Japan 2017

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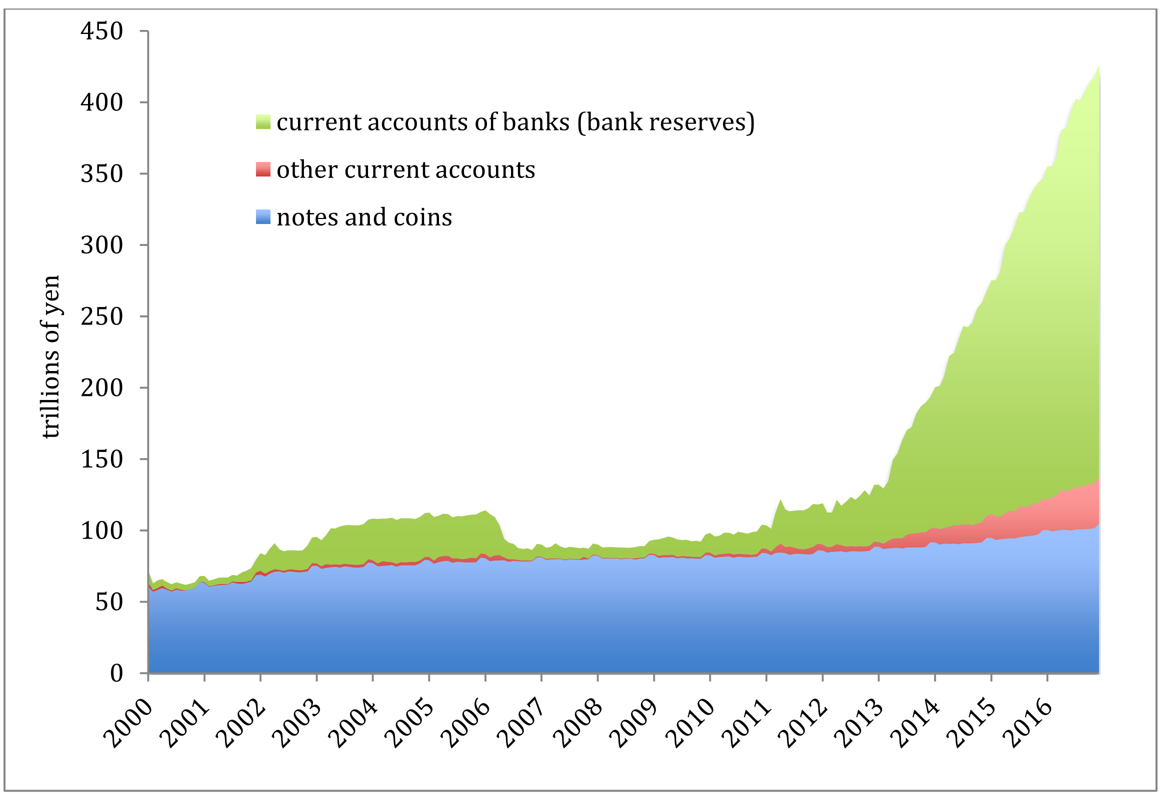
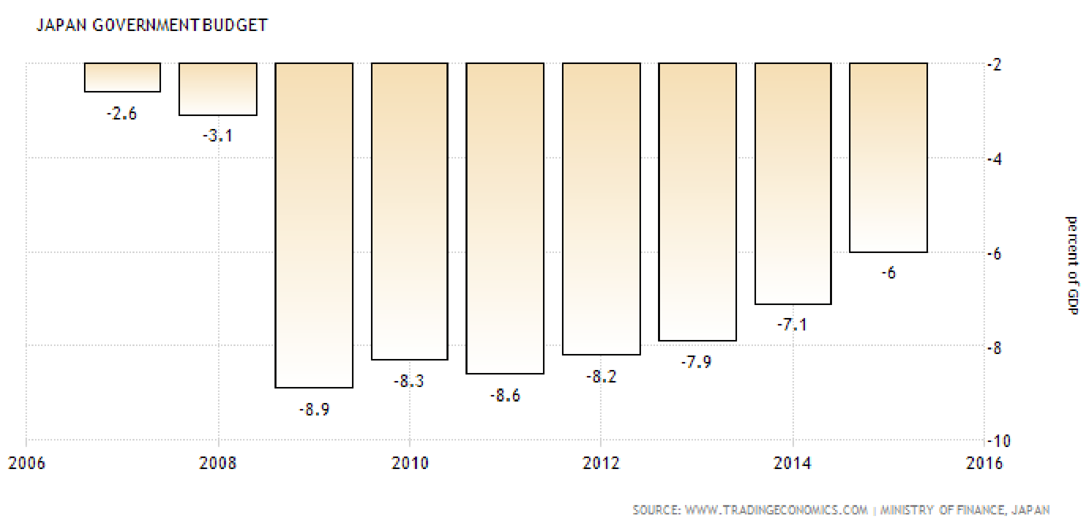
Since our last look at Japan in 2014, the Bank of Japan has been "printing money" via asset purchases at the astonishing rate of ¥80 trillion a year – equivalent to about 15.3% of GDP. (GDP was statistically revised upward in 2016, making figures like this look a little better than they used to.) This includes about ¥6 trillion of equities purchases, with most of the remainder consisting of government bonds. Here's what the monetary base looks like:



