NRI

lakyara vol.332

Special Edition

2021 fiscal and monetary policy outlook

- Interview with Seki Obata by Takahide Kiuchi -

28.January.2021

Nomura Research Institute, Ltd.

Executive Summary

The global economy was hard-hit by the COVID-19 pandemic throughout most of 2020. With macro policy already stretched thin, will policymakers be able to kick-start Japanese economic recovery? How will the global leadership regime change under the US's incoming Biden Administration? We discussed these and other questions facing Japan with political economist Seki Obata, Associate Professor at Keio Business School.

Seki Obata

Associate Professor, Keio Business School

Awarded PhD from Harvard University in 2001. Associate professor at KBS since 2003. Previously worked at Japan's Ministry of Finance (1992-99) and taught at Hitotsubashi University's Institute of Economic Research (2001-03). Primary area of research is behavioral finance. Author of numerous books, the most recent of which is a prognosis of modern capitalism in a post-bubble world.

Takahide Kiuchi

Executive Economist, Nomura Research Institute

Began career as NRI staff economist in 1987. Joined Nomura Securities in 2004 following stints at NRI Deutschland (1990-96) and NRI America (1996-2002). Appointed chief economist and head of Nomura Securities' Economic Department in 2007. Served on BOJ Policy Board in 2012-17. Appointed to current position in July 2017. Author of multiple books, most recently one on Libra and the digital currency revolution.

Japanese economic inflection point

Takahide Kiuchi: First off, what's your Japanese economic outlook for 2021?

Seki Obata: I expect 2021 to be a pretty benign year, not an inflection point. There's a risk of a breakdown or forced shift in monetary or fiscal policy, but it's unlikely to manifest until after BOJ Governor Kuroda's tenure has ended in 2023. New BIS rules also take effect from 2023. If there's an inflection point ahead, I think it'll most likely arrive in 2023.

The one good thing about Prime Minister Suga succeeding former PM Abe is that Suga is focused exclusively on micro policy. While professing to perpetuate Abenomics, he's actually pursuing a small-ball policy agenda that's the antithesis of Abenomics. I expect the Suga Government to be less fiscally profligate than its predecessor because Suga is keen to boost stock prices. I accordingly don't see fiscal concerns escalating. Nor do I see them abating.

However, the government overspent on its policy response to the pandemic's first wave and is now overcompensating by being stingy with pandemic relief, creating an imbalance between needs and funding. The current third wave is more severe than the first wave in terms of case counts. If the pandemic or some other event leads to fiscal strains, a fiscal crisis could occur earlier than I anticipate.

Monetary policy has managed to hold up well so far, but if the risk of a fiscal crisis increases and the government pressures the BOJ to paper over the crisis, monetary policy failure could occur even before 2023. Such an outcome is my biggest concern.

Kiuchi: Many agree with you on the Suga Government's micro, not macro, policy focus. The government seems to be targeting micro policies solely at its pet issues without any coherent strategy. I feel the public is becoming increasingly skeptical of policy execution because the government hasn't explained the macro rationale behind its various micro policies. While a big-picture policy agenda without any specifics would be just as bad, the government is unlikely to gain public support without articulating its policy agenda on both a micro and macro level.

I too am a bit concerned about fiscal policy. For instance, the third FY20 supplemental

budget may be quite large. With ample reserves still available, the LDP has been talking about a ¥30tn supplemental budget. Pandemic relief alone does not warrant so much spending. I suspect the budget will also include infrastructure spending, the current need for which is questionable. With fiscal-expansionary elements still at play even within the Suga Government, I see a risk of further fiscal deterioration. I believe the supplemental budget should be limited to funding required for pandemic relief. I'm guessing you're opposed to more spending on pandemic relief.

Obata: I am.

Kiuchi: I don't think it's advisable to fund supplemental budgets through unrestrained JGB issuance alone.

Obata: I agree but I'd rather the government cut spending than raise taxes to fund essential spending. Its shotgun approach to the first pandemic relief package was a big mistake in my opinion.

Kiuchi: Yes, doling out cash even to people who don't need it was a bad idea. When fiscal or monetary policy failure occurs, what form do you expect it to take?

