# Japan Watch

Group Economics

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# Has the BoJ reached its limits?

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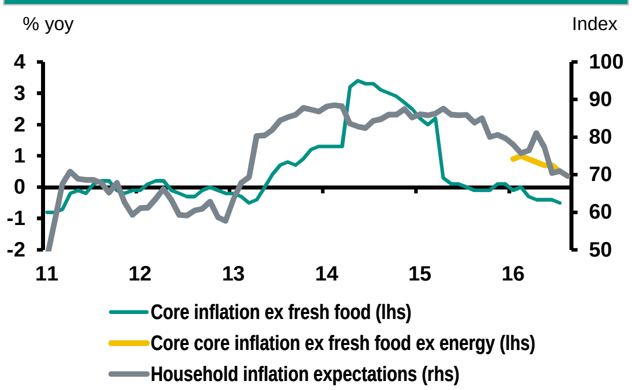
- **We do not think that the Bank of Japan (BoJ) has reached its limits, but there is limited room left for aggressive easing**
- **We expect the Bank of Japan to increase its asset purchase programme by 5-10 trillion yen per year and to extend the range of assets at the Monetary Policy Meeting on 21 September**
- **We expect the BoJ to cut the policy rates by 10bp to -0.2%. To reduce the impact for banks, the interest rate on funding through the Loan Support Program will likely be lowered to -0.2%**
- **An appropriate policy mix, including reforms in the labour market and a fiscal plan, would increase monetary policy effectiveness**
- **We expect hedging of foreign currency flows to support the yen above 105 against the USD; 2016 year end USD/JPY forecast: 103**

**Assessing the BoJ's options for September**

Economists are debating the measures that the Bank of Japan can take to inflate the economy ahead of the Monetary Policy Meeting on 21 September. This note looks at the steps taken so far and future monetary policy options. We do not think that the BoJ has reached its limits yet, but there is limited room left for aggressive monetary easing. In our view an appropriate policy mix, which includes reforms in the labour market and a fiscal plan that would increase policy credibility is needed to achieve a more effective impact of monetary policy. Increasing the toolkit to more extreme unconventional policies, including buying foreign bonds and "helicopter money" does not seem appropriate for the moment, given that the risks of implementing such policies would outweigh the benefits.

**Inflation continues to lose forward momentum**




Source: Thomson Reuters Datastream

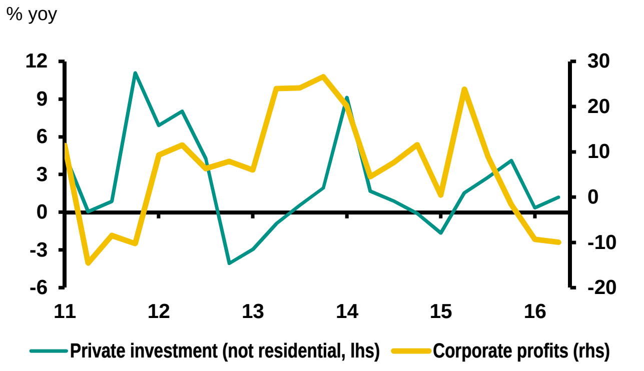
**The Bank of Japan seems relaxed…**

The BoJ will do more, but the policy package will likely be less significant than we had expected at the start of the year. Governor Kuroda appears relatively relaxed and considers that the measures taken so far are sufficient. To begin with, he argues that inflation expectations have remained stable despite the strong headwinds and that it is a question of time for the forward looking inflation expectations to pick up. He expects consumers to become more forward looking and to incorporate the impact of monetary easing in their expectations. On top of this, in his most recent speech he mentioned that the factors that hampered the achievement of the 2% inflation target were essentially exogenous, referring to the decline in oil prices, the slowdown in emerging markets and the impact of the VAT hike on consumption.

**…although boosting inflation, amidst weak growth is still a challenge…**

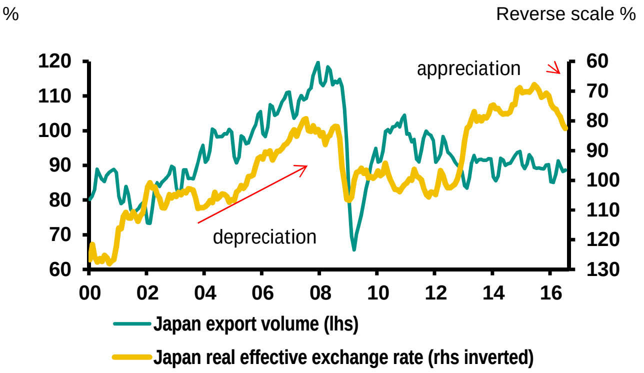
However, inflation expectations remain well under the 2% target and have been even trending down, despite the monetary stimulus. Weak inflation dynamics seems to be influencing inflation expectations. We project average inflation to remain flat in 2016, reflecting the drag from energy prices, the recent yen appreciation and weakness in demand. Growth in business investment has been modest, and corporate profits have been recently declining. The strong yen has been a drag on exports. On top of this, despite the tighter labour market, with unemployment at around 3%, wage growth has been modest. Firms remain cautious about expanding their costs. Our forecast for GDP growth is 0.6% in 2016 and 0.7% in 2017. Meanwhile inflation is expected to only increase to 1% in 2017.

