Japanese and US Ease

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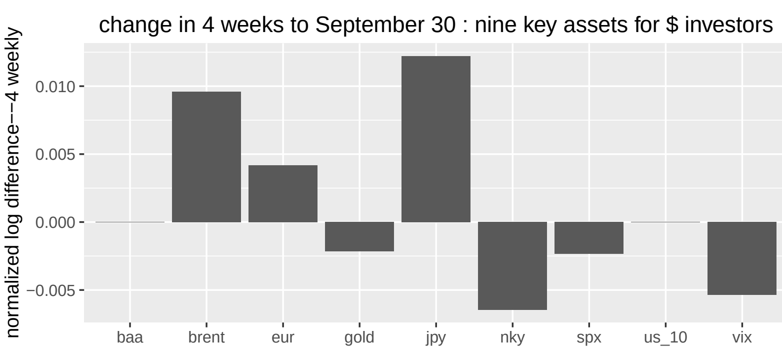
- **Central banks are taking no chances in getting to inflation**
- **Japan: a yield curve policy for inflation**
- **US: notching up the inflation target**

Oil prices jumped last week as Saudi Arabia seemed to find a basis for agreement with Iran on cutting oil production.

The dollar was broadly weaker after the Fed skipped a move and shifted down its expected rate hike path. As both the US and Japan took easing steps, the dollar-yen was caught between both forces and has been volatile, gaining this month what it lost last month.

Other markets were divided on how to treat the Fed and BoJ easing moves. Ten-year US and corporate BAA rates bonds ended up roughly unchanged, higher risk bonds including in emerging markets continued to do well, and core equity markets were choppy.



The Fed and BoJ are taking no policy chances with a return to deflation, as each took a step toward ease. Their moves partly compensated for the pause in the pace of new ECB actions amid a sudden round of funding fears for Deutsche Bank.

Investors are uncertain at a turning point. Sudden sell-offs in Mexican assets on the risk of a Trump presidency are one example, another is the drop in Deutsche Bank shares on fear of a big fine. At the same time, inflation-compensation markets began to slowly factor in higher inflation: what if these extreme central bank actions actually begin to work?

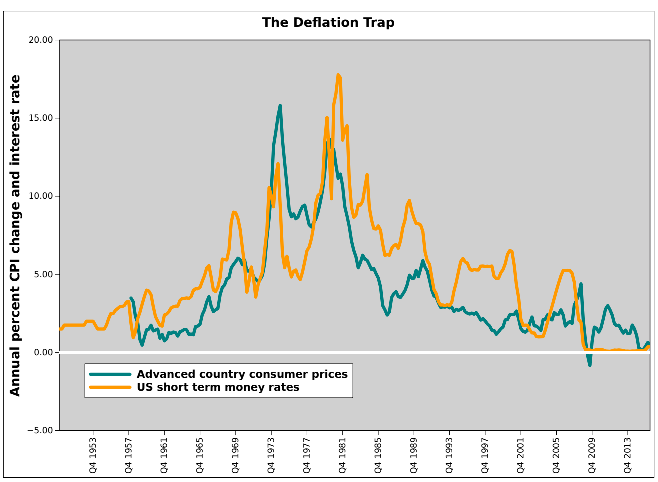
In this environment of extreme policy settings to stop deflation, the merest wiggle in commodity prices may have an oversized effect on investor views. In this light, the jump of oil prices is on the point of becoming an important macro event.

Central banks are taking no chances in getting to inflation. Monetary policy pre-2008 was based on the idea that interest rates could be cut until private borrowers stepped in to take up the cheap savings available. Controlling this lever, central banks claimed the lion's share of economic policy making. But since 2008, when interest rates hit zero, seemingly blocking rate policies, the new idea was to use central bank balance sheets to buy up government bonds and leave the public with excess cash that would be converted into consumption. In fact, that mostly led to an inflation of the *financial alternatives*, bidding up asset values. A weak secondary effect was noted as the wealthiest members of society, those that own most of the assets, slightly increased their current spending. It worked briefly, but not on a politically sustainable basis.

