The BOJ's Difficult Path Towards an Exit from Current Easing: Impact of ETF holdings on corporate management

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Key Points

- Stock buying by central banks is highly unusual
- No need to worry that unrealized losses will push BOJ into negative equity
- One option is for BOJ to simultaneously sell ETFs and buy an equivalent amount of stocks

There is much debate surrounding the BOJ's exit from monetary easing. In particular, market watchers and players alike are keeping an eye on developments in the BOJ's Exchange Traded Fund (ETF) Purchase Policy. In this article, I would like to examine the impact of the BOJ's ETF purchases and its exit strategy.

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The BOJ started buying ETFs as part of the monetary easing policy introduced in December 2010 under Governor Shirakawa Masaaki. ETF purchases were initially intended to reduce Japan's high market risk premia (additional returns) in the aftermath of the global financial crisis. However, the BOJ made it a rule that the amount of ETF purchases must not exceed the limits of its Asset Purchase Program.

But after Kuroda Haruhiko became Governor in 2013, the Asset Purchase Program was scrapped, and ETF purchases were ramped up both in terms of frequency and amount as part of the Quantitative and Qualitative Easing (QQE) policy. The BOJ has bought an estimated 25 trillion-yen worth of stocks through ETFs. Given that the total market capitalization of the First Section of the Tokyo Stock Exchange (TSE) at of the end of June was 644 trillion yen, this means that the BOJ owns around 4% of stocks listed on the First Section of the TSE.

The Federal Reserve Board (FRB) and the European Central Bank (ECB) have used purchases of loan asset-backed securities as a monetary easing tool. These securities are financial

instruments which have maturity dates, but ETFs are types of assets which do not have maturity dates and which decline in value unless their dividends are reinvested. The foreign stock purchases by the Swiss National Bank (SNB) are one example of stock buying by a central bank, but this was done as part of the SNB's foreign exchange reserve operations. As for the FRB, stock purchases are regulated by law from the start.

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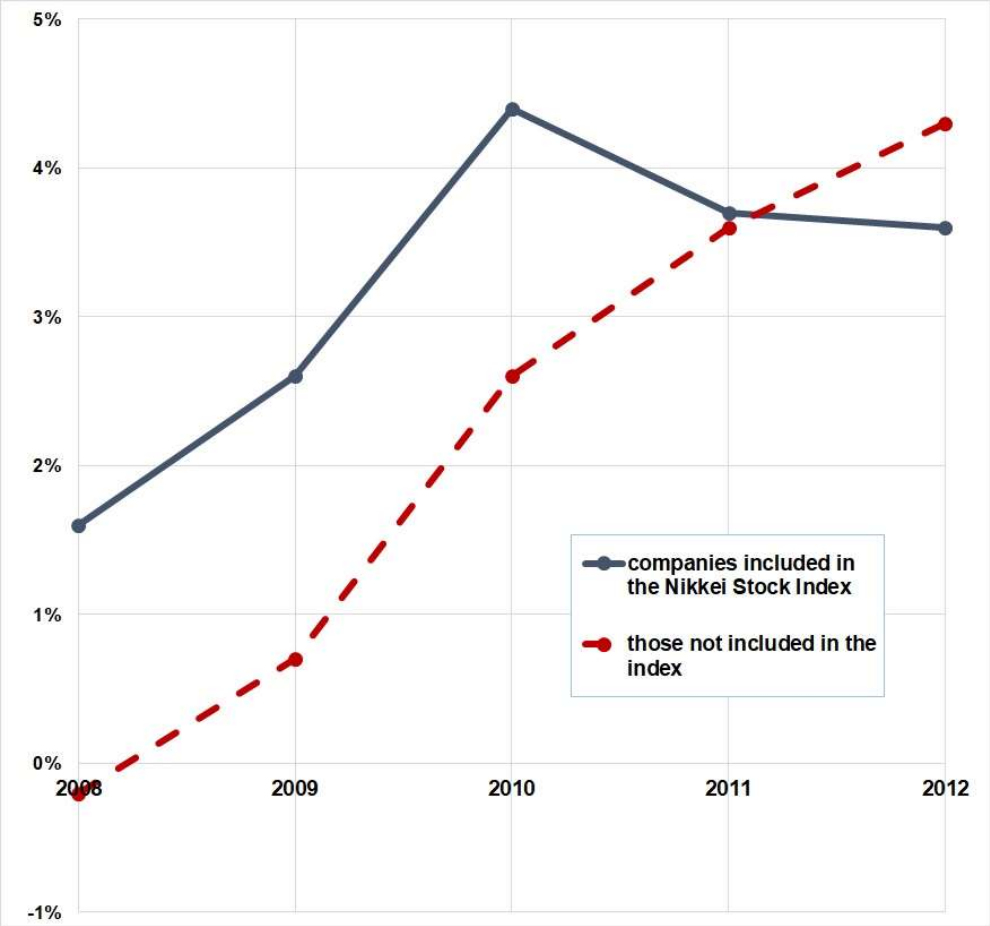
There are several ways in which the BOJ's ETF holdings could have an impact. Firstly, the BOJ's ETF holdings could bring about changes in corporate management.

