Mizuho Economic Outlook & Analysis

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Bank of Japan's new leadership nomination underscores intention to maintain current monetary policy stance

Vice Governor Wakatabe emphasizes quantity but no change in policy direction

< Summary >

- The Japanese government indicated its intention to maintain the current policy by reappointing Bank of Japan Governor Haruhiko Kuroda to a second term. The government also nominated Masazumi Wakatabe, an advocate of massive monetary easing, as deputy governor, most probably to contain growing market speculation that the Bank will modify its current policy.

- Although Mr. Wakatabe insists on expanding the purchase of Japanese government bonds (JGBs), the Bank may find it more difficult to increase its purchases with financial institutions no longer slashing their JGB holdings. Therefore, it is highly unlikely that the Bank will achieve its additional JGB purchase target.

- While the yield curve has not steepened since the Comprehensive Assessment, the potential side effects of the prolonged ultra-low interest rate policy are the main concern. But given next year's rise in the consumption tax rate, the Bank of Japan will probably not be able to revise its current monetary policy.

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1. Reappointment of the BOJ governor emphasizes the maintenance of its current policy

On February 16, the Japanese government nominated candidates for the next Bank of Japan's governor and deputy governors, whose terms of office will expire in March and April, respectively. The reappointment of the current governor, Haruhiko Kuroda, was in line with market expectations, while the candidates for deputy governors drew more attention, with the promotion of the current executive director Masayoshi Amamiya and the new appointment of Masazumi Wakatabe, a professor at Waseda University and an advocate of reflation, as successor to the current deputy governor Kikuo Iwata. Looking at the postwar list of Japan's central bank governors, the governor has been picked alternately from candidates in the Ministry of finance and the Bank of Japan (**Chart 1**), and the reappointment of the current governor will be the first time since Governor Yamagiwa served two terms. Going forward, the Bank's proposed candidates will formally take office after hearings at the steering committees in the upper and lower houses and majority approval at the plenary session of the House of Representatives and the House of Councillors.

Chart 1 List of Bank of Japan Governors

Name	Appointment	Retirement	Reason for retirement	Former position
Eikichi Araki	1945/10/9	1946/6/1	Unknown	Executive Director, Bank of Japan
Hisato Ichimada	1946/6/1	1954/12/10	Voluntary retirement	Executive Director, Bank of Japan
Eikichi Araki	1954/12/11	1956/11/30	Voluntary retirement	Chairman, Tokyo Electric Power Company
Masamichi Yamagiwa	1956/11/30	1964/12/17	Voluntary retirement	Administrative Vice Minister of Finance
Makoto Usami	1964/12/17	1969/12/16	Expiration of term	President, Mitsubishi Bank
Tadashi Sasaki	1969/12/17	1974/12/16	Expiration of term	Deputy Governor, Bank of Japan
Teiichiro Morinaga	1974/12/17	1979/12/16	Expiration of term	Administrative Vice Minister of Finance
Haruo Mayekawa	1979/12/17	1984/12/16	Expiration of term	Deputy Governor, Bank of Japan
Satoshi Sumita	1984/12/17	1989/12/16	Expiration of term	Administrative Vice Minister of Finance
Yasushi Mieno	1989/12/17	1994/12/16	Expiration of term	Deputy Governor, Bank of Japan
Yasuo Matsushita	1994/12/17	1998/3/20	Voluntary retirement	Administrative Vice Minister of Finance
Masaru Hayami	1998/3/20	2003/3/19	Expiration of term	Executive Director, Bank of Japan
Toshihiko Fukui	2003/3/20	2008/3/19	Expiration of term	Deputy Governor, Bank of Japan
Masaaki Shirakawa	2008/4/9	2013/3/19	Voluntary retirement	Deputy Governor, Bank of Japan
Haruhiko Kuroda	2013/3/20			Vice Minister of Finance for International Affairs

Source: Made by MHRI based on the Bank of Japan and other sources.

