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The BOJ's new policy framework — Different dimension

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Introduction

In spite of the diminishing expectation in both domestic and overseas markets, the BOJ announce the bold set of policy action, to say the least. I apologize for my belated Note for the obvious reasons. While I hope most of the readers may have read the policy statement in the meantime, I explain the major points below for the sake of efficient discussion later .

<Brief summary of the policy decision>

It should be noted that all the policy measures decided today are intended to achieve the inflation target within two years. At the same time, the operational target is changed from the level of O/N call rate to the amount of monetary base (MB). As a result, the forward guidance for the BOJ is to maintain the new framework until the 2% inflation by CPI is stably preserved.

The target amount of MB is ¥270tn at the end of CY 2014, approximately double the amount of that at the end of last December (¥136tn). It implies that the MB should be increased by ¥60tn to ¥70tn annually.

In order to inflate the amount of MB at such a rapid pace, the BOJ chose the JGB purchase operations as the major instrument. JGB purchases by the APP and as the Rinban are integrated to a single type of operation. At the same time, the range of eligible maturities of the JGBs is expanded (I will return to its detail). The BOJ will increase the JGB holdings by ¥50tn annually, which will require ¥7tn purchase in every month (according to the BOJ's estimates). As a result, the outstanding amount of the JGBs at the BOJ will reach ¥190tn at the end of CY 2014, again approximately double the size at the end of December (¥89tn).

On the credit market front, the BOJ will purchase ETFs and J-Reits by ¥1tn and ¥30bn respectively. Interestingly, the purchase operations of both corporate bonds and CPs are only marginally modified.

It would be needless to say that the APP was abandoned. At the same time, "Banknote rule" is "suspended" during the period when the new framework of the monetary policy is conducted. Another notable part of the policy statement is the BOJ's intension to reinforce the dialogue with the markets.

Discussion:

Let me discuss some major points of the policy decision.

Point 1: Achieving the target

Drastic reactions of the markets including ¥500 jump of our equity indices apparently imply that the policy decision today was surely a big surprise. Nevertheless, the market economists seem to wonder whether it is effective enough to achieve the inflation target in two years.

Naturally, their views are based on empirical analyses by econometric models. For example, an estimated "Philips Curve" suggests that we should have 4 to 5% economic growth in real terms to regain 2% inflation. Moreover, possible downward effects of long-term yields would not be large enough to accelerate our economic growth at such faster pace.

One implicit but important element is possibly further depreciation of JPY, which could have positive effects on our economy both through inflation of corporate profits and increase in exports to a certain degree. Nevertheless, there is a skeptic view among the economists that the multiplier may be small and the large enough depreciation of the JPY would not be accepted by the international financial community. In fact, some press reporters raised this core issue at the press conference today.

While Governor Kuroda's responses were not so clear, the readers should recall that there has been a discussion among the proponents of the aggressive monetary policy – those with "reflation" line of thoughts – that the size of the MB (or the balance sheet of the BOJ) should be doubled to reach 2% inflation. If you like to rationalize their views, you could refer to the money multiplier or something. Alternatively, we should take into account of possibly additional effects of monetary easing by negative real interest rates if our inflation expectation could be successfully improved.

All in all, however, the probability of achieving the goal is uncertain at best. The most successful outcome might be some positive rate of inflation in two years, partly assisted by the economic policy measures by the government. I believe that this kind of outcome is surely welcome by the general public and the politicians in the end.

Governor Kuroda may also think it is desirable for the BOJ to cling to achieving the inflation target for themselves. Otherwise, the BOJ could appear to escape from the mandate of monetary policy, which would prevent the drastic improvement of our inflation expectation that are crucial.

Point 2: Monetary base

One of the most interesting element of the policy decision is choosing the monetary base (MB) as the operational target. Domestic markets participants as well as economist who have long job experiences recall the famous theoretical debate between Professor Iwata, the current deputy Governor and Dr. Okina, who was the outstanding economist in the BOJ. Governor Kuroda should of course be aware of it.

In reply to the question at the press conference, Governor Kuroda emphasized that the correlation between the MB and the inflation rate has been confirmed in the academic community. Moreover, the MB is simple enough as a tool of communication with the markets.

In fact the author had expected that the BOJ might introduce the SOMA account like the Fed, by way of incorporating the APP and the JGBs held as the Rinban operations. My idea has a positive aspect of stronger controllability as the policy tool, and the BOJ's SOMA account could form an efficient instrument for dialogues with the markets. At the same time, however, the SOMA could appear quite similar to the APP, which the new BOJ may have liked to abandon at all.

In any case, selecting the MB as the operational target could face two kinds of issues. First, the developments of the amount of the MB could depend on the other factors than the BOJ could manage. Second, the correlation between the MB and the inflation rate would still to be tested under this special economic and financial environment.

