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# Japan's monetary policy: Next bazooka imminent?

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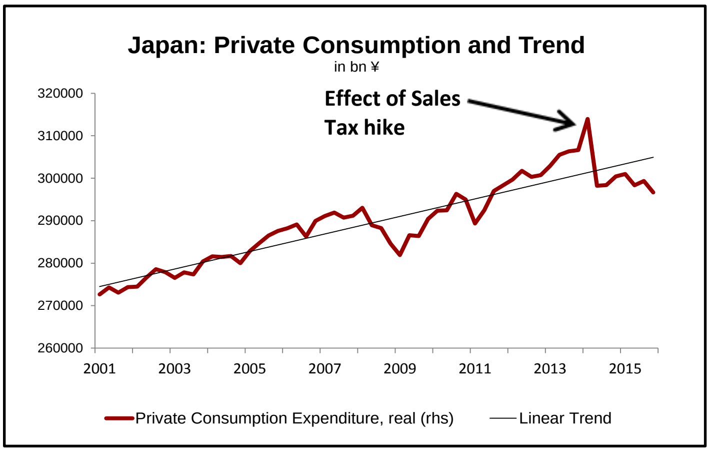
- Over the last weeks, sentiment towards Japan has been more and more grabbed by recession fears. In addition, the BoJ's negative interest policy has recently been accused of additionally dragging on consumer sentiment.
- We see Japan to only marginally avoid a recession in Q1. Risks are mainly on the downside.
- The government is likely to soon set up a fiscal policy package and will potentially postpone the next sales tax hike, not least due to forthcoming parliamentary elections.
- On top, we expect the BoJ to step up its monetary policy stimulus. Markets have started to discuss even bolder concepts like 'helicopter money', i.e. a transfer of central bank money to the household sector.
- Near term, such a drastic step still seems unlikely. Further out, however, with monetary policy still not having the desired results on inflation, the BoJ may yet again surprise as a pioneer of the next bazooka of monetary policy.

Over the last weeks, sentiment towards Japan has been more and more grabbed by recession fears. Especially the BoJ's Tankan report from the turn of last month deteriorated markedly, intensifying investor's worries. Stock markets took it badly and lost about 6% in the immediate aftermath. Looking beyond the headline figures, we consider the underlying forces of these growth worries to be a volatile private consumption and international headwinds.
Indeed, in Q4 2015 Japan's GDP receded by 1.4% qoq on an annualized basis. The main culprit was private consumption, which dropped by 3.3% qoq ann, drawing down the total year 2015 result to -1.2%. In fact, Japan's private consumption has still not recovered consistently from the sales tax hike in April 2014. Recent 2016 data were mixed and pointed to ongoing volatility. However, the Japanese real consumption index – which is also used in GDP calculations – had a relatively strong start into the year, suggesting still a small positive contribution to Q1 growth.

## BoJ accused of contributing negatively to consumer sentiment

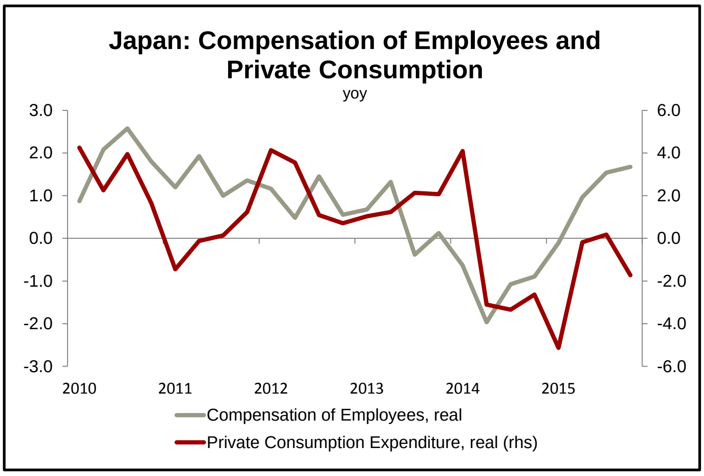
On top of these realized purchases, worries were fuelled by a softening consumer sentiment. The seasonally adjusted February results of the Cabinet Office's Economy Watchers Survey recorded the sharpest drop since April 2014, which continued in March. Moreover, consumer confidence receded in February by 2.4 index points, but partially recovered meanwhile. While the figures were taken in the midst of strongly rising global risk aversion and dropping international stock markets, plenty of press comments also drew a strong connection to the latest BoJ's monetary