A joint study by myself, Miura Kazuki, associate professor at Tokoha University, and Yuan Yuan, associate professor at East China Normal University explained how the return on assets (ROA) of companies included in the Nikkei Stock Index and those not included in the index changed after the BOJ's ETF purchases. Analysis of the average ROA of each group of companies between 2008 and 2012 shows parallel fluctuations until 2010 but then a relative decline in the average ROA of companies included in the Nikkei Stock Index from 2011 (See Figure).

Changes between ROA of companies included in the Nikkei Stock Index and those not included in the index



***Source*:** Created from the data of Nikkei Stock Index by Gunji, Miura and Yuan

It is fair to say that the profits of the group of companies more heavily impacted by the BOJ's ETF policy declined after implementation of the policy. While the cause of the decline is unclear, it is perhaps natural to assume that the governance of the companies was somehow impacted by the BOJ becoming an indirect shareholder.

It is estimated that the BOJ holds a stake of 10% or more in around 30 companies. The BOJ can also be said to have deprived the private sector of rights it ought to hold. However, since 2014, adoption of the Japan Stewardship Code which sets out principles for responsible institutional investors has become more widespread and institutional investors such as trust banks are starting to exercise their voting rights more responsibly. Consequently, the BOJ's ETF holdings are starting to have less impact in this respect.

Secondly, the BOJ's ETF holdings may have an impact on the allocation of resources. On first introducing the policy, the BOJ purchased ETFs linked to the Nikkei 225 Stock Average and the Tokyo Stock Price Index (TOPIX) according to their market capitalization and, from December 2014, the central bank also started buying ETFs linked to the JPX-Nikkei 400. Since TOPIX is a capitalization-weighted index of all the companies listed on the First Section of the TSE, when the BOJ purchases TOPIX-linked ETFs, stock purchases are conducted broadly evenly. However, in the case of purchases of ETFs linked to the Nikkei 225 Stock Average and the JPX-Nikkei 400, only certain stocks are bought.

Furthermore, since the Nikkei 225 Stock Average employs a calculation methodology that is similar to a simple average, stocks with a high unit price are more likely to be included in ETFs linked to the Nikkei 225 Stock Average. It is feared that if the BOJ continues with ETF purchases in this way, the remaining free float in some stocks will be soaked up. There are also concerns that there will be fewer shares floating in the market (those not held by the BOJ) and market liquidity will decrease.

Partly due to such concerns, at the end of July, the BOJ raised the ratio of purchases of ETFs linked to the TOPIX which is a free-float adjusted market capitalization-weighted index. Since this change will result in fewer purchases of stocks with small floats, it should lessen the impact of the BOJ's ETF purchases on such low float stocks.

