JAPAN: MORE POLICY INNOVATION NEEDED TO BOOST INFLATION EXPECTATIONS

The Bank of Japan has reaffirmed its position as the most innovative central bank, introducing “yield curve control” into its existing quantitative and qualitative monetary easing (QQE) framework. On September 21, the BoJ announced that it will attempt to anchor 10-year Japanese government bond (JGB) yields at close to current levels of zero percent. With the short rate unchanged at a negative 10 basis points (bps), the move effectively enforces a shallow upward-sloping yield curve. While the JGB purchases are likely to remain in the region of Y80 trillion per year, the magnitude of the expansion of the monetary base is no longer an explicit target.

Although the BoJ may still have the title of the most innovative central bank, we think it will also remain the least effective when measured against its ability to meet its inflation target. The BoJ sought to address this failing by initiating an “inflation-overshooting commitment,” included in its latest policy statement.

The yen and inflation dynamics

Despite the rhetoric, the inflation dynamics in Japan continue to look unfavorable. Granted, the 3.0% unemployment rate is the lowest since 1995, suggesting that the economy is close to full employment. Yet wage inflation (as measured by scheduled...
earnings of full-time employees) is subdued and has held steady at around 0.5% year-over-year (y/y) for nearly two years. Consumer inflation expectations remain weak and market-based 5-year inflation expectations in five years’ time are just 4bps.

The persistent strength of the yen may be the more important driver of Japan’s inflation outlook. There is a clear pass through from the exchange rate to import prices to core inflation. Import prices fell 16.7% in the year to August, mirroring the 23% appreciation in the yen over the same period. 

**Exhibit 1** shows that changes in core import prices typically feed through to core inflation with a lag of nine months. We expect Japan’s inflation outlook to deteriorate in 2017.

The BoJ’s decision fell on Prime Minister Shinzo Abe’s 62nd birthday, but it was the Japanese banks that received the biggest present from BoJ Governor Haruhiko Kuroda. The BoJ’s commitment to provide an upward sloping yield curve and the lack of a policy rate cut were both supportive for earnings (each 10bps decline in short-term interest rates reduces earnings of the Japanese megabanks by approximately 5%). In addition, the BoJ’s decision to place greater emphasis on Topix-based ETFs (8% of which are banks) rather than Nikkei-based funds (with only a 1% bank weighting) added further ballast to the BoJ’s new policy. Japanese banks rallied 7% on the BoJ announcement, outperforming the Topix by 4 percentage points.

**Is this a gift that keeps on giving? We’re skeptical. A yield curve slope of just 10bps is pitiful and we see little upside potential for loan growth from its current run rate of 2.0% y/y. In an economy with a trend economic growth rate of 0.5%, that’s already pretty good going.**

So while the pendulum of Japan’s monetary policy has (at least for the time being) swung marginally toward favoring financials and away from weakening the currency, a steeper yield curve is likely required to sustain the bank rally (**Exhibit 2**). It’s also worth noting what Governor Kuroda said at his press conference: While the BoJ did take into account the future impact of policy on bank earnings, this consideration would not limit how far short-term rates can fall.

**Abe’s missing birthday present that only he can buy**

In introducing a new tool into the BoJ’s kit, Kuroda may have alleviated some market concerns about the ammunition of central banks. However, though Kuroda insisted that the BoJ “don’t intend to fine tune policy at

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**EXHIBIT 1: YEN STRENGTH HAS CAUSED IMPORT PRICES TO PLUMMET, PLACING DOWNWARD PRESSURE ON CORE INFLATION**

In recent years, Japanese core inflation has improved from negative territory to 0.5%, but it is too soon to declare that the threat of deflation has been beaten back. The disinflationary impulse from recent currency strength has already led to a slump in import prices. We are concerned that weaker import price inflation is beginning to feed through into softer core CPI inflation, posing a threat to the efficacy of recent Bank of Japan policy innovation.

![Graph showing import price index and CPI excluding fresh food and energy](image-url)
The inability of the BoJ to raise inflation expectations is the critical issue. One hope, albeit a distant one at present, is for a greater degree of coordination between monetary and fiscal policies. We expect that greater economic stress will be required for this hope to be realized, but it is worth highlighting the repetition of BoJ language that hints at future collaboration (“both parties strengthen their policy coordination and work together in order to overcome deflation early and achieve sustainable economic growth”). In fixing long-term interest rates, any increase in inflation expectations would feed straight through to lower real yields, exactly the present Japan needs.

**ASSET CLASS IMPLICATIONS**

We see little reason to alter our view on Japanese assets following the BoJ’s policy innovation. The combination of yen strength and optimistic earnings expectations keep us underweight Japanese equities and the BoJ’s effective endorsement of the status quo in the JGB market confirms our neutral stance on JGBs. Although we are comfortable with our neutral stance on the yen, a possible tapering of BoJ purchases could add upside pressure.

The Bank of Japan is still caught (if not trapped) in the modern central banker’s dilemma. Central bankers are on the one hand reluctant to further cut interest rates for fear of damaging bank profitability and thus impeding the provision of credit to the real economy, but on the other hand they have little appetite to raise rates and thus risk currency appreciation and a further undershoot of their inflation targets.

The anchoring of 10-year yields at close to current levels has also raised the prospect that the BoJ may be effectively tapering its JGB purchases. By endorsing the status quo and with apparently little appetite to force a steeper curve by skewing JGB purchases to the front end of the curve, (both because of the impact on banks and because the BoJ already owns around 45% of the market), there is effectively less need for the BoJ to deploy such forceful spending power.

**EXHIBIT 2: JAPANESE BANKS HAVE OUTPERFORMED AS THE YIELD CURVE HAS STEEPENED**

By seeking to establish “yield curve control” and not push interest rates further into negative territory, the Bank of Japan has provided some support to the banking sector. There is a close relationship between the relative performance of Japanese banks and the slope of the yield curve. While shareholders will welcome some respite, the reprieve is likely to be short-lived as the earnings outlook remains challenging.

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Global Multi-Asset Strategy:

John Bilton
Head of Global Multi-Asset Strategy
London

Thushka Maharaj
Global Strategist
London

Michael Hood
Global Strategist
New York

Benjamin Mandel
Global Strategist
New York

Diego Gilsanz
Global Strategist
New York

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