IS JAPAN'S NEGATIVE RATES POLICY A FAILURE?

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Taken at face value, one can understand the criticism of Japan's experiment with a negative interest rate policy (NIRP). If judged by currency impact, Japan's NIRP has failed so far—the yen is up, not down.[1] But let me make a counterargument to support Bank of Japan (BOJ) governor Haruhiko Kuroda's claim that all is on track: • Since NIRP, Japanese institutions have conducted an unprecedented portfolio shift: the purchase of global securities surged to over ¥5 trillion in March alone, the highest outflow recorded in history.[2] Sure, these investors are "fleeing" domestic money markets—but that is exactly what NIRP was supposed to stimulate. The long-term implications, despite short-term market movements, clearly support a weakening yen environment that has been supportive for Japanese asset markets and inflation trends. • NIRP was implemented to force an end to business as usual for Japanese banks. Quantitative easing (QE) and the buying of Japanese government bonds was the carrot, as the BOJ offers to buy bank assets at a higher price. NIRP is the stick: their idle cash balances get taxed. It's no surprise that bankers complain vociferously. However, banks also are beginning to change: since NIRP, we have seen two mergers of regional banks, seven capital tie-ups between regional banks, and eight regional banks setting up a joint asset management company. All this would have been unthinkable only a couple of months ago. These actions are a fully intended consequence of NIRP, namely to inflict pain on banks in general and regional banks in particular. Both the Ministry of Finance (MoF) and the Financial Services Agency (FSA) want a consolidation of the secondary banking system. Kuroda has delivered a concrete trigger to achieve this. • In the same way the BOJ, MoF and FSA are encouraging a shift away from deposits and toward securities, NIRP is forcing the issue; and yes, Japanese bankers now actually have to accelerate their strategic plans to develop proper asset management businesses at home and proper global lending business abroad. NIRP should continue to encourage the portfolio rebalancing the BOJ has intended from the start of its QE program, and the development of the aforementioned joint asset management company is an example of this development. • NIRP is also delivering a boost to households' purchasing power by dramatically reducing interest expenses. Since its introduction, mortgage rates have dropped dramatically—a 10-year fixed rate is now offered at 0.70%, down from about 1.3% since six months before NIRP. And, yes, mortgage refinancings have surged fourfold from last year's run rate[3]. If 10% of mortgages get refinanced, the savings in interest expense could boost disposable income by as much as half a percent. NIRP has triggered a transfer of profits away from banks and to Japanese consumers. • Finally, the recent fearmongering in the press—that money markets would "freeze" and spell disaster in a Lehman-style shock—is good journalism but bad economics, in my opinion. The de-facto nationalization of Japan's money markets is reducing, not raising, private credit risks. The fact that global investors are raising their exposure to yen fixed income tells us exactly that. I am fully aware that this is not the prevailing narrative as spun by Japanese banks. But team Abe (Japan's prime minister) and Kuroda do have an agenda, and they are not afraid to be the first ones to try to disrupt outdated practices. But what about the yen? Record portfolio outflows from Japan indicate that NIRP is doing what it's supposed to do. Yes, for now these positions have been fully hedged—hedge ratios on Japan's global portfolio have gone up from barely 50% at the end of September 2015 to almost 100% by the end of March.[4] I believe we will see this turn into a force for yen depreciation, once the U.S. yield curve steepens and confidence in the dollar returns. [1]Source: "Introduction of 'Quantitative and Qualitative Monetary Easing with a Negative Interest Rate,'" Bank of Japan, 1/29/16. From 1/29/16 to 4/18/16, the yen has appreciated more than 11% against the U.S. dollar: Bloomberg. [2]Source: Bank of Japan, as of 3/31/16. [3]Source: Bloomberg, as of 3/31/16. [4]Source: Bank of Japan, as of 3/31/16.

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DEFINITIONS

Negative Interest Rate Policy (NIRP) : A monetary policy where by interest rates.

Inflation : Characterized by rising price levels.

Quantitative Easing (QE) : A government 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.

Run-rate : Extrapolation of a financial figure for the purpose of adding context to a singular data point.

Credit : A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

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.