At present, the monetary base is about 82% of GDP, which is pretty special any way you look at it. Despite every reasonable expectation, there doesn't seem to have been a lot of consequences. The yen, instead of falling, actually went up! This is very, very perverse.

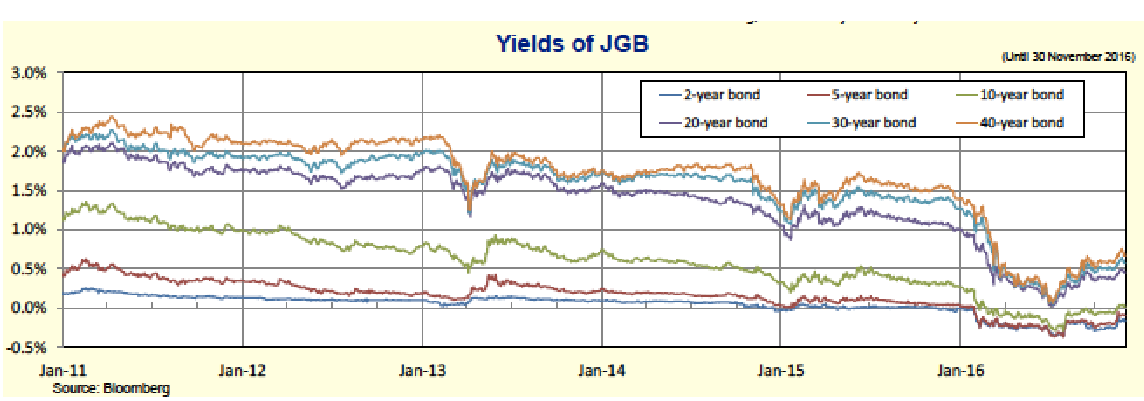
The Japanese government, in its desperation, seems to have stumbled upon the fiscal Fountain of Youth. They can print – and spend – some very large sums of money, funded by nothing but the printing press, and get away with it for year after year. This is good, because they are still running a big deficit.



This deficit comes in part from the roughly 6%-of-GDP increase in government spending since 2007. This stemmed from the 2008-2009 crisis, but I guess it became a habit. The government is still trimming some expenses here and there, and then later indulging in "stimulus packages" which have become as traditional as Golden Week.