**Investment spending slowing**




Source: Thomson Reuters Datastream

**Strong JPY a drag on exports**




Source: Thomson Reuters Datastream

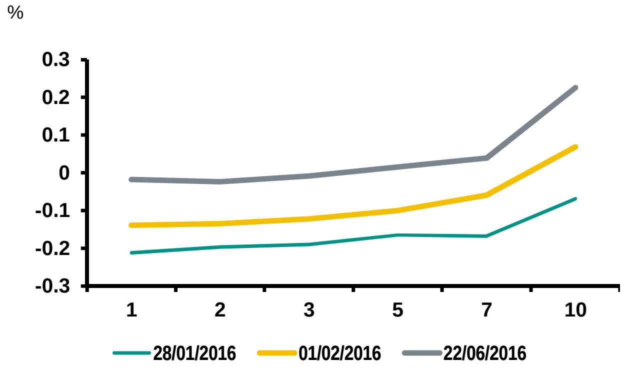
**…while the monetary policy toolkit continues expanding**

The BoJ will conduct a comprehensive assessment at the next Monetary Policy Meeting on 21 September. This assessment will evaluate the impact of monetary policies and trends of economic activity. It may be too soon to make conclusive remarks about the effectiveness of these policies, while at the same time there is uncertainty regarding some global developments that will have a direct impact of the exchange rate and on the economy, including a Fed rate hike. This all argues in favour of a more cautious approach from the BoJ. Below we review the main policy tools.

*Quantitative and qualitative easing*. Since 2013 the BoJ has been gradually expanding its asset purchase programme in size, while it also introduced a tweak to the asset purchase programme, when it decided to invest in exchange-traded funds (ETFs) and the Japan real estate investment trusts (J-REITS) with emphasis on objectives such as promoting human and physical capital.

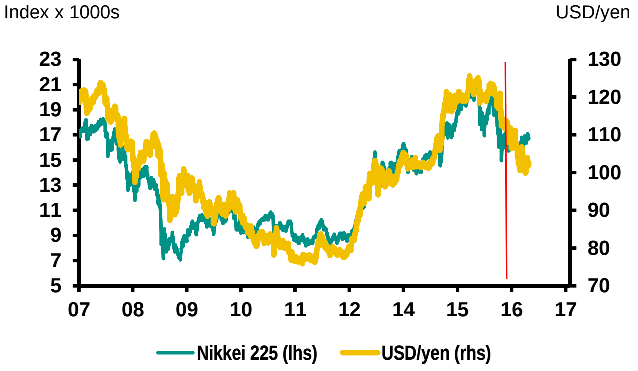
The purchase of Japanese government bonds (JGBs) has now expanded to 80 trillion yen per year. There has also been some fine-tuning regarding extensions to the maturities of the bonds. However the scope for future expansion is limited given constraints of bond holders. Indeed banks, pension funds and insurance companies are required to hold a minimum level of JGBs due to collateral needs, asset allocation targets and regulatory requirements. Our estimates suggest that the BoJ's holdings of government bonds are expected to rise to over 50% of the total within the next two years. Meanwhile, the new ETF purchases (originally started in 2010), have also been extended in several rounds, amounting now to 6 trillion yen per year. As mentioned above the criteria for eligibility regarding ETFs have been tweaked. The BoJ holdings of ETFs are limited to 50% of the shares of any ETF, which means that other buyers have to buy the remainder. The most recent data show that the BoJ owns about 62% of Japan's domestic ETFs.

**Yield curve following NIRP**




Source: Thomson Reuters Datastream

**Exchange rate and equity prices following NIRP**




Source: Thomson Reuters Datastream

*Negative interest rates*. The BoJ has had a negative deposit rate in place since January this year. To reduce the impact on financial institutions, a three-tiered system for negative interest rates was introduced (for details see [Japan Watch – After rate cut BoJ still needs to do more]). According to Governor Kuroda, negative interest rates have helped reduce banks' lending rates as well as interest rates on corporate bonds significantly. The 3 month LIBOR has declined from 17bps at the beginning of the year to -0.2bps. Meanwhile, Governor Kuroda mentioned that the results of surveys suggest financial institutions lending attitudes continue to be "proactive". As for the impact of the decline in deposit rates, it has been different depending on the characteristics of the banks. Some of the larger banks have been reporting a steady decline of interest rate margins, which has come at the expense of their profits. How this will continue to impact the banking system in the future is still uncertain.

