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Why the G7 May Be Hastening Helicopter Money

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The G7 countries' finance ministers recently ended their two-day meeting in Sendai, Japan, without an agreement on any economic policy issues, including those surrounding the recent sharp appreciation of the yen. The unwillingness of policymakers to address Japan's fervent appeals for exchange rate intervention may inadvertently hasten the implementation of helicopter money by Japan and other industrialized nations.

"Helicopter money"—named after Milton Friedman's colorful metaphor for an increase in public spending or a tax cut that is financed by a permanent increase in the money stock—is a central bank's last resort to stoke inflation, devalue the currency and induce consumer spending. Stuck with a moribund economy and a strengthening yen, if the Bank of Japan's (BOJ) monetary policy cannot get sufficient support from fiscal policymakers or from other central banks around the world, it may not be left with any other choice.

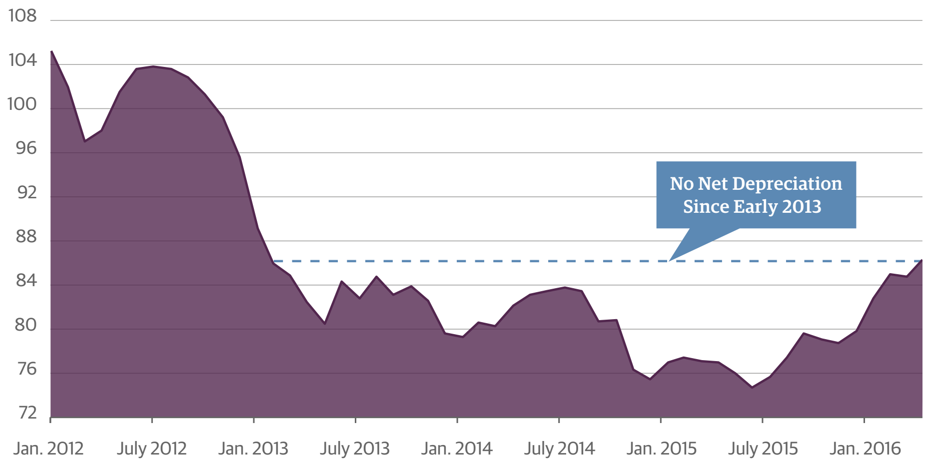
The Bank of Japan surprised markets with the unexpected adoption of negative interest rates earlier this year. This came after its long slog of large scale asset purchases—which absorbs more than the annual net issuance of Japanese government bonds (JGBs) and has been expanded to include other assets—failed to sufficiently boost inflation and inflation expectations.

Since January's negative-rate announcement, policymakers have been startled by the stark appreciation of the yen, an unwelcome outcome that, as of last week, had taken back about a third of the 40 percent Japanese currency depreciation against the U.S. dollar since the beginning of Abenomics. As the yen began its sharp rebound, the U.S. Treasury suddenly announced that if Japan intervened to slow or smooth the currency's rapid ascent, Washington would view it as currency manipulation. Secretary Jack Lew suggested that Japan instead look to increase domestic demand rather than weaken its currency to make exports more attractive.

More than three years into Abenomics, Japan's recovery is threatened by a strengthening yen. With policymakers running out of options on how to reverse the trend, the Bank of Japan may be forced to intervene with unorthodox and untested policy, such as "helicopter money."

Bank of Japan Easing Is Not Having the Intended Effect

Japan Real Broad Effective Exchange Rate Index



Source: Haver Analytics, JPMorgan, Guggenheim Investments. Data as of 4.30.2016. Note: a decline indicates a depreciation of the yen.

A weaker yen has been a cornerstone of Prime Minister Shinzō Abe's plan to revitalize the Japanese economy. Its recent sharp reversal threatens to undo the modest progress his policies have achieved since he has come to office. Yet his options are limited. The rising yen is reducing export competitiveness and increasing deflationary pressures. A failure to stem the yen's continued appreciation, let alone reverse its recent rise, threatens the success of Abenomics.

Japan's appeals at the G7 seem to have been largely rebuffed. Secretary Lew and others turned a deaf ear to Japan's currency problems by refusing to consider any form of intervention. Indeed, if they agree on anything, it is that countries should avoid generating growth at the expense of other nations through competitive currency devaluations. The intransigence of G7 leaders may have a bigger consequence than risking a slowdown in Japan's economy.

Policymakers are drawing a peculiar distinction between monetary policy that is designed to address domestic needs and that which is intended for exchange rate intervention. Somehow creating a surfeit of currency through domestic monetary expansion by purchasing domestic assets is readily accepted but using that currency for direct exchange rate intervention is not. Yet the outcome is similar.

At this point, Finance Minister Taro Aso and other Japanese policymakers are anxious to forestall further currency appreciation and would welcome an opportunity to engage in unsterilized exchange intervention to stabilize or weaken the yen. Exchange rate intervention is designed to change the supply of currency on a relative basis. Through the creation of yen to purchase dollars the BOJ would be increasing the supply of yen and reducing the available supply of dollars.

Approximately $200 billion of unsterilized intervention of this sort could push the yen down by 10 percent, based on past experience, though it would likely require even larger interventions over time to effectively maintain this new lower exchange rate. G7 policymakers resoundingly rejected this idea.

However, Japan can change the relative supply of yen versus dollars by increasing the money supply in its domestic economy. As markets are currently discounting the large scale quantitative easing already underway and the BOJ continues to be challenged to find assets to effectuate the existing program, helicopter money, more formally known as a money-financed fiscal expansion, offers a powerful new means to increase the supply of yen versus other currencies.

Under such a program, Japanese authorities could announce large new supplies of yen to be distributed directly into the economy as tax cuts or through spending. The size of this new monetary program could be modulated based on macro variables such as output and inflation or even the exchange value of the yen. Japan's government is certainly determined, but its policy options are becoming increasingly limited. Despite aggressive measures already undertaken, real domestic output today is still no higher than it was in 2008, prior to the financial crisis.

Unwittingly, G7 leaders may have hastened the implementation of helicopter money in Japan. Japanese policymakers have shown a strong willingness to experiment with new policy innovations to push the economy ahead. If Japan lends its credibility to helicopter money by becoming the first to legitimize its use, then other nations may soon follow. The unintended consequence of the G7's failure to act may well be the catalyst which results in further experiments becoming part of the new monetary orthodoxy around the world.