The End of Independence

Japan's Shift to Fiscal Dominance

October 2016

Neil Dwane
Global Strategist

Japan's imposition of yield-curve controls marks the moment that monetary policy finally became subservient to government policy. Neil Dwane says "fiscal dominance" is a dangerous successor to financial repression – not just for investors, but for entire economies.

Key takeaways

- The BOJ's recent decision to implement yield-curve control opens a new chapter for central-bank monetary policies
- After QE and NIRP failed to reinvigorate economic growth and inflation, the BOJ is stepping up its efforts by explicitly financing government policies
- As Japan legislates for pay increases and the BOJ underwrites the expenditures, expect a weaker yen and rising inflation in Japan; this will exacerbate trade tensions and challenge bond investors globally
- As yields rise and fiscal dominance spreads, the great wealth stored in overvalued bond markets today will erode, and bond markets around the world could reprice lower
- After peak liquidity, investors may need to position for both higher volatility in currency and bond markets as well as potential losses in fixed-asset portfolios

With its new policy of yield-curve control, the Bank of Japan (BOJ) has begun supplanting financial repression with "fiscal dominance". Japanese monetary policy will now be subservient to government policy, which will use domestic fiscal measures such as wage controls to create the necessary levels of inflation that have up to now been hard to manufacture.

Allianz Global Investors

By choosing yield-curve control instead of what the market expected – helicopter money and infrastructure stimulus – Japan has all but ended the pretence of central-bank independence. If the practice of financing fiscal policy with monetary policy is successful, it will create inflation that erodes capital savings in many bond markets, it will endanger the purchasing power of retirement savings, and it will threaten global trade by raising international tensions as currencies become more volatile again.

If Japan's new initiative is successful, it will create inflation that erodes capital savings, endangers the purchasing power of retirement savings and threatens global trade

Will the world follow Japan's lead?

At our recent Investment Forum, AllianzGI's investment experts extensively discussed whether Europe was confronting the same demographic and economic challenges as Japan did in the 1990s – and making some of the same mistakes. We also discussed the folly of negative interest-rate policies (NIRP) and the confusion they caused; NIRP has not only crushed banking profitability in Japan and Europe and undermined consumer confidence, but it has ironically caused savings levels to rise.

With central banks now dominating many bond markets – the BOJ, for instance, owns approximately 40 per cent of all Japanese government bonds – investors have been corralled into higher-risk and longer-duration bonds, and into bond-like equities with lower volatility. This situation may persist for some time, as there is no sign that any major central banks will be raising rates anytime soon – with the only prospect of monetary policy divergence coming in the form of a rate hike by the US Federal Reserve.

However, the BOJ's recent changes to monetary policy are worthy of serious reflection: They are a tacit admission that NIRP is not working, and they are proof of Japan's acceptance that a new policy response is required to avoid a crushing classic recession. Japan's actions come after six years of central banks justifying their actions as a way to generate the economic growth and inflation needed to resolve the global economy's excessive levels of debt – which is the essence of our financial repression thesis.

Yet yield-curve control moves central-bank policy in a momentous new direction. The BOJ is promising to keep bond yields at their currently low levels – 10-year Japanese government bonds yield zero per cent – while increasing the supply of yen into Japan's economy until inflation meets or beats the BOJ's 2 per cent target. This sounds like continued financial repression but in reality it is much, much more. It will allow the Japanese government to fight the labour constraints of its ageing and shrinking population by implementing a "wages policy" that will mandate income and pay increases until inflation rises sufficiently. (Of course, it is notable that even when the yen was much weaker, Japan's policies failed to create inflation – so pressing are the forces of demographic deflation in Japan.)

The BOJ has raised the stakes in a dangerous game

Far beyond being merely a successor to financial repression, fiscal dominance is in fact more dangerous than its predecessor policy because the BOJ has not actually promised to cap Japanese bond yields; instead, it may in fact allow yields to rise as inflation returns, imposing potential capital losses on bond holders as well. If that happens, fiscal dominance would not only lessen the purchasing power of bonds through inflation but also create drawdowns of capital for an ageing and cautious population of savers.

Far beyond being financial repression's mere successor, fiscal dominance is in fact more dangerous

Moreover, a weaker yen could reward Japanese exporters just at a time when the political cycle is moving against globalization, possibly toward protectionism. This could sow

About fiscal dominance: A central bank's blank check for its government

When a government forces its central bank to buy its debt, which the bank does by "printing" more currency, it creates a rare situation known as "fiscal dominance". A government usually takes this extreme step to finance higher spending levels – perhaps with the express goal of manufacturing inflation. The biggest downside of fiscal dominance is that central banks lose their independence and meet their governments' *spending* needs rather than their countries' *economic* needs, and their currencies generally suffer greatly. Japan has experimented with fiscal dominance before, in the 1930s, as have Argentina, Brazil, Italy and Zimbabwe. All have found it difficult to escape.

the seeds of trade wars and retaliation, all of which would further lessen global economic growth and confidence.

With much debate at the Fed's recent Jackson Hole meeting about the policy responses needed to soften the inevitable US recession, the BOJ has substantially raised the stakes: It will be monetizing its government's financial needs at the expense of the yen. The Fed has admitted that it normally eases interest rates by approximately 5 per cent during a recession, which it cannot do now. As such, it may resort to another significant bout of quantitative easing (QE). For its part, the European Central Bank (ECB) has already begun to reach the limits of its own monetary programs, and it may be forced to taper regardless of its willingness to lessen its support for the economy. Indeed, central banks globally now recognize that the longer QE lasts, the more it distorts markets and economies, and the harder it is to cease.

Ironically, it is still possible for the Fed to implement fiscal dominance as it has in the past, but it will be impossible for the ECB to do so, since that would require even bigger Target 2 balances; at their current level, the ECB is already transferring enormous quantities of funds from strong European members to weaker ones.

Why fiscal dominance matters

Clearly, we are migrating from a world of financial repression – where interest rates are held below stubbornly low inflation rates – to fiscal dominance, where the monetary policy of central banks becomes subservient to the solvency and fiscal requirements of their governments. This is a significant shift for many reasons:

- If more governments adopt this stance, they will be able to influence inflation with fiscal policy. This would complete the re-politicization of central banks and draw them back into the arms of the governments from whence they were created.
- Fiscal dominance also pushes central banks further down the road they had been travelling down for years, after their failure to exercise oversight and economic control resulted in two equity market crashes and one enormous financial crisis in 20 years.
- Fiscal dominance means that Japan's government will generate enough inflation to ease the distress that has been affecting Japan for the last 25 years. However, as the yen devalues (importing inflation), the BOJ will find itself unable to control interest rates, bond yields and the level of its currency at the same time.

Investment implications

- As Japan heads down this path, the yen and Japanese government bonds will likely come under pressure. A weaker yen would likely help Japanese exporters, but the overall trend against globalization and free trade may ultimately work against them.
- Although fiscal dominance is so far limited to Japan, it could have profound implications for investors elsewhere if other governments follow Japan's lead and ensure that their bonds no longer protect the purchasing power of savers.

Although fiscal dominance is so far limited to Japan, it could have profound implications for investors elsewhere if other governments follow Japan's lead

- Whether driven by financial repression or fiscal dominance, this negative environment may persist for decades. As such, global economic growth will remain slow and low, and investors' returns will be driven by their appetite for accepting volatility and risk.
- It continues to be important for investors to pursue alpha with active management, since beta returns are set to be low and volatile, which could undermine cheap index investments. And given the ongoing environment of volatility, investors should continue taking a close look at the risk-mitigation and diversification benefits that alternatives provide.