Central Bankers Gone Wild

By John Mauldin | June 1, 2013

Exporting Deflation
DC, NYC, France, Cyprus, and Vegas…

When Jonathan Tepper and I wrote *Endgame* some two years ago, the focus was on Europe, but we clearly detailed how Japan would be the true source of global volatility and instability in just a few years. "A Bug in Search of a Windshield" was the title of the chapter on Japan. This year, I wrote in my forecast issue that 2013 would be "The Year of the Windshield." For the last two weeks we have focused on the problems facing Japan, and such is the importance of Japan to the world economy that this week we will once again turn to the Land of the Rising Sun. I will try to summarize the situation facing the Japanese. This is critical to understand, because they are determined to share their problems with the world, and we will have no choice but to deal with them. Japan is going to affect *your* economy and *your* investments, no matter where you live; Japan is *that* important.

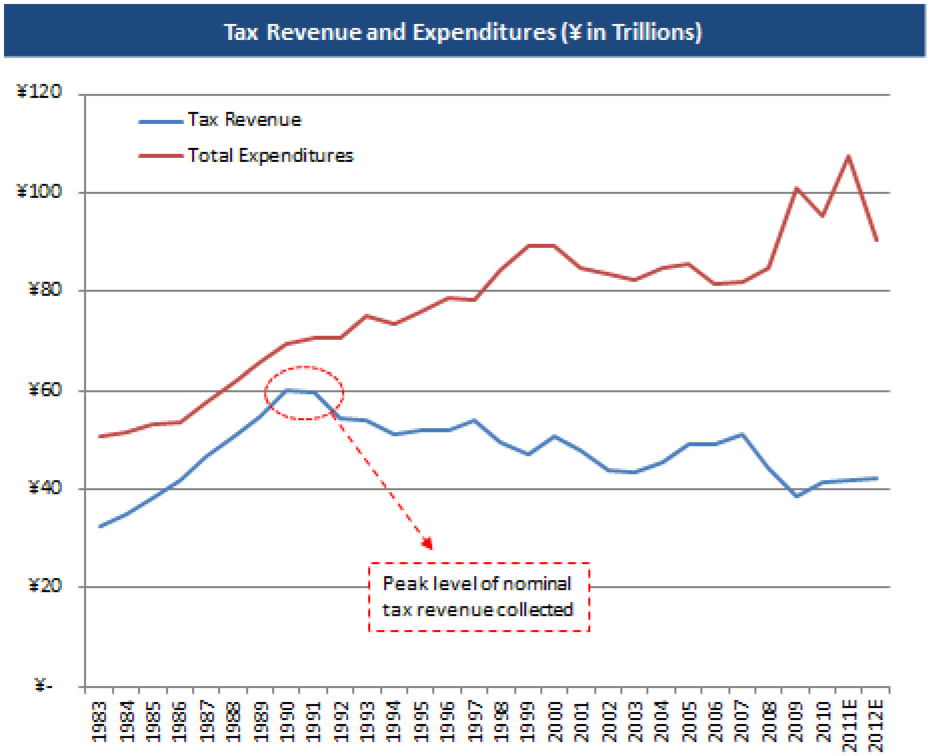
In bullet-point fashion, let's summarize the dilemma that faces Abe-san, Kuroda-san, and the other leaders of Japan.

1. Japan is saddled with a yawning fiscal deficit that, if it were closed too quickly, would plunge the country into immediate and deep recession. The yen would strengthen, and Japan's exports would once again be damaged. Such is the paradoxical outcome if you suddenly decide to live within your means when you have been on a spending binge. The Japanese deficit is close to 10% of GDP. For my US readers, think about what would happen next year if the government cut $1.6 trillion from our budget.

   Japan has a GDP that is now close to 500 trillion yen (give or take a few tens of trillions). Their most recent budget calls for Y92.6 trillion in spending, almost evenly divided between Y43.1 trillion financed from tax revenues and Y42.9 trillion from the issuance of new bonds, adding to Japan's massive public-sector debt that already totals nearly Y1 quadrillion. Say that with a straight face: 1 quadrillion. And this massive debt is not a recent phenomenon: it has been accumulating for many years.

