EXPLANATION OF THE BANK OF JAPAN'S BOLD PROGRAM, IN ITS OWN WORDS

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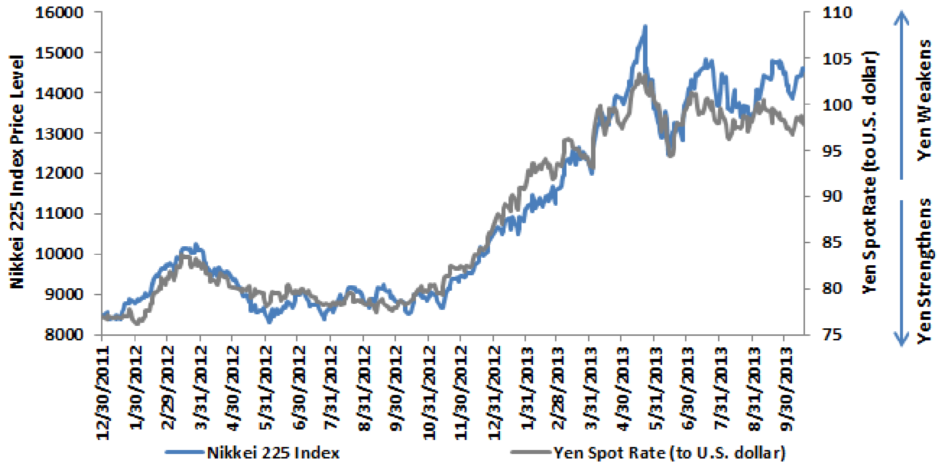
On October 18, 2013, the deputy governor of the Bank of Japan (BOJ), Kikuo Iwata, gave a speech that went into great detail about the new quantitative and qualitative monetary easing ("QQE") program that the BOJ introduced in April of this year. This speech provided some great insight into the BOJ's thinking. The BOJ is on track to be the most aggressive central bank in the world in its battle against the deflationary forces that have gripped Japan's economy for the last 15 years. The new QQE program is starting to impact Japan's economy measured by GDP, interest rates, inflation expectations, currency value against the U.S. dollar and equity markets[1] —and it's all going in the direction the BOJ desires. Let's review key elements from Iwata's speech: On April 4, the BOJ decided to embark on its QQE program for "as long as it is necessary"[2] to attain its 2% inflation target. The key words are "as long as it is necessary." There is no sense of potential failure in the language coming from the BOJ—it will continue to hold to its policies to achieve these goals. **Iwata answered why it is so important to reach this 2% inflation goal:** *… deflation must be avoided once and for all. It squeezes corporate profits through price declines of goods and services … Put differently, the real value of debts will increase as deflation continues. In light of an increasing real value of debts, firms become cautious in terms of their attitude toward business investment that requires fund-raising. As a result, production and labor demands of the economy as a whole will decline, leading to a rise in the unemployment rate and a decline in wages; hence, people's living standards will go down as well. On top of this, an inflation rate of about 1 percent is not necessarily enough as a buffer against the slightest risk of deflation.*[3] Iwata then went on to describe the two pillars of the QQE program: 1) A commitment to achieving the 2% inflation target at the earliest possible time, with a time horizon of about two years 2) A demonstration of concrete actions toward that commitment As far as concrete actions: • The BOJ aims to take the monetary base from 138 trillion yen at end of 2012 to 270 trillion yen by year-end 2014—in effect nearly doubling it. • The composition of the balance sheet is also changing to favor riskier assets. o Regarding the purchase of Japanese government bonds (JGBs): the BOJ "now purchases JGBs in all maturities including those with super-long maturities of 40 years. As a result of this, the average remaining maturity of the Bank's JGB purchases has been more than doubled, extending from slightly less than three years to about seven years."[4] One of the most interesting elements to me is Iwata's description of the risky asset purchases: *On top of this, the Bank has increased the purchases of exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) in order to suppress risk premiums associated with those types of assets.*[5] Those are big statements. When the BOJ says it is trying to suppress risk premiums, it conversely is saying it is targeting higher asset prices and wants to bring comfort to the market for both real estate assets and equities more broadly. We have all heard the phrase "Don't fight the Fed"—when central banks are providing monetary policy easing, it can be very good for asset prices. The BOJ is really taking this to the next level by very directly purchasing risky assets in a goal to suppress risk premiums. Who are we (or more precisely, who are the Japanese citizens) to fight the BOJ, given its control of the printing press to keep extending its purchases? In essence, the BOJ has unlimited ammunition with which to fight its battle against low asset price appreciation and low inflation—it may make more sense for Japanese citizens and foreign investors alike to position their portfolios alongside these actions. The Bank of Japan's QQE program provides very important support for risk markets. Iwata stated the reasons quite clearly when he said: *… if people expect prices to go up down the road, the real rates of return from cash as well as deposits and bonds—for which interest rates are fixed—will decline. Holding those assets will become less attractive than in the past. In light of such developments, market participants with rising inflation expectations will shift part of their portfolios from cash, deposits, and bonds including JGBs to equities (including equity trust funds), real estate and homes (including real estate* *investment trusts such as J-REITs) or, alternatively, foreign-denominated assets for which returns are higher than those derived from yen-denominated assets. As a result of this, expectations would be for stock prices to rise, the yen to depreciate, and foreign currencies to appreciate.*[6] **[Nikkei 225 Index](#) vs. Japanese Yen (12/30/2011–10/18/2013)—Referred to as "Chart 3" in Iwata's Speech**



Period: This period was selected to showcase a period in which one can see a change from approximately one year prior to Shinzo Abe's election as the Japanese prime minister to nearly one year after, so as to contrast any differences in more recent time frames due to his policy prescriptions thus far. Past performance is not indicative of future results.

And that is exactly what is happening thus far, as can be seen in Chart 3 from Iwata's speech. To view the full speech, go to this BOJ link. In a future blog post, we will explore how inflation expectations have been shifting thus far and what that may mean for the yen going forward. We will also explore what the early evidence shows for the shifting of assets by Japanese households from their huge piles of cash into the riskier assets—as that can be a major force driving equity markets going forward. [1]Equity markets: Here refers to the Nikkei 225 Index. [2]Governor Koruda, Bank of Japan Governor, April 2013 as cited by Bloomberg [3]Kikuo Iwata, "Purpose and Mechanism of Quantitative and Qualitative Monetary Easing," Bank of Japan, October 18, 2013. [4]Iwata, 2013. [5]Iwata, 2013. [6]Iwata, 2013.

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DEFINITIONS

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.

Deflation : The opposite of inflation, characterized by falling price levels.

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

Interest rates : The rate at which interest is paid by a borrower for the use of money.

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

Monetary Base : For a particular economy, the sum total of all cash and bank deposits in circulation. Increasing this number is one way to stimulate economic growth.

Riskier assets : Assets not backed by the full faith and credit of a government entity.

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.

Japan real estate investment trusts (J-REITs) : Investment structure containing a basket of different exposures to real estate, be it directly in properties or in mortgages traded on the Tokyo Stock Exchange. Returns predominantly relate to changes in property values and income from rental payments.

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.

Nikkei 225 Stock Average Index : A price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.