Notes on Financial Markets Vol.77

Press conference by Governor Kuroda —Second moment

11 June 2013

Introduction

Both domestic and overseas markets negatively reacted to the BOJ's policy decision to leave the basic framework of their policy unchanged. The press briefing by Governor Kuroda, however, covered broader range of policy challenges. Let me focus some of them in this current issue of my Note.

Point 1: Time lag of policy effects

Some press reporters asked if the recent reversal of price dynamics especially in stock and foreign exchange markets implies the failure of the QQE. Not surprisingly, Governor Kuroda denied such skepticism, and rather insisted that the BOJ identified the signs of improvement of economic activities both on private consumption and business investment. Moreover, he emphasized that inflation expectation has been on the gradual upward trend.

In fact, Governor Kuroda's line of thoughts appears quite reasonable. Every action of monetary policy could have substantial time lag before having meaningful impacts on the economy. In addition, readers may like to remember that the expected mechanism of policy effects of the QQE, after its initial phase of "shock and awe" in particular, would rather be "traditional" except for its scale.

Nevertheless, the BOJ could not ignore the recent reversal of market dynamics, since the markets is expected to play the important role in transmitting the policy effects as Governor Kuroda admitted in the press conference today. And what is worse, lack of sustainability of financial asset prices might imply the mixed success of the QQE in the initial phase: "shock and awe" to change our deflationary minds.

If this is the case, the monetary policy conducts in the second phase could be facing tougher challenges to achieve the policy goal, due to stronger skepticism in the domestic markets. This issue is then relates to the second point below, because the higher volatilities in three major markets (FX, JGB and Stock) have been the source of concerns about the effectiveness of the QQE so far.

Point 2: Reducing volatilities

There was a growing expectation that the BOJ would introduce some measures to calm down the volatilities in JGB markets at today's MPM. One probable measure was the ultra long-term money market operation with 2 to 3 years maturity.

Having observed that the BOJ did not introduced such unusual measure today, we have realized the delicate balance of the policy discussion.

On the one hand, ultra long-term money market operation could substantially reduce the volatilities of JGB yields, especially in the shorter end. Because the major banks reportedly have large JGB holdings with shorter maturities, funding by such operations could fix their risk positions from the viewpoints of the ALM. This would contribute to less volatilities, since it could reduce the risk of forced reduction of JGB holdings whenever the yields go up.

On the other hand, introduction of ultra long-term money market operations could effectively encourage the banks to buy more JGB, by providing stable source of funding. Readers may think this is quite similar to the effects of LTROs by the ECB on the banking systems across the euro-zone. While it was meaningful when the euro-zone was severely hit by fiscal crisis, it would be problematic to the BOJ today. It is apparently inconsistent with the original and important pillar of the policy intension of the QQE: encouraging the portfolio rebalancing by the banks.

To make the matters more complicated, as the market players suggest, higher volatilities themselves could undermine the risk appetites by our investors. And all the above lines of thoughts appear to have some reasonable appeals.

As the reason for the inaction by the BOJ, Governor Kuroda mentioned that more flexible and deliberate management of JGB purchase has already proved to contribute to lower volatilities to some extent. Moreover, he suggested some part of the higher volatilities of JGB yields are not "homemade", but have been affected by those of US treasury notes.

In the long run, the author would agree to Governor Kuroda's idea that accumulated stock of JGB on the BOJ's balance sheet could function as an anchor to JGB yields. This is the Japanese version of "stock view" by the FRB with regard to their government bond holdings. Still, the inaction by the BOJ could generate the policy vacuum until as early as our general election, which would be the source of volatilities so far.

Point 3: International context

It was interesting to find that some press reporters asked Governor Kuroda's view on the outlook of the overseas economies. It is quite natural because Mr. Kuroda was the head of the international institution – Asian Development Bank - and had abundant opportunities to exchange views with the global policy makers.

In replying these questions, he showed his confidence in the fundamental economic strength of the US economy. At the same time, however, he expressed concerns about the European economies and some discouragement about slower recovery of some major emerging economies.

One important implication, as correctly pointed out by a press reporter, would be lack of momentum of the recovery of our exports, in spite of the rapid depreciation of JPY for the past several months. Moreover, from broader perspectives, weakness of global economic recoveries might play some roles in enhancing the spillover impacts of prospective "tapering off" of "QE3" by the FRB.

From the Japanese point of view, however, the shifts in the focus of our discussion from the impacts of JPY depreciation on the global economies to the impacts of the global economic slowdown on our economy may also be the symptom that the initial phase of the QQE is already closing to the end with mixed performances with regard to generating higher expectation of inflation.

Author: Tetsuya Inoue
General Manager and Chief Researcher
Financial Technology and Market Research Department
Nomura Research Institute