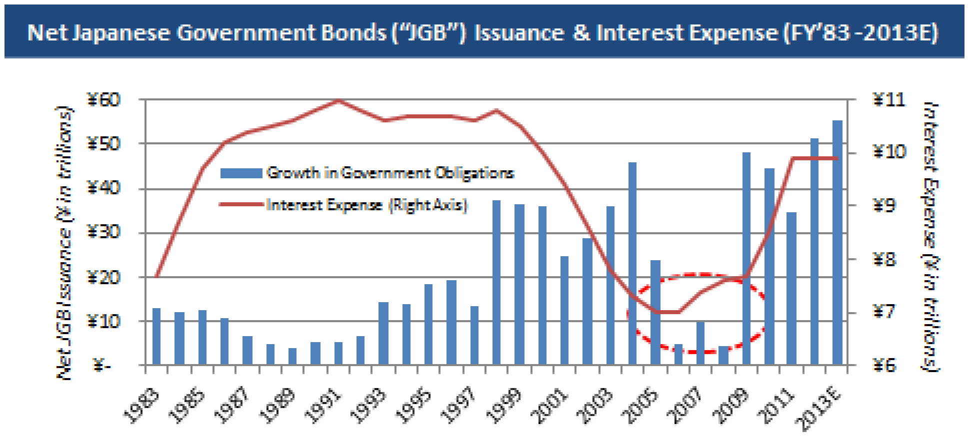
   Tax revenues have been going down for decades, as the country has been mired in no-growth deflation for 24 years. Revenues are now down to where they were in 1985. By way of comparison, US tax revenues in 1985 were $734 billion (or $1,174 billion in constant 2005 dollars). Last year, US revenues were $2,450 – that is, more than double the 1985 total. (taxpolicycenter.org)

The following chart is courtesy of my friend and Japan expert Kyle Bass at Hayman Capital Management. If this were a stock, would you be a buyer?

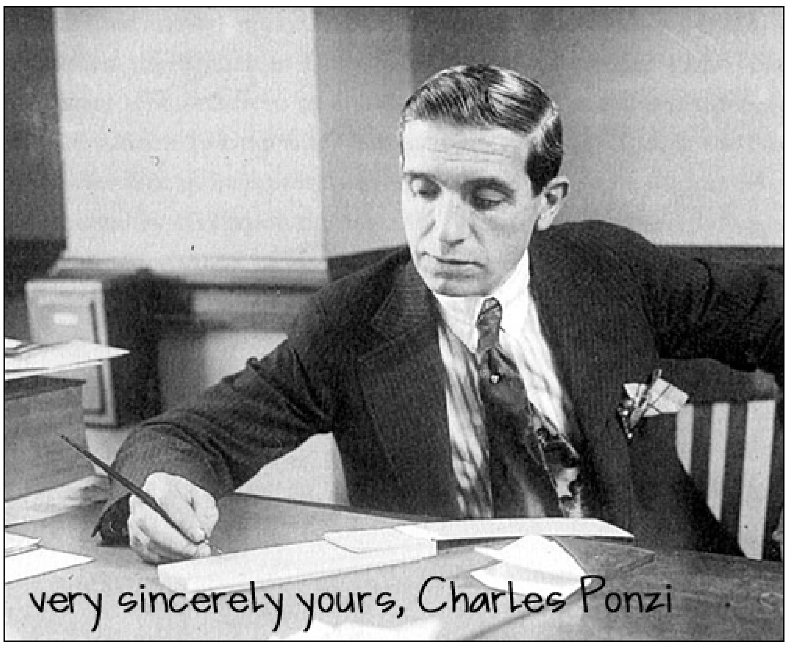


2. Japanese ten-year interest rates exploded from just above 30 basis points to over 1% at one point in the past month. The Bank of Japan (BOJ) intervened, but rates closed today at 0.85%. Note that they are still down from the 1.3% where they stood two years ago.

3. It costs the Japanese government 24% of its revenues just to pay the interest on its debt at current rates. According to my friend Grant Williams (author of *Things That Make You Go Hmmm...*), if rates rise to just 2.2%, then it will take 80% of revenues to pay the interest. Even at the low current rates, the explosion in Japanese debt has meant that interest rate expense has risen from Y7 trillion to over Y10 trillion. Note in the chart below (also from Kyle) that the Japanese government is now issuing more in bonds than it pays in interest. Somewhere, Charles Ponzi is smiling.