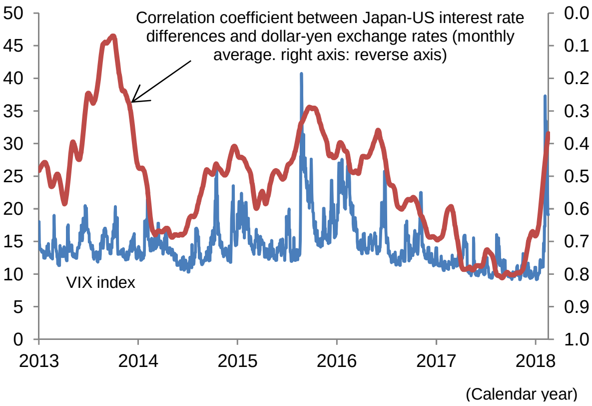
As investors mainly overseas strengthen their views on the Bank of Japan shifting its policy to exit from the current monetary easing policy, and the yen continues to rise in the foreign exchange markets, it seems that the Abe administration wants to dispel such speculation by showing its stance on maintaining the current policy through the reappointment of Governor Kuroda to another term and the nomination of Mr. Wakatabe, an advocator of aggressive monetary easing, as deputy governor. But with the reappointment of Mr. Kuroda to a second term falling in line with market predictions, its impact on the dollar to yen exchange rate has been limited. The current rise in the yen seems more attributable to risk aversion following the sharp drop in stock prices and the depreciation of the dollar out of concerns over the deteriorating state of US finances. Correlation between the dollar to yen exchange rate and the Japan-US interest rate difference tends to decline when the VIX index rises (**Chart 2**), and therefore we hold it is difficult to affect the current foreign exchange rate by controlling the monetary policy only.

BOJ Executive Director Amamiya has been engaged in planning and coordinating a wide array of monetary easing measures. Beginning from quantitative and qualitative monetary easing in 2013, various policy ideas adopted by the Bank of Japan are said to have been originated with Mr. Amamiya. Concerning the yield curve control policy, Mr. Amamiya presented the concept of natural yield curve and said he would investigate the most appropriate interest rate level. In light of his ability to explain monetary policy in a comprehensible manner, we believe Mr. Amamiya will be able to fully display his abilities when communicating the Bank’s policy to the market, a task of ever-growing importance, when the Bank changes its policy by raising the target long-term interest rate.

On the other hand, the nomination of Mr. Wakatabe as deputy governor can be viewed as an attempt to contain growing market speculation that the Bank will move to exit from its current policy by employing an advocator of huge monetary support. At the same time, it can also be seen as a move to stop any potential shift in the current policy within the Bank due to rising concerns over the negative side effects of the current ultra-loose monetary policy. In January’s Monetary Policy Meeting, it was argued that the Bank should reassess its ETF purchases and the level of long-term interest rates. Expanding this argument might trigger the movement to revise the current policy. Mr. Wakatabe stated, “Although the Bank has not yet attained its inflation target, we no longer see deflation in the sense that prices continue to fall consistently. The job situation has improved, the number of bankruptcies has declined, and corporate earnings have increased,” thereby giving a positive assessment of the Bank’s current policy (**Chart 3**).

Japan's current ambassador to Switzerland, Etsuro Honda, was also considered a deputy governor candidate for the BOJ, but with his past remarks suggesting the possibility of a “helicopter drop,” an unconventional tool of monetary policy, he was scratched from the list of candidates out of concern that his appointment would raise uncertainties about the current policy. “Once the government decides to raise the consumption tax, it is essential to achieve the inflation target of 2 percent at all costs to minimize its damage. The government must take fiscal measures to generate synergies. If the government issues more JGBs, the Bank of Japan is ready to buy any additional issuances." His close relationship with Prime Minister Abe may be another factor why he was dropped from the nomination list for the next deputy governor.

