The BOJ's Difficult Path Towards an Exit from Current Easing: The BOJ should win the market over and prevent a sharp increase in interest rates

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Key Points

- The Government and the BOJ must prevent national finances from spiraling toward collapse
- The BOJ cannot reduce JGB purchases to zero through the manipulation of interest rates
- The BOJ should spell out that it will maintain easing whilst withdrawing from large-scale asset purchases

At its Monetary Policy Meeting at the end of July, the Bank of Japan (BOJ) adopted the policy of "strengthening the framework for continuous powerful monetary easing." While pledging to keep short- and long-term rates low, the central bank said that it would allow long-term yields to move up more than before. Is the BOJ's true intention to strengthen easing or to move a step closer to an "exit"?

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Since the 2008 global financial crisis, the central banks of the world's leading economies have deployed all manner of unconventional monetary policies including large-scale asset purchases, forward guidance and negative interest rate policies. These are policy innovations to address a situation in which policy rates are near zero and conventional easing tools are no long effective.

Out of the Big Four central banks, the US Federal Reserve Board (FRB) and the Bank of England (BoE) used only large-scale asset purchases and forward guidance, while the BOJ and the European Central Bank (ECB) also used a negative interest rate policy. The tool which has the most side effects and the biggest impact on withdrawal is large-scale asset purchases. It is fair to say that when we discuss an exit from easing, we are discussing an exit from large-scale asset purchases.

"Large-scale asset purchases" means that the central bank purchases long-term government bonds and other assets to lower long-term interest rates and stimulate the economy. The FRB began tapering (gradually reducing) asset purchases in December 2013 and concluded its asset purchase program in October 2014. Later, in December 2015, the FRB started raising the funds rate, and in October 2017, also began decreasing reinvestment of principal from maturing securities and it is ahead of its peers in withdrawing from asset purchases.

The BoE closed its asset purchase facility in November 2012 and switched to a policy of using forward guidance to control long-term interest rates under Mark Carney, who became governor the following year. At the time of Britain's referendum decision to leave the European Union (EU), the BoE implemented one-off easing measures but started raising the Bank Rate from November 2017. The ECB has also been reducing the amount of purchases gradually since April 2017 and plans to phase out its asset purchase program (APP) by the end of 2018.

Identified side effects of large-scale asset purchases include (1) decline in liquidity and a lack of price discovery in the financial asset markets, (2) rising inflation fears due to complication of the exit, (3) financial instability caused by the creation and bursting of an asset bubble, and (4) the losses incurred by the central bank upon exiting.

Side effect (4) occurs because, when the central bank raises short-term policy rates, excess reserves held by commercial banks at the central bank also accrue the same rate of interest, which adversely affects the central bank's net interest income. But, as pointed out in this column on October 3, 2017, the FRB looks like it will be able to avoid negative net interest income. In the BOJ's case, however, the coupon rates of the JGBs which the BOJ holds as assets are low and, therefore, interest rate increases could be troublesome, causing the BOJ's liabilities to exceed its assets.

However, the biggest and ultimate problem with large-scale asset purchases is that they increase the risk of a fiscal crisis in a country with a high level of government debt. This is the case where continuation of government bonds purchases by the central bank and government inaction over financial deterioration occur as a "set." When the market believes that the government has no intention of reconstructing national finances until government bonds run out, this gives rise to a spiral whereby government bonds are sold, interest rates rise and the increase in interest payment expenses causes further deterioration in finances, and national finances collapse, making it difficult for the government to raise money.

One central bank that is falling into this trap is the BOJ. Japan's government debt to GDP ratio (end of FY2017) sits at 224%, which is almost double that of the US (105%), the UK (118%) and the EU (105%). Similarly, Japan's government bond holdings to GDP ratio (end of FY2017) is 82%, far exceeding that of the FRB (12%), the BoE (21%) and the ECB (17%), and extreme implementation of policies as a "set" in Japan is obvious.

