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Econotes is a research publication available free on request. It is not a solicitation for business. It is devised and written by Dr. Andrew F. Freris based on 46 years of market experience which included senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well senior academic posts with universities in London and Hong Kong

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THE EU AND JAPAN: INEFFECTUAL MONETARY POLICIES TO PERSIST

Summary

- The European Central Bank (ECB) and the Bank of Japan (BoJ) have committed to achieving inflation rates of 2.0% via, in the case of ECB, very low interest rates and targeted expansion of bank credit, while in the case of BoJ by doubling its monetary base within 2013-15.Hopefully these policies would also help accelerate GDP growth.
- There is no theoretical or practical reason why the expansion of monetary aggregates will cause the prices of bread and shoes to rise, or help GDP growth. More likely only the prices of financial assets will rise.

Investment Conclusions

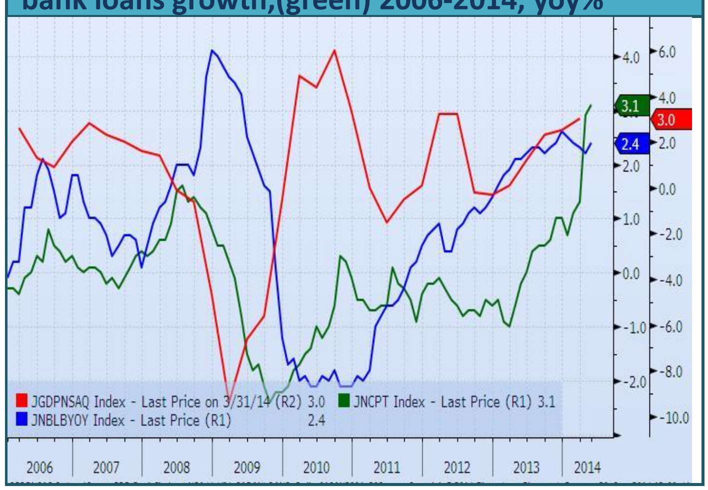
- Poor growth in the EU will, eventually, impact equities, and once USD yields rise in 2015 the EUR will weaken. Sell short EU indices,the Nikkei,JPY and EUR nine months ahead from now.
- Any Nikkei rallies from now till yearend likely to be short-lived. There is nothing in the policies so far to improve short to medium term productivity. Equity investors do not invest on the bias of 5 year prospects!
- In the unlikely event that inflation in both countries accelerates and **stays** high, the asset price which will increase will be that of the USD vs. the EUR and JPY! Stay long on USD.

Why QTM has not and will not work

The Factbox next page explains the basics of the Quantity Theory of Money (QTM) on which most the policies linking inflation to money stock growth are based. Although neither the ECB nor the BoJ have stated publicly anything about the QTM, their express beliefs that more money/credit will cause prices of goods and services to rise hark back to this simple but fundamentally flawed theory .Consider:

- What is money and what part of the large number of assets used as money should increase? BoJ sticks to deposits of the financial system with the BoJ while the majority of people and firms use cash and bank deposits. The link between expanding monetary base and bank deposits can be very tenuous.ECB stick to expanding bank loans to firms.
- Is it true that people hold a relatively stable amount of "money" as part of their wealth and income? The answer is a resounding "NO" especially during the current recession when insecurity led to very large increases cash balances in firms' and peoples holdings
- Is it true that prices of goods and services go up as people demand more of them as they have "more money"? The truth is that prices of financial assets tend to go up first and, hopefully, this causes people/firms to feel better off and so they spend and invest more. Also weakening exchange rates may cause import prices to rise and drive domestic prices up.The key element of the QTM is that it affects nominal values, prices, interest rates and yields and not real output. Any impact on output is a bonus,from the developments in the monetary sector

Chart 1: Japan:GDP growth (red)Inflation (blue) bank loans growth,(green) 2006-2014, yoy%



Source: Bloomberg

Japan and the EU: Pumping away, well, sort of…

Chart 1 shows that in **Japan** the recovery of GDP growth may be flattening out, after the spurt in spending occasioned by the sales tax hike in April.Inflation seems to have peaked but loans growth is expanding. The just-announced "third arrow' measures supplementing looser monetary and fiscal policies ("Abenomics") included promises to cut corporate tax in 10 years (!!) and an extra 10,000 crèche places (Japan's population 127 ml…) to encourage women to augment the rapidly ageing workforce ! Do not hold your breath. Pumping money, may, eventually weaken the JPY but will do nothing on its own to change the structure of the economy; let alone create enough demand to kill permanently low inflation.

The case of the **European Union** is far stranger. Up until the June 2014 announcement of further easing of credit policies and of negative interest rates, the ECB had been busy **SHRINKING** the monetary base of the EU. The ECB was accepting bank loan repayments thus withdrawing liquidity from the markets. When it would buy assets, thus adding to liquidity, it would sterilize the action by selling some different assets. Hence EU banks had also been **SHRINKING** their loans. (See Chart 2, green line).So much for loose EU monetary policy ! Now, however, the idea is that banks will be provided with cheap liquidity to lend more and, hopefully, reverse the trend. More lending to firms could lead to more investment and, help accelerate the tepid GDP growth and decelerating inflation which threatens to become deflation.(Chart 2)

FACTBOX : The Quantity Theory of Money

The basis of claiming that expansion of money will cause inflation to accelerate is based on the simple, but totally erroneous,notion that as money stock expands (however defined, little detail !) people and firms will only want to hold a certain percentage of it in their assets and of their current spending flows, and they will spend the rest. As demand can increase indefinitely but supply is limited by resources, prices will rise In symbols MV=PT where M is "money" V is velocity of circulation- how quickly money is spent- P is the price level and Q the amount of goods available. As V and Q are effectively fixed, when M goes up so does P. Simple, but totally untrue!

Chart 2:EU:GDP growth(red),Inflation(blue) growth of bank loans (green) 2006-2014,YoY %

Source: Bloomberg

Why doubting the efficacy of monetary policy ?

The case of **Japan** is relatively easier to appraise. Years of low growth and of deflation led to the decision to implement an extremely loose monetary policy hoping that this, in combination with a looser fiscal policy (funded by the BoJ!) and structural reforms would do the trick. Absence of meaningful structural reforms leaves a large sum of money (deposits of the financial system with the BoJ) trying to do the trick with no explanation how this would translate to more consumer demand and business investment. Zero interest rates are now irrelevant as they have been in place of years now with no impact on investment or inflation.

The declaration of the **ECB** in July 2012 that it would do "what it takes" to avoid another sovereign crisis, should not be confused with injections of liquidity as, until now, there have been net withdrawals of liquidity as witnessed by the shrinkage of loans growth and of the absolute size of the balance sheet of the ECB.

Whether negative interest rates and subsidized liquidity to banks in order to lend more will have any impact on consumer and business spending, and thus on the prices of good and of services, remains to be seen, but seems doubtful given the tenuous links between money, spending and inflation.