Notes on Financial Markets Vol.102

Press conference by Governor Kuroda – Underlying inflation

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Introduction

The MPM decided to maintain the QQE as widely expected. Nevertheless, markets appeared to pay attention to Governor Kuroda's comments largely from the viewpoints of communication, after some debates over the benefits and costs of another round of stimulus (when necessary).

Let me discuss the points of Governor Kuroda's press conference today as usual.

Effects and side effects of the QQE

Several press reporters raised this issue that was carried over from the previous conference in January. Governor Kuroda reiterated that the QQE have been stimulating our economic activities both through depressing long-term nominal yields and supporting inflation expectations. He also referred to some signs of portfolio rebalancing in terms of bank lending and/or securities investments. All in all, he appeared to be confident in the role of the QQE as economic policy.

From a technical viewpoint, it is interesting to note that Governor Kuroda expressed his view that the policy effects will continue to develop. A candidate reason would be the QQE has "stock" effects on financial system and economy. Alternatively, we could think that the QQE has some time lags before making meaningful impacts on our economy. Gradual but continuous improvements of corporate sentiments seem to be consistent with the alternative view.

Meanwhile, some press reporters expressed their concerns that depreciation driven by the QQE has become rather harmful. The idea is in line with the comments outside the BOJ in recent weeks. Governor Kuroda explained that it would be inevitable to observe a diversified balance of benefits and costs across the economy. And he insisted that the level of foreign exchange rate would not have substantial benefits or costs as long as it is consistent with economic fundamentals.

Governor Kuroda thus effectively avoided to repeat the previous message that depreciation of JPY would have benefits on net. Depreciation itself is apparently beneficial to achieving the inflation target, and he insisted the portfolio rebalancing as a pillar of the QQE's effects as above. Nevertheless, depreciation would be costly for recovery of private consumption, because the improvement of nominal wages substantially lags behind.

Discussion on another round of additional stimulus

Readers may remember that this is another carried-over issue. At the press conference in January, a number of press reporters criticized the BOJ, because, in their view, no policy action would not be consistent with substantial fall in inflation rate since the additional stimulus in October 2014.

This time, the tones of voices by press reporters sounded milder, probably because our economy is on a better track of economic recovery. A few reporters asked Governor Kuroda, however, if the BOJ is ready to enhance the QQE when inflation rate becomes lower. In fact, we could observe negative rate of CPI inflation as early as this spring even if crude oil prices would stabilize around the current level.

In response, Governor Kuroda explained that the BOJ is pursuing 2% inflation in a stabilized manner, while they are making efforts to achieve 2% inflation as early as possible. Moreover, he insisted that underlying inflation is the important concept with this regard. Governor Kuroda further referred to aggregate demand/supply gap and medium-term inflation expectation as major elements for underlying inflation. Lastly he added that the BOJ would adjust the QQE without hesitation if something happens to underlying inflation.

All in all, Governor Kuroda effectively explained that the BOJ is pursuing 2% underlying inflation driven by these two real factors. As a result, the BOJ's reaction to crude oil price developments, especially when it would fall further, would be different whether they would affect underlying inflation or not. According to this line of idea, both no policy action for now and additional stimulus in October 2014 are consistent, because economic conditions are different with each other.

Press reporters appear to understand this idea. Moreover, the markets also seem to digest it, according to the price actions at major financial assets during the press conference today. However, it may still be too early to expect that the BOJ could avoid tough times of communication in the future. Underlying inflation is conceptually clear but sometimes uncertain in practice. Among all, we may not be able to be confident in the robustness of our economic recovery when our inflation rate is going down in coming months.

Market function

As second to the last question, a press reporter raised the issue of function of JGB market. He referred to recent rise in volatilities in long-term yields since the auction several weeks ago, in addition to the reduction of turnover in cash market during the period of the QQE.

In reaction, Governor Kuroda expressed his view that JGB yields have been affected by gradual rising yields of the US treasury notes in recent weeks. Moreover, he explained that JGB yields are expected to regain stability, and that the BOJ would not be so concerned about the liquidity of JGB markets.

In general, a central bank intervenes in the market, because they understand the policy effects would be larger and more important than its potential costs. And it would also be the case with the QQE for the BOJ. Nevertheless, the balance of benefits and costs would not be static, and this is the reason why Governor Kuroda insisted the importance of frequent dialogue between the BOJ and the markets.

Furthermore, if the issue of market function has something to do with the incentives of financial institutions to participate in the purchase operations by a central bank, it would have some implications for sustainability of a large scale asset purchase. This could be an emerging issue for the QQE if the BOJ keeps the current framework for coming years.

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