Bank of Japan: Assessing the outcome of its strategic review

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Key points

- The Bank of Japan kept the status quo at its March monetary policy meeting but the market's attention was on its policy review
- The Bank judged that the current quantitative and qualitative easing with yield curve control, as well as its inflation overshooting commitment, function well, and that there is no need to revise its basic policy framework
- Beyond its "basic" policy framework, it reinforced its policy to alleviate the impact of persistently low interest rates on financial institutions. It will allow more fluctuation of 10-year bond yields around its target, with an asymmetric cap to upside pressure, as to not jeopardise the recovery. And it will adopt a more flexible approach to exchange traded fund purchases
- Those marginal changes were necessary but we still believe the longer the current accommodative stance lasts, the more its side effects must be addressed

Bank of Japan concludes its strategic review

When the Bank of Japan (BoJ) last conducted a strategic review of monetary policy in 2016, it resulted in the adoption of yield curve control (YCC). This time, Governor Haruhiko Kuroda stated that the "aims of the assessment were to find a way to conduct policy effectively while curbing side-effects, and to respond flexibly to changes in the economy, prices, and financial conditions".

In its assessment, the BoJ remains confident that the current quantitative and qualitative easing (QQE) with YCC and its inflation overshooting commitment, function well, and that there is no need to revise its policy framework. Consequently, changes were marginal, but there are still lessons to draw. The BoJ would allow more fluctuation in 10-year bond yields and it launched a subsidy scheme to help banks continue to provide credit. It also adjusted the tiering system to correct misallocations and adopted a more flexible approach on its exchange traded fund (ETF) purchases.

We believe the changes are largely cosmetic, suggesting the BoJ has lost faith in the massive monetary stimulus it launched eight years ago, and is now focused on mitigating its side effects rather than pushing to reach a 2% inflation target.

This note explores the BoJ's assessment and its subsequent policy actions.

Policy framework intact - focus on side effects

The BoJ remains confident that its current policy framework is well calibrated to current conditions. QQE coupled with YCC has had the intended impact i.e. keeping nominal interest rates at extremely low levels, while inflation expectations have risen relative to the pre-YCC period, meaning that real interest rates have declined. Consequently, low real interest rates have improved financial conditions, mainly through low funding costs as well as favourable conditions in financial and capital markets. The BoJ estimates economic activity has improved with these programmes, boosting corporate profits, employment and wages. More precisely, the BoJ undertook some counterfactual analysis and estimated that between 2013 and the third quarter of 2020, QQE with YCC pushed up real GDP by around 0.9-1.3 percentage points (ppt) and the year-on-year rate of change in core CPI is around 0.6-0.7 ppt higher.

The BoJ also recognises that its monetary policy framework has side effects. It mentioned the effect of YCC on the functioning of the Japanese Government Bond (JGB) market but insisted that without YCC the cost would have been largely higher. On the other hand, it acknowledges that downward pressure on financial institutions' profits from persistently low interest rates could make financial institutions more reluctant to lend. Effectively, core profitability has continued to decline due to the shrinking of the margin between domestic deposit and lending rates. Structural factors such as Japan's declining population and severe competition among institutions have also played a role but the BoJ recognises that prolonged downward pressure on profits may lead to a gradual reduction of financial intermediation. Finally, the BoJ reiterated its worries that a decline in super-long-term interest rates have a negative impact on consumer sentiment and consequently on economic activity.

Still committed to inflation overshooting

As expected, the BoJ didn't change its objective of, "aiming to achieve price stability of 2%", nor its overshooting commitment to "expand the monetary base until the year-on-year rate of increase in the observed consumer price index exceeds 2% and stays above the target in a stable manner". However, both goals appear quite redundant and coupled with no material increase in policy accommodation add to uncertainties about whether it will ever be able to reach its target.

The BoJ reiterated that inflation expectations are backward-looking (or adaptative). In other words, economic agents – mainly firms and households – form their expectations by putting a higher weight on past experience instead of being rational and/or forward-looking – for example assessing the price outlook by anticipating movements or gauging central bank credibility to achieve its price target. This mechanism is important for inflation developments in Japan given that inflation remains very low, with CPI excluding volatile components at 0.4% year-on-year (yoy) on average over the last four years and before the VAT hike in 2014, Japan had been in deflation since the beginning of 2000's. Another estimate by the BoJ indicates that the lower the natural rate of interest, the longer the past inflation rate should be used as a reference.

The BoJ assesses that true inflation expectations are a bit more complex, in part reflecting different types of economic agents. In its assessment, the BoJ concluded that about 60% of firms are subject to 'sticky information constraints' – it takes time for information to be incorporated into expectations given that acquiring information involves costs – whereas 40% frequently acquire information and update their inputs. Of those 40%, only half are "fully information rational" using all the information available while the remainder are "rationally inattentive" focusing only on information that matters.