Chart 2 Correlation between Japan-US long-term interest rate differences and dollar-yen



Source: Made by MHRI based on Bloomberg.

Chart 3 Remarks by Mr. Wakatabe on monetary policy

Current policy	・The Bank has yet to attain its inflation target, but we no longer see deflation in the sense that prices continue to fall consistently. The job situation has improved, the number of bankruptcies has declined, and corporate earnings have increased. Excessive appreciation of the yen has been corrected, and stock prices have also gone up. ・The BOJ's 2 percent inflation target is appropriate. If the target rate were lowered to 1 percent, the Bank would not be able to even achieve the 1 percent target. ・The negative interest rate policy is doubtful given its unclear effects.
Policy management in the future	・It is necessary to adopt powerful easing measures to absorb the negative impact of the consumption tax hike while pushing inflation to 2 percent. ・Quantitative and qualitative expansion is effective. We will raise the purchase amount of JGBs from 8 trillion yen a year to 9 trillion yen. It is also worth studying the possibility of increasing the range of assets subject to purchase.
Consumption tax hike	・To ensure that Japan escapes from deflation, the government should introduce fiscal stimulus measures to improve the synergistic effects with monetary easing. The consumption tax hike set for 2019 should be postponed. ・GDP growth is necessary to achieve fiscal consolidation on a sustainable basis.

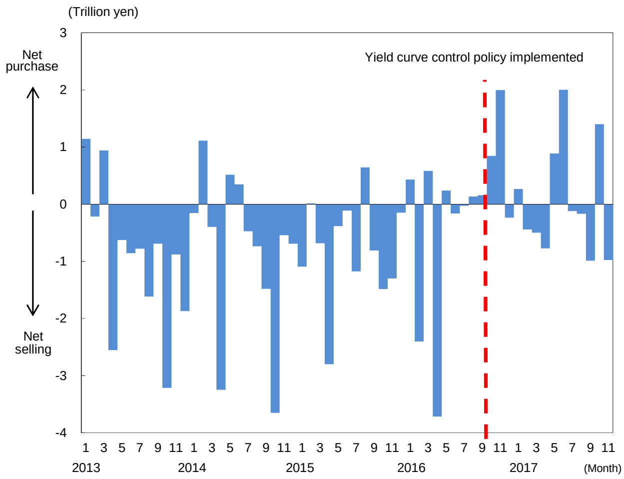
Source: Made by MHRI based on various media sources.

2. Increasing the purchase amount of JGBs is becoming difficult

The Bank of Japan's new administration will likely stick to the current policy by continuing to aim at achieving the 2 percent inflation target. Although Mr. Wakatabe is asking for a further increase in the purchase amount of JGBs, Goushi Kataoka is the only current Policy Board member to adopt a similar stance, greatly lowering the possibility of quantitative expansion. Mr. Kataoka insists on a lower yield for JGBs with a maturity longer than 10 years, but he has not made a formal proposal at the Monetary Policy Meeting. Looking at the net purchase amount of mid- to long-term JGBs (**Chart 4**), it seems that the downward trend of JGBs held by financial institutions (city banks), which have been the source of JGB acquisition for the Bank of Japan thus far, is coming to a halt. Since financial institutions need to hold a certain amount of JGBs to cover their own security requirements, it is becoming more difficult for the Bank of Japan to acquire JGBs. The Bank's net JGB increase in 2017 totaled 58 trillion yen, falling short of the Bank's JGB net purchase target of 80 trillion yen significantly. Since the redemption amount of the JGBs held by the Bank of Japan will increase, and there will be less JGB issuance in the market in 2018, the Bank's net purchase is expected to fall below 40 trillion yen.