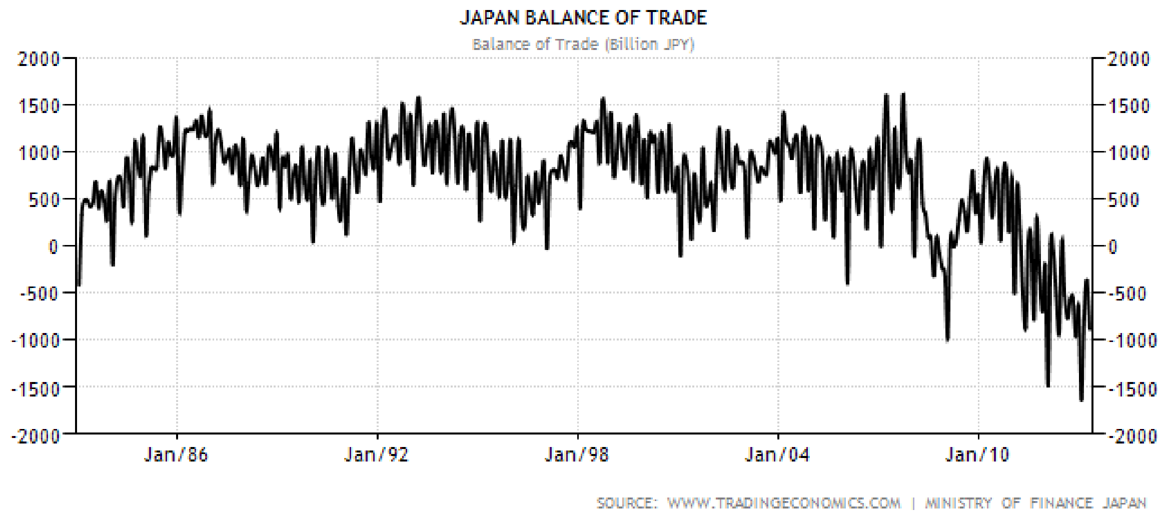
Just for fun, here is a picture of Mr. Ponzi writing a check (courtesy of Geert Noels).



4. For 20-plus years, Japanese nominal GDP has barely risen. If your nominal GDP stagnates and you are running large deficits every year, then your debt-to-GDP ratio rises. For Japan, the ration will be a staggering, never-before-seen 245% this year.

5. The only way you can lower the rate of debt-to-GDP expansion – and perhaps convince investors to continue to buy your bonds – is to increase your nominal GDP while slowly lowering your deficit over time until the increase in your debt is less than the nominal growth of your economy.

6. After years of running trade surpluses, Japan is now running a trade deficit. Basic economic accounting tells us that for Japan to get to its goal of sustainability, it absolutely must have a trade surplus. And as deep a hole as Japan is in, it needs seriously large trade surpluses. Like back in the good old days of only a few years ago. Not to mention that the country's current account surplus is down by over half from its peak in 2007 and back to where it was 20 years ago. The trend is ugly.



7. There are only two ways to get nominal growth. You can get real growth or you can create inflation. There are not many things that you can get Hayek and Keynes and every other economist to agree on, but this one thing is the universal answer to your fiscal problems: Growth, with a capital G. That is the remedy put forth by every economist and every politician : "We need to grow our way out of the crisis." But there are two problems as Japan tries to get to growth.

Problem #1: Your nation is aging, and internal consumer spending is not going to be a source of real growth. You have to talk like that can happen, but you know it is just not all that realistic. You have been trying for 20 years to get your country to spend, and people are just not up to it. What you really need is for your export base to get with the program and massively increase its sales to the rest of the world. In fact, that is your only real option. And one of the easiest ways to do that is to drive down the value of your currency, especially against the currencies of competitor nations. That boost in exports can help relieve your chronic excess productive capacity and maybe, possibly, hopefully, engender a labor shortage and drive up the cost of labor, which will help stimulate inflation.

Problem #2: You are mired in deflation and have been for 20 years. Since there is no natural source of inflation in Japan – a nation of savers and an increasingly elderly population –you have to create inflation by increasing the prices of your imports. And the way to increase those prices is to drive down the value of your currency, especially against the dollar and the euro.

Hmmm, we see a possible strategy emerging here.

8. But if you set out to decrease the value of your currency, you violate all sorts of central banker and G7 codes and rules. Given the scale at which you need to operate, you would start a currency war, and no major central bank could possibly be associated with something so distasteful. That is a touchy problem, but fortunately for you there is a solution: you *can* engage in quantitative easing in order to stimulate your economy. That is certainly within the rules, as the central banks of every other major member of the club (the Fed, ECB, and Bank of England) have been doing it for years.

