Mizuho Economic Outlook & Analysis

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Commitment to 2% price stability target to be tested with BOJ "September Comprehensive Assessment"

< **Summary** >

◆ The Bank of Japan (BOJ) decided on additional easing measures including an increase in purchase amount of ETF at its Monetary Policy Meeting held on July 28 and 29.

◆ The BOJ also maintained its schedule for achieving the price stability target of "during FY2017", but flagged a high level of uncertainty and committed to a comprehensive assessment of the policy effect for the next meeting in September.

◆ The risk of market volatility has increased with the awareness of current policy "limitations" and prospect of new "easing policies".

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1. Additional easing policies consider “confidence in policy” and “market disappointment”

The BOJ implemented additional easing measures at its Monetary Policy Meeting held on July 28 and 29, deciding to increase purchases of exchange-traded funds (ETF) and enhance its lending program to support growth in US dollar funding (Refer to Chart 1). The measures were attributed to increased uncertainties surrounding overseas economies following the UK referendum to leave the EU and a growing need to prevent such uncertainties leading to deterioration in business confidence and consumer sentiment. The BOJ considered an increase in the purchases of ETF to be the most effective policy.

The underlying movement in prices, such as the Consumer Price Index (excluding fresh food and energy), was evident prior to the Monetary Policy Meeting, and there was clear indication of a downturn in the indices being monitored by the BOJ. There were increased market expectations that the BOJ would implement additional easing measures such as increasing the level of negative interest rates. However, concerns were also raised about the negative impact of lowering the level of interest rates in negative territory such as the downward pressure on financial institution profits and the lifestyles of pensioners. The market also doubted the sustainability of outright JGB purchases, so these measures were not considered to be options for additional easing. Nevertheless, the downward trend in prices meant any delay in additional easing measures would raise questions about the ability to achieve the price stability target and inevitably have an impact on “confidence in policy”. On the other hand, there was also a desire to avoid “market disappointment” that would be caused by delaying additional easing when economic stimulus measures are being implemented by the government. This was behind the decision to ease at this time.

The FY2016 outlook for economic activity and prices was downwardly revised in the Outlook for Economic Activity and Prices (Outlook Report), released following the Monetary Policy Meeting, but the BOJ kept its forecast timing to achieve the price stability target of during FY2017 (Refer to Chart 2). The rate of economic growth had been lowered for FY2016 because of the absence of front-loaded demand due to the postponement of the previously planned consumption tax hike. However, there was a substantial upward revision for FY2017 from +0.1% to +1.3%, factoring in the impact of government economic stimulus. On the other hand, the outlook for prices is lower for FY2016 due to the appreciation of the yen and the delay in the timing for inflation expectations to improve, while the projected rate of increase for FY2017 is more or less unchanged. Consequently, the projected timing to achieve the price stability target remains unchanged (during FY2017). However, this is accompanied by considerable uncertainties including those surrounding the prospects for overseas economies and the view that Japan tends to be more influenced by the actual inflation rate than the expected inflation rate.

2. Remaining options given the ‘limitations’ of the negative interest rate policy

Given the increased uncertainty about achieving the price stability target, the BOJ has decided to conduct a ‘comprehensive assessment’ of the policy effects at the September Monetary Policy Meeting (September 20 and 21) with a view to achieving the “price stability target” of 2% at the earliest possible time. The financial markets are already becoming aware of the ‘limitations’ of current policy and anticipate that new monetary easing measures will be implemented at the September Monetary Policy Meeting based on the comprehensive assessment. Mizuho Research Institute predicts an expansion of the assets targeted for outright purchases such as corporate bonds, which would be a way to reduce corporate funding costs without increasing the level of negative interest rates. However, there is also the prospect of policies that could be considered by the market participants to be ‘helicopter money’ in order to boost inflation expectations.

The BOJ originally planned for financial institutions to lower the interest rates on their loans due to the negative interest rate policy. While the adoption of negative interest rates may have caused long-term yields to have fallen further than anticipated, depreciation of the yen has been difficult to achieve given the US ongoing stance towards a weak dollar. The impact of negative interest rates on the foreign exchange markets has waned. Therefore, expansion of the targets for outright purchases such as corporate bonds and CPs etc. would be an option for reducing the cost of funds. The corporate bond market was in the order of 57 trillion yen as at the end of FY2015, which is miniscule compared to the JGB market, so the policy impact will be limited. Consequently, we also see scope to expand the range of assets targeted for outright purchase to financial institution loans and residential mortgages.

On the other hand, Quantitative and Qualitative Monetary Easing has focused on a mechanism to boost inflation expectations through a strong commitment by the BOJ to achieving the price stability target. However, given the magnitude of the adaptive formation mechanism for formulating inflation expectations, a decline in the rate of inflation due to weaker oil prices for example would once again make it hard to boost inflation expectations. Therefore, options such as ‘helicopter money’ could be considered as policies able to have a strong influence on moving inflation expectations.

