

Macro Keys

Bank of Japan Preview: Set for further easing based on the Comprehensive Assessment

Economics

Global

Comprehensive Assessment's purpose, BoJ action

Speeches by BoJ Governor Kuroda and Deputy Governor Nakaso have hinted at the Comprehensive Assessment and at the direction of further monetary policy measures. This shows a change in the BoJ's communication policy, which has hitherto involved staging surprises. However, it is also true to say the market was somewhat disappointed in the content of the speeches.

The speeches reveal that the Comprehensive Assessment will focus on two points: reasons for not hitting the 2% target, and an evaluation of negative interest rates. The BoJ's response is that although the expected inflation rate has fallen because of factors such as the oil price decline, it thinks the expected inflation rate will turn up and rise once again. The BoJ also emphasizes that negative interest rates have had a positive impact in areas such as lifting residential investment, but notes that side-effects such as the squeeze on financial institutions' earnings need to be taken into account. Of greater importance will be what the BoJ plans to do to reach the 2% inflation target as soon as possible in light of this analysis.

Our view is that the BoJ will decide to ease further on 21 September in light of its Comprehensive Assessment. This will likely involve an increase in the value of JGB buying and a switch to a target range of ¥70 – ¥100trn of annual purchases, as well as a further 20 bps cut in negative interest rates. In this case we believe there is a good chance it would be combined with measures to steepen the yield curve, in order to take the side-effects of negative interest rates into account. That said, there is the risk of further easing being deferred if USD/JPY is approaching ¥105.

Market reaction will depend on communication

Our call for a 20 bps cut to the IOER at the September meeting should generally be considered a dovish surprise (and hence bullish for USD/JPY) given current pricing (~5bps). We think that the BoJ should strive for a weaker yen, other things being equal, but communication will be crucial. Communicating an easing bias along with steeper curves and a potential 'twist' operation will be a challenge; we think that USD/JPY could sell-off by 1-2 big figures in the absence of convincingly dovish communication. Such a move could in fact extend further if the FOMC strikes a more dovish tone than expected on the same day, further complicating the BoJ's task.

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PIVOTAL QUESTIONS

Q: What will the Comprehensive Assessment Contain?

Key points in the Comprehensive Assessment will be (1) why inflation has not reached 2%, and (2) what impact the negative interest rate policy (NIRP) has had on the economy and industry. The BoJ is due to discuss what it needs to do to achieve its inflation target as soon as possible in light of its assessment.

Q: Will the policy meeting bring further monetary easing?

We think the BoJ will decide to ease further on 21 September in light of the Comprehensive Assessment. This will likely involve an increase in the value of JGB buying and a switch to a target range, as well as a further cut in negative interest rates. On the other hand, we think surprises such as foreign bond buying and helicopter money are unlikely. That said, there is the risk of further easing being deferred if USD/JPY is approaching ¥105.

Q: Will the yield curve steepen?

The BoJ is likely to encourage the yield curve to steepen in a bid to mitigate the side-effects of a further cut in interest rates. Specifically, we think measures such as focussing increased JGB buying into relatively short-term bonds and conducting a twist operation could prevent the curve from flattening.

UBS VIEW

We believe the BoJ is likely to ease further at its 21 September policy board meeting in light of the Comprehensive Assessment due to be published on the same day, expanding the value of JGB purchasing and adopting a range for this (¥70–100trn), as well as lowering negative interest rates still further (by 20bp). However, there is the risk it will opt not to ease if USD/JPY is approaching ¥105.

EVIDENCE

The Comprehensive Assessment will form the basis for debate about achieving the 2% inflation target as soon as possible. Although we expect the depressed expected inflation rate to rise from here on, we believe it will take a long time to reach 2%.

WHAT'S PRICED IN

A cut in the IOER and JGB-buying set at a range of ¥70–100trn would engender a bullish view on USD/JPY provided the BoJ communicates effectively. Market prices are a long way from a 20bp cut, and in our basic scenario we expect the yield curve to steepen. A twist-style operation or commitment to appropriately adjusted measures to shift to short-term JGB purchases in large volumes would steepen the curve to the maximum degree.