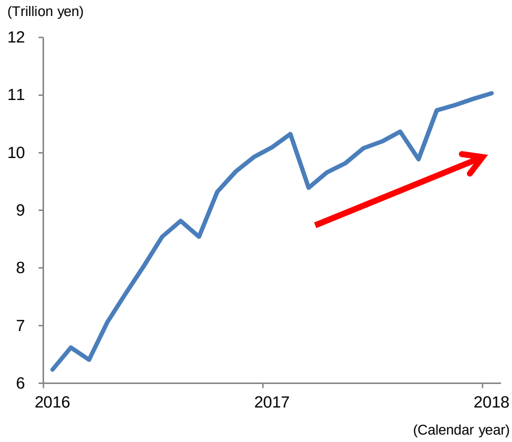
If the Bank is forced to buy more JGBs, their purchase value will rise and possibly push the Bank's redemption burden even higher. The redemption burden, which is calculated by the difference between the face value of JGBs owned by the Bank of Japan and their acquisition value, has expanded since the introduction of the negative interest rate policy in 2016 (**Chart 5**). The Bank of Japan does not make market valuations of JGBs, so there is no risk that unrealized losses will surface. However, if the Bank continues buying JGBs at high prices to realize its large-scale JGB purchase program, it may become a factor in lowering JGB returns, since the Bank will need to redeem the difference between the JGB's face value and the acquisition value by the maturity date of the JGBs it owns.

Chart 4 Net purchase of mid- to long-term bonds by city banks



Source: Made by MHRI based on the Japan Securities Dealers Association.

Chart 5 Estimate of the redemption burden of JGBs



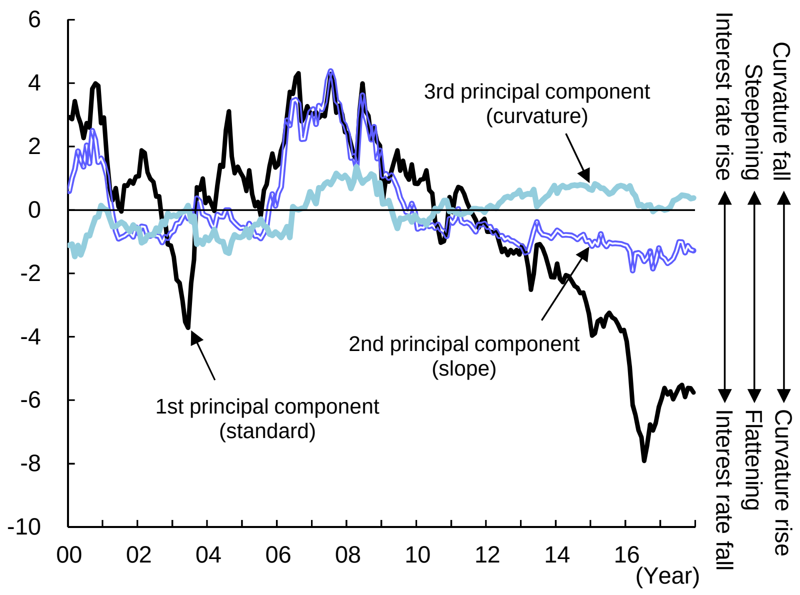
Note: The difference between face value and acquisition value from *Japanese Government Bonds Held by the Bank of Japan* and *Bank of Japan Accounts (Every Ten Days)*.
Source: Made by MHRI based on the Bank of Japan.

3. Policy revision by the Bank of Japan has become more challenging

Ever since Governor Kuroda referred to the reversal rate concept last November, the market has been more alert to the possibility that the Bank of Japan will curtail its ultra-easy monetary policy. Although Governor Kuroda said, "Since the achievement of the 2 percent price stability target still seems distant, we are not yet at the stage to investigate the timing of an exit or other subsequent measures," market speculation that the Bank will modify its monetary policy is strong, particularly among foreign investors. While the yen continues to rise due to the sharp drop in stock prices after the hike in the US Treasury bond yield, we hold that the Bank will not be able to adjust its monetary policy in the immediate future.