A helicopter money policy is one that supports government funding with the central bank underwriting government bonds. Such measures help to avert concerns about deterioration in public finance and are likely to foster the spread of fiscal policy. On the other hand, implementation requires caution since such measures could reportedly increase the risk of hyperinflation due to a reduction in the government's fiscal consolidation and ongoing increase in fiscal spending. However, inflation expectations could also rise due to the awareness of inflation risk.

The BOJ is prohibited from directly underwriting JGBs under the Public Finance Law, which makes it hard to implement helicopter money. However, the BOJ could implement policies that would give the notion of helicopter money such as introducing a time frame for maintaining the balance of assets purchased, and reinvesting the amount of JGBs redeemed until considerable time has passed after achieving the inflation target. Apart from this, the BOJ could cancel the target for expanding the monetary base, and target interest rate levels where there would be arrangements for unlimited purchases of JGBs were interest rates to go above the target level.

Chart 1: Additional Easing Measures from the Bank of Japan

Easing Measures	Before July 29, 2016	Decided on July 29, 2016
Negative interest rates	-0.1%	Unchanged
Annual increase in amount of ETF and REIT outstanding	ETF: About 3.3 trillion yen REIT: About 90 billion yen	<u>ETF: About 6 trillion yen</u> REIT: Unchanged
Annual increase in amount of JGBs outstanding	80 trillion yen	Unchanged
Purchase of CP and corporate bonds	Outstanding amounts maintained Corporate bonds: About 3.2 trillion yen CP: About 2.2 trillion yen	Unchanged
Lending program to support growth in US dollars	$12 billion	<u>$24 billion</u>

Note: Underlined text indicates the changes made in July 2016
Source: Made by Mizuho Research Institute Ltd. (MHRI) based upon the Bank of Japan, Enhancement of Monetary Easing

3. Market sentiment is likely to waver with 'hint' of new easing policies

The types of policies that will be instituted in response to the BOJ's comprehensive assessment are currently unknown. However, the government plans to submit/deliberate economic policies at an extraordinary session of the Diet around the time of the September Monetary Policy Meeting. The BOJ, which stresses the synergies of government economic policies and monetary easing, is highly likely to implement some form of additional monetary easing. Reasons given for the comprehensive assessment in the 'Summary of Opinions at the Monetary Policy Meeting on July 28 and 29, 2016', released on August 8, were “It is necessary for the Bank to conduct a comprehensive assessment from the perspective of what should be done to achieve the price stability target of 2 percent at the earliest possible time” and “In planning policy actions to achieve the price stability target, a comprehensive assessment of the developments in economic activity… is essential”, ‘hinting’ at the likely implementation of some form of policy.

This has led to an increase in market concerns about the monetary policy outlook. Bond market volatility has increased due to concerns about a possible reduction in monetary easing policies that could include a reduction in the outright purchases of JGBs. BOJ Governor Kuroda’s post Monetary Policy Meeting press conference and comments by BOJ Deputy Governor Iwata suggest there is little likelihood of the 2% price stability target being lowered nor is the negative interest rate policy likely to be withdrawn. However, concerns about the outlook for monetary policy persist and we anticipate the bond market to waver ahead of the September Monetary Policy Meeting on speculation about monetary policy. The BOJ will need to deal with the increased market anxiety by appropriately conveying the intent of the comprehensive assessment. The BOJ’s communication ability will be tested in the lead up to achieving the price stability target.

Chart 2: Outlook Report (July 2016)

		Real GDP	CPI (all items less fresh food)	Excluding the effects of the consumption tax hikes
FY2016		+0.8 to +1.0 (+1.0)	0.0 to +0.3 (+0.1)	
	Forecasts made in April 2016	+0.8 to +1.4 (+1.2)	0.0 to +0.8 (+0.5]	
FY2017		+1.0 to +1.5 (+1.3)	+0.8 to +1.8 (+1.7)	
	Forecasts made in April 2016	0.0 to +0.3 (+1.0)	+1.8 to +3.0 (+2.7)	+0.8 to +2.0 (+1.7)
FY2018		+0.8 to +1.0 (+0.9)	+1.0 to +2.0 (+1.9)	
	Forecasts made in April 2016	+0.6 to +1.2 (+1.0)	+1.0 to +2.1 (+1.9)	

Note: Year-on-year % change. Forecasts of the Majority of Policy Board Members. Figures in brackets indicate the median of the Policy Board members' forecasts (point estimates)
Source: Bank of Japan, Outlook for Economic Activity and Prices (Outlook Report)