Obata: I suspect it will be triggered by a series of failed JGB auctions in response to widespread market speculation about an impending change in BOJ policy. The consensus would expect JGBs, like German bunds during the European sovereign debt crisis, to fall in price but not crash. In response, buyers will retreat to the sidelines to await lower prices. Once they do, the government would find itself unable to refinance maturing JGBs. JGB prices would then start to plunge in the secondary market. Equities and the yen would soon follow suit, leading to a global market selloff. That's the scenario I envision.

Another possible catalyst is a collapse of the global equity bubble. Even if the banking sector is unscathed by first-order impacts, I'd expect the repercussions of a crash in equity and real estate markets to eventually ripple through to the financial sector. Once the fallout reaches the banking sector, the JGB bubble also would burst. The 21st century to date has been marked by a series of asset bubbles. Each time a bubble has collapsed, fiscal and monetary authorities have sprung into action to cushion the downside. Their policy response gives rise to a new bubble, deferring the ultimate day of reckoning. This time, however, they can't kick the can down the road any further because they no longer have enough fiscal or monetary firepower. They don't have any effective policy levers left to pull.

Kiuchi: So you see a JGB market selloff precipitated by a loss of confidence in JGBs as the most likely trigger of a fiscal crisis. With government debt growing rapidly worldwide, such a scenario is indeed a risk.

Obata: But I anticipate a JGB market crash triggered solely by a disappearance of willing buyers for newly issued JGBs, not by debt levels themselves. Japan is more dependent than the US on its central bank essentially underwriting new debt issuance. Although the Fed buys USTs in massive size, USTs have long been in demand among a wide range of investors globally. Japan is in a more perilous position in my opinion.

Kiuchi: So you're saying there's more risk in the primary market than in the secondary market even though Japan has a primary dealer system?

Obata: Yes. MUFG Bank has already resigned as a primary dealer. Other primary dealers could follow its lead in rapid succession. Another possibility is that primary dealers become unwilling to bid for JGBs at yields acceptable to the MOF Financial Bureau and the secondary market gets wind of the impasse.

QE bubble prolonged by response to pandemic

Kiuchi: The Fed responded to the pandemic with large-scale monetary easing that I believe has distorted financial markets in some respects.

Obata: It has indeed.

Kiuchi: Unlike the Global Financial Crisis, the financial market upheaval sparked by the pandemic didn't directly impact the banking sector, as you already mentioned. However, it did impact nonbank players such as hedge funds and mutual funds that owned relatively risky securitized products and high-yield bonds.

Although equity markets were the first to tumble for reasons that are unclear to me, the real problem was in credit markets in my view. High risk assets are owned largely by nonbanks. I don't think Japanese nonbanks like life insurers, for example, own much risk. From such a perspective, I believe financial problems were confined mainly to Europe and the US. Once European and US credit markets rolled over, equity markets sold off globally and interest rates backed up on default-risk concerns.

Since the GFC, the market-making function has migrated from banks to nonbanks. In the process, some market-making capacity may have been lost. This loss of capacity manifested as market illiquidity problem, which prompted the Fed to unleash what I consider to be an excessive policy response in March.

Obata: In other words, the pandemic-response bubble deferred the collapse of its predecessor, the global QE bubble.

Kiuchi: Yes, it's inconceivable that such protracted monetary easing would not cause some sort of financial distortions. Even though Japan experienced no major problems with financial institutions or securitized products, its markets are inevitably roiled by episodes of global financial market volatility.

Obata: Perhaps the biggest impact in Japanese markets was significant yen appreciation.

Kiuchi: I believe the yen is prone to strengthen as a safe-haven currency whenever a global financial crisis occurs. Even absent a crisis, I think there are several potential drivers of yen appreciation.

Obata: Like dollar weakness.

Kiuchi: One factor weighing on the dollar is the US's Twin Deficits. I think fiscal deterioration can have various consequences that differ from country to country. In the US, fiscal deterioration tends to impact financial markets. One such impact is yen appreciation.

Another factor, albeit one with a long fuse, is speculation about the dollar losing its hegemonic reserve-currency status. With China launching a central bank digital currency to challenge the US's financial and currency supremacy, the dollar would likely weaken if the digital renminbi is seen as a threat to it.