policy action. On January 26, 2016 the BoJ had surprised with the introduction of its "Quantitative and Qualitative Monetary Easing with a Negative Interest Rate", despite the fact that Governor Kuroda had broadly excluded a negative interest rate policy (NIRP) before. Although this negative rate will only be charged on a portion of banks' deposits at the BoJ, the private sector's initial assessment was overwhelmingly negative. The NIRP has been described as resulting in anxiety and confusion, especially among pensioner households (the ratio of pensioners to salaried workers has risen to 7:10). Therefore the policy is seen as having contributed to the deterioration of consumer sentiment which – if true – is counterproductive in terms of stimulating demand. Moreover, a backfiring public opinion could be a new restriction in extending the NIRP further. The BoJ obviously took public mood seriously and issued a booklet "Negative Rates in Five Minutes" to win over critics. This was, however, essentially demonstrating the strength of the unease that was created.

## Wage increases back rising private consumption

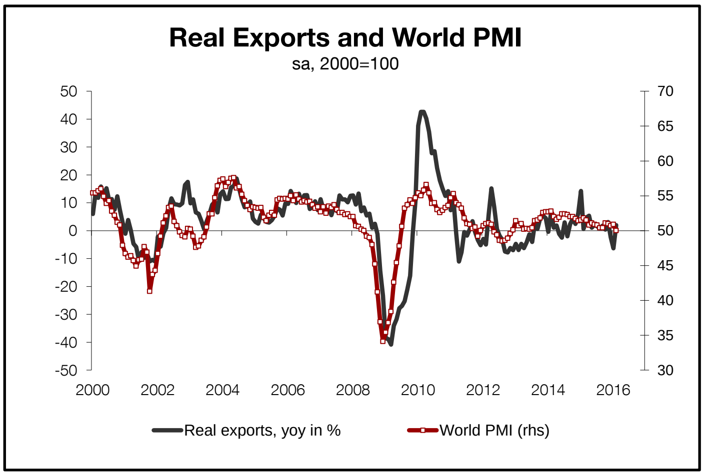
Regarding the outlook of private consumption, fundamental factors continue to tend to point at a recovery. Real compensation of employees accelerated to 1.7% yoy in Q4 2015, after the sales tax hike had previously eroded real incomes. Moreover, the rise in wages is likely to continue although – as the first round of this year's Shunto spring wage negotiations suggests – at a more moderate pace. The Japanese Trade Union Confederation published a first round wage increase by 2.08%, down from 2.43% last year. Thus, wage increases do not look bold but will result in overall slightly rising income.




## Weak international environment added to worries

On top of the volatility of private consumption, international demand has generally been soft and accordingly, real exports in sum lackluster. In Q4 2015, real exports receded by 3.3% qoq annualized while imports dropped even more strongly by 5.6% qoq ann. Consequently, net exports contributed positively to GDP growth by 0.3 pp. However, existing data for Q1 2016 point to a much stronger rebound of imports than exports. Thus, net exports are likely to drag markedly on growth in Q1. Going forward, the global environment suggests, that lackluster foreign demand will not improve soon.

However, firms' worries run even deeper. Abenomics was – de facto – largely built on a strongly expansionary monetary policy, which, in turn, depreciated the currency and, by that, pushed up turnover and profits in yen terms. High profits were intended to trickle down into higher wages and investment, thus improving demand (starting a positive wage-inflation spiral), while, at the same time, higher import prices also led to a cost-push contribution in CPI inflation. Unfortunately, the latest move of monetary policy – despite a negative interest rate – has been unable to halt the appreciation of the yen against the US-dollar, in nominal as well as in real effective terms. The yen has traditionally been a safe haven currency which typically appreciates on bouts in international risk aversion. Nevertheless, this will put pressure on Abenomics as it jeopardizes the policy concept. Given this backdrop, it comes as no surprise that firms have become already more reluctant to increase wages and also scaled back their inflation expectations, according to the Tankan report to only 1.3% in five years' time, down from 1.6% in last December.



