Notes on Financial Markets Vol.45

# BOJ's another round of easing: first impression

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## Notable features

・The BOJ decided further expansion of asset purchase program at their monetary policy meeting today; they decided to increase the target size of the program by ¥5tn (at the end of CY2012) from ¥50tn to ¥55tn. Moreover, unlike the recent cases, all of such incremental increase in asset purchase was allocated to JGBs. While there was a good reason for most of the market players to watch closely the last minute deals of the "comprehensive policy package" in Europe, additional stimulus by the BOJ today raises some interesting issues as discussed below.

## Economic backgrounds

・If you would like to evaluate the monetary policy in the context of economic fundamentals, you might wonder the reasons for today's policy decision.

・According to the economic outlook revised and released by the BOJ today, Japan's economy is expected to grow at 2.1 to 2.4% in FY 2012 (which begins in April 2012). This is far faster than our potential growth rate which is estimated to be around 0.5% by the BOJ. Economic activities are expected to decelerate in FY2013, but it would still expand at 1.3 to 1.6%. The BOJ's policy statement suggests that our economy will be supported both by resilient external demand (mostly from emerging economies) and growing domestic demand relating to reconstruction efforts in the area affected by the earthquake.

・On the inflation front, the BOJ is less optimistic. Nevertheless, our central bank anticipates that the rate of core CPI inflation would be gradually accelerating to 0.4 to 0.6% in FY 2013. This is much closer to the rate that is shown in their "understanding of price stability".

・All in all, there seems to be little imminent need for additional economic stimulus. Indeed, the BOJ implied that additional stimulus was intended as "insurance" against high uncertainties about global financial markets and overseas economies. Generally, such precautious conducts of monetary policy is one of the reasonable strategy and is desirable in some cases. Still, in light of the small set of remaining policy instruments, it is uncertain whether the BOJ could afford to tap one of them at this moment.

## Choice of the asset and transmission mechanism of the policy

・At the press conference today, Governor Shirakawa reportedly pointed out that there has been less stress in our credit markets, and this is why the BOJ decided to allocate all of the incremental funds (¥5tn) for purchasing JGBs. From technical point of view, it should be noted that the BOJ has been suffering from chronic "under-subscriptions" of lending operations against pooled collateral, which is the core measure for short-term monetary operations. When taking account of these factors, there might be little choices before the BOJ when they would like to increase the scale of asset purchase program.

・Much more important issue regarding the increased purchase of JGB operation is its policy intension. While we could not find any explanation in the policy statement, Governor Shirakawa reportedly suggested that larger amount of JGB purchase is expected to affect longer-term rates. This is not their conventional line of thoughts on JGB purchase operations, although it was not the first time to refer to such mechanism of policy transmission.

・This line of thoughts is not without a precedent case in overseas economies. And the BOJ is cautious enough to try to differentiate the policy intension of JGB purchase by the asset purchase program from those of conventional operations. Nevertheless, the idea of controlling longer-term rates by JGB operations could be controversial in the long-run, especially when taking account of our fiscal conditions.

・Market participants are fully aware that the BOJ is mindful of such risks. That might be why the BOJ limits the remaining maturities of the JGBs eligible for asset purchase program within 2 years. We, however, are also aware that such discipline could be at risk, when the BOJ would like to inflate the scale of asset purchase again and again. Because, in light of the possibility that JGB yield curve would be flattened further when additional stimulus is required, extension of maturities of the JGBs purchased would be the most convenient way for avoiding any "under subscriptions" of the operations for fund injections.

## Foreign exchange markets

・In spite of such interesting issues discussed above, most of the market players (probably not only limited to those in Tokyo) appear to focus on the relationships between BOJ's monetary policy and foreign exchange rates. In fact, since last summer, all three cases of the BOJ's additional monetary stimulus until today were accompanied by the MOF's foreign exchange intervention.

・An important backgrounds for this, which might be hard to be observed from global markets, is very strong voices of concerns among Japanese manufacturers. In addition to their medium-term fears about losing technological advantages, they are suffering from rising production costs due to disruptions in supply chain both domestic and globally. Therefore, there is good reason for them to raise strong voices even when the incremental magnitude of JPY's appreciation is rather contained.

・Market's criticism of effectiveness of such coordinated policy actions on JPY rates would not always be reasonable; we could only expect slower pace of JPY's appreciation in consideration of some fundamental and persistent upward pressures on JPY rates, especially on European front.

・From shorter-term perspectives, however, the markets appear to think that appreciation of JPY has been triggered and strengthened by a talk on possible additional monetary stimulus in the US. It is about "QE3" this time. If this is the case, the series of monetary stimulus by the BOJ (coupled with the MOF's intervention) could be perceived as a kind of "soft" peg policy in effect. Such policy strategy could function well for domestic economy in exiting from deflation as a "reverse" nominal anchor. Still, looking from global perspective, this could result in an exhausting competition of the scale of monetary operations among major central banks.

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