A third factor is worldwide Japanification, by which I mean burgeoning government debt, low growth, low inflation, low interest rates and progressively diminishing returns from monetary easing. Japanification of Europe and the US has accelerated during the pandemic. As a result, Japan's woes have become less prominent, leading to a re-rating of the yen.

One final factor is monetary policy, as you mentioned. The Fed has eased more forcefully than any other central bank in response to the pandemic. The ECB and BOE also eased policy. The BOJ, by contrast, has done little besides pledging to take action as needed.

Obata: Because the pandemic has been better contained in Japan than in Europe and the US.

Kiuchi: With the ECB, Fed and BOE still gung ho on continued monetary accommodation, monetary policy has diverged between Japan and the West. This divergence is another factor conducive to yen strength. Given these four factors, I see a risk of yen appreciation in 2021.

Obata: While yen appreciation is a short-term negative for the Japanese economy, I think the yen is trading below its long-term fair value.

Kiuchi: I agree. When the yen strengthened during the GFC, both the public and government raised a ruckus, which I believe prompted the BOJ to embark on QQE. This time, the pandemic has affected not exporters but domestically focused companies, mainly SMEs and micro-enterprises in the service sector. Such companies benefit from a stronger yen. I think the BOJ has consequently become more tolerant of yen appreciation than in the past.

Obata: But politicians always have the same kneejerk reaction to yen appreciation. Because they tend to act based only on narratives without performing a reality check and are swayed by public sentiment, they take cues from the public's reaction in deciding how to respond, pro or con, to any given situation. They exhibit absolutely no leadership.

Bureaucrats won't change unless politics change. If politicians rant and rave in kneejerk fashion, the bureaucracy will likewise operate on autopilot because there's no longer any point in thinking. In such a scenario, the entire country of Japan would end up on autopilot. I believe such a vicious cycle is already in motion. The BOJ may not be as bad as the government.

Kiuchi: True, but what the BOJ has already done still remains to be dealt with. How it will unwind its policies isunclear. It will be hard-pressed to normalize its balance sheet. With over ¥30tn of ETF holdings, the BOJ could be rendered insolvent by a bear market in equities.

Obata: Gov. Kuroda has recently been talking about risk premia more than previously. I suspect that instead of purchasing equities in predetermined quantities, the BOJ will switch to targeting risk premia. In other words, whenever the equity risk premium gets too high, the BOJ would buy stocks to compress it.

Kiuchi: The BOJ first bought ETFs during former governor Shirakawa's tenure. Back then, the equity risk premium was indeed too high. The BOJ's first round of equity purchases was intended to normalize market function as an exceptional policy modeled after the Fed's credit easing. When Kuroda took the helm in 2013, however, he explicitly targeted risk premia through ETF purchases. In other words, he wanted to boost the equity market. The Kuroda BOJ's ETF purchases are not appropriate central bank policy in my opinion.

Obata: The big difference between Shirakawa and Kuroda is that the former is a central banker whereas the latter is not. I think the biggest philosophical difference between them is their respective attitudes toward market manipulation. During Shirakawa's governorship, the BOJ did large-scale monetary easing and bought JGBs and equities to normalize markets. The Shirakawa BOJ's equity purchases didn't materially affect equity prices. Back then, sizing purchases so they would not have any market impact was a given. Today, the BOJ buys equities specifically to drive up equity prices. It has philosophically done a complete 180.

Kiuchi: And I think it went down that path without any discussion beforehand.

Global leadership going forward

Kiuchi: Do you expect China to become a global economic hegemon?

Obata: Yes, I think China wants to assume the hegemonic role abdicated by the US. When a country that no longer wants to be the preeminent global power is challenged by a would-be successor, the latter will win. Which is not to say that China has actually assumed the mantle of hegemony.

I think we are living in more of a G0 world than a G2 world. In a world with no hegemon, ascendant countries have more influence than countries in decline. I expect China to become the global leader, which differs in nuance from a hegemon. I think it's already well on its way to assuming global leadership.

Kiuchi: What about political power?

Obata: I think China will become the global leader politically also. The postwar period was an anomaly. The US has historically been isolationist. It got involved in the global order by accident. It's not simpatico with Europe. That said, with China not yet ready to assume global leadership politically, I anticipate an increasingly acute political leadership vacuum internationally.

