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Mizuho Economic Outlook & Analysis

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Sustainability of Quantitative and Qualitative Monetary Easing

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1. Bank of Japan focuses on basic price trend

While an increase in the consumer price index remains subdued on the back of falling crude oil prices, the Bank of Japan (BOJ) is keeping on the sidelines to measure the effect of its monetary easing policy. BOJ Governor Haruhiko Kuroda stated in the press conference after the Monetary Policy Meeting (held on March 16 and 17) that “the basic price trend is improving. It is highly likely that the inflation target of 2% will be achieved within FY2015.” This suggests that he feels no need to change the current monetary policy as long as the “basic price trend,” which is defined by the output gap and the expected medium-to-long-term inflation rate, continues to improve toward the price target of 2%. The BOJ maintains its view that inflationary expectations have remained mostly unchanged even with a drop in crude oil prices. According to the *Inflation Outlook of Enterprises* in the BOJ’s *Tankan* Survey (*Short-term Economic Survey of Enterprises in Japan*) which was started from last year, the inflation outlook of companies has been more or less unchanged despite the decline in crude oil prices since last summer.

The outlook of wage negotiations is what the BOJ will be paying the most attention to in the future. The BOJ believes that inflation expectations will rise steadily in the event there is another wage hike subsequent to last year. The BOJ also believes that the decline in crude oil prices will contribute to the positive development of the Japanese economy and boost prices over the medium-to-long-term. However, given the impact of the fall of crude oil prices, inflation is forecast to follow a downward trend and dip into negative territory. Whether the market will maintain inflation expectations even in a deflationary trend will serve as the key to forecast the direction of future monetary policy. In addition to the trend of the Japanese economy and prices, the *Inflation Outlook of Enterprises* which will be announced in the *Tankan* Survey in April and July will also gather attention.

2. The Government’s statement put a brake on additional easing

Meanwhile, the Government made a statement presumably to keep additional monetary easing in check. It reflects the Government’s concern that a rise in expectations on additional monetary easing would lead to a rapid weakening of the yen, which may have an adverse effect on the earnings of small-and-medium-sized companies.

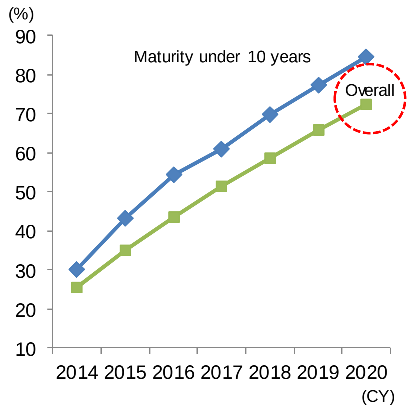
On February 5, the Japanese government proposed Waseda University professor Yutaka Harada, a proponent of reflationary monetary policy, to be put on the Policy Board to replace Ryuzo Miyao whose term ends in March. Professor Harada claims that “the BOJ has room to buy more government bonds and should boost stimulus” to meet the inflation target. This suggests that there has been no change to the Government’s stance to push through the quantitative and qualitative monetary easing (QQE). However, the Government has started to show flexibility when it comes to the timing to meet the inflation target. Akira Amari, Minister of State for Economic and Fiscal Policy, commented on the time limits for accomplishing the inflation target as follows; “No commitment has been made by the government nor by Bank of Japan on the concrete time limits of the inflation target (January 27)”. Furthermore, in the Cabinet Office’s *Monthly Economic Report* released in January, the wording “at the earliest possible time” was deleted from the sentence that describes the timing to achieve the price stability target. At the Council on Economic and Fiscal Policy held in January, there was a discussion that the judgment on price trend and deflation should not only be based on the consumer price index, but also on various other indicators such as the GDP deflator and unit labor cost. Etsuro Honda, Special Advisor to the Cabinet, commented that “prices will naturally go up toward the end of the year since the impact of the consumption tax hike will start to fade from April. Additional monetary easing would not be necessary unless prices fail to rise even in the event of an upturn of crude oil prices” (March 2 and 3). While the weakening of the yen after the introduction of QQE brought about a rise in stock prices, it also exerted a negative impact on the profitability of small-and-medium sized firms which are heavily dependent on imported raw materials. With a nationwide local election scheduled in April, the Government seems to demonstrate its cautious stance toward a further depreciation of the yen caused by a rise in expectations for additional monetary easing.

