Connolly Insight

Vision beyond the horizon

What Matters Most for the BOJ?

Bernard Connolly, October 29, 2015

- What matters most for the BoJ is not the inflation rate for its own sake but the public-sector debt trajectory.
- We think the BoJ and the government are quite happy to approach the inflation target slowly.
- Core inflation on the new measure is, at 1.1%, comparable to that in the US; with Japan now effectively at full employment, additional stimulus would run the risk of an overshoot in underlying inflation or, more plausibly, of approaching the inflation target *too soon* – from the point of view of maximising monetisation.
- Further increasing the rate of QQE purchases now might also bring a "taper" date forward for market-functioning reasons and would presumably increase the risk of future major disruption (a "taper tantrum") in the JGB market.
- Deferring the question of what should be done to BoJ holdings of JGBs if and when the inflation target is reached is tremendously attractive politically; in effect, the present outcome of QQE looks like a Goldilocks one in many respects from the point of view of the government, however worried one might be about its longer-term implications.
- The politics of income distribution also suggest that, unlike a year ago, there is no obvious pressure from the government on the BoJ to take additional steps – indeed if anything the pressure seems to be not to take additional steps.
- No change in policy is thus our most-likely scenario.
- However, we suspect that Japanese officials may be a lot more concerned about China than they are letting on in public; if, contrary to our base case, the BoJ did indeed move tonight we would be inclined to take that as a signal about China that could very well have implications for policy elsewhere, and notably for Fed policy.

What matters most for the BoJ in deciding whether to add further "stimulus"? We think it is not the inflation rate but the public-sector debt trajectory. The BoJ has been engaged in a massive debt conversion – a monetisation – exchanging money, a zero-interest perpetuity – for JGBs. At present the size of this debt conversion is about 10% of the JGB market a year. Clearly, if the BoJ could, hypothetically, purchase the whole of the JGB stock and hold it indefinitely[1] without creating an inflationary conflagration, that would

[1] There is some confusion in market commentary about BoJ purchases of JGBs relative to purchases of ETFs. One hears it said that since ETFs are perpetuities and JGBs are not, the risk of future market disruption if QQE is ever wound down is greater if the BoJ has bought lots of ETFs, since winding down its stock of ETFs would involve actual sales by the BoJ, whereas winding down the BoJ's stock of JGBs could take place without BoJ sales and could happen just through the maturing of bonds. But if

be one way of resolving the debt-sustainability question – by depriving the private sector of the income flow from JGBs (or from ETFs or from whatever other yield-producing assets the BoJ buys). Such an outcome would amount to a fiscal tightening, whose size would depend on the extent to which the Japanese private sector displayed Ricardian Equivalence behaviour in the posited circumstances (one telling indication of fairly widespread Ricardian behaviour is the continued presence of a current-account surplus and substantial net foreign assets in the face of a continued very large budget deficit and an enormous public-sector-debt ratio).

More to the point, however, it is unlikely that both or indeed either of the two conditions for this outcome would be met indefinitely. Thus, for instance a recent IMF staff paper suggests that on plausible assumptions about the behaviour of banks, pension funds and life insurance companies, the BoJ might have to taper its purchases by 2017 or 2018. Increasing the rate of QQE purchases now would bring that "taper" date forward and would presumably increase the risk of major disruption (a "taper tantrum") in the JGB market. Alternatively the BoJ could further extend the range of assets it purchases, leaving some supposedly "safe" assets in the hands of the domestic financial sector for collateral and asset-liability-management purposes and acquiring a greater volume of risk assets from the private sector.