Government debt/GDP inches higher:

Yields headed lower, and even went negative for much of 2016:

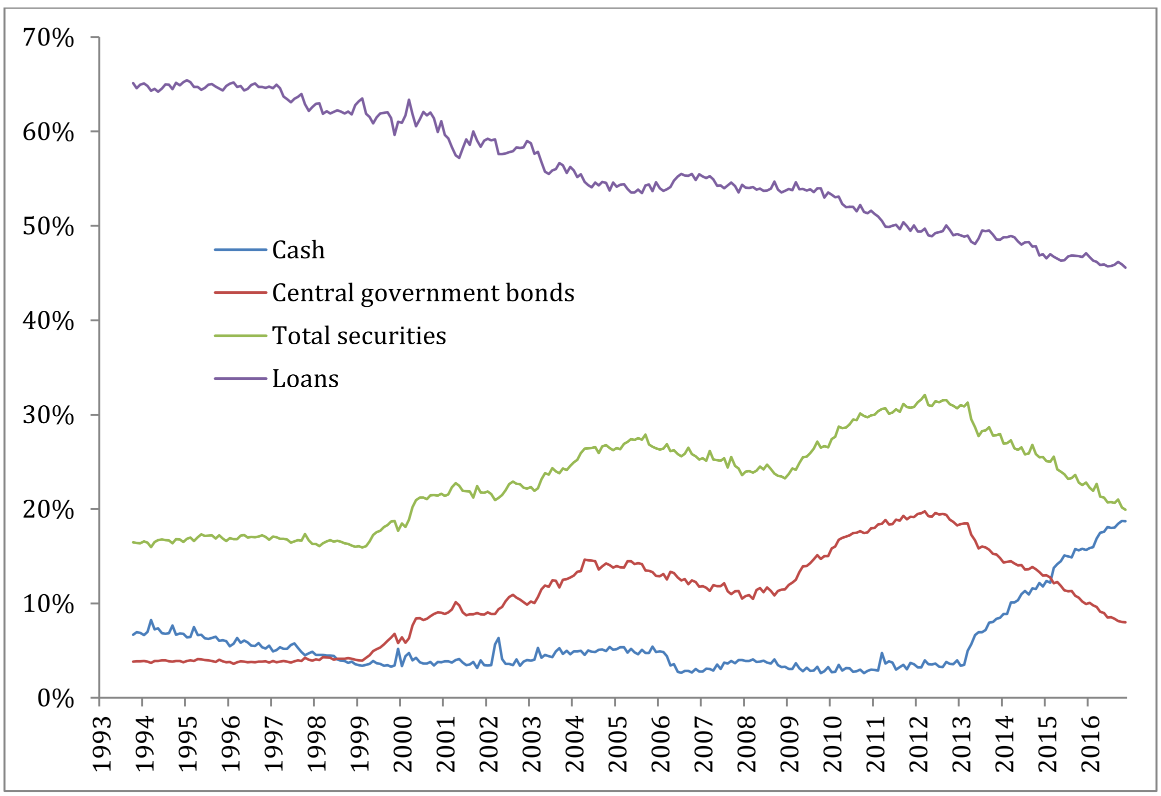


What's going on here? You can bet a lot of governments would like to know – and, given a similar pattern for yields worldwide, probably found out somewhere along the way. I've long held the view that Japan is the wayshower here, and this view has not been disappointed.

Here is what I think is going on.

If the value of the yen hasn't fallen, and instead has shown a persistent rising tendency even against the apparent wishes of the government (they would like a yen closer to 120/dollar I'd say), then we should assume that the extraordinary increase in money supply has been matched somehow by an extraordinary increase in demand. This demand is not for banknotes and coins – at any time, any depositor can go to the bank and get as many banknotes as they would like, and the banknotes would be printed if necessary to satisfy this demand. This has not happened. Rather, the demand has been from banks themselves, for bank reserves.

This is what banks' balance sheets look like. All figures are shown as a percentage of total assets:



Japan: Assets of Domestic Banks, as a Percentage of Total Assets, 1993-2016

"Cash" used to consist largely of overnight lending, but now it is almost entirely deposits at the BOJ.