   How can anyone object to a policy that simply targets inflation? The fact that such a pursuit happens to drive down the value of your currency is merely a by-product of the necessary pursuit of mild, 2% inflation, which is the only way for your country to get out of its slump. The other big players all have 2% inflation targets; you are just aligning Japan's course with their own stated policies. And besides, even with the huge size of your announced quantitative easing, you can point out that you are way behind the growth of the monetary base of the Fed, the ECB, and the BoE.

9. That brings us to a major dilemma, which Kyle Bass calls the Rational Investor Paradox. If you are an investor or fiduciary in Japan and you now believe the Bank of Japan is quite serious about creating inflation, do you continue to hold Japanese government bonds (JGBs)? Any serious analyst would assume that interest rates will climb to at least the rate of inflation, assuming you believe that Japan can create inflation. And especially if they pursue a policy that is going to lower the purchasing power of the yen, why would you, a rational investor, want to hold long-term Japanese bonds? Why wouldn't you sell as soon as Kuroda announced the “shock and awe” policy? (It certainly left me in shock and awe! And intellectually, I knew it had to be coming!) And that is exactly what happened the day after Kuroda announced his policy. The BoJ had to step in a few days later and start buying bonds in significant quantities to hold the rate down.

10. Your problem is compounded by the fact that the natural buyers of your bonds for the last 20 years have been the retirement plans of your workers. But your country is rapidly getting older, and now those pension plans and individual savers are starting to cash in those bonds in order to meet pension obligations and to live in retirement. Your major pension plans are now sellers (on net) of JGBs. Mrs. Watanabe is not going to be a buyer of bonds in retirement. She will want to sell in order to buy rice and help out her grandkids. She will need to pay for rising energy and healthcare expenses and other basic needs. In short, you are rapidly running out of buyers “at the margin,” which is where markets are made.

11. Now, to the crux of the problem. You cannot allow interest rates to rise much more than they already have. That way lies fiscal disaster. Yet the buyers of Japanese bonds are starting to get nervous and to leave the market, which is a rational consequence of your drive for inflation, which you absolutely must have if Abenomics is to have a snowball’s chance in Hades of working. That means there is only one real source of bond buying power left: The Bank of Japan.

> The Bank of Japan is on its way to becoming the market for Japanese bonds. It is eventually going to have to "hit the bid" on every bond that is issued by the government, because if the current policy is maintained it will drive all buyers from the market, leaving just sellers. The pension systems will not necessarily exit their JGBs, but they will let them roll off as they need to raise cash to meet their pension obligations. International buying of your bonds will also slow to a trickle.
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> The Bank of Japan is going to have to print – sorry, Kuroda-san, I mean pursue quantitative easing – to a far greater extent than it has announced in order to keep up with the demands that will be heaped upon it. We are talking about numbers that will stagger the imagination. This will be bigger than Carl Sagan's "billions and billions." It will not be long before the word *quadrillion* starts to be used more frequently. Kyle Bass remarked during the webinar that he, Jon Sundt, and I just recorded that if you started counting and called out one number every second, it would take 33 million years to get to a quadrillion. A quadrillion is a thousand trillion, or a million billion or a billion million. We humans simply have no way to grasp the enormity of such a number. Nor can we understand the implications when such fantastic numbers must be applied to the world's money supply.

Exporting Deflation

12. In summary, along with increasing your exports of cars, flat-panel screens, robots, and machine tools, you are going to try and export the one thing you have in abundance that the world does not want: deflation.

This is a nightmare scenario for central bankers worldwide. If there is a mandate, a central theme in the Handbook for Central Bankers, it is that deflation must always and everywhere be fought tooth and nail. Deflation must be given no quarter. Who wants to become the next Japan?

If deflation shows up on your watch, you have to fight it. And if your interest rates are already low, then the only tool you have in your deflation-fighting toolbox is quantitative easing.

Let me be very clear. Japan is about to unleash the most significant currency war since the 1930s, when the world was still on the gold standard. The problem today is that politicians, labor unions, and businesses everywhere want to use exchange rates as the tool to manage their balance of trade, rather than focusing on improving their own competitiveness and manufacturing skills, not to mention controlling their own spending and fiscal budgets. The problem as they see it is the competition from abroad, which is always seen as doing something unfair.