3. Sustainability of QQE

As described above, while the Government revealed its stance to allow certain flexibility on the timing to achieve the price target, it has not changed its policy to press ahead with ample monetary easing to overcome deflation. The BOJ is likely to stick with QQE until the inflation target of 2% is met, but it needs to pay attention to the fact that the purchase of Japanese government bonds (JGBs) is not a sustainable means of monetary policy over the long term.

The charts below show the share of BOJ in the amount of outstanding JGBs by maturity assuming that the BOJ will continue to purchase long-term JGBs at the current pace (annual net increase of 80 trillion yen), and estimate on the share of JGBs by private investors other than the BOJ. According to our estimate, the percentage of the BOJ’s JGB-holdings in outstanding JGBs issued will reach the 70%-level in 2020 (**Chart 1**).

Chart 1: Percentage of the BOJ's JGB-holdings in outstanding JGBs issued

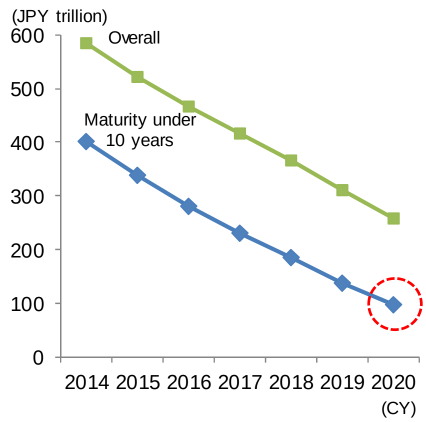


Note: Based upon the assumption that the BOJ will purchase JGBs at a pace of JPY80 trillion each year. The amount of purchase by maturity is calculated based on the actual outstanding amount as of January 2015. The amount of JGBs issued is based on the plan for FY2015

Source: Made by Mizuho Research Institute Ltd. (MHRI)

Looking at the percentage by maturity, BOJ's share of JGBs maturing in less than10 years will rise over 80% in 2020 since the BOJ buys more JGBs maturing in those time zones. On the other hand, the amount of JGBs possessed by private investors other than the BOJ will gradually decrease along with an increase of the amount of JGBs held by the BOJ (**Chart 2**). The reduction pace is faster with respect to JGBs with maturities less than 10 years, which is estimated to decrease to the 90 trillion yen-level at the end of 2020. The foregoing appears to indicate that the BOJ would be able to continue with the

Chart 2: Amount of outstanding JGBs held by private investors other than the BOJ



Note: Based upon the assumption that the BOJ will purchase JGBs at a pace of JPY80 trillion each year. The amount of purchase by maturity is calculated based on the actual outstanding amount as of January 2015. The amount of JGBs issued is based on the plan for FY2015

Source: Made by Mizuho Research Institute Ltd. (MHRI) purchase of JGBs until 2020. However, considering that other financial institutions are also required to buy a certain amount of JGBs to fulfill their collateral demand, it might become difficult for the BOJ to keep buying JGBs even before 2020. JGBs owned by financial institutions to meet collateral demand are centered on those with short maturities. Our study shows that JGBs owned by private investors with maturities over 1 year but less than 5 years will be zero in 2020. Although the actual amount of JGBs needed as collateral is uncertain, it may become difficult to buy additional JGBs after 2018 when taking into account that the amount of collateral accepted by the BOJ at the end of February 2014 was approximately 46 trillion yen. In light of the current move to strengthen regulation on financial institutions, collateral demand will likely increase further in the future. According to the summary of minutes of the Monetary Policy Meeting held in January, some of the members pointed out that “although a continued purchase of JGBs is technically possible for the time being, we need to be careful on its sustainability in the future.” The BOJ is required to pursue the price target while also paying attention to the sustainability of QQE. Once the smooth execution of monetary easing becomes difficult, it will not only diminish the policy effect but may also seriously damage the BOJ’s credibility.

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