Upside/Downside

On the other hand, we think USD/JPY could sell off by ¥1–2 in the absence of convincingly dovish communication. This move could extend further, depending on the FOMC. The yield curve will depend on whether the BoJ mentions how far it will cut long-term JGB-buying. We think the BoJ will need to clearly communicate the fact that it is keen for the curve to steepen in order to lift yields further to any significant degree.

BoJ's communication method changing

Speeches by BoJ Governor Kuroda and Deputy Governor Nakaso on 26 August and 5 and 8 September hinted at the Comprehensive Assessment due on 21 September and at the direction of further monetary policy. Unlike previous speeches, these included points such as reasons for not reaching a 2% inflation rate, the impact of negative interest rates, and the direction of policy from here on, marking a change from the BoJ's communication policy to date, which has involved staging surprises. However, it is also true to say the market was somewhat disappointed by the content of the speeches. Specifically, (1) the BoJ thinks the expected inflation rate is picking up alongside economic recovery and the rise in the oil price, and was hawkish on prices, (2) the speeches made no mention whatsoever of room to expand quantitative easing (QE), and (3) they hinted at taking negative interest rates still lower, while touching on their side-effects, dashing expectations that had risen among some market participants. Appetite for steepening the yield curve was evident in the fact speeches mentioned the side-effects of negative interest rates. For our assessment of the speeches please refer to our [5 September Japan Economic Comment](#).

Details of Comprehensive Assessment broadly clear

The Comprehensive Assessment will be published alongside the end of the Monetary Policy Meeting. The speeches reveal that the focus will be on two points, and two issues will be crucial, namely (1) why inflation has not reached 2% despite the large-scale QQE conducted so far, and (2) what impact the NIRP has had on the economy and industry. Comments pointing to answers have already been made in the speeches. On the first point, Mr. Kuroda says the expected inflation rate is governed by the 'forward-looking formation mechanism' and the 'adaptive formation mechanism', and that the influence of the latter remains strong in Japan. The fall in the oil price, weak domestic demand after the consumption tax hike, and concerns over economic downturn in emerging markets have slowed price rises, and the expected inflation rate has also declined because of the 'adaptive formation mechanism.' He suggested that although uncertainty remained, the expected inflation rate would rise once more on the back of economic recovery and the climb in the oil price. On the second point (NIRP), he pointed out that there were positives, such as rising household residential investment and an increase in corporate bond issuance, but he also emphasized side-effects, including the squeeze on financial institutions' profits, falling pension and insurance asset management yields, and downward pressure on profits from rising retirement benefit obligations. We expect the Comprehensive Assessment to broadly talk about these two issues, but it will be even more important to watch what the BoJ does in light of this analysis. Mr. Kuroda has said the BoJ will discuss what needs to be done to reach the inflation target at the earliest possible date in light of its assessment, and it should indicate what it will do to achieve this.

Focus on BoJ's first move in light of its Assessment

However, the BoJ may regard stabilizing the yen-dollar rate as important for corporate and household spending patterns, and there is also the risk it will opt not to ease if USD/JPY is approaching ¥105. Furthermore, the problem is that the above speeches indicate that the details of any easing may not come as any great surprise to the markets.

Firstly, we think the BoJ will change its JGB purchasing program from ¥80trn a year to a range of ¥70–100trn, and increase its target to the midpoint of this. Switching to a range will allow the BoJ to respond flexibly to the economic and market environments, since any impediments to future JGB buying could cause the markets to become

abruptly aware of the limits to QE. Highlighting a reduction in future buying would be negative, but combining this with an increased median level will likely put an overall increase in QE at the forefront.

Upside for QE could involve increasing the scale not just by ¥5trn but by ¥10–20trn, including local government and public corporation bonds. Financial institutions own a total of ¥116trn in government and public corporation bonds, and the BoJ has not bought up any of these at all. If the BoJ sticks to quantitative expansion, this is a possibility (subjective probability of around 30%).

We think there is a good chance of a further cut in negative interest rates (by another 20bp; subjective probability of about 60%). Mr. Kuroda's view is that negative interest rates have had a beneficial impact so far by increasing housing investment and corporate bond issuance. On the other hand, he has also touched on side-effects, including depressing financial institutions' earnings, and we expect a comparison between costs and benefits at the policy board meeting. If the BoJ deems that benefits outweigh costs, a further cut in interest rates is likely.