The BoJ also argued that some labour market shifts had an impact on inflation pressure. Women and senior's participation in the labour market has accelerated, and as they have higher wage elasticity – the rate of increase in labour supply in response to a given increase in wages – this has constrained wage increases. Meanwhile, to address labour shortages, firms have absorbed upward pressure on costs by enhancing labour productivity and started to invest massively in automation.

Rate flexibility while protecting the financial system

The BoJ assesses that a further cut in short-term interest rates would reduce profits at financial institutions by several hundred billion yen. This could limit the impact of further monetary policy accommodation by adversely affecting institutions' ability to lend. Consequently, the BoJ introduced a new interest subsidy scheme to promote lending by compensating financial institutions for the reduction of lending margins associated with negative policy rates. This was done to incentivise them to continue to provide specific loans – currently loans for COVID-19 backed by the special fund supplying operations without government support. Most importantly, it will be tied to the level of the short-term rate, meaning subsidies will increase if the BoJ cuts the refinancing rate further.

The introduction of this measure suggests that we are close to the limit for financial institutions where further rate reductions would not be passed on to the broader market without further support from the BoJ. At this stage, the subsidy will lower the burden of negative rates on financial institutions (+¥75bn), but we continue to doubt that the BoJ will cut rates further. The BoJ decided not to publish its estimates of the impact of further cuts due to concerns that "it would draw attention to the negative side of cutting interest rates".

Exhibit 1: New interest subsidy scheme to promote lending – Rates incentive on bank reserves deposits at the BoJ

Lending operations	Until now	New scheme	Policy rate cut (-0.1%)
Category I COVID-19 operation not guaranteed by credit guaranteed corporations	0.1%	0.2%	>0.2%
Category II COVID-19 operations secured by credit guaranteed corporations	0.1%	0.1%	0.2%
Category III Other operations like Loan Support Program	0.0%	0.0%	>0% & <0.2%

Source: Bank of Japan and AXA IM Research, 14 April 2021

Assuming a further 10-basis point (bp) reduction in the official call rate, banks' profits would suffer from direct and indirect effects[1]. We estimate those to reach respectively -31.4bn and -¥280bn. The direct cost is obtained by multiplying the policy rate balance at the BoJ, currently at ¥31.4tn, by the estimated policy rate change. However, there is a concern that some domestic banks want to avoid holding funds in the policy-rate account and hold surplus funds at even lower-yielding T-bills and repos – suggesting ¥31.4bn would be the lower end of the range for estimated direct costs. We estimate the indirect cost by assuming that the loan deposit margin would shrink by 0.05% (from 0.2%) as it did after the introduction of negative rates in 2016. We then reduce the current margin income of ¥1.15tn by that proportion to estimate a loss of approximately ¥280bn.

On the other hand, under the new interest subsidy scheme the total loss to the banking system is reduced. Presently, ¥56tn over ¥172tn of loans are currently eligible for positive subsidies (0.2% and 0.1%), equivalent to ¥75bn of subsidies. If a rate cut occurs, the BoJ would switch schemes (third column in Exhibit 1), raising total subsidies to approximately ¥185bn – or only ¥110bn if we only consider the extension of the subsidy scheme. Overall, the net loss from a rate cut would then be this ¥110bn gain, less the direct and indirect costs totalled above, or a total of around ¥200bn (17% of total margin income). (Exhibit 2)

We believe that this new scheme has been introduced to signal that the BoJ could deliver further rate cuts if necessary, in response to recent scepticism reflecting the damage it would inflict on financial institutions.

[1] Direct effects refer to the negative payments on the outstanding balance of current account deposits / Indirect effects are based on the decline of lower interest rates on loan-deposit margin