Second, while QQE may ceteris paribus represent fiscal tightening, other things are of course not equal in the face of the programme. Thus, for instance, the portfolio-rebalancing channel appears to have been more evident under QQE2 than under QQE1. As a result, net asset returns (including appreciation in the prices of bonds as well as of "risk assets") to the Japanese private sector may be higher, although with correspondingly higher risk, than in the absence of QQE: the Keynes windfall effect probably prevails.[2] Moreover, the effect of QQE1 and QQE2 (and, in the case of QQE1, the signalling effect that preceded it) has no doubt been to weaken the yen. The combination of the risk-taking channel, lower borrowing costs and thus higher spending, the windfall effect and the exchange-rate effect have undoubtedly provided a net stimulus to the Japanese economy, whether or not it needed it for reasons other than a desire to increase the inflation rate. And inflation expectations did go up as a result of the initial signalling of QQE, although they have subsequently plateaued well short of the 2% target, and core inflation on the new measure is, at 1.1%, comparable to that in the US and significantly higher than in the euro area or in other European countries or in Britain. This suggests that, with Japan now effectively at full employment, additional stimulus would run the risk of an overshoot in underlying inflation. If that happened, and

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JGBs held by the BoJ mature, the *government* has to sell new JGBs to replace them. The question of whether the BoJ's asset holdings, in whatever form they might be, would in fact ever be run down is treated in the text, below.

[2] Individual Japanese households hold rather few bonds or equities directly. But the windfall effect has improved the position of pension funds and life-insurance companies.

inflation expectations moved up, a continuation of the QQE programme, and a fortiori a ramping-up of its size, would lead to much heavier outflows from Japan, a rapidly depreciating currency and an powerful feedback loop to inflation that would leave the BoJ caught between allowing an inflation acceleration that could be very dangerous given the extremely large monetary base, on the one hand, and being forced to terminate or even reverse QQE, on the other.

The longer-run politics of how to resolve the public-sector debt problem will ultimately come to dominate all choices about monetary and fiscal policy in Japan. But for now the present scale of QQE seems optimal politically. It is improving the debt trajectory, and the longer it is maintained *while inflation has not yet reached the target* the more helpful it will be in debt-trajectory terms. And one should not forget the academic consensus at the beginning of the millennium that the BoJ must "responsibly commit to irresponsibility" and must make it clear that an increase in the monetary base would be *permanent,* not reversible, as was the case with QE from 2000 to 2006, as soon as inflation picked up. Whether that academic consensus was correct is a question that cannot be considered in today's note (although we remind readers of past notes which tend to the view that it was not correct). But as long as the inflation rate in Japan is trending slowly up – as it now seems to be, in contrast with the situation in October of last year – the BoJ's (short-term) credibility is not at issue and, more important, as long as inflation, although edging up, remains below the target, the question posed is not one the Japanese authorities have to grapple with *yet* – and that is an enormous political attraction. In effect, the present outcome of QQE looks like a Goldilocks one from the point of view of the government, however worried one might be about its longer-term implications.

If there is a fly in Goldilock's porridge it is that the income-distribution effects of QQE are becoming politically-undesirable. Given what is otherwise the apparent, even if delusionally so, Goldilocks aspect of the situation the government is clearly prepared to fly through any flak resulting from the effects of the programme in its present size. But the yen depreciation – clearly judged desirable at the inception of Abenomics – which would be associated with any substantial expansion of the scale or scope of the programme might have short-run aggravating effects on income distribution which, given the electoral cycle, the government might want to avoid. Thus, again unlike a year ago, there is no obvious pressure from the government on the BoJ to take additional steps – indeed if anything the pressure seems to be not to take additional steps.

The trend of our discussion thus far has been to indicate that we think that additional measures are unlikely to be announced after the BoJ meeting. That is indeed our most-likely scenario. But we have so far said nothing about short-term developments in Japanese economic activity, of the sort which in the US case would be expected to have a determining effect on Fed decisions. Reacting to such developments, we think, is not top of Kuroda's list of priorities, as long as they are not seen as signalling the complete defeat of his strategy; today's production numbers will be comforting in that respect. What we do think has to be taken into account is China. We suspect that Japanese officials, including BoJ officials, may be a lot more concerned about China than they are letting on in public. It is conceivable that they might want to get in ahead of other countries in trying to protect their economy from the effects of China's troubles. To repeat, this is not our base case. But if the BoJ did indeed move tonight we would be inclined to take that as a signal about China that could very well have implications for policy elsewhere, and notably for Fed policy: no-one wants to be the first to seem to panic about China, but if one does the others will follow.