Turning to the yield curve, Mr. Kuroda's Jackson Hole speech on 26 August suggested that the January NIRP had brought interest rates close to their potential level, and that even a further cut in rates would not lead to as much of a drop in the long-term zone as in January. Even then, we believe there is a good chance that any further cut in interest rate will be combined with measures to steepen the yield curve, taking the side-effects of negative interest rates into account. Specifically, we think measures could include (1) suggesting a reduction in purchasing in the superlong zone through a reverse Operation Twist, (2) focussing any increase in QE into relatively short-term JGBs, and (3) collaborating with the Ministry of Finance to bring an increase in superlong JGB issuance by the MoF. On the last of these the MoF has clearly stated its policy of an increase already.

We think large-scale fiscal policy measures, foreign bond buying or the helicopter money expected by some market participants are unlikely. There is the risk that foreign bond purchases would be seen as currency policy, and could trigger opposition from various countries. Furthermore, currency policy lies in the remit of the MoF in Japan. The MoF's position is that it is happy to intervene in currency markets when needed, and we do not believe the BoJ would be permitted to involve itself in currency policy. Furthermore, speeches to date have made absolutely no mention of the possibility of measures such as direct JGB underwriting or perpetual bonds, and we think a helicopter money policy is unlikely. A decision to implement such a policy would come as a great surprise to the market, but would also strengthen the view that the BoJ has no communication policy.

Market reaction will depend on communication effectiveness

In July we highlighted that the BoJ's main challenge was high market expectations for aggressive easing. Expectations are arguably lower now; this is both with regards to prospects for an imminent deposit rate cut but also likely regarding the scope for a significant upsizing of QQE. The steepening of the JGB curve by ~20 bps in 5s30s since mid-August in anticipation of the review is arguably reflective of this. But has risk reward improved for USDJPY upside?

Our call for a 20 bps cut to the IOER at the September meeting should generally be considered a dovish surprise (and hence bullish USD/JPY) given current pricing (~5bps), at least assuming that markets are fairly confident that such a decision is not a policy mistake. Hence, the BoJ will have to explain more convincingly why QQE with even more negative rates will work better, thus dispelling the concerns raised since January regarding its effectiveness.

A shift to a 70-100trn target range for JGB purchases could also be bullish USD/JPY if communicated appropriately. In particular, the BoJ could emphasize that a switch to a JGB purchase range is not a capitulation and that "flexibility" still means the purchases will occur in the upper end of the target range if necessary.

Curve behavior will likely also be a function of the BoJ's communication. A "twist-style" operation or a shift in the purchase bucket of JGBs in favor of shorter-maturities will have the maximum effect in terms of curve steepening if it is accompanied by the conviction that it is a properly calibrated measure to the aim of reflating the economy (thus also boosting inflation expectations).

Conversely, slippage into the policy-mistake direction could have little additional (or even the opposite) effect on curve steepness. This is especially so if a drive to even more negative rates territory is not seen as appropriately designed or offset by modifications in the JGB purchase modalities.

Consequently communication is crucial, leaving ample space for the market to misinterpret the BoJ's intentions. As we think that the BoJ should other things equal strive for a weaker yen, we think that USDJPY could sell-off by 1-2 big figures in the absence of convincingly dovish communication. Such a move could in fact extend further if the FOMC strikes a more dovish tone than expected on the same day, further complicating the BoJ's task.

Investors' frequently asked questions

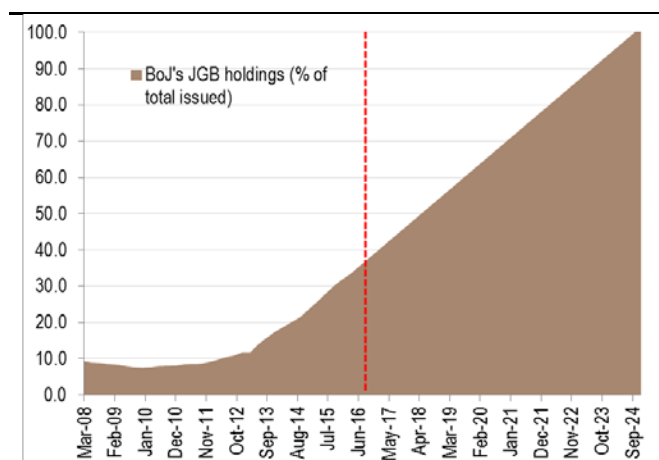
Question 1: Will BoJ really move before FOMC meeting on a same day and before US presidential election in Nov?

