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Market Comment

CLARMOND

Gamblernomics

The concept of continuously doubling down in order to achieve financial and economic goals is now a respectable and established norm. Takahashi's Wager of 1930s Japan shows that such a policy, while initially successful, can remove all sensible restraints.

FOR A GAMBLER ON A LOSING streak the classic trap is to borrow money, trying to break even. Doubling down, time and time again, becomes routine as all caution is discarded; this does not make for sound financial planning.

In 'Resurrecting Reflation' (November 2012) we highlighted when this policy was first attempted; in 1931 Finance Minister of Japan, Takahashi Korekiyo, paid for Japan's invasion of Manchuria whilst countering the collapse of capitalism around Japan with unorthodox measures of massive QE and deficit spending. These twin policies were heralded as a great success 70 years later by Governor Ben Bernanke and a decade after that by Prime Minister Abe.

'Takahashi's Wager' led to a tripling of the Japanese stock market, a 40% currency devaluation and warfare spending that rose from 30% to 70% of the national budget. Having taken the gamble to reflate, the octogenarian established the principle that capital is costless and unlimited; doubling down had become routine.

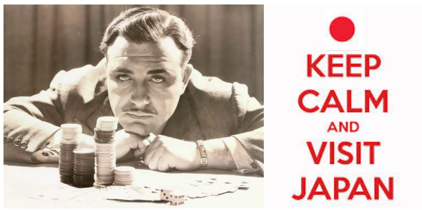
This band-aid boom ended in a calamitous collapse years later; by then Takahashi was long gone… literally, as he had belatedly tried to slow the handout-hooked warfare train. In 1937 another 'routine' incident occurred at the Marco Polo Bridge, which gave Japan the excuse to invade the rest of China. This was, in effect another 'doubling down', but by this time Japanese economic statistics had plateaued, war casualties had hit a 100,000 and warfare spending comprised nearly the entire government budget. But the unorthodox 'policy genie' was out of the bottle, as Takahashi had demonstrated, one could double down again and again, as the goalposts for success were simply moved and all gambles appeared sane.

Loaded Dice

Modern day Japan finds itself in a similar predicament, but instead of warfare the Japanese leadership is confronting the dual burdens of welfare spending and interest payments, which, at current interest rates, now account for 60% of the budget.

The Bank of Japan's unconventional policy of massive QE, which is nearly 18% of GDP, is intended to ignite inflation and break the twenty-year deflationary cycle. This scheme, put in place by the current Prime Minister, has been dubbed 'Abenomics'. Given zero interest rates for last 15 years, and the occasional bout of QE, 'Abenomics' is another 'doubling down' but, this time, it has staked everything on this one final throw of the financial dice. Perhaps 'Gamblernomics' may be a more reasonable nomenclature.

On the surface 'Gamblernomics', like the 'Takahashi Wager', appears successful - the equity market has risen substantially, the currency has fallen, and



All on Red

government bond yields remain low. So far, so good.

How is the government gauging the success of this dice roll? They are looking for two percent inflation, a positive growth number, and have committed to two years of massive QE to achieve these goals. As time passes and these targets are not met, the policy makers will double down again, by which point interest payments and welfare spending are likely to comprise most of the budget. Emergency shall have become routine and all further gambles shall appear sane.

Lessons

All gamblers are aware of their accumulated losses, in economic parlance this means their 'sunk costs.' Today's adherents of 'Gamblernomics' are not only found in Tokyo, but also reign in all major financial capitals, each playing their own version of a similar wager. All believe that doubling down is a sober strategy given the sunk costs of lost growth. As a new generation of gamblers sit at the table, ghosts of gamblers past whisper - "Place your bets." ■