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QQE's sustainability

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Executive Summary



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As the BOJ's Q QE program approaches the third anniversary of its launch, concerns about how long the BOJ can continue purchasing JGBs have started to emerge. When explaining its policies, the BOJ must henceforth make a cogent case for their sustainability in addition to their effectiveness. This imperative will pose communication challenges for the BOJ.

How long can BOJ continue to purchase JGBs?

The BOJ's quantitative and qualitative easing (Q QE) program is approaching the third anniversary of its inception. Eschewing incremental monetary easing, the BOJ launched Q QE as a decisive short-term policy aimed achieving its 2% inflation target within two years. Q QE's prolongation has recently been drawing scrutiny because the inflation rate is far below the BOJ's 2% target and the BOJ has repeatedly extended its timeline for achieving its target.

Also under scrutiny is Q QE's sustainability. Specifically, how long can the BOJ continue purchasing JGBs? The BOJ currently continues to expand its JGB holdings by ¥80 trillion annually through its JGB purchasing operations. New JGB issuance is running at about ¥30 trillion per year net of refunding issuance. With the BOJ's JGB purchases outstripping new issuance, they will inevitably encounter supply limitations at some point.

Some take comfort in the fact that the BOJ's JGB holdings, while massive, account for around 30%¹⁾, far less than 100%, of total outstanding JGB issuance. However, the view that the BOJ's growing JGB hoard poses no problem as long as the BOJ owns less than 100% of outstanding JGB issuance is misguided for several reasons. First, outsized JGB purchases by the BOJ impair market function, as bond market participants have been warning since shortly after Q QE's launch. A second problem is policy credibility. If market participants perceive Q QE to be unsustainable, continued Q QE could trigger market volatility, most likely in the form of sharp rise in long-term interest rates that would defeat Q QE's original purpose. BOJ Policy Board members have expressed sustainability concerns at Monetary Policy Meetings (MPMs). According to the publicly released minutes of the January, February and March 2015

NOTE

1) The BOJ owns 33% of outstanding JGB issuance as of November 2015.

- 2) The minutes of the January 20-21, February 17-18 and March 16-17 2015 MPMs stated that, "A few [Policy Board] members noted that the feasibility of continuing JGB purchases into the future warranted attention, even though it seemed technically possible to continue such purchases for some time."
- 3) The minutes of the September 14-15 and October 6-7 MPMs stated that, "[One Policy Board] member expressed the recognition that there was a risk of term premiums increasing significantly if the possibility of the [BOJ] facing a limit on its JGB purchases was taken into consideration, and therefore, to enhance their sustainability, it was necessary for the [BOJ]—while announcing that it would continue with its JGB purchases for a while—to take action to reduce the amount of such purchases."
- 4) S. Arslanalp & D. Botman (2015), "Portfolio Rebalancing in Japan: Constraints and Implications for Quantitative Easing" (IMF Working Paper) and K. Iwata, I. Fueda-Samikawa & E. Takahashi (2015), "Nippon Ginko no Ryoteki Shitsuteki Kinyu Kanwa (QQE) Seisaku 2017-nen Nakaba nimo Ryoteki Genkai ni" (JCER).

- 5) Per the BOJ's Flow of Funds statistics (preliminary June 2015 data).

MPMs, Policy Board members were concerned about JGB purchases' sustainability by early 2015²⁾. At the September and October 2015 MPMs, one Policy Board member proposed reducing monthly JGB purchases to increase JGB purchasing operations' sustainability³⁾.

Third, given private financial institutions' collateral needs and life insurers' ALM (asset-liability management) programs, the private sector must retain at least some portion of its existing JGB holdings. Very interesting forecasts on this point have been published by IMF economists and the Japan Center for Economic Research (JCER)⁴⁾, both of which estimated the maximum amount of JGBs purchasable by the BOJ, taking into account factors such as collateral demand from private banks and life insurers' ALM requirements. The IMF estimates that the BOJ's JGB purchases will reach their limit in the 2017-18 timeframe; the JCER estimates that the limit will be reached by mid-2017. In contrast to the first two reasons, which are qualitative, the third reason is quantitatively based, giving more credence to concerns that the BOJ's JGB purchases will reach their limit before long. Twenty-fifteen was the year in which QQE's prolongation and sustainability started to garner concern.

FY2016 outlook: even if inflation rate rises toward BOJ's target...

In terms of the outlook for QQE's fourth year (FY2016) and beyond, we first consider the BOJ's policy options if, contrary to the BOJ's inflation forecasts, the inflation rate remains far below the BOJ's 2% target. Given such a scenario, many would automatically conclude that the BOJ must ease further. However, as long as the BOJ maintains a policy framework predicated primarily on quantitative easing, it does not have many available policy levers other than JGB purchases. While it could increase its ETF and/or J-REIT purchases, the BOJ has never regarded these assets as instruments of quantitative easing. Moreover, it is unclear how increased ETF/J-REIT purchases would affect real interest rates, QQE's transmission channel. Among non-JGB bonds, the BOJ could conceivably start purchasing municipal bonds and/or government-affiliated agency bonds, but their outstanding issuance as of June 30, 2015, was only ¥74 trillion and ¥77 trillion⁵⁾, respectively, or roughly ¥150 trillion in total. Municipal and agency bonds thus do not have much promise as quantitative easing instruments from the standpoint of available supply. The BOJ therefore may revise its quantitatively focused policy framework if it eases again.

Conversely, if the inflation rate rises toward 2% in accord with the BOJ's forecast as FY2016 progresses, the BOJ would tend to turn its attention to normalizing policy in

anticipation of its target's attainment. Unfortunately, however, we see little likelihood of such a scenario, given the likely adverse economic effect of the pending consumption tax hike (from 8% to 10%) in April 2017. After the consumption tax rate was raised from 5% to 8% in April 2014, the economy slid into a severe downturn, with GDP contracting at a 7.7% annualized rate in the second quarter of 2014. The economy is unlikely to avoid a recessionary relapse when the consumption tax rate is raised in 2017.

From such a standpoint, even if the inflation rate is rising toward the BOJ's target in the second half of FY2016, it would not be realistic for the BOJ to start preparing to normalize policy in the face of a near-term recession threat. In the second half of FY2016, the BOJ will presumably decide to ascertain the pending tax hike's economic impact before starting to normalize policy. It would likely wait at least until the 2017 second-quarter GDP statistics are released.

The problem, however, is that while the BOJ is gauging the tax hike's economic impact, its JGB purchases will be approaching their limit as estimated by the IMF and JCER. Even if the inflation rate is tracking in line with the BOJ's forecast in FY2016, the BOJ would likely ultimately be forced to prepare for a policy course correction.

Based on BOJ MPM minutes released to date (late November 2015), BOJ Policy Board members concerned about policy sustainability appear to be in the minority. In FY2016, however, policy sustainability will likely emerge as a more pressing concern as discussed above. The BOJ has hitherto been demonstrating the effectiveness of its policies and its commitment to early attainment of its inflation target by purchasing JGBs on a scale that does not seem sustainable for much longer. Whether the BOJ steps up QQE again or revises its policy framework, it will henceforth have to justify its policies in terms of not only their effectiveness but also their sustainability. Having to thus change how it communicates with the markets will likely pose challenges for the BOJ.

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