I guess that Governor Kuroda rather decided to choose the MB by prioritizing the merits of having larger impacts on our inflation expectations, while he was in deed aware of the issues above.

Point 3: JGB purchase

As explained above, this is the core operation in the new policy framework, and it is substantially modified in most of its aspects. As the new operations, the BOJ will purchase the JGBs with the all range of maturities of fixed rate bonds, floating rate notes and indexed bonds. Its pace would be ¥7tn monthly, with the view to increase the outstanding amount by ¥50tn annually on the net basis.

At the same time, the BOJ will manage the operations so that the average maturity of their JGB holdings would extend to 7 years, which is approximately consistent with the aggregate outstanding of the JGBs. Apparently, the BOJ's idea is to have downward pressures on longer end of the yield curve, which is the same as the Fed in doing the LSAP.

We could claim its effects both from the point of view of the quantity and the quality of the new monetary stimulus. From the viewpoint of quantity, purchasing long-term bonds could technically contribute to achieving the MB target. The reason is that most of them would not be redeemed in two years. On the quality aspects, as Governor Kuroda reiterated, lower long term rates would stimulate a wide range of economic activities. Hopefully, the real rates could turn to be negative, if the inflation expectation improves.

In order to make the discussion fair, possible side effects should be reviewed. For this purpose, it would efficient to apply the criteria suggested by Chairman Bernanke at the latest press conference. In fact, he mentioned the risks associated with a large scale asset purchase: 1) triggering rapid inflation, 2) distorting functions of the markets and 3) destabilizing the financial system.

With regard to the risk of inflation, the case of the BOJ seems to be too early to discuss. Moreover, according to the forward guidance, the BOJ may suspend the JGB operations when our inflation rate gets closed to the target. Concerning the risk of distorting the market functions, the BOJ has introduced the detailed guideline of the JGB purchase. It was in fact announced later today.

Nevertheless, the risk of destabilizing the financial system may be a tough challenge. In fact, some participants of the fixed income markets express some concerns about possible corrections of the yields, when the yield of 10Y JGB hit the lowest level at 44bp today for the obvious reasons.

The BOJ did not specifically refer to this kind of risk in the press statement. In my view, this is a representative example of the clear contrasts of the characteristics of the two Governors. Mr. Kuroda may not like to refer to so many caveats in a front-loading manner, and he may think that the BOJ could modify the JGB operations when and if they identify some signs of the risks in the financial markets.

The more tough challenge would be the risk of monetization that Chairman Bernanke did not mention about. The BOJ's policy statement seems to be in line with the comments by Governor Kuroda: the BOJ would purchase the JGBs solely for the purpose of monetary policy.

It is, however, difficult to set any specific guideline by the BOJ, because the task of fiscal policy is solely delegated to the government. The BOJ could only vocally argue that the fiscal consolidation should be actively pursued (as the ECB). Moreover, if the risk of instability of our financial system is identified, it would be extremely hard for the BOJ to decline to purchase the JGBs for the different purposes. The BOJ has the another mandate of maintaining financial stability.

Point 4: Credit easing

As a reply to the question at today's press conference, Governor Kuroda explained the reason why the management of purchase operations across the range of credit assets are made different. From the viewpoints of the BOJ, the prices of the ETFs and J-Reits still contains some risk premia which should be properly addressed. In contrast, the yields of corporate bonds and CPs have less rooms to be addressed. This kind of view is fairly consistent with the markets views, and this is why the operations of corporate bonds and CPs face frequent under-subscriptions.

In addition, a senior official of the BOJ suggested that the increase in the scale of operations of the ETFs and J-Reits has the intension of driving inflation expectations, because their underlying assets are the stock and the real estate, which are the representative example of the "real" assets.

In any case, while the contribution of the credit easing to the quantitative aspects of the new framework would be limited, this part of the framework is still significant. The reason is that Governor Kuroda has been vocally argued the BOJ should purchase the kinds of assets less substitutable to the MB. In this respect, the readers may understand why the money market operation and the TB operation do not appear in the BOJ's balance sheet in the policy statement.

From the technical point of view, the markets pay close attention to the new practice of the operations of the ETF and J-Reit, because the detailed management is delegated to the Financial Market Department.

Point 5: Transparency

There has been a significant step forward in terms of transparency of the monetary policy. Combining the JGB operations (as discussed above) is the major example. Moreover, choosing the MB as the operational target and increasing the overall size of operations twice may be the elements of higher transparency, from the point of view of the BOJ. In fact, Governor Kuroda insisted that 2% inflation in 2 years by increasing the MB and the average maturity of the JGB holdings twice. Lucky number for the BOJ may be 2 for the moment. Last but not in the least, the press reporters may be impressed to find the chart of projection of the MB in coming years. It certainly has the different dimension.

Governor Kuroda and the BOJ will face the true challenge of transparency of the new policy framework in several weeks time, however, when their policy performance is reviewed at the Cabinet Office.

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