



16<sup>th</sup> March 2009

## Japanese lessons

“The [Japanese] central bank’s implementation of quantitative easing at a time of zero interest rates was similar to a shopkeeper who, unable to sell more than 100 apples a day at Y100 each, tries stocking his shelves with 1,000 apples, and when that has no effect, adds another 1,000. As long as the price remains the same, there is no reason consumer behaviour should change – sales will remain stuck about 100 even if the shopkeeper puts 3,000 apples on display. This is essentially the story of quantitative easing, which not only failed to bring about economic recovery, but also failed to stop asset prices from falling well into 2003.”

- Richard Koo, ‘The Holy Grail of Macro Economics: Lessons from Japan’s Great Recession’ (John Wiley 2008).

President Harry S Truman famously called for a one-handed economist, given the propensity of his economic advisors to blather “on the one hand.. and on the other..” Those who like their economics comparably definitive should warm to Richard Koo, Chief Economist of Nomura Research Institute, whose book on the Japanese recession amounts to one of the clearest explanations of the mess we’re now in. [The Centre for Strategic & International Studies](#) carries a presentation from Richard Koo which summarizes his book. Seekers after truth would be well advised to turn off [Bubblevision](#) and [Pestovision](#) and quietly contemplate Mr. Koo’s considered presentation for the hour or so that it lasts.

There is a particularly interesting anecdote about 31 minutes into the presentation. Mr. Koo refers to the Latin American debt crisis of the early 1980s – which at the time amounted to the worst banking crisis in US history. Nassim Taleb pointed out in ‘The Black Swan’ that

“In the summer of 1982, large American banks lost close to all their past earnings (cumulatively), about everything they ever made in the history of American banking – **everything.**”

Working at the New York Fed then, Mr. Koo reckoned that seven out of eight US money centre banks were bust. Federal Reserve chairman Paul Volcker and in turn the New York Fed called all of their central banking partners around the world to ensure that all foreign banks kept their credit lines open to US banks **knowing fully well that all these American banks were actually bankrupt.** But of course they couldn’t say that – acknowledging the fact would make the fact real. And of course we now know that fractional reserve banking itself is one giant confidence trick. Banking sector confidence, then, is not so much J.P. Morgan as P.T. Barnum.

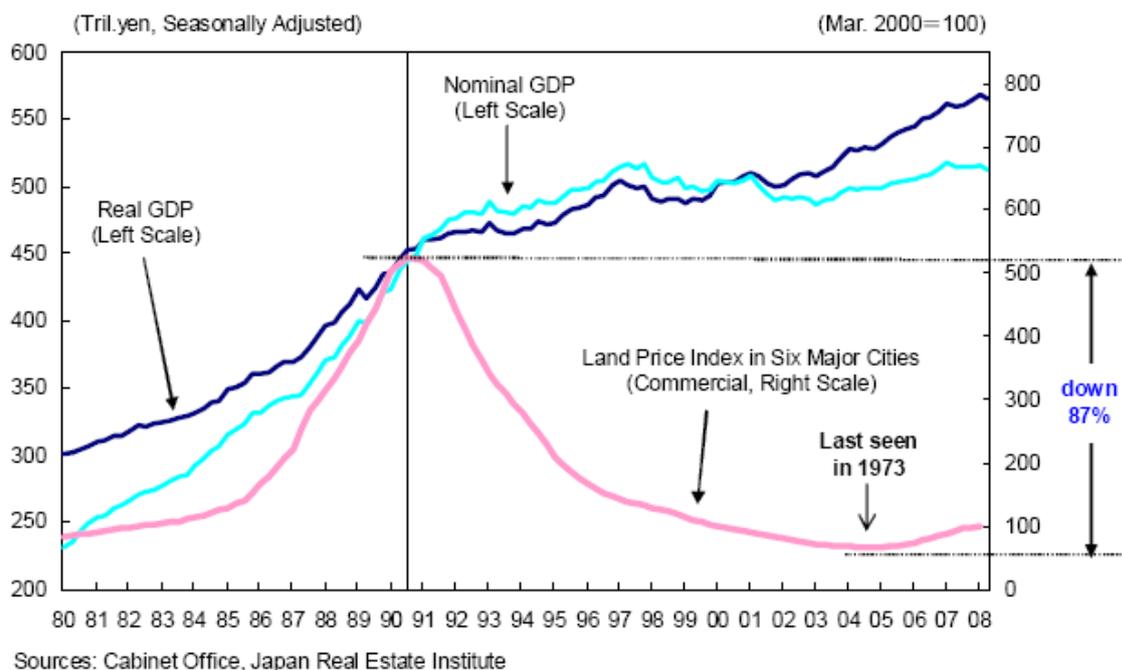
Richard Koo is particularly good at pointing out that the monetarist Emperor has no clothes. Cutting interest rates to zero in post-bubble Japan had little impact because in a balance sheet

