GENERALI INVESTMENTS

Focal Point

BoJ to show commitment to its interest targets

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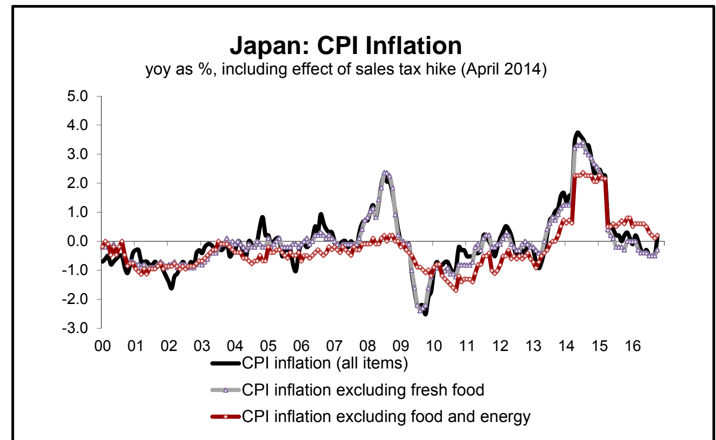
- Since the introduction of the Qualitative and Quantitative Easing (QQE) policy in April 2013, Japan's monetary base has risen from around 35% to 90% of GDP. Nevertheless, inflation has remained on low levels.
- Back in September, the Bank of Japan (BoJ) surprised with a fundamental policy shift to outright yield curve control. We expect no change in this new framework nor regarding interest targets at the monetary policy meeting next week.
- We see the BoJ as to have implicitly "given up" on hopes to influence inflation expectations quickly. It prepared for a long-term battle against low inflation while trying to contain negative side-effects from its policy on banks.
- However, the recent re-depreciation of the yen together with rising oil prices will make the BoJ's life easier. Moreover, the strongly rising international yield environment speaks for a lift of interest targets in the medium term.
- As a result, we forecast JGB yields to slightly move up medium-term. The JPY/USD will likely weaken on normalizing Fed policy, helping Japanese equities to generate positive returns slightly above the range of other peer markets.

When back in April 2013, the freshly appointed Governor Kuroda first announced the introduction of quantitative and qualitative easing (QQE) policy, the Bank of Japan (BoJ) drastically broke up with its previous policy concept. Under its predecessor Shirakawa, the BoJ considered the mild deflation process as driven by falling real potential growth – especially due to unfavorable demographics – which monetary policy was essentially not able to cure. Kuroda replaced this approach by an inflation targeting policy, aiming at consumer price inflation of 2%, to be reached at the earliest possible time with a time horizon of about two years. Since then, the BoJ's balance sheet expanded by 161%, raising the monetary base from around 35% to 90% of nominal GDP. Nevertheless, Japan's headline consumer prices receded by 0.5% yoy until September 2016, before the strong re-deprecation of the yen lifted them by 0.1% yoy in October. However, underlying inflation remains close to zero percent. Thus, the fundamental inflation impact of monetary policy over the last three and a half years can only be described as disappointing.

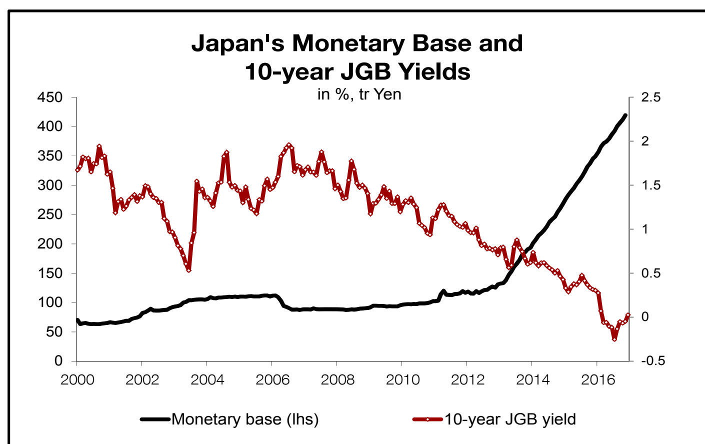
Monetary policy part of a wider approach

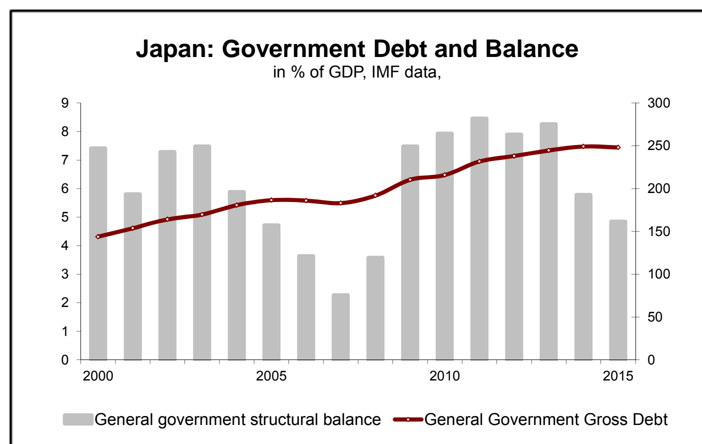
The Kuroda monetary policy must be seen as part of a wider concept of Abenomics. Domestically, the monetary easing was clearly intended to change inflation expectations. Moreover, the strong monetary easing entailed a major depreciation of the yen which weakened from levels of about JPY/USD 78 in late 2012 to its peak of just less than 125 JPY/USD in mid-2015. The depreciation pushed up profits of exporting firms and thus benefitted stock markets, giving hope to trickle down effects in the form of



