Brexit turned out to be during the summer (chart 5), 10-year Japanese yields could fall meaningfully below zero. The new Yield Curve Control framework would imply that the BOJ sell 10-year government bonds to drive the 10-year yield back up towards the target of 0%. In a nutshell, this policy framework could induce the BOJ to tighten policy during a negative shock at which point policy easing could likely be more appropriate.

Sources:
[1] Economic & Social Research Institute Japan
[2] Bank of Japan: https://www.boj.or.jp/en/announcements/release_2016/k160129a.pdf
[3] Economic and Social Research Institute Japan as of 6/30/2016