Bank of Japan update: Pump it up

Economic research note

3 November 2014

- The Bank of Japan (BoJ) has surprised markets for the second time in as many years with a further aggressive easing of monetary policy.
- The BoJ's qualitative and quantitative easing (QQE) program will now be enlarged and will be purchasing approx.. Y80 trillion of JGBs on an annual basis, up from the previous pace of approx. Y50 trillion.
- This will take monthly Japanese government bond (JGB) purchases to Y8-12 trillion, from Y6-8 trillion, This implies that the BoJ will now be purchasing around 100% of net new issuance of JGBs from the Ministry of Finance (up from around 70% previously).
- The BoJ will also lengthen the maturity of its JGB portfolio and will increase its purchase of ETFs and J-REIT securities.
- These changes should be viewed in combination with the reform of the government pension fund (GPIF) which plans to decrease its exposure to the JGB market and increase investment in equities and foreign assets.
- The changes also confirmed the BoJ's commitment to achieving its 2% inflation target and should help embed rising inflation expectations in Japan.
- The further monetary policy easing also supports the ongoing implementation of the other 'arrows' of Abenomics and should help the government confirm the second round of the Consumption tax hike planned for October 2015.
- Further QQE in Japan is consistent with our 'Great Divergence' view and should help put downward pressure on JGBs and the Yen and support the Nikkei.

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For the second time in consecutive years, Governor Kuroda of the Bank of Japan (BoJ) has surprised the markets with the aggressiveness of his monetary policy easing.

While there was some concern in markets over the post-consumption tax hike path of the economy and inflation and some speculation that a further expansion of the BoJ's qualitative and quantitative easing (QQE) could be forthcoming in the months ahead, almost nobody in markets had anticipated action at the BoJ's policy meeting on 31 October.

However, that is exactly what happened. We also note that, very unusually, the vote by the BoJ Board was only 5-4, suggesting that Governor Kuroda had not been working behind the scenes to build consensus for his ramped up QQE.

So Governor Kuroda not only surprised the markets, but also his fellow Board members.

This development also fits very neatly into our 'Great Divergence' view on global monetary policy – with the US and other $ Bloc central banks on one side and the European Central Bank (ECB) and BoJ on the other. For further details see the October 2014 edition of our economic quarterly publication *First Insights*.

The expansion of the QQE program announced by the BoJ included the following:

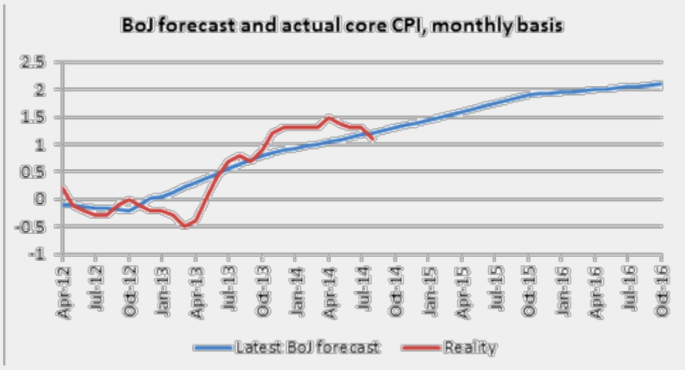
- The BoJ will aim to expand the monetary base at an annual rate of around Y80 trillion – an increase of about Y10-20 trillion on the previous target.
- The BoJ will expand its holdings of Japanese government bonds (JGBs) by about Y80 trillion per year, up from the previous level of approx. Y50 trillion per year.
- The BoJ will now be buying approx.. Y8-12 trillion JGBs per month, up from the previous level of Y6-8 trillion.
- This will mean that the BoJ will now be buying around 100% of net new issuance from the Ministry of Finance (MoF), up from the previous level around 70%.
- The average maturity of the BoJ's holdings of JGBs will be extended by 3 years out to the 7-10 year maturity range.
- The BoJ will triple the amount of ETF's (to Y3 trillion) and REITs (to Y90 billion) they will purchase on an annual basis.

- In addition, the BoJ will make ETFs that track the Nikkei 400 index eligible for purchase.
- Significantly, the BoJ kept their commitment to achieve the 2% inflation target "in about 2 years", implying that any further undershooting of the target could see a further ramp up in the QQE program.