Currency-wise, I expect the US dollar to remain a global reserve currency but to share that role with not one but two other currencies.

From an ultra-long-term perspective, I have long thought, probably contrary to most experts, that the euro has the best shot at becoming the next global reserve currency because it's the only currency that's formally independent of any country's national sovereignty. Because I expect political independence to become a more important factor in currency issuance, I believe the euro has a structural advantage over other currencies.

I'm against unification of fiscal and monetary policy. I think they should be separate. The euro of course poses risk because of its fragile or nonexistent foundation. It could very well go down in flames before becoming the most important currency globally.

Another currency independent from politics is Libra[1], but I doubt a privately issued currency could become part of the monetary infrastructure given the profit motive at play on the part of its founders.

1) In December 2020, the Libra Association rebranded Libra as Diem and renamed itself the Diem Association.

Even if the US loses its hegemony, I expect the dollar to remain the most influential currency given its dominance in asset markets.

Kiuchi: China has surpassed the US in terms of trade volume and it's on track to overtake the US in terms of GDP by as early as sometime this decade. In the financial and currency realms, however, China still trails far behind the US. I don't see the renminbi supplanting the dollar anytime soon, even after the digital renminbi goes live. I doubt developed countries will use the digital renminbi. It's unlikely to be widely used anywhere outside of China's orbit. The battle for supremacy between the renminbi and dollar will be waged in a different arena.

China is currently embroiled in a trade conflict with the US. The Biden Administration will likely take a hard-line stance toward China, though probably less so than the Trump Administration. I accordingly expect China to step up its efforts to build friendly relations with more countries, mainly through its One Belt One Road Initiative. If China expands semi-compulsory renminbi payment arrangements within its economic bloc, the renminbi may supplant the dollar in some EM economies that have been using the dollar for trade settlement. I expect such a trend to gain momentum under the Biden Administration because it aims to strengthen ties with US allies to attack China, whereas the Trump Administration was tough on both China and US allies.

Obata: I don't understand how Japanese can say that Trump is better for Japan than

Biden because he's tough on China. Those who subscribe to this view include even politicians and so-called experts. Biden is better suited to building a coalition to contain China. Trump weakened our alliances, giving China an opening to expand its economic power. I think Biden is a more formidable adversary for China.

Kiuchi: I think the battle lines in the Sino-US conflict will likely be redrawn as developed countries vs. China or developed countries vs. China and the EM countries in its orbit. From such a standpoint, I believe the Hong Kong protests were a major turning point. Before the protests, I think Japan and Europe were -somewhat sympathetic to China in light of Trump's draconian anti-China policies. Such sympathy was extinguished by China's response to the Hong Kong protests and its subsequent defiance. If the US mends relations with Japan and Europe under the Biden Administration, China would have to independently build its own network of allies.

With the Regional Comprehensive Economic Partnership (RCEP), I suspect China may be aiming to not only expand trade but also change trade rules. China is presumably loath to be bound by incumbent trade rules because they favor developed countries. The RCEP was launched with a lenient set of rules that may be flexibly modifiable.

Another possibility is that the RCEP and Trans-Pacific Partnership (TPP) might end up being rival EPAs on opposite sides of the Sino-US conflict. Aside from the conflict between the two countries, the two EPAs have conflicting standards. China could spearhead a movement to change standards in response to EM countries' opposition to postwar trade rules set by developed countries.

Obata: What would Europe do in such an event? Politically, Europe is of course on the side of democracy and containment of China. Economically, however, both Germany and the UK have mercantilist intentions toward China.

Kiuchi: I think Europe wants to do business with China if possible, but the Hong Kong situation is a big deal. When the international community is aligned against China, I think seeking to benefit economically from China is off the table. Additionally, Europe is not particularly dependent on China economically. The Japanese economy, by contrast, would be in dire straits without China.

Obata: From a solely economic standpoint, it makes sense to give into China, but many politicians and thought leaders are opposed to doing so. Ultimately, though, refusing to let China have its way may end up only hurting the Japanese economy.

Kiuchi: I feel it boils down to a country's shared values and their universality.