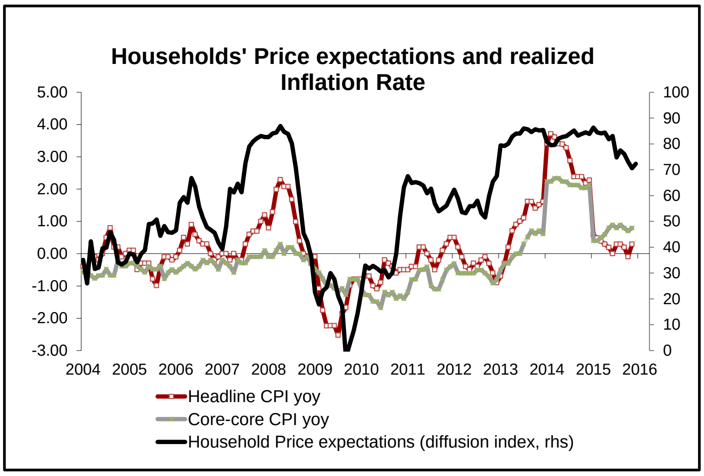

## Will fiscal policy come to rescue?

Of course, recent developments have not gone unnoticed by the government. According to press reports, PM Abe plans to formulate an economic stimulus package ahead of the G7 meeting, to be hosted in Japan on May 26/27. The size of the package is expected at least at JPY 5 tr (1% of GDP), depending also on the size of other measures. The package will likely focus on private consumption (considering shopping vouchers, child-care vouchers, cash handouts). In addition, a discussion has started whether the (already delayed one time) second part of the consumption tax hike from 8% to 10% in April 2017 should be further postponed. This decision could be taken after mid-May, when the first estimate of Q1 GDP growth will have been published, but before the Upper House parliamentary elections likely in mid-July. There are also more and more rumors that Abe could combine the Upper House with a fresh Lower House vote, to lengthen his term, and to cast the election as a referendum on his sales tax policy. The postponement of the sales tax hike would change the structure of the quarterly growth profile substantially. Currently, we anticipate consumers to bring forward demand ahead of the tax hike and draw back expenses thereafter.

Regarding the GDP outlook, we see growth in Q1 to be only marginally positive, helped by the leap year effect. Risks are clearly on the downside. Looking further ahead, we see rising income to support household demand, however its volatility is unlikely to subside immediately. The US ISM as well as China's PMIs have recently send some stabilization signals. Nevertheless, we see exports to continue to be lackluster. On the other hand support will come from fiscal policy. In sum, we revised down our growth forecast for 2016 to 0.4%, after 0.7% before.

## BoJ: Already time for the next bazooka?

The BoJ has missed its inflation target of 2% substantially so far. Japan's headline inflation rate came in at +0.3% yoy in February, while core inflation (ex fresh food) was at 0.0% yoy and core-core (ex food and energy) at +0.8% yoy. The difference shows the drag from the energy component. We consider the rise in core-core inflation mainly as the result of the cost-push effect of the past yen depreciation. With this impact receding strongly, and the yen appreciating to around JPY/USD 109 of late, the up-trend of the core-core inflation has already come to a halt. Given the importance of the past depreciation for the whole concept of Abenomics, the BoJ must be alarmed. On top, consumer inflation expectations have suffered recently.




BoJ Governor Kuroda has repeatedly said that the central bank would take additional monetary easing steps if needed. Reuters reported of late that sources familiar with the bank would see a next step already on the April 27/28 meeting. Moreover, market discussions have been extended recently to the question, what effective options the BoJ still have, given the unfavorable FX development. These options are:

**Extension of government bond buying**: It is estimated that the BoJ already buys about 90% of newly-issued JGB, excluding the short-term bucket. Thus, this option runs into an upper limit. In addition, this policy could be seen as a beggar-thy-neighbor policy and a detriment to global coordination ahead of the G7 meeting on May 26/27. However, QQE clearly helped in the past to depreciate the currency.

**Extending other components of the QQE**, esp. stock purchases. Here, the exchange rate effect is rather uncertain. This option could attract foreign investors and thereby appreciate the yen instead of depreciate it.

**NIRP:** The bank would likely want to see more data on the household's response to the NIRP, before proceeding.

**Helicopter money**: This option would be a bold move into unchartered territory. While working like expansionary fiscal policy, it does not have the deficit implications. It needs to be done on a repeated basis in order to generate inflation and not only a price shift. Moreover, as such a measure would have direct implications for other fiscal policies, it would need to be thoroughly coordinated with the government. It also requires (as we see the Bank of Japan law) the consent of the Minister of Finance and of PM Abe.

## Conclusions

Given that (1) private consumption fluctuates but is likely to improve going forward, that (2) a part of the appreciation may be unwound with less international risk aversion and (3) the expected help from fiscal policy, we see the need for an immediate bold (helicopter money) move as limited. A extension of established policies – which is still our base case – will likely calm some Japan worries but is unlikely to markedly ease global growth and "lowflation" fears. However, as conventional QQE has suffered from decreasing effectiveness, if there is any county prone to use this helicopter option, it will likely be Japan. Helicopter money would be clearly a game changer especially for the stock markets. Given the coordination effort and the political risks, we would expect an introduction only after the elections at the earliest. Against the background of this year's headline inflation to recede to 0.1% after 0.8% in 2015, we deem the likelihood of this policy to be material.

# Imprint

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