On making its decision, the BoJ noted that the Japanese economy "has continued to recover modestly as a trend and is expected to continue growing at a pace above its potential", however the decision to expand QQE was driven by the price front, where weaker developments in demand post the consumption tax hike and the substantial decline in crude oil prices have seen downward force.

The chart below shows how the core Consumer Price Index (CPI) (ex food ex consumption tax hike) has fallen below BoJ forecasts. There was clearly real concern within the BoJ over the re-emergence of a "deflationary mindset", hence Governor Kuroda's aggressive policy stance.

Japan inflation: BoJ forecast and actual



Source: The Observatory Group

The following table shows the BoJ's new economic growth and inflation forecasts relative to those released in July.

Bank of Japan: GDP and Core inflation forecast – Latest (Previous)

%/yr	Real GDP	Core CPI (ex-Consumption tax)
FY14	0.5% (1.0%)	1.2% (1.3%)
FY15	1.5% (1.5%)	1.7% (1.9%)
FY16	1.2% (1.3%)	2.1% (2.1%)

Source: Bank of Japan, 31 October 2014

Some key issues:

To our mind the expansion of QQE in Japan will have an impact on a number of factors, including:

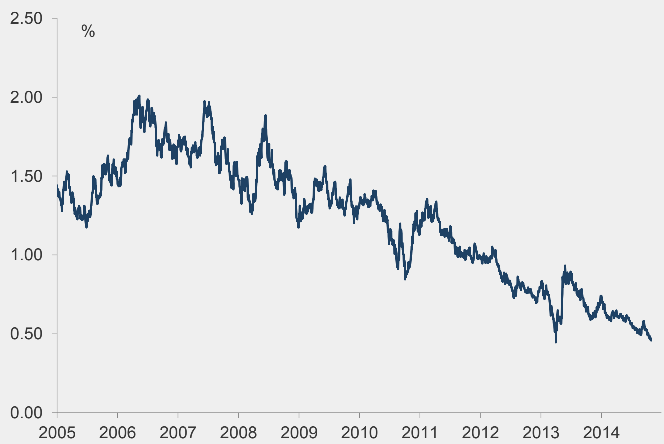
- The key issue for the BoJ is to ensure that participants in the Japanese economy and markets change their inflation expectations – and the 'surprise' ramp up in QQE will surely help this process.
- The pressure will remain on the Abe government to continue to come good with their fiscal policy and growth strategy policies, ie. the second and third arrows of Abenomics.
- This will include the planned second round of the consumption tax hike on 1 October 2015, with the rate set to rise from 8% to 10%. Note, Prime Minister Abe has promised to confirm this increase, or not, before the end of this year.
- This move by the BoJ to ramp up QQE should also be viewed in concert with the recent reforms of the Japanese government pension fund (GPIF).
- The GPIF will now be buying less JGBs (so essentially selling JGBs to the BoJ) and will increase their purchase of the Japanese equity market.
- The GPIF will also be allocating more funds to international markets – helping to put further downward pressure on the Yen.

Impact on markets:

With the BoJ now going to be purchasing around 100% of all net new issuance from the MoF and despite less buying from the GPIF, downward pressure on JGB yields is likely to remain in place.

Despite, therefore, the natural tendency for a rising higher inflation expectations environment to work to push bond yields higher, we continue to expect to see JGB yields trade in a low and narrow range around 0.4%-0.5%.

JGB 10yr yields



Source: Bloomberg, data to 3 November 2014

The other key target of QQE is likely to be a further weakening of the Yen. Indeed, after trading around USD/JPY100-102 for much of this year, the Yen has been shifting lower in recent weeks and is now trading around USD/JPY112.75, its weakest level since late 2007.

With the US Federal Reserve now finishing QE and expected to raise rates from mid-2015, the further aggressive QQE move by the BoJ should help see the Yen continue to weaken in the months ahead.

JPY v USD

Source: Bloomberg, data to 3 November 2014

The other market that will likely be most affected by the further aggressive easing of monetary policy is the Nikkei, which has rallied strongly since the ramp up in QQE and is likely to remain well supported – including by the GPIF and the BoJ.

With thanks to research from (in alphabetical order):

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