

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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