*Forward guidance*. Since January 2013, the BoJ communicates an explicit inflation target as part of the guidance. Policymakers have repeatedly pushed the time horizon for hitting the 2% inflation target though. This has raised questions regarding the commitment to achieving this goal. However, policy predictability is crucial for any central bank willing to impact long-term interest rates and anchor inflation expectations  For instance, it is not clear whether core-core inflation, which excludes food and energy and alcohol beverages, is the driver of  monetary policy or other measures of infaltion.  Therefore, more clarity around the time frame and inflation measure that is being targeted could improve the credibility of the BoJ. We think that at this stage, the BoJ will not want to venture this path of tweaking with its target given there has been little discussion of any change.

**Pushing the limits further in unconventional measures**
There are additional monetary policy options to expand the toolkit. We think that these measures are currently not an option, but could be considered in extreme situations.
*Buying foreign bonds*. This could be an effective instrument in influencing exchange rates. But it  will likely be interpreted as violating the G-7 agreement to avoid competitive currency devaluations. Moreover, the BoJ guides policy to achieve price stability and it does not guide policy to influence currency or stock price levels. The BoJ is prohibited from conducting trading that directly aims to influence exchange rates. It only intervenes in the currency market as an agent of the Finance Ministry.

*Perpetual bonds or “helicopter money”*
As the limits in expanding the asset purchase programme with JGBs comes nearer, alternatives including the BoJ’s buying of a zero coupon perpetual bond from the government or ‘helicopter money’ are being debated. Both assume that fiscal spending is directly supported by monetary financing. There are several risks in Japan implementing this framework. This could affect the central bank’s independence and increase political risks, associated with its excessive use.

**Our view**
Comments from BoJ Governor Kuroda and deputy governor Nakaso suggest that pursuing QQE with a negative interest rate remains the most appropriate policy. We expect the BoJ to cut the policy rates by 10bp to -0.2% and increase its asset purchase program by 5 to 10 trillion yen per year. In order to reduce the impact of negative rates on banks’ profits, we expect the interest rate on funding to stimulate bank lending conducted through the Loan Support Program to be lowered to -0.2%. We do not expect any further increase of the ETF programme. We think the BoJ will fine tune its forward guidance, specifying which inflation measure it is targeting.  We do not think that they will drop yet their commitment to the two year timeframe to reach the 2% inflation target.

**Monetary policy toolkit**

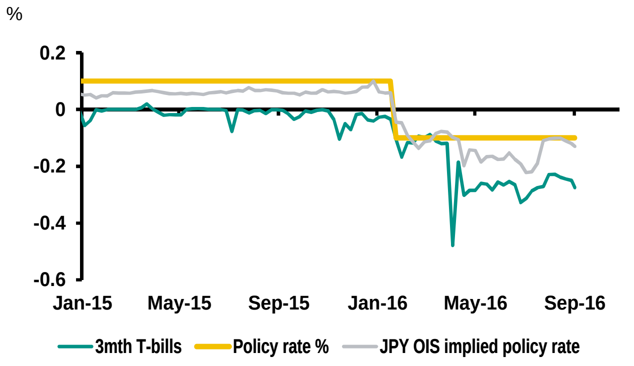
| Measure In trillion yen unless otherwise specified | Now | 21 September |
|---|---|---|
| JGB purchase programme | 80 | 85-90 |
| Corporate bonds | Maintain stock | 1 |
| Municipal bonds | - | 0.5 |
| Buying foreign bonds | - | - |
| ETFs | 6 | 6 |
| Negative policy rates | -0.1% | -0.2% |
| Negative rate fund provisioning measure | 0% | -0.2% |
| Forward guidance | Inflation target 2% | Inflation target 2% |
| Perpetual bonds or helicopter money | - | - |

Source: BoJ, ABN AMRO

**Implications for USD/JPY**

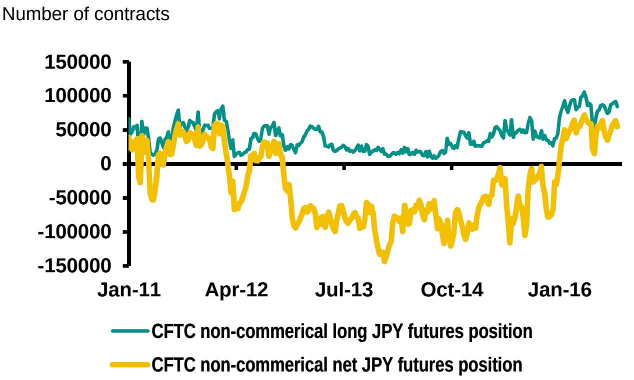
As our view that the BoJ is likely to lower the policy rate by 10bp is not fully priced in by financial markets, we expect the yen to decline as overcrowded speculative long yen positions are unwound. However we expect domestic investors and exporters to increase their foreign currency hedging activities  if the yen were to weaken above 105 against the USD. This is expected to support the yen. Nevertheless the peak in the yen against the USD of around 100 earlier this year is probably over.  This is based on our view that the Fed is likely to raise interest rates by 25bp in December. This is not fully priced in by financial markets. Hence a firmer USD is expected. Our year end USD/JPY forecast is 103.

**10bp rate cut not fully priced in by financial markets**




Source: Bloomberg

**Overcrowded speculative long JPY positions**




Source: CFTC

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