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Press conference by Governor Kuroda – With negative rate...

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Introduction

The BOJ's policy decision today surprised the domestic markets again, not only because there had been a pessimism about flexibility of the QQE, but also because Governor Kuroda had clearly denied the possibility of negative policy rate at a number of occasions.

Outlook of Economy

The BOJ conducted the quarterly review of its economic outlook at the MPM today. Interestingly, it maintained the main scenario for a large part. Median numbers of the expected growth rate of real GDP from FY2016 to FY 2017 are +1.5% and +0.3%, and they were +1.4% and +0.3% at the time of October MPM.

Meanwhile, the MPM made a substantial downward revision on its outlook of inflation. For FY2016, it is changed to +0.8% from +1.4% as median. For FY2017, it is also revised from +3.1% to +2.8%. Nevertheless, Governor Kuroda explained that its major reason is delayed recovery of crude oil prices.

Nevertheless, the new outlook admits the balance of risk is downside for the moment. First of all, it mentions a potential negative impacts from overseas emerging economies. While the BOJ still expects their gradual recovery throughout this year, it has come to be concerned about the risk of its delay and/or further deterioration of such economies.

Moreover, the BOJ started to worry about the impacts of instabilities of global financial markets in these weeks on the sentiment of firms. It could become crucial for the BOJ, because their supports through raising wages and increasing business investment are absolutely necessary to achieve the inflation target within the committed time frame.

Monetary Policy Decision

Governor Kuroda explained at press conference that the concerns about risk of further delay in achieving the inflation target, resulting in preventing improvements in inflation expectation, was the reason for enhancement of the QQE.

It should be noted that the MPM delayed the expected time of achieving the target from "sometime in later FY 2016" to "sometime in early FY2017", in spite of the policy decision today. According to the outlook, it seems to be purely "technical" due to delayed recovery of crude oil price. Nevertheless, policy decision is expected to prevent its second-round effects on inflation expectations.

In any case, the MPM's choice of the introduction of negative policy rate is the most interesting point. Governor Kuroda insisted that the BOJ intends to utilize this option to cause further downward pressure on JGB yield curve. Policy statement today also implies that adding this option to the toolkit of the QQE could enhance its flexibility. It is intended to correct the pessimism about the QQE in terms of its sustainability. As a result, the BOJ's commitment to achieve the target would be more credible, which could pave the way to improving inflation expectations.

Author would like to add an implicit reason. Ironically, upward pressures on JPY rates in these weeks (for obvious reasons) may have reduced the concerns about side-effects of JPY's depreciation both from international and domestic perspectives. As evidenced by today's market dynamics, negative interest rate policy would have most powerful effects through foreign exchange rates. If JPY rates had continued to depreciate until recently, today's policy action might have been a tough challenge.

Technical Aspects

There are important reasons why the framework of negative policy rate by the BOJ is complicated. First, the potential cost to financial institutions could be extremely large, because of the huge size of current account balance. The outstanding amount was ¥250tn approximately at the end of last year, about 50% of nominal GDP. Second, the BOJ introduced the QQE first. Then, an introduction of negative policy rate could become unfair, because financial institutions could not escape its cost. Third, the BOJ maintains quantitative measure, which implies that the cost of negative rate could continue to grow unless some measures are taken.

These considerations led the BOJ to introduce the three-layer system of policy rate. "Basic Balance" as the first layer is fixed at the size as the average amount of current account balance for CY2015. And the BOJ continues to pay +0.1% interests on this balance. Such design is intended to deal with the issues above (first and second issues).

"Macro Add-on Balance" consists of 1) required reserves, 2) fund provided by the BOJ as stimulative measures for bank lending, and 3) a certain ratio of "Basic Balance". Its outstanding bears 0.0% interest rates. Inclusion of 2) above is intended not to prevent usage of the measures. Moreover, 3) above is intended to reduce the cost of negative rates to financial institutions by way of its regular adjustments.

Finally, Policy-Rate-Balance as the residual of current account balance bears -0.1% interest rate. It should be noted that the potential cost for financial institutions would not be large, because the outstanding amount of Policy-Rate-Balance would grow from virtually zero, and could be managed within a certain amount by controlling the size of "Macro Add-on Balance" (by element 3) above in particular).

Initial assessment

The BOJ's new scheme of negative policy rate is designed well in taking balance between the intended policy effects and the costs to financial institutions under our special financial conditions as discussed above. From broader perspectives, as Governor Kuroda mentioned, introduction of negative interest rate to the QQE could enhance its flexibility. It could possibly imply that the BOJ has come to realize that the battle against low inflation would take longer time and it is necessary to have sustainable framework of monetary policy.

There is also a sign of evolving strategy of the QQE. In contrast to its simple and straightforward manner of policy messages in earlier years to stimulate inflation expectations, the QQE has become somewhat complicated with potential taste of fine-tuning whose effectiveness would be tested.

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