Clearly the simplest possible solution to deflation, and the one we think is most likely across the board, is simply higher public spending, easily financed *without risk* by a central bank that turns the new debt permanently into zero-interest, long-term claims. So funded, direct public spending cannot help but drive up total spending. If pursued vigorously, it is a policy that will certainly lift prices, then provoke a shift out of money and even more demand, and so yield enough inflation to wipe out the value of money and government debt to more than compensate for the transitory initial risk from the added public debt. If done, it were best done decisively.

A second decisive policy choice could be to break through the nominal floor of zero rates for the banking system.[1] In that case, if it can be done, interest rates might move down so far to reward borrowers so that, indeed, the price signal could work once again to instigate new investment. Again, this is a plan that can only work when used decisively to roll back deflation, or interest rates risk inching down slowly, never catching up with deflation, and never reaching the deeply negative real expected rates that can be too hard to resist.

Similarly, during the long fight with high inflation, it took central banks 6 years to gather the courage to move interest rates higher than runaway inflation, in 1980. Today the opposite struggle could be to get to decisively low negative rates to turn a long cycle of deflation and it could take as long. But whatever it takes, fiscal policy or negative interest rates, the acid test of success is going to come when observable inflation starts to stir. See chart below.



[1]Ball,L et.al.(September 2016) *What Else Can Central Banks Do?* Geneva Reports on the World Economy, London and Geneva.

Japan: a yield curve policy for more inflation. Which takes us to the Bank of Japan's new measures. These include an effort to control rates, again, but this time with a "yield curve" policy. As the Bank sees it, the object is to provoke the expectation of inflation that once ignited will provoke a flight out of money that right now, under deflation, remains highly attractive. The trick is to propose a way to lower rates that matter for investors by reducing marginal overnight rates (not applied to the bulk of bank reserves), as has been done already to -0.10%. But to also keep the 10-year rate near zero and allow longer rates to rise. This "yield curve" policy does not yet move shorter rates sharply into negative territory but it prepares the way to do so if needed. And it is coupled with a declared bias to tolerate higher inflation before emergency measures are relaxed.

So, this policy could rock expectations into the view that reflation is possible in Japan without destroying the net worth of its financial system, and it could go a long way if needed. The key innovation is a plan to buy or sell 10-year government bonds in any amount needed to nail its yield down at zero, implying a positive yield for longer than 10-year bonds, and a survival path for banks. As the Bank of Japan points out, its 10-year price support operation means that the money base will now potentially become volatile as the Bank stands ready to either buy and sell these 10-year bonds in potentially very large size in return for base money.

On balance, a global leader in extreme policies to fight deflation has found something new. Japan's "yield curve" policy opens the way to deeply negative rates for part of the curve, and also suggests more inflation than expected will be tolerated before emergency measures are rolled back. So this can be seen as a convincing version of the drastic negative rate policy. We also think the other option, public spending, is coming to Japan. Certainly, fiscal tightening as we saw with the sales tax increase of 2014 that first derailed the Bank's reflationary quantitative ease policy is not going to be repeated.

US: notching up the inflation target. Well, I was wrong on Fed policy, which I though held off from a hike in June and July based on an overwrought impression of risks due to Brexit. As those risks turned out to be a fiction, I assumed we would be sure to have a corrective hike in September. Supporting that view, I assumed a solid third quarter GDP growth report, based mainly on inventory dynamics. As the details of the third quarter accumulate, underlying demand in consumption, investment, and housing are all coming in lower, diminishing the GDP jolt that can be expected from any inventory shock, and lending support to the Fed's unexpectedly cautious plans.