Thirdly, the flow of funds may be affected by fluctuation in stock prices. After purchasing the ETFs, the BOJ makes no further payments to the private sector, but the private sector continues to pay dividends to the BOJ. This means, that, in the event of deterioration in corporate earnings, the private sector pays lower dividends to the BOJ whilst in the event of improvement in corporate earnings, the private sector pays higher dividends. For the private sector, dividend payments to the BOJ are similar to progressive taxation and can be said to act as a built-in stabilizer.

Fourthly, falling stock prices could cause the market value of the BOJ's ETF holdings to fall short of their book value, and the BOJ could incur unrealized losses. In this case, a provision for the losses would be recorded on the liability side of the BOJ's balance sheet and the BOJ's net assets would decrease.

As Tomura Hajime, associate professor at Waseda University pointed out in his article dated June 30, 2017, the monetary base (cash and reserves at the BOJ) which accounts for the majority of liabilities on the BOJ's balance sheet is, for accounting purposes "a liability that is not a debt." In other words, even if the BOJ falls into negative equity for accounting purposes, this is different from the negative equity of a household or corporation and legally speaking there is not a problem.

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Since ETF purchases increase the monetary base, on exiting easy policy, the BOJ must ultimately reduce the amount of ETF purchases to zero to ensure that there is no major impact on the stock market. At its Monetary Policy Meeting in July, the BOJ stated that it may increase or decrease the amount of purchases.

The exit strategy will no doubt need to a be a fairly long drawn out campaign. The central bank also has the option of selling its ETF holdings to other public institutions such as the Government Pension Investment Fund (GPIF) or transferring them to a special purpose company. However, this would also probably require some political judgment and also gives the impression that the BOJ is postponing a solution to the problem.

I would therefore like to make two proposals. The first is that the BOJ keeps holding the ETFs. Since the dividends are procyclical (their returns vary with economic activity), they act as a built-in-stabilizer and there is also no need to worry that unrealized losses will push the BOJ into negative equity. The BOJ can sell the ETFs at a time when only stock prices and other asset prices increase while the CPI remains stable, as in the "bubble" economy of the late 1980s. The BOJ should keep them in reserve as assets that act like foreign exchange reserves during foreign exchange intervention.

However, it must be noted that stock which is held long term is regarded as fixed stock by the TSE and will affect the TOPIX, which is a free-float adjusted market capitalization-weighted index.

Another proposal is that the BOJ simultaneously sells ETFs on the open market and buys up the equivalent number of shares via trust banks, and then makes a shareholder's proposal to raise dividends and wages at the general meetings of shareholders which it has not been actively involved in before. Since the BOJ is now a major shareholder at certain companies, in some cases its proposal would probably be approved.

Demands for higher wages will mean higher costs for companies but provided the BOJ also demands higher dividends, this would control stock prices. If this led to wage increases at certain large corporations, the effects would spill over into the wider economy. Since the wage's increases would be passed onto prices, possibly triggering inflation, this move would also probably not be in violation of the Bank of Japan Act.

On two occasions in the past between 2002 and 2004 and between 2009 and 2010, the BOJ has also bought shares held by financial institutions of up 2 trillion yen via trusts and it still holds around 1 trillion yen of such shares today. However, according to the BOJ's Outline of the Stock

Purchasing Plan and Policy on Exercise of Voting Rights, the BOJ and other shareholders are required to exercise voting rights in financial institutions which manage assets with a view to increasing the economic profits of the financial institutions. In the case of my proposed action, costs would increase due to higher wages, possibly resulting in a conflict of interests. Consequently, these provisions need to be amended to something like "with a view to increasing the economic profits of the Japanese people including workers."

The Outline of the Stock Purchasing Plan also includes provisions to the effect that the BOJ should comply with company demands for share buybacks and, if companies dislike the shareholder's proposal, they could always make returns to shareholders through share buybacks. Of course, this is an emergency measure and, therefore, if inflation does happen and the government successfully implements policies that prop up wages, then the BOJ probably will not need to make a shareholder's proposal.

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