UBS Answer: There is clearly the risk of no action (we put the subjective probability of easing at 70%, and of a cut in the IOER at 60%). However, the aim of the Comprehensive Assessment is to consider what the BoJ needs to do in order to meet the 2% inflation target as soon as possible. The content of this suggests that the BoJ will stick firmly to its 2% inflation target, and that although it will take the side-effects of negative interest rates into account, they are having a major impact. Inaction at the forthcoming policy board meeting will likely be interpreted as the BoJ answering that it has nothing more it needs to do to achieve the 2% target, effectively highlighting the limits of monetary policy more strongly. If the BoJ remains committed to the 2% target and sets out to achieve this at an early date, we think a desirable program would involve a combination of greater flexibility in an expanded JGB purchasing program, and negative interest rates to stimulate the economy. However, there is the risk that any failure in communication could lead to a stronger yen, as noted above, even if the BoJ eases.

Question 2: How long can the BoJ continue to buy JGBs?

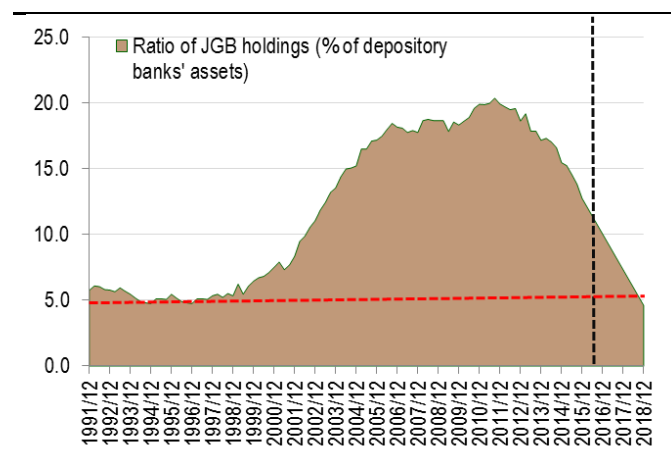
UBS Answer: The amount of JGBs and FILP bonds in issue stands at ¥955trn (end-March 2016), implying it will take until around 2024 before the BoJ has bought up all JGBs at the current pace of acquisitions (Figure 1). However, financial institutions and others need to hold on to a certain level in view of their asset management requirements, and we think end-2018 or so will mark the limit. JGBs accounted for around 5% of depository institutions' assets in around 1999, and this can be seen as the bare minimum requirement in terms of their risk management (Figure 2). This ratio consistently rose after the zero interest rate policy (ZIRP) was introduced, but then started to fall because of the BoJ's active JGB purchasing, and has currently dropped to 13%. If this pace continues, we think it will reach the 5% level we see as the bare minimum requirement by around the end of 2018, and depository institutions will no longer be able to make any further sales.

Figure 1 Still a long while before BoJ could buy 100% of JGBs currently in issue



Source: Bank of Japan, UBS

Figure 2: 5% holding at depository institutions could mark lower limit



Source: Bank of Japan, UBS

Question 3 : What other assets could be bought besides JGBs?

UBS Answer: We think there is particular scope in local government and public corporation bonds. There is a balance of ¥154trn or so of these, with ¥116trn held by financial institutions (Figure 3). The BoJ has not hitherto purchased these, and likely has room to increase buying in this area. Its industrial bond holdings are not high, either. Foreign bonds account for a small proportion of the total, but we believe the BoJ is unlikely to buy these for the reasons mentioned above.

Figure 3: Balance of financial assets, value held by financial institutions, BoJ's holding ratio