rising employees' income, which the government actively promoted. This, in turn, should benefit consumer demand and thus inflation, setting in motion a positive feed-back loop while ending the deflationary mind-set.

However, Japan's plan also faced headwinds. First, public fiscal debt amounts to about 250% of GDP, pointing to the need of fiscal consolidation. According to IMF data, Japan reduced its general government structural deficit from 8.6% of GDP in 2013 to 4.8% in 2015, i.e. a marked fiscal contraction. Part of the story was the sales tax hike from 5% to 8% in April 2014 which led to large fluctuations, especially a drop by 17.9% qoq annualized of private consumption in Q2 2014. This was a hit, from which household demand has not yet fully recovered. Accordingly, the second part of the sales tax hike was postponed to late 2019. A second disinflationary factor was the development





of oil prices, which started to drop strongly from mid-2014 on, reaching their trough only in Q1 2016. Third, against the background of renewed recession fears, the yen reversed course in mid-2015, appreciating to levels between JPY/USD 100-105. Citi Research recently estimated that a 10% appreciation of the yen to the US-dollar pushes core CPI down by 0.6%. However, of late, these detrimental factors changed again substantially. In the wake of Donald Trumps election, the yen re-depreciated again markedly to around JPY/USD 115. Thus, base effects from oil prices and the depreciation will not cancel each other out any more, but will work in the same direction, going forward, making BoJ's life much easier.

BoJ set up new policy frameworks twice in 2016

The BoJ introduced new policy frameworks twice this year, adding much more complexity to the previously simple quantitative easing targets. At first, on January 29, it divided the commercial bank deposits at the central bank (outstanding balance of current account at the Bank) into three subdivisions, and pushed the rate on the so called "Policy-balance" into negative territory with -0.1%. Despite the fact, that this negative interest rate (NIRP) will be charged only on a small portion of deposits at the BoJ, the private sector's initial assessment was overwhelmingly negative. The NIRP sparked worries especially among pensioner households (the ratio of pensioners to salaried workers has risen to 7:10) and thus likely contributed to the deterioration of consumer sentiment. However, the NIRP had the intended effect of further pushing down the yield curve. After the decision, 3-month money market rates dropped from 0.08% to around -0.03, while 10-year JGBs yields receded first to -0.1%, but later diminished even further. The flattening of the yield curve below the zero-percent line also sparked strong criticism that the BoJ jeopardized the viability of the banking sector.

On Sep. 21, the BoJ surprised again markets by introducing QQE with yield curve control. The new framework marks a fundamental change from previous concepts. Under the yield curve control the Bank targets the short-term and long-term interest rates. This comes in the form of the overnight rate (held constant at -0.1%, as explained above) as well as the 10-year JGB yield (aiming at about zero percent). A guideline for market operations will specify both rates, which principally can be changed at each BoJ monetary policy meeting. To bolster its market instruments the BoJ introduced two new tools (outright purchases of JGBs with designated yields by the Bank and fixed rate fund-supplying operations for a period up to 10 years).

In sum, the BoJ changed over from targeting QE quantities to directly targeting prices.

Nevertheless, at the same time the BoJ announced to purchase JGBs more or less in line with the current pace, i.e. 80 tr per year. While these purchases lost its previous status as an explicit target, the level remained a guideline. To underline this, the BoJ explicitly stated that the ratio of monetary base to nominal GDP is expected to exceed 100% in about one year, whereas the monetary base may fluctuate short-term. However, maintaining a quantitative guideline and establishing a price target at the same time may run into a logical inconsistency, as it seems not to be possible to control price and quantity simultaneously.

How to make sense of this policy framework?

How to make sense then of this policy framework? First of all, the BoJ formally ratcheted up its commitment to raise inflation. Instead of the previous inflation target it introduced a mild form of price level target, implying that it intends to make up for too low an inflation in one period by allowing an inflation overshooting in a following period, in order to reach the previous envisaged absolute price level path again. The Bank said, it will continue expanding the monetary base until the core CPI inflation exceeds 2% and stays above the target in a stable manner.