Exhibit 2: Interest Scheme to Promote Lending

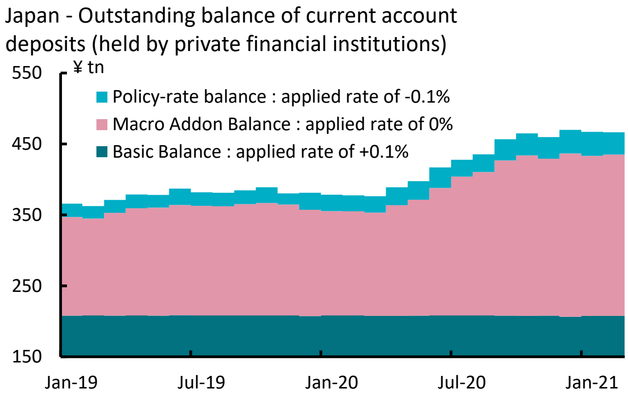
Interest Scheme to Promote Lending

Loan Outstandings Daily ave. of monthly balance in Feb 2020		(a) Current scheme Short-term policy rate : -0.1%		(b) -10bps rate cut Short-term policy rate : -0.2%		(b) - (a) Impact	
	¥ tn Outstanding	Applied rate	¥ bn Income	Applied rate	¥ bn Income	Applied rate	¥ bn Income
COVID-19	56.1	-	74.9	-	131.0	-	56.1
Proper Loan*	18.7	0.2%	37.4	0.3%	56.1	0.1%	18.7
Non-proper	37.4	+0.1%	37.4	+0.2%	74.9	0.1%	37.4
Bank Lending	53.6	0.0%	0.0	0.1%	53.6	0.1%	53.6
Disaster Areas	0.5	+0.0%	0.0	+0.1%	0.5	0.1%	0.5
Economic Growth	5.5	0.0%	0.0	0.0%	0.0	-	0.0
Total	171.9		74.9		185.1		110.3

Source: Bank of Japan and AXA IM Research, 14 April 2021

In addition, the tiering system continues to alleviate the burden of negative rates even if the BoJ made some technical adjustments as there is a gap between the actual policy-rate balance and the hypothetical one, computed under the assumption that arbitrage transactions fully take place. In practice, due to transaction costs, arbitrage between counterparties holding policy-rate balances and those with unused amounts of macro add-on balances have not fully occurred. The BoJ has also updated the Basic balance as this has not evolved since its introduction and current account balances have increased substantially. This impacts the other balance, which is a multiple of the Basic balance through the benchmark ratio (Exhibit 3).

Exhibit 3: Tiering system is another support for banks to alleviate the burden from negative rate



Source: BoJ and AXA IM Fixed Income Tokyo calculations, 13 April 2021

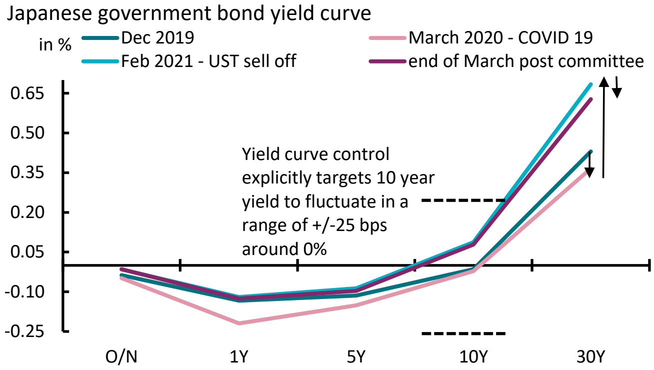
Adjusting QQE and YCC

The BoJ introduced YCC after its last policy review in 2016. This time, it stated several weeks before the review's conclusion that it would not remove QQE, nor adjust its YCC. But, unexpectedly, Governor Kuroda announced that the range around the 10-year yield target would rise to +/-25bp, from officially 10bp before, but unofficially an expected 20bp. Even if the move is marginal, it allows a little more volatility and may help to revive JGB market functioning. More interestingly, it will introduce "fixed-rate purchase operations for consecutive days […] to set an upper limit on interest rates when necessary" while "it will not strictly respond to interest rate declines that temporarily deviate frow downward from the range", suggesting an official asymmetry to the BoJ's interventions.

This 50bp YCC range is not arbitrary. The BoJ has estimated that fluctuations in long-term interest rates of over 50bp over the preceding six months can negatively affect business investment. But now that the BoJ has established its rule, it will be difficult to allow wider fluctuation in the future.

We believe this move highlights the different tensions faced by the BoJ. It is maintaining the yield curve as low as possible to encourage recovery, while at the same time allowing super-long-term rates to rise a bit to alleviate the burden for financial institutions and reduce any negative impact on consumer sentiment. (Exhibit 4)

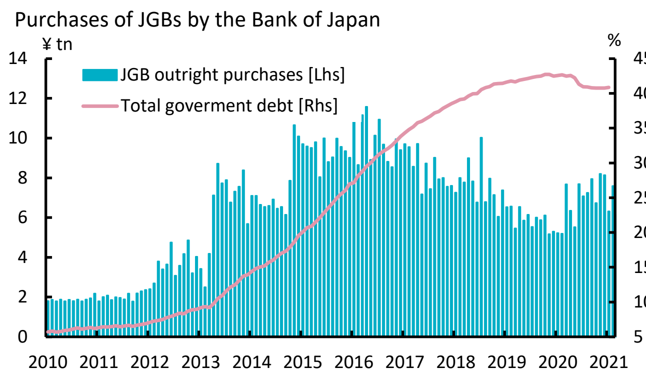
Exhibit 4: Super-long sell off, while BoJ focuses on 10y