As you can see, cash has risen to nearly 20% of total assets. That is very high. This rise has come about mostly via a reduction in securities, and within that category almost entirely via a reduction in government bonds. Government bond holdings were previously rather low, actually around 4% before 2000. They began to rise in 1999, in what I believe was a coordinated effort to put a lid on yields. At the time, I knew a fellow, Richard Werner, who was the chief economist at Jardine Fleming in Tokyo. Through his contacts in the banking industry and the BOJ, he learned of a coordinated program to suppress bond yields, via purchases and also various tricks involving derivatives. He decided to take the other side of this trade, and predicted a "bond crash!" Needless to say, this did not work out; and soon, he was not working for Jardine Fleming. But, I suspect that there was something to his thesis, even if his conclusion was wrong.

Anyway, bank holdings of government bonds soared to very high levels. Probably, banks were not too happy about this. The BOJ's bond-buying program since 2013 has largely amounted to taking bonds off the hands of banks, and swapping BOJ deposits instead.

Normally, banks minimize their holdings of low-yielding (or, in the case of central bank deposits, normally non-yielding) "cash" instruments, and instead reinvest the money in higher-yielding assets. These could include loans. But, loans have liquidity risk. Although sales of straight loans are not so uncommon today, traditionally loans were held until maturity, and this remains more common in Japan than the U.S. Thus, a bank wanted to hold some liquid assets, but which also had a better yield than cash. These were typically bonds and bills, either corporate or government, which could be sold on the market in a pinch.

Yields soon went so low that bonds were all downside and no upside. Their advantage to cash was negligible; the risks were acute. So, banks would naturally be inclined to swap their bonds for BOJ deposits. This sets up a self-fulfilling cycle: low yields prompt demand for BOJ deposits from banks; to satisfy this demand, the BOJ buys bonds, thus driving down their yields. With a little quiet coordination, to keep an orderly market, everyone would be happy.

When yields on 10yr JGBs are negative, it makes more sense to hold cash. Conceivably, banks might want to swap their entire bondholdings – even corporate bonds – for BOJ deposits. Thus, we have, potentially, an excess demand for deposits (base money), even while the BOJ is producing base money at a rate of 15%+ of GDP per year! The result is a rising yen.

How long can this go on? Potentially, for some time longer. The BOJ has instituted an overt yield target of 0.0% on the 10yr JGB. Banks still have quite a lot of government bonds, not to mention other bonds that trade at a spread to JGBs and thus are equally overpriced and risky, which they could trade for BOJ deposits. Also, their regular loan book has been shrinking, which allows them to hold more cash.

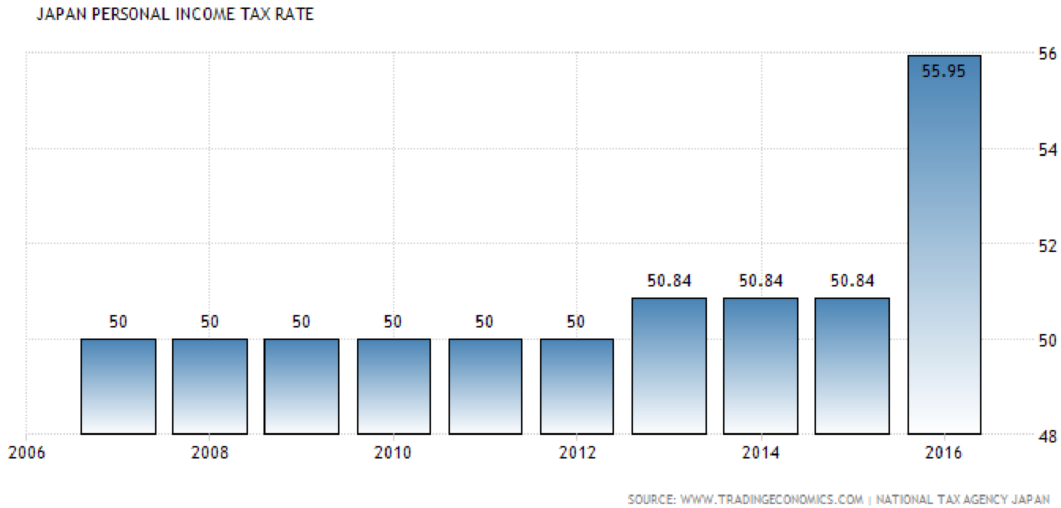
One can argue that banks' holdings of JGBs and securities in general are getting closer to what they were historically. But, that was not an environment of 0% yields. In practice, there does seem to be some resistance among banks to reduce their JGB holdings still further.