recession, when companies are determined to pay down debt to stay alive, they will not borrow at any price. 'The Holy Grail..' illustrates what [Gaius Marius](#) nicely calls

“the massive if somewhat accidental triumph of Japanese fiscal policy in the 1990s, as well as the desperate need of massive government deficit spending today to avoid the dire economic consequences of a debt deflation.”

As the chart below shows, Japanese GDP grew throughout the 1990s despite a collapse in asset values amounting to 1500 trillion Yen. That collapse equates to three years' worth of Japanese GDP. At the depths of the Great Depression, the US had by then lost the equivalent of one year's worth of GDP. The Japanese collapse equated to, in Koo's words, the largest peacetime loss of wealth in human history. But in the Great Depression, US GDP fell by 46% and the unemployment rate reached 25%. During Japan's "lost decade", its unemployment rate never rose higher than 5.5%. How did they escape ? The Japanese government issued bonds and spent the excess savings of the private sector in order to sustain GDP.

### Japanese GDP grew even after a massive loss of wealth – thanks to Japanese government borrowing



So, repellent as it seems, there looks to be no alternative to the governments of the world borrowing in order to replace private sector spending. Be that as it may, the Bank of England's bold step into monetary no man's land, quantitative easing, is by no means assured of success. Consider Japan. In Koo's words,

“Quantitative easing was the twenty-first century's greatest monetary non-event.”

The following data have been kindly provided by Patrick Perret-Green of Citigroup. If quantitative easing by the Bank of England is taken to the limit of £150bn, with £100bn being dedicated to the purchase of Gilts, the Bank of England would effectively be buying two thirds of the 2009/2010 budget deficit, which is hardly small beer. But the deficit in 2010/2011 will be larger still and is unlikely to decline by any meaningful margin until 2013/2014. Even then a budget deficit of 8% would be the largest in post-war history, at least before the onset of the financial crisis.

So while we have a large short-term buyer of UK Gilts (the Bank of England), we also have an even larger “perma-seller” in the form of UK plc.

As Citigroup’s interest rate team point out, the only other G-10 country to have reached such deficit levels has been Italy. 10 year Italian government bonds yield 4.5% and 30 year Italian government bonds yield 5.5%. Meanwhile, UK Gilts (with 10 year paper yielding less than 3%) now yield less than German government bonds. When your investment case essentially rests on nothing more substantial than ‘greater fool theory’ (the greater fool in this case being the Bank of England) and a somewhat magical process whereby the Treasury issues debt which is immediately bought back by the central bank, it is probably time to look to a less heavily manipulated market. Playing chicken with the government isn’t much fun. Our conclusion ? Gilts are now best owned, if at all, at the front end, but high quality corporate paper offering historically wide spreads has a far more compelling investment case.

On the likely impact of quantitative easing in the UK, Richard Koo again:

“At the risk of belabouring the obvious, imagine a patient in the hospital who takes a drug prescribed by her doctor, but does not react as the doctor expected and, more importantly, does not get better. When she reports back to the doctor, he tells her to double the dosage. But this does not help either. So he orders her to take four times, eight times, and finally a hundred times the original dosage. All to no avail. Under these circumstances, any normal human being would come to the conclusion that the doctor’s original diagnosis was wrong, and that the patient suffered from a different disease. But today’s macroeconomics assumes that private sector firms are maximizing profits at all times, meaning that given a low enough interest rate, they should be willing to borrow money to invest.. In reality, however, borrowers – not lenders, as argued by academic economists – were the primary bottleneck in Japan’s Great Recession.”

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