When we break down the spot rates of JGBs up to 30 years into the first principal component ("standard factor" that defines the height of the entire curve), the second principal component ("slope factor" that defines the angular degree of the curve," and the third principal component ("curvature factor" that defines the degree of curvature of the curve), the "slope factor" flattened after quantitative and qualitative monetary easing and has remained almost unchanged after implementing yield curve control in September 2016 (**Chart 6**). In its Comprehensive Assessment conducted in September 2016, the Bank disclosed its analysis and concluded that falling investment returns by life insurance companies and pension funds due to flattening of the yield curve, including the ultra-long-term zone, would exert a negative impact on economic activity by affecting the business sentiment. In light of this analysis, the Bank adopted the yield curve control policy with a view to steepening the yield curve. Nevertheless, it seems that the yield curve has not steepened to the extent expected by the central bank. The Bank of Japan is believed to be counting on the timing to steepen the yield curve by lifting the target long-term interest rate after reducing the purchase amount of JGBs, but communication with the market is becoming increasingly difficult.

Chart 6 Principal component analysis of the yield curve



Source: Made by MHRI.

Concerning policy management by the BOJ in the immediate future, we expect the Bank to reiterate its current policy while watching the trend of wage increases in the spring wage negotiations and price setting by companies, given that the judgement on consumption tax hike will be made in the latter half of the year. In the phase where upward pressure on the yen interest rate strengthens due to overseas interest rate hikes, the Bank will likely adopt the measure of fixed-rate purchase operation and restrain rises in the interest rate. The Outlook Report to be issued in April will include the Bank's economic and price outlook up to FY2020.

According to the latest available Outlook Report, the Bank stated that the price stability target is expected to be met in around FY2019, but seven of the nine Policy Board members including the governor judged the downward risk to be high. In the Outlook Report issued in January 2018, the Bank presented its forecast that economic growth in FY2019 would slow down compared with FY2018. The Bank projected that business fixed investment would likely decelerate, mainly reflecting cyclical adjustments in capital stock after the period of prolonged economic expansion and Olympic Games-related demand peaking out. Household spending is also likely to begin declining in the second half of the FY2019 affected by the scheduled consumption tax hike. The Bank's outlook on the economy and prices under its new leadership is expected to draw much attention in the market.

4. The new governor needs to consider the Bank's time constraints when managing the monetary policy

The issue the new governor needs to address is to maintain the monetary easing policy until the Bank's price stability target is met. But over the next five years, Governor Kuroda needs to be aware of the time constraints affecting the BOJ when making policy decisions. MHRI forecasts that the global economy will continue to expand toward FY2019, but growth momentum will gradually moderate due to the Chinese economy slowing down and the IT cycle peaking out[1]. We do not know whether the global economic recovery will last for another five years.

It should be added that although the Federal Reserve Bank is working on interest rate hikes, core inflation has not yet reached 2 percent, so the Federal Open Market Committee (FOMC) under the new leadership of Jerome Powell is expected to reconsider the path of interest rate hikes. As the FRB will temporarily refrain from raising interest rates and the value of yen is expected to rise gradually against the US dollar, it is predicted that the Bank of Japan will find it more difficult to change its policy day by day. If the Bank continues to overemphasize its price stability target and

[1] "FY2017, FY2018, FY2019 Economic Outlook – While the global economy will continue to expand, keep a close eye on shifts in the financial market – (Summary)," Mizuho Research Institute, February 15, 2018. https://www.mizuho-ri.co.jp/publication/research/pdf/eo/EconomicOutlook1802s.pdf

maintains its current policy, there will be less room for adjustment if the global economy begins to contract. In this case, Japan’s government is projected to expand its fiscal stimulus measures and ask the central bank to consider adopting a helicopter-drop style of policy. While the new governor carries the mission to realize the price stability target as early as possible, it will also be important to study what alternative measures the Bank of Japan may take in the case where downside factors emerge in the economy.