There is a bit of a discrepancy: the bank balance sheet data shows ¥191 trillion of bank reserves, while the BoJ's current accounts "subtotal of institutions subject to reserve requirements" show a total of ¥282 trillion. Some of this is "other institutions subject to the reserve requirement" of ¥77 trillion. This probably consists mostly of the life insurers. Plus, our figures are assets of domestic banks, which don't include foreign banks.

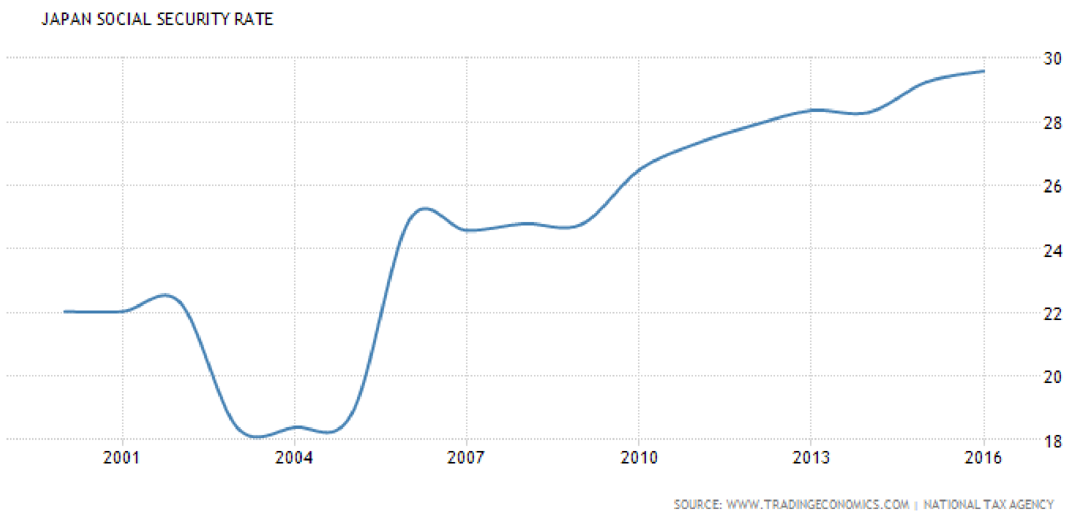
While I said that this cycle apparently could go on for a while, it might also be upset somehow, and the rapid decline in the yen after Trump's presidential victory in November is the sort of disruption that might somehow make a mess of things.

After a few years of apparently painless printing-press finance, there is, as one might expect, not a whole lot of motivation to do much of anything about all of the various fiscal problems of the day. This has a good side: attempts to close deficits by raising taxes have been set aside, especially an increase in the national sales tax to 10% from 8% presently. Corporate taxes have been gradually lowered; but this has been accompanied by a reduction of deductions and expenses, so the overall net benefit is not very clear. Japanese corporations have long been able to prosper, even with high rates, via a system of very generous deductions and expenses. Overall, ten percentage points is nothing to scoff at, so let's call it a positive. It is scheduled to fall a couple points more, to around 28%.

The top personal income tax rate, however, rose.