Obata: Pardon the negative stereotype but Japanese don't really have any values in particular.

Kiuchi: The bottom line is that Japan is dependent on the US for security, so we share values with the US. Those values are considered universal. I don't think we can compromise our values in favor of China, a human rights violator. Let me add, though, that there is no universal and absolute value .

BOJ policy normalization fraught with challenges

Obata: Who do you expect to succeed Kuroda as BOJ governor and what are the implications for policy normalization?

Kiuchi: I think former PM Abe's resignation has at least opened up the possibility of a BOJ insider or alum being the next governor. If so, policy normalization would hopefully be more likely to happen.

Obata: Will the BOJ wait until a crisis forces it to start normalizing policy or will it gradually normalize of its own accord?

Kiuchi: I think normalization is already underway. For example, the BOJ's JGB purchases are now tracking at an annualized run rate below ¥20tn, down from over ¥80tn previously. Meanwhile, the BOJ has paused its ETF purchases despite rhetoric to the contrary. Additionally, I think recent changes to the treatment of interest on excess bank reserves on deposit at the BOJ were intended to aid long-suffering regional financial institutions hurt by the BOJ's monetary laxity.

Obata: I think the BOJ should give up on negative interest rates.

Kiuchi: When it starts to normalize policy, I expect it to raise its negative policy rate back above the zero bound as its first step.

While the BOJ has already throttled back on its JGB purchases, it won't be able to reduce its JGB holdings without abandoning its commitment to overshooting its inflation target. When that time comes, it would have to formally announce a change in policy. I don't see such a change happening as long as Kuroda is governor.

Obata: Although the BOJ arguably should halt its ETF purchases immediately, is it unable to do so because the market impact would be too great?

Kiuchi: It might be able to reduce its ETF purchases but selling down its holdings is definitely out of the question.

Obata: But equities never roll off the balance sheet. The BOJ has to sell them eventually.

Kiuchi: I think the BOJ will decide to remove its ETF holdings from the balance sheet at some point. Holding over ¥30tn of equities is a huge risk to the BOJ's solvency.

Obata: The conventional wisdom is that unless the equity market is rallying, the BOJ would have a hard time selling without crashing prices. In reality, however, it can't sell even when the market is rallying.

Kiuchi: If the BOJ start selling equities, it will definitely be blamed for any equity market selloff that may occur, even if completely unrelated to BOJ policy. In other words, selling poses substantial political risk. It's therefore not feasible.

The ETF holdings need to be cleared off the BOJ's balance sheet somehow. I don't think the BOJ can pull off such a move by itself. It would have to seek the government's help, at which point the BOJ would likely lose much of its independence. In the event of a deep enough equity market selloff, the BOJ would be rendered insolvent and unable to remit any more funds to the national treasury. Such a scenario would give rise to major political problems.

Obata: What would prompt to the BOJ to discontinue its JGB purchases?

Kiuchi: One possibility is a shortage of JGBs available to purchase. If banks are unwilling to sell JGBs to the BOJ, high price volatility could immediately ensue in the JGB market. But with the BOJ limiting its JGB holdings to less than 50% of outstanding issuance, I believe liquidity risk has been reduced to some extent.

I'd love to keep going but I'm afraid we're out of time. Thank you for sharing your views, some of which differ from my own. I found our conversation very meaningful.

about NRI

Founded in 1965, Nomura Research Institute (NRI) is a leading global provider of system solutions and consulting services with annual sales above $4.8 billion. NRI offers clients holistic support of all aspects of operations from back- to front-office, with NRI's research expertise and innovative solutions as well as understanding of operational challenges faced by financial services firms. The clients include broker-dealers, asset managers, banks and insurance providers. NRI has its offices globally including New York, London, Tokyo, Hong Kong and Singapore, and over 13,000 employees.

For more information, visit https://www.nri.com/en

Inquiries to : Financial Market & Innovation Research Department
Nomura Research Institute, Ltd.
Otemachi Financial City Grand Cube,
1-9-2 Otemachi, Chiyoda-ku, Tokyo 100-0004, Japan
E-mail : kyara@nri.co.jp

https://www.nri.com/en/knowledge/publication/fis/lakyara