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What if Japan Monetized 100% of outstanding JGB's? Perhaps Nothing??

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(*Followed by a few brief peer review comments)

Wow! As Christmas season rolls in, several high powered SG's are still contemplating some of the big issues. One of the biggest issues at the moment is what is unfolding in Japan.
Happy Holidays! —Dave Berry

I have just read the Kyle Bass piece on Japan monetization, and your comment, both of which are fascinating **(see www.scridb.com/doc/11361307/Kyle-Bass,** and **DG Questions,** Nov 26, 2012).

Here's how I approach this issue: Let's assume the BoJ comes out tomorrow and purchases the entire stock of JGBs by creating bank reserves (money) and cancels the debt. Contrary to Kyle's assertion that you never get paid back, you actually get it all back tomorrow. Call it "super QE".

What would happen to inflation, growth and the currency?

First, let's go through the balance sheet effects: 1. The government now has no debt. 2. The value of the Japanese private sector's assets is unchanged - they used to hold JGBs, now they hold the same value in cash. So overnight, the government's debt is eliminated, and the private sector's net wealth is unchanged.

The income effects are also interesting: 1. The government's budget position improves. 2. The income of the private sector falls because bonds paying interest have been replaced with cash holding none.

So what happens to the economy?

Most people tend to say, "hyperinflation", but that makes little sense. Why on earth would the Japanese household sector rush out and buy things when their interest income has fallen, their wealth is unchanged, and they are used to falling prices. The private sector already has a high wealth to GDP ratio and are spending less than they produce (which is precisely why the government runs a deficit).

The Yen might weaken because the yield on overseas assets has risen relative to Japanese assets, but this spread is hardly offering much compensation for exchange rate risk. My conclusion is that nothing would change in Japan if you had 100% monetisation of the stock of JGBs! In essence, I am completely reversing

Kyle's logic. He is really asking (in my terms) what happens to inflation when money relative to GDP hits 300-400%. I am asking, What is the constraint on government borrowing (or financing government spending through money printing) when there is spare capacity and falling inflation?

Andres, you may remember the famous "Pigou effect". Pigou argued that deflation ultimately caused demand to rise because the real value of money would rise to the point where demand recovered. I think Japan is a test case. In the circumstances I have described money and bonds are perfect substitutes (given how low yields in Japan are, this is already the case), so it is easiest to just assume all the debt gets monetised - go straight to the end game. The status quo in Japan only ends when real wealth (real holdings of money) cause stronger demand for goods than Japan produces, and the inflation rate starts to rise. Will this be a catastrophe, or will the government just tighten fiscal policy in such circumstances?

What is wrong with this analysis?
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***An SG kindly offered the following comment:**
Always great to hear from you, Andres. I agree with the broad lines of the thinking, especially the conclusions. I might describe it a little differently: Central bank purchases of government bonds in local currency are just asset swaps. They have no impact on the total claims on government help by the private sector. A dollar (or yen) of currency or excess reserves is the same notional claim as a dollar (or yen) of government bonds. The only effect is on the term structure of interest rates. So, to the extent that there is any effect at all on economic activity it comes entirely from the lowering of the term structure of interest rates. My guess is that this effect is close to zero at the moment. There are even credible arguments that the effect is negative – ie. The depressing effect on income in a high household net worth country outweighs any potential stimulus to borrowing.

The government budget effect is uncertain. The treasury pays legacy coupons to the central bank which then transfers them back to the treasury at the end of the year as profits, but interest payments in the future will be more volatile and dependent on the path of central bank policy.

By the way, as my colleague often points out, the effect of the central bank buying the government bonds is basically the same as not having issued them at all. Perhaps that's the way things should work all the time. Government deficits create excess reserves –end of story.

No comment on the Pigou effect – you know much more about that than I do. I would certainly love to hear your take on it.

***A second SG added:** There are only two differences between bonds and money. One is that money can be used to transact for goods and services. Bonds cannot, in principle, though in this world it may well become the case that economic agents begin to use bonds for transactions purposes. The second difference is that the interest rate could rise to be above zero, handing you a capital loss on your bond. (Ie., if you held a bond with a stated interest rate of zero, selling at par, and the interest rate became positive, then the bond would sell below par.) Notice that money dominates bonds. Money does everything bonds do, plus more (can be used for transactions; no risk of capital loss.) Logically, nobody would want to hold bonds at all.