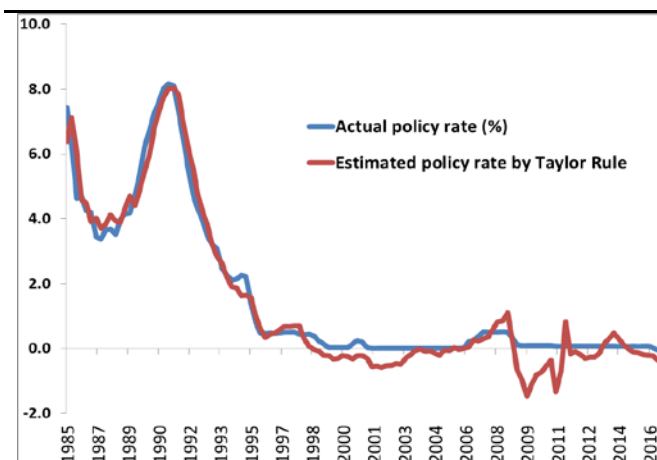
	Total outstanding (JPY trn)	Ratio of BoJ holdings (% of total outstanding)	Holdings by financial Institutions (JPY trn)	(BoJ holdings) (JPY trn)	Ratio of BoJ holdings (% of financial institutions holdings)
T-bills	119.9	39.4	61.1	47.3	77.3
JGB & FILP bonds	955.0	33.2	825.5	317.1	38.4
Local government bonds	76.0	0.0	59.3	0.0	0.0
Public corporations bonds	78.4	0.0	56.7	0.0	0.0
Industrial bonds	83.4	3.8	65.6	3.2	4.8
CP	11.3	17.5	9.9	2.0	19.9
Investment trust beneficiary certificates	167.8	5.5	58.5	9.2	15.6
Foreign securities	578.7	0.8	327.2	4.4	1.4

Source: Bank of Japan, UBS

Question 4: How low should negative interest rates go?

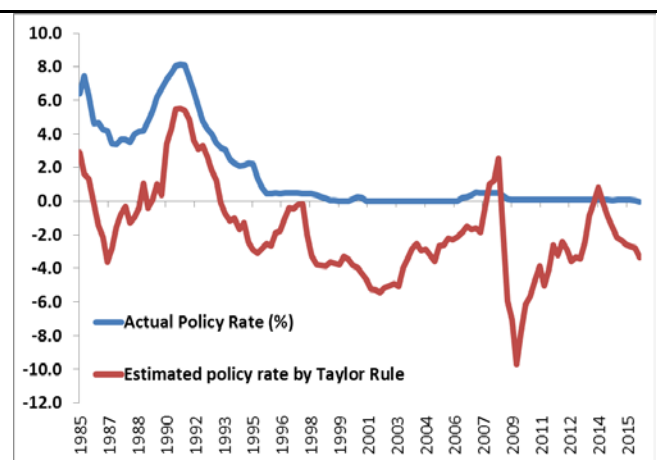
UBS Answer: BoJ Governor Kuroda's speech indicated there is still scope for a further reduction, while also mentioning the relationship with the cost of holding cash. Further, looking at this from the Taylor rule perspective, interest rates could go down at least as far as -0.4% (Figure 4), while if there is a strong reaction due to the inflation gap, a reduction to around -2% could be justified (Figure 5).

Figure 4 Policy interest rate according to the Taylor rule (coefficient based on historical estimated value)



Source: Bank of Japan, UBS

Figure 5: Policy interest rate based on Taylor rule (applying the coefficient a priori)



Source: Bank of Japan, UBS

Question 5: How can the yield curve be steepened?

UBS Answer: If the expected inflation rate rises, the yield curve ought to steepen of its own accord. However, the BoJ may seek to actively steepen the yield curve to counter the side-effects of the NIRP. We think measures could include (1) suggesting a reduction in purchasing in the superlong zone through a reverse Operation Twist, (2) focussing any increase in QE into relatively short-term JGBs, and (3) collaborating with the Ministry of Finance to bring an increase in superlong JGB issuance by the MoF.

Question 6: Could the BoJ launch a policy of helicopter money in the future?

UBS Answer: We do not believe there is any chance of a policy of perpetual bond issuance and of BoJ buying or directly underwriting these, thereby entailing risk. Even then, we might see methods close in nature to helicopter money, such as BoJ commitment to holding longer-term JGBs (in this case, gearing up policies active over a longer timeframe such as setting a nominal GDP target would also be effective), or setting up a special account at the BoJ exclusively for the MoF, as suggested by Ben Bernanke.

The important point for helicopter money is that it is a method to overcome a liquidity trap in which monetary policy is not working, and problems when fiscal policy is not working either. Even though the BoJ is buying up large amounts of JGBs, funds remain stalled in BoJ deposit accounts. Despite the introduction of negative interest rates, there is no growth in lending in the absence of demand to