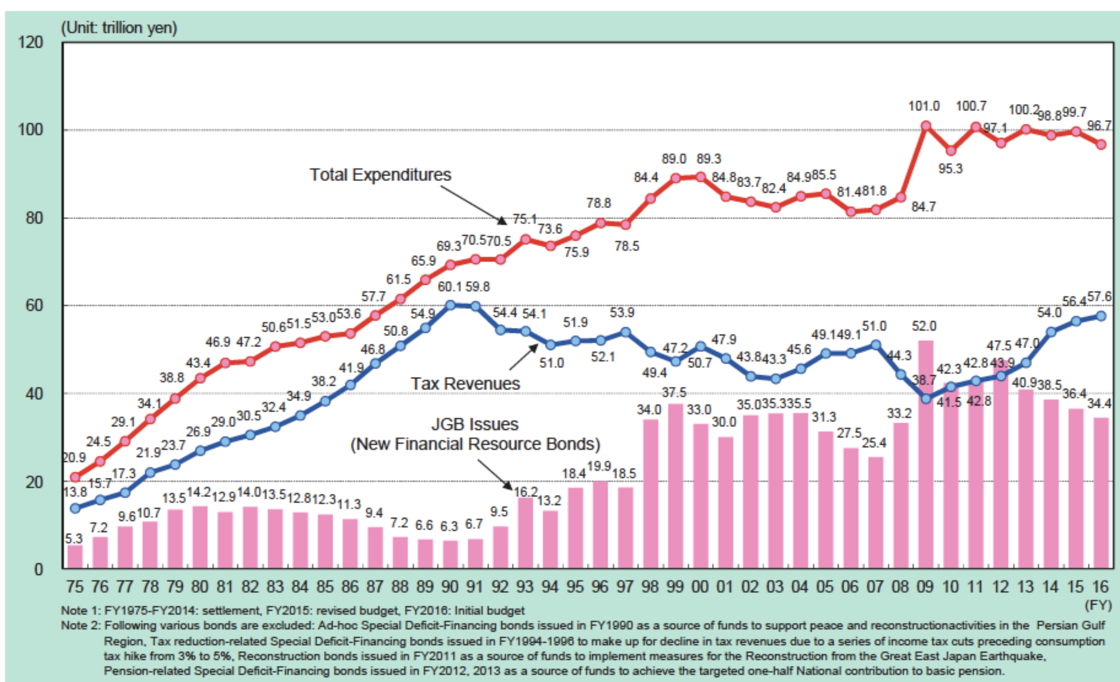


The payroll tax – which does not have an upper limit on income – continued to click higher, and is now roughly twelve percentage points higher than its lows around 2004.



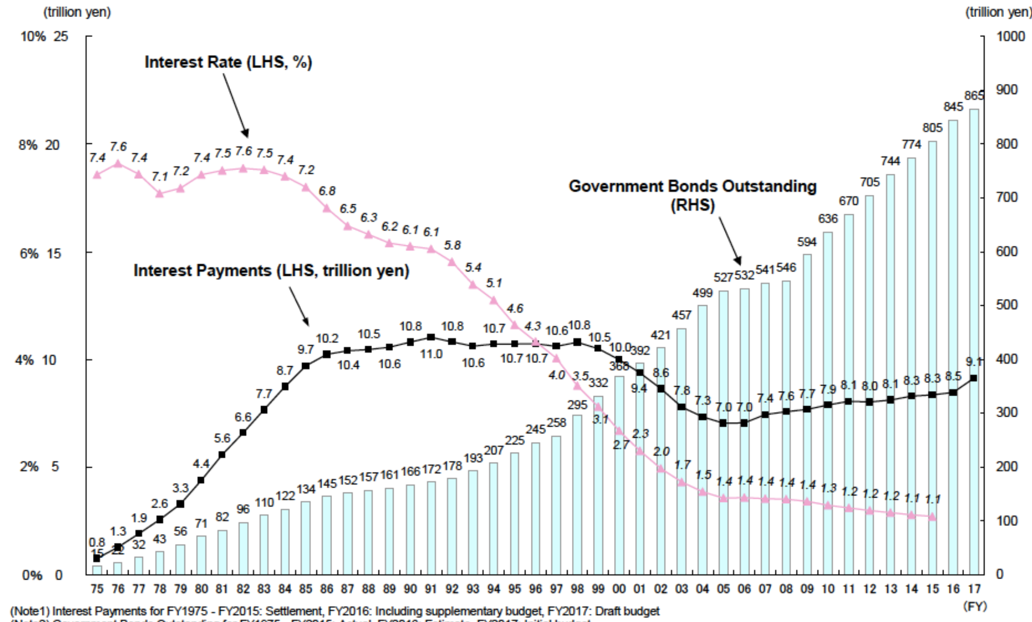
My overall impression is that these minor wiggles in policy are not particularly relevant, given the giant pile of dynamite related to debt, deficits, the bond market and BOJ monetization. For now, there is a slight positive tendency, with a little lower corporate taxes and a little smaller deficits. The electoral scene has been relatively quiet, with an Upper House election in 2016 not changing the situation much.