Source: Datastream and AXA IM Research, 14 April 2021

The introduction of YCC had also allowed the BoJ to gradually retreat from large JGB net purchases. As mentioned earlier, these purchases distort market functioning and the BoJ now holds more than 40% of government debt. Before the COVID-19 crisis, it had gradually succeeded in reducing its net purchases. Since the crisis, these have increased again. But this is the purpose of this programme – to keep enough flexibility to act decisively, while decreasing net purchases when there is more room. (Exhibit 5)

Exhibit 5: YCC introduced to lower BoJ intervention



Source: Datastream and AXA IM Research, 14 April 2021

Lastly, the BoJ introduced a new process of financial stability monitoring. At each monetary policy meeting that includes an outlook report (published four times a year), it will report financial system conditions to the Policy Board members, to deepen the discussion of the financial intermediary function and financial stability. This appears to be further proof of growing concerns over financial instability.

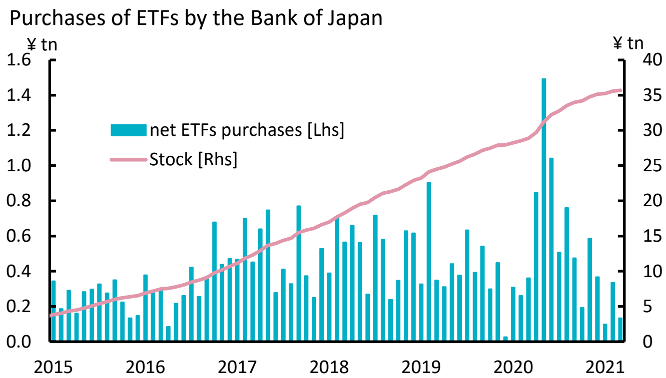
Fine-tuning ETF purchases

The review concluded the ETF purchases scheme has lowered risk premia and effects were more important if:

- The level of stock prices relative to their trend is lower at the time of purchases
- The volatility is higher and stock prices are below their trend
- The purchases occur during a period of stress
- The amount of purchases is higher

But the BoJ is also aware that its ETF purchases programme is distorting equity markets. The share of BoJ's holding now reaches approximately 7% of the market and was concentrated on the Nikkei 225 index (Exhibit 6). This growing presence is altering companies' governance as the BoJ acts as a neutral shareholder.

Exhibit 6: A flexible ETF programme is more appropriate

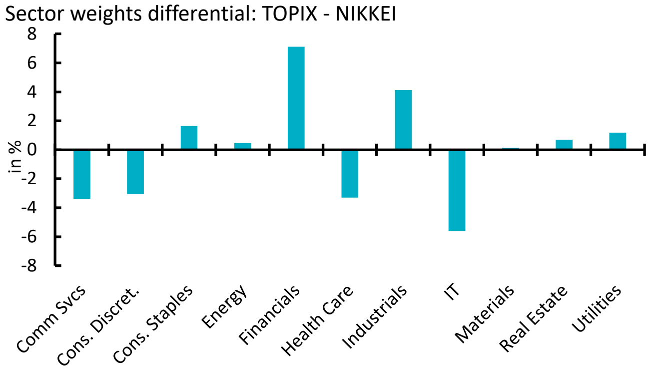


Source: Datastream and AXA IM Research, 14 April 2021

Consequently, the BoJ removed the ¥6tn baseline guideline for ETF purchases while maintaining the ¥12tn upper limit to allow the purchases of large volumes when necessary. The BoJ also decided to change its focus index to the TOPIX index to avoid the distortions mentioned earlier on corporate governance and allow for more diversification among sectors (Exhibit 7).

The Japanese Real Estate Investment Trusts (J-REITs) will be subject to the same rule but the upper limit will be ¥180bn.

Exhibit 7: BoJ TOPIX focus will see sector reallocation



Source: Bloomberg and AXA IM Research, 14 April 2021

Conclusion: Banks sees no need to revise substantially its policy strategy

Ultimately, the BoJ judged that the current policy mix of QQE, with YCC and an inflation overshooting commitment function well, and that there is no need to revise this basic policy framework.

Beyond its basic policy framework, the BoJ has reinforced its policy to alleviate the impact of negative rates on financial institutions. The introduction of interest subsidies to promote its lending programme is useful, but not enough to fully compensate financial institutions in the event of another rate cut. The widening of the range around the 10-year JGB is also favourable for financial intermediation, even if the BoJ has capped the upward pressure to protect the recovery. In other words, those marginal changes were needed, but the longer this super-accommodative phase lasts, the more its side effects must be addressed.

As the debate about climate considerations through monetary policy grow (especially in the euro area), it is also worth mentioning that the BoJ made no mention of any such a possibility in its own review.

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