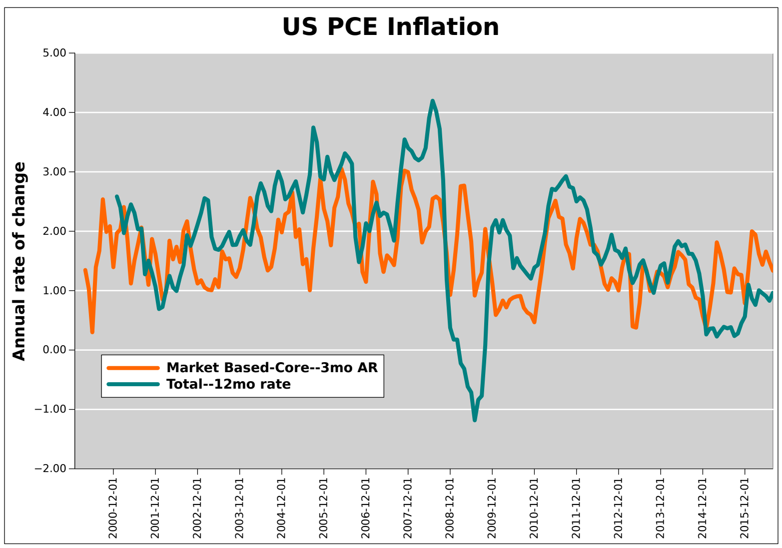
Besides the risk of still-slow growth, Chair Yellen referred, as well, to two other points to argue for a very slow path of rate hikes to come. Inflation may remain low because the unemployed who spilled off the regular rolls into part time work or who stopped trying to find jobs are slowly reemerging to take up jobs and doing so, hold down potential wage gains. Ms Yellen said we may have "found a little more running room" before labor markets tighten enough to signal big wage increases.

The other argument is that in an increasingly integrated global economy, US rate hikes long before the others can drive up the dollar. And higher US rates can also contribute to financial instability that disrupts global growth and commodity prices. A "new normal" was referred to by both Ms. Brainard and Ms. Yellen, which really means that the Fed needs to consider soggy global demand conditions together with local US ones in setting rates. Perhaps.

Taken together, these new arguments actually point to a policy designed to insure an overshoot of US inflation. One way to see this is by looking at the Personal Consumption Expenditure (PCE) deflator. Yearly growth of the total deflator was, indeed, near zero in 2015 because of falling oil prices, and is only inching up to 1% now. But an important leading indicator, market-based core PCE, has been rising since the end of 2014 and will soon be running over 2%. If we have any bad luck, an upward adjustment to fuel prices could take headline PCE deflator to 3% in 2017. So, Ms. Yellen's policy seems to be deliberately aiming at over the 2% inflation target, in an effort to pull definitely free of the supposed gravitation pull of the world economy into deflation. See chart below.

Effectively a milder version of the Japanese policies of desperation are implied in the US. We are going to tighten late, it is implied, only after inflation is clearly over 2% on a sustained basis. During this phase, we will go through a phase of very negative real rates that implies a haircut to cash and bond investments. That could perform a useful stabilizing function for this still-overlevered system. But we need to be quick about it or we are going to have some disruptive investor reactions to the impending losses.

Amid all this, the US presidential elction is approaching. Donald Trump's amateur candidacy, based on low insults and promotion of factions at the expense of others is a familiar populism that has crippled many other nations in history. If by any chance it is adopted here, almost all business expectations will have to be revised by a big margin, creating an added layer of political risk amid the other elevated asset market risks in the situation.



Clearly, central bankers are more interested in inflation overshooting than I thought. For investors, the real choice was always between 1) decisive reflation using monetary and fiscal policy, compared to 2) inching along with half measures into a state of chronic, system wide, deflation. I never thought reflation was likely to stumble, partly because the public so loves public spending, particularly at zero cost of debt. But, increasingly, monetary policy overkill is what seems to be also on offer. The answer seems to be pointing ever more certainly one way: toward reflation.

These new measures mean recovery and inflation are more likely at a time when inflation is already incipient in global commodity markets. So un-pegged bond markets outside of Japan could get very volatile indeed as inflation picks up and investors react to the clear intention to create a measure of inflation overshooting. Cash and low yielding bonds will fall in value. Stocks are likely to hold up if there is growth, but suffer as the long-term discount rate must go up and from Trump risk. Trump has a low chance of taking office, but if he does the risk of unprincipled and self-destructive policy is plainly rising.