After rate cut BoJ still needs to do more

- Against the backdrop of global headwinds and tighter domestic financial conditions…
- …the Bank of Japan (BoJ) decided to expand its toolkit with negative interest rates
- We expect inflation to hover around 0.5% yoy in 2016, undershooting the BoJ’s target and GDP growth to reach 0.8%
- We think that the BoJ will have to step up stimulus further this year…
- …likely combining additional rate cuts with larger asset purchases
- We expect the yen to reach 120 at the end of 2016, likely supported by FX interventions

Japan’s economy remains weak

Japan’s economy ended the year on a disappointing note. Japan’s preliminary Q4 GDP growth contracted 0.4% qoq (-1.4% yoy), undershooting market expectations. Growth for the full year 2015 was 0.5%, following almost zero growth in 2014. Private consumption and net exports were the main drags in Q4. Capital investment growth was the bright spot of the report. We expect growth to turn positive in the next quarters, but remain modest, reaching 0.8% in 2016. However the risks of a recession remain high as a result of the low growth potential.

GDP growth shows slow recovery

Source: Thomson Reuters Datastream
Japan’s authorities are expecting strong labour productivity growth to lift potential growth in time, which is currently around 0.5%. Japan’s productivity has fallen since 2014 and authorities think that there is room to catch up.

This makes the case for more aggressive structural reforms to bring economic growth to a higher level. In the meantime, authorities will have to stimulate the economy with more monetary easing to strengthen demand.

Deflation risks still linger…

Given the ongoing weakness in demand, the risks of deflation are increasing. We now see core CPI inflation (CPI ex food) hovering around 0.5% yoy in 2016. Low oil prices and weak food prices are holding down inflation and now a stronger yen will also put downward pressure on prices. On top of this inflation expectations have been falling.

Although authorities often highlight that monetary easing has managed to keep inflation positive for more than two years, we think it has not completely erased the deflationary mind-set. This and mounting global headwinds, likely led the BoJ to cut rates in 29 January.

…rate cut to complement asset purchases

Indeed in addition to the ongoing annual asset purchase programme of 80tn yen, the BoJ decided to push the yield curve further down through the support of negative rates. The Governor of the BoJ mentioned that he expected this to stimulate capex for consumer spending and to have a stronger effect on the portfolio rebalancing. On top of this the BoJ chose for a tiered structure of rates on deposits to reduce the losses for financial institutions. The negative rate is applied only to the marginal increase in excess reserves (see box) in order to reduce the impact on banks’ profitability.

More stimulus ahead

We think that the BoJ will announce in the next couple of months additional monetary easing to support growth and inflation ahead. Although it is still soon to evaluate the impact of negative rates, we expect a further cut in the IOER to -30bp from -10bp and it could increase the annual pace of asset purchases from about JPY80tn to over JPY100tn. This will likely be combined with the expansion of ETFs and J-REITS purchases to 5 trillion yen and 200bn yen per annum respectively. We see the following reasons for further easing: i) Since the BoJ’s surprise rate cut, global headwinds have resulted in substantially tighter domestic financial conditions driven by the stock market selloff, the appreciation of the yen. This and the economy contracting in the fourth quarter of 2015 is increasing the downside risks of the BoJ reaching its inflation target. ii) By committing itself to more easing in the near term, the BoJ will be able to influence the inflation mind set before the spring wage talks. iii) This will buy time for authorities to explore fiscal measures which we expect the government to announce before the July Upper house election.

We expect the yen to reach 120 at the end of 2016, likely supported by FX interventions (see G10 FX Weekly - JPY: Rising FX intervention risk).
Stronger real effective exchange rate a new threat

Source: Thomson Reuters Datastream

Key forecasts for the economy of Japan

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(*) FY April-March CY calendar year

Source: ABN AMRO Group Economics, Thomson Reuters Datastream

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