

WHAT'S NEXT FROM THE BANK OF JAPAN

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I had the opportunity to meet with Takeshi Yamada of the Market Intelligence Group at the Bank of Japan (BOJ), and I attended a presentation at the Mizuho conference by Eiji Maeda, the director-general of the Research and Statistics Department. For disclosure, the views reflected herein were their personal opinions and not those of the BOJ. I will recap the conversations, giving attribution to the speaker in each case. **Japan's Economy Resilient** Maeda believes the Japanese economy is resilient and analysts should not get overly pessimistic about the [consumption tax](#) hike. There was an acceleration of demand before the implementation of the consumption tax hike, and then a big drop. But if one looks at a normalization of the trend in economic growth, Maeda shows about a 1.2% [real growth](#) in the economy, above Japan's 1% potential growth, reflecting strength in Japan's economy to grow above its potential. In rationalizing why investors should not be as pessimistic on the consumption tax hike, he cited: • Like the U.S., which was plagued by bad weather in the first quarter, Japan had terrible weather in July/August that weighed on the economy and the subsequent data releases. • A fiscal spending cut in 1997 had an impact, and there were big bankruptcies that shocked the country in late November 1997. The [fiscal drag](#) in 2014 is quite different, and the Japanese banks are in much better shape. Yet in discussion with Yamada, he said the sustainability of growth in Japan's economy is important and continues to be assessed in an ongoing manner by the BOJ's economics team. Yamada has stated that since the BOJ launched its [qualitative and quantitative easing \(QQE\)](#) program, domestic demand has surged. Recent data shows that private consumption is leveling off. There may be a weaker recovery in play compared to what many have expected. The third-quarter [gross domestic product \(GDP\)](#) print will be quite important for deciding the relevance of the next stage of the consumption tax. Yamada's personal opinion is that if the government postpones the consumption tax hike, it could be harmful to the economy and stock prices. **Many are focused on the weak yen, and so is the BOJ: Yamada:** In April/May the BOJ held a meeting with the head of local bank branches. One leader mentioned further weakness in the yen may not support manufacturing companies in his region. Yet Mr. [Haruhiko] Kuroda [the governor of the BOJ] has argued that further weakness in the yen would not hurt manufacturing in general. **A Statement on Japanese Yields — Surprising Conviction: Yamada:** Current interest rates cannot be justified. Interest rates should be a function of [real growth potential](#) plus [inflation expectations](#) plus a risk premium. The numbers can be debated, but Japan's growth potential is approximately 0.5% to 1%, inflation expectations 1% to 1.5%, plus a [risk premium](#) for longer maturities. The theoretical level of [Japanese government bond \(JGB\)](#) yields is thus much higher than the current levels. The BOJ always thought QQE would put downward pressure on the whole [yield curve](#). And the BOJ never had specific targets for JGB yields, but the gap between theoretical level and actual level looks "too much." *[Editor's note: This is the second time I have visited the BOJ when someone in the Market Intelligence Group commented that interest rates were surprisingly low. While it is never couched in official BOJ policy and always reflects personal opinions, I feel there is something important underlying the comments. These comments may reflect deeper thoughts within the BOJ and would explain why it has not taken further actions to boost JGB purchases. To wit, why would the BOJ buy more bonds to drive yields lower if it already thinks the yield gap is perhaps too wide already? The QQE purchase program of monetary accommodation comprises three types of securities: JGBs, [real estate investment trusts \(REITS\)](#) and exchange-traded funds (ETFs). I see ETFs being the only one of its assets the BOJ would not be worried about increasing in volume of purchases. The BOJ's ETF purchases—at 1 trillion yen per year¹—have been said to have almost no impact on the market because they are so small relative to the size of the market. I would not be surprised if ETFs were the focal point of adding further easing measures with a doubling possible and maybe even tripling.]* For more insights from my trip to Japan and discussions with market strategists, please see my roundtable [here](#). ¹Source: "Introduction of the 'Quantitative and Qualitative Monetary Easing,'" Bank of Japan, 4/4/13.

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DEFINITIONS

Consumption tax : Tax applied to spending on goods and services.

Real growth : Refers to the rate of economic growth with the inflation rate subtracted from it.

Fiscal drag : This occurs when a national government's spending less any taxes does not meet the net savings goals of the private economy. This usually leads to deflationary pressure in the economy.

Quantitative and qualitative monetary easing (QQE) : A central bank monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Real growth potential : Potential rate of growth for an economy given that a set of policy assumptions are realized.

Inflation expectations : Expectations of inflation based on the pricing of nominal and inflation-adjusted bonds.

Risk premium : Equity investments are not risk free, but it is thought that investors buy stocks because the returns they expect are high enough to allow them to take the risk.

Japanese Government Bond (JGB) : A bond issued by the government of Japan. The government pays interest on the bond until the maturity date. At the maturity date, the full price of the bond is returned to the bondholder. Japanese government bonds play a key role in the financial securities market in Japan.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Real estate investment trust (REIT) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages. Returns predominantly relate to changes in property values and income from rental payments.