(1) General Account Tax Revenues, Total Expenditures and Government Bond Issues



Tax revenues have actually been creeping a little higher.

(6) Trends in Interest Payments and Interest Rate



(Note1) Interest Payments for FY1975 - FY2015: Settlement, FY2016: Including supplementary budget, FY2017: Draft budget
(Note2) Government Bonds Outstanding for FY1975 - FY2015: Actual, FY2016: Estimate, FY2017: Initial budget
Government Bonds Outstanding includes Reconstruction Bonds as a source of funds to implement the measures for the reconstruction from the Great East Japan Earthquake in FY2011 - FY2017 (FY2011: 10.7 trillion yen, FY2012: 10.3 trillion yen, FY2013: 9.0 trillion yen, FY2014: 8.3 trillion yen, FY2015: 5.9 trillion yen, FY2016: 7.7 trillion yen, FY2017: 6.6 trillion yen), and Pension-related Special Deficit-Financing Bonds as a source of funds to achieve the targeted national contribution to one-half basic pension (FY2012: 2.6 trillion yen, FY2013: 5.2 trillion yen, FY2014: 4.9 trillion yen, FY2015: 4.6 trillion yen, FY2016: 4.4 trillion yen, FY2017: 4.1 trillion yen).

Lower yields have kept interest payments manageable even as principal has soared.

For now, the BOJ has, if anything, been more concerned with a rising yen. A lot of it boils down to the yen/dollar rate. A decline of the yen to ¥125/dollar or so might prompt some new tightening action from the BOJ. A decline beyond ¥135-140 would certainly do so. That is the next stage of the drama to be played out. Or, the yen might rise again after its post-Trump stumble, banks might swap more of their securities holdings for BOJ deposits, and the Fountain of Fiscal Happiness will continue to pour its bounty over the land for a while longer yet.

Oddly enough, it might be a tightening action by the BOJ that knocks over the apple cart. Higher yields and reduced BOJ monetization might lead banks to decide that they don't really want to hold 20% of their balance sheet in BOJ deposits yielding negative 0.1%. There might be a great demand to borrow money in depreciating yen, even from overseas divisions of Japanese corporations. In short, base money demand might contract a lot faster than supply. (One response to this would be to pay a positive interest rate on BoJ reserves, as the Federal Reserve does.) I can imagine a situation where it seems that the yen really, really must be supported, and the BOJ would be required to respond. But if they stop buying JGBs, or even turn around and start selling, yields might rise substantially. Even at a 3% yield, which is not really very high especially considering the inherent credit risk -- the Japanese government would eventually have to pay 6.6% of GDP just for interest payments alone, compared to about 1.6% presently, a quadrupling in interest costs and an overall increase of government expenditures of 5% of GDP for which there is no apparent means of funding except further bond issuance.

As for guesses as to the timing, I will defer to Martin Armstrong, whose black box has a better track record in these matters than anyone else I could point to. He expects a global crisis centered on “sovereign default” in 2017 and 2018. If such a thing comes to pass, we should expect Japan to be a leader once again, perhaps followed closely behind by the likes of Italy and Greece.