The pressure on central banks to respond to Japanese QE is going to be immense. As the yen has risen from 78 to around 100 today (against the dollar), central banks have so far said very little, since they realize that only a few years ago the yen was at 120 and falling. But we need to remember that the yen has been at 350 within the last 40 years.

However, Japan is going to need to depreciate the yen by 15%-plus a year to get their 2% inflation, and within two years that means a yen at 130. And then 150 the next year, with 200 the extrapolated destination in five years. Can that happen in a vacuum?

It is unrealistic to think it can. I think we may be entering a most dangerous period where politicians and central bankers feel the need to "do something," and that something will include quantitative easing, exchange-rate actions, and protectionism. Think in terms of Central Bankers Gone Wild, armed with electronic printing presses and dreaming of new, ever more creative ways to stimulate the markets.

Stay tuned. We will continue to focusing on these topics as the summer advances.

In closing, a few notes on recent events that may not have come up on your Japan radar . Japan is discussing the need to impose rules on foreign exchange trading "to protect investors and limit speculation." The nasty volatility that has developed is not the fault of their own policies, they say, but that of traders and hedge funds. Here is some discussion.

And this note: Major Japanese banks plan to hike mortgage rates in June for the second consecutive month as long-term rates continue to creep up despite the Bank of Japan's efforts to guide them lower.

This is just the beginning. Do not rule out exchange and capital controls when things get very wild in a few years. Those have been tried many times in many places. If I lived in Japan I might want to take a vacation in, say, Singapore, and maybe check out the new botanical gardens and casinos. And if perhaps I walked by a bank, I might drop in just to see how easy it is to open a bank account and transfer a little money. Just for some diversification, you understand. And perhaps I'd go ahead and move a few assets out of yen into a different currency.

DC, NYC, France, Cyprus, and Vegas…

I will be in Washington DC Monday evening meeting with the team at Mauldin Economics, shooting a few videos that we will soon post. One will be with Newt Gingrich, and we will be talking about the changing world from the positive perspective of accelerating progress in technology. That is so much more fun than talking about Japan. We are also going to be making some very exciting announcements about new projects and additions to the team in months to come.

Then it's on to NYC for our *Investing in the New Normal* video webinar with Kyle Bass, Mohamed El-Erian, John Hussman, Barry Ritholtz and David Rosenberg. I have a lot of questions I want to ask these guys. You can join the fun (for free) by registering right here.

After Father's Day I am off to Monaco for a speech at the GAIM conference, and then I'll make my way to Cyprus to see for myself what the latest crisis aftermath looks like. Then on July 6 and 7 I'll be in Las Vegas. Reid Walker, friend and recovering hedge fund manager based here in Dallas, is organizing an event during the World Series of Poker on the theme of the intersection between investing and poker skills. This is just an entirely different world for me. I will not be entering the tournament –I know my limitations! But talking to some of the best players in the world and meeting Nate Silver and some of the other speakers will make for a fun weekend. The event is not cheap, but you can get a 10% discount by putting in the code "Mauldin10". Let me know if you're coming, and we'll get together for a meal. You can read more about the conference and register here. And here's an article in *Hedge Fund Intelligence* about Reid and the event.

I know I mentioned Sagan's famous riff "billions and billions" above. I also know he did not actually say it. The quote is actually from Johnny Carson, doing his impersonation of Carl Sagan. Eventually, Sagan did use "billions and billions" as the title of one of his last books. Just for the record – as some of you astute readers would have been quick to point out.

We are down to the wire on closing on the apartments. Finally! Just a few documents to sign and then construction begins. I will move into a small place in the same building during the transition, which is optimistically scheduled to last three months but realistically could run a lot longer. But at least I will have access to my "stuff" and more than the one pair of shoes I trot the globe in now. I did not plan to be "homeless" and in a hotel this long.

A positive aspect of it all is that I and my personal staff are becoming quite adept at being a virtual company. We have been progressing in that direction for years, but these last few months with no physical office have been the real test. Other than missing my multiple large screens, I am getting along quite well.

Have a great week. I have friends waiting on me tonight and family to spend time with this weekend. And I'll hit the gym, catch up on a lot of reading, and enjoy a few episodes of the one TV show I watch, *Game of Thrones.* I look forward to relaxing and enjoying a long weekend.

Your needing to get in the gym more analyst,

John Mauldin

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