What advantage over money do bonds have in a zero interest rate environment? Only thing I can think of is that bonds may be a more convenient store of value, because they come in bigger denominations, and/or because they can be held electronically rather than physically.

Otherwise there is no reason to hold bonds at all. Everybody would be happy if the government exchanged them for money.

But why should this set off a hyperinflation? Preposterous! If the government exchanges green pieces of paper for red pieces of paper that are otherwise identical, why should that change anyone's spending behavior? Just for fun I'll give you the reason a not-so-bright monetarist might conclude that a hyperinflation would ensue. The conventional monetarist argument is that economic agents want to hold money in fixed relation to their income or expenditure. For example, I want to hold 1 month's income in the form of money. If my money balances go up, I still want to maintain 1 month's income in the form of money, so I start to spend like crazy, in order to get rid of the 'excess' money I am holding.

The defect in this argument in the current example should be clear. My bonds, before I sold them, were almost completely fungible with money. Ie., bonds and money are close substitutes. When I get rid of my bonds my demand for money will increase. In fact if in the old days I held 1 month's income as money, and 2 month's income as bonds, after the exchange I will want to hold 3 month's income in the form of money, because I am holding less of a very close substitute, bonds. I don't need to spend to get rid of the 'new' money I hold, I am happy to hold it. Formally, my demand for money increases as the bonds disappear from my portfolio. To make a monetarist argument the demand for money must be stable, remember?

***Andres added:** Thank you both for helping clarify these issues. It takes me back to one of the best discussion pieces we ever published, back in Feb 2010 on the issue of monetizing debt in a fiat currency country. The limits of monetized financing of budget deficits are (1) whether the currency holds up and (2) when full capacity is reached which then means that any excess demand resulting from a government deficit will start to generate inflation rather than more growth. As I have argued many times before, we will typically see a healthy growth spurt before that happens when an economy starts with excess capacity. Thus, the issues of monetary financing, twist, and all that stuff is a term structure argument, and is at best 2nd order if that. In a liquidity trap, fiscal stimulus is crucial if private sector spending is insufficient.

Re, the pigou effect. It played an important role in my PhD thesis many many years ago. I don't agree with Eric's view of it regarding Japan. The Pigou effect was a theoretical argument to counter the idea of a liquidity trap. It was perhaps the original 'wealth effect', but captured in a model with only goods and money (money being the only way to hold wealth in his little model). As Eric notes, Pigou argued that sufficient deflation via reductions in **goods prices** (not asset prices) would make the real value of money holdings rise, so people would have more wealth and thus purchase goods at a faster pace, leading to recovery. Their purchasing power increases.

It was essentially a way of resuscitating the 'classical' view that fiscal policy stimulus isn't necessary in a slump. In fact, it suggests easy money isn't necessary either, making monetarists like Friedman or Greenspan seem overly activist (they argue for tight fiscal and easy money in a slump). The Pigou effect was essentially an argument for laissez faire and letting the economy on its own recover from a protracted slump.

The Pigou effect **as a concept** fails on several counts . . . (1) dynamics: falling prices by definition lead to postponement of spending, so even if one concedes the point on wealth effects, it still doesn't address the dynamic path towards depression vs recovery; (2) redistribution effects work strongly against the model (this is what my thesis picked on): deflation redistributes towards lenders and against debtors via real value of debts effect; this tends to reduce aggregate spending, working against the real money balances effect Pigou relied on; (3) add in other asset values, introduce deflation in those assets and then you have a vastly more complicated set of wealth effects that may well serve to counteract the positive effect of falling (asset and goods) prices can have on the value of money holdings.

That's the theoretical argument. With regards Japan, I don't think wealth effects are the issue here...what's missing is faster income generation, not higher wealth. Take for example currency depreciation. We all think that is a necessary component to help lift off Japan after 20yrs of slump (and currency appreciation). Yet, currency devaluation reduces purchasing power of a trade deficit country (now that includes Japan!).

Nonetheless, the idea is that currency depreciation will encourage import substitution and export promotion, thus adding to total demand for Japanese goods. That, combined with perhaps even more fiscal stimulus, seems the best recipe for a Japanese recovery.

In simple terms, my friends . . . the importance of wealth effects are vastly overestimated!

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