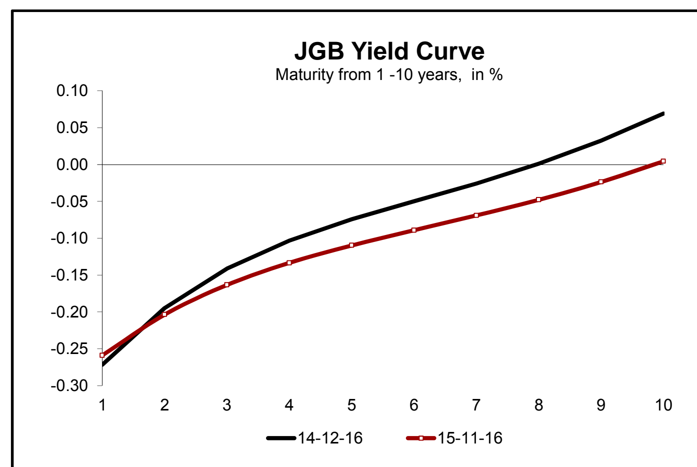
However, the new BoJ framework is best understood against the September outlook of downward pressures to inflation. In an October speech (at Brookings Institution in Washington, D. C.), Governor Kuroda conceded, that "*despite unprecedentedly large-scale monetary easing, inflation expectation formation in Japan is still adaptive to a large extent. That is, the expectations are formed in a backward-looking manner. In the wake of the substantial decline in crude oil prices since summer 2014, a reduction in the observed inflation has pushed down inflation expectations.*" In other words, the BoJ had become skeptical or has even "given up" on calculating larger effects from QE or the announcement of inflation targets on actual inflation expectations. The adaptive expectation building is unlikely to change soon. Consequently not being able to influence expectations quickly, the BoJ had to prepare for a protracted battle against low inflation for many years ahead. Moreover, with the expectation channel less reliable, the BoJ has to focus on the fundamentals for investment and consumption decisions, i.e. the control of interest rates for an extended period.

Second, the BoJ currently holds about a third of Japan's outstanding government bonds. However, this figure could rise to 60% by the end of 2018 at the current purchasing

pace of ¥80 tr per year. Given the high need of pension funds for JGBs, the scarcity issue could become binding even earlier.
Third, Governor Kuroda explicitly acknowledged in the same speech the possible side effects of a flat and below zero yield curve, "*as to weaken the functioning of financial intermediation, which may reduce monetary easing effects.*" Targeting the level and the slope of the yields curve is unprecedented among central banks.

What policy can be expected?

Since the introduction of QQE with yield curve control, the international environment has changed significantly. The election of Donald Trump has entailed expectations of a more expansionary US fiscal policy, above potential US growth and thereby together with higher oil prices, a more strongly rising inflation. This, in turn, has also lifted market expectations for the Fed monetary policy. In a first move, 10-year Treasury yields jumped by about 60 bps since early November and increased further after the recent Fed monetary policy statement. We expect these yields to rise markedly further until end-2017.
This quick development likely took (not only) the BoJ by surprise. By the time the QQE with yield curve control was introduced, the prospect of rising yields and thus the need for the BoJ to stem against the international yield pull was deemed much lower. Markets have started to test the commitment of the BoJ towards its current interest targets. 10-year JGB yields temporarily rose slightly above 0.08%. Last month, the BoJ already shot a warning signal via unlimited fixed rate JGB operations at the shorter end of the curve. Most recently, the bank used regular operations at the long end of the curve. In sum, given the international yield environment, the BoJ will likely have to step up its purchases beyond the planned 80 tr per year for the time being. As the current inflation rate still remains near zero percent, already changing the interest targets now looks much too early in our view, given that the ultimate goal of the BoJ is to maintain real interest rates close or below zero.
However, Japan's inflation outlook has improved with the re-depreciation of the yen. We see headline inflation to rise to 0.6% in 2017, after -0.1% in 2016. Ironically, the adaptive formation of households inflation expectations should help the BoJ this time. This, medium term, also opens up room to slightly increase the interest targets, possibly in autumn 2017 from currently 0% to – at first cautious – 0.1%. Consequently, the BoJ's need for intervention would be reduced then again which would also help to limit the scarcity issue in the longer run.
The slightly better inflation outlook could also benefit from the macro side. Fiscal policy will continue to help growth, but – like in the recent supplementary budget – we expect fresh water spending to be limited, not providing any lasting boom. However, the last Tankan report proves sentiment in Japan to have improved against the backdrop of expected expansionary fiscal policy in the US. Moreover, the re-depreciation of the yen has the potential to restore some of the intended workings of Abenomics. Therefore, we expect growth to reach 1.0% in 2017, after 0.7% this year.
Against the fundamental backdrop of the BoJ to stem against (but at least to lag) the backup in international yields until inflation has responded, we expect the yen-US-dollar exchange rate to be largely driven by the Fed policy. As a consequence, we expect a further weakening the yen against the US currency to slightly above JPY/USD 120 over the course of next year. With regard to stock markets, unlike to the past, monetary policy is unlikely to give important impulses. Instead, the exchange rate, growth and market multiples are more likely to determine the development. That is, for the Topix, we remain slightly above a neutral position inside the equity space.



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