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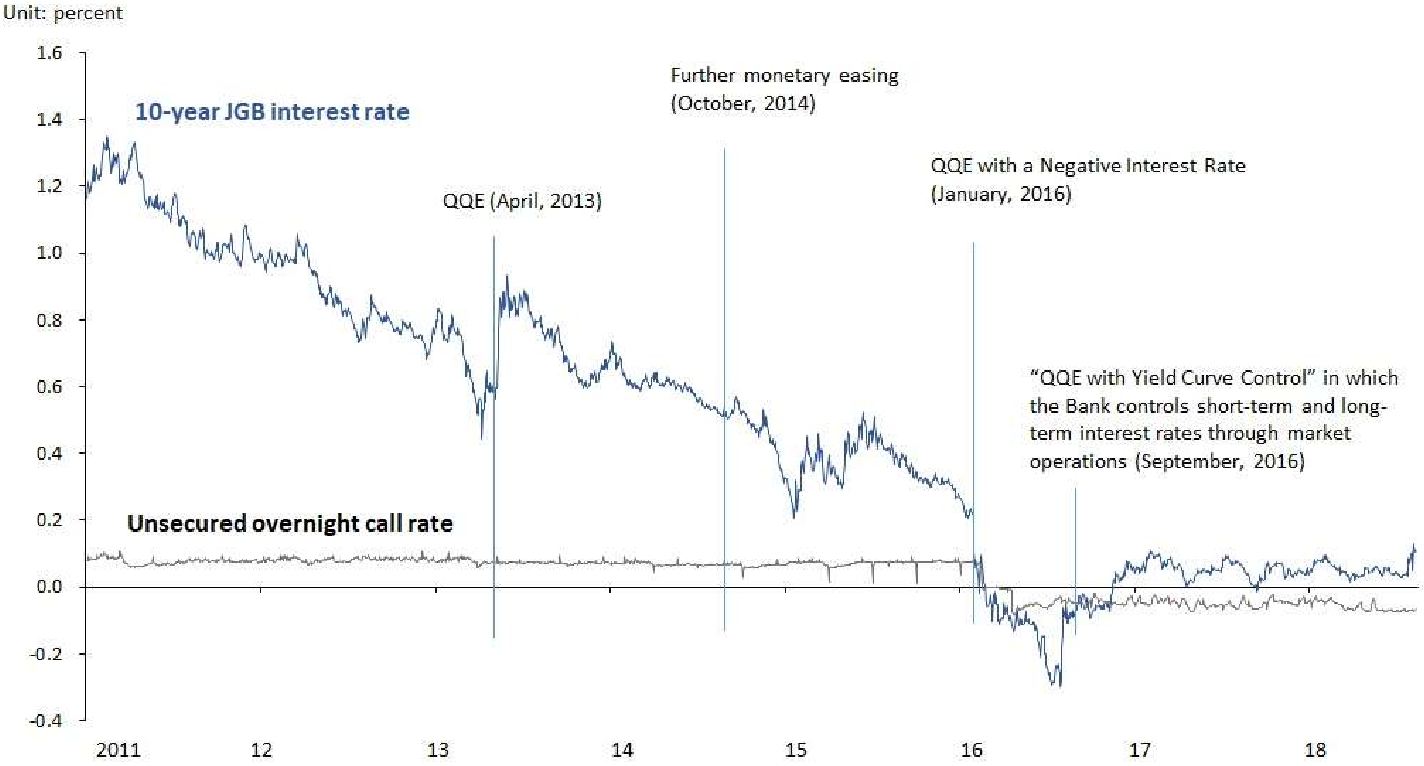
The Quantitative and Qualitative Easing (QQE) policy which the BOJ introduced in April 2013 under Governor Kuroda Haruhiko is based on large-scale asset purchases like the policies of the other three central banks, but it includes some fairly special elements.

Figure: Asset Purchases & Short- and Long-term Interest Rates



Source: Created from the data of Ministry of Finance, Bank of Japan by author

Firstly, it positioned the 2% inflation target as a target which must be reached in the short term.

Secondly, to achieve this target, the BOJ made active use of a type of forward guidance that raises the expected rate of inflation of economic entities by pledging expansion of the monetary base. The FRB and the BoE have mainly implemented the type of guidance policies that put downward pressure on long-term rates through a pledge to keep the short-term policy rate at a low level in the future. The forward guidance which the BOJ provided before with its zero interest rate policy (1999–2000) and its quantitative easing policy (2001–2006) was also the latter type of forward guidance.

Thirdly, the BOJ has maintained mass purchases of equity traded funds (ETFs) as part of its asset purchases. The FRB purchased mortgage backed securities (MBS) in large quantities but the BOJ is the only central bank to purchase assets that are directly linked to stock price increases.

Later, with the introduction of QQE with a Negative Interest Rate (NIR) in January 2016, the yield curve became extremely flat and the net interest income of financial institutions deteriorated. To correct this, QQE with Yield Curve Control (YCC) was adopted in September 2016, making the short- and long-term interest rates the target of manipulation, and the target of increasing the monetary base by 80 trillion yen annually was downgraded to a guide. Most recently, JGB purchases have fallen to 40 trillion yen annually and commentators say that tapering has already begun (stealth tapering).

The biggest challenge facing the BOJ now is to successfully withdraw from asset purchases without causing national finances to spiral towards collapse. At the same time, the BOJ needs to drive a mild steepening of the yield curve and dispel concern that deterioration in the net interest income of financial institutions will destabilize the financial system.

Exiting from large-scale asset purchases will require two policy changes. Firstly, the BOJ needs to reposition the 2% inflation target as a target to be reached in the long term and confirm with the government that the economy has already escaped from deflation.

Secondly, the BOJ must at some point abandon YCC and bring in FRB-style tapering. Since YCC predetermines the long-term interest rate, the extent to which the BOJ can reduce asset purchases will be left to actual market conditions to determine. The BOJ will not be able to reduce the amount of purchases to zero by raising the target range of the 10-year JGB yield under this framework.

Another important factor is communication with the market. The BOJ will need to carefully allow the exit to be woven/factored into the market. This means making skillful use of speculation in some quarters that the BOJ is looking for an exit. On the other hand, the BOJ should communicate to the market that it plans to keep monetary conditions sufficiently accommodative even after the start of tapering. For example, a forward guidance that the BOJ will maintain its JGB holdings and keep the short-term policy interest rate low for the time being would be effective. This will separate withdrawal from large-scale asset purchases from continuation of easing to achieve the 2% inflation target in the long term.

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The monetary policy meeting at the end of July suggests that the BOJ is turning towards an exit in terms of communication. While the BOJ's allowance of upward movement in the long-term rate and its control of increases through the new forward guidance are contradictory at first glance, they can also be seen as part of a strategy to withdraw from asset purchases while preventing national finances from spiraling toward collapse.

The 10-year JGB yield fell to 0.3 - 0.4% as a result of further easing in October 2014 and fell below 0% due to the introduction of NIR, but it has now been guided to around 0.1% (See Figure). Now that long-term JGB purchases have converged to 40 trillion yen annually, long-term interest rates are lower than they were in 2015 when the BOJ was purchasing long-term JGBs at an annual pace of 80 trillion yen.

If the BOJ maintains its forward guidance and negative interest rate policy in the future, even if the BOJ embarks on tapering, a sharp increase in long-term rates could be avoided. The BOJ should create a chain of events through which the market judges the withdrawal from large-scale asset purchases favorably. It should "win the market over," so to speak.

This path will be narrow and steep, but Japan will be underpinned by the strength of its economy. Japan's current account surplus will work in its favor and it will be necessary to raise the potential growth rate of the economy by improving productivity. The Government should show a strong determination to reconstruct national finances and should also shift the focus of policies from monetary policy to growth strategy.

To control increases in long-term rates, action before achievement of the 2% inflation target would be more convenient and, from the viewpoint of preventing appreciation of the yen, action whilst the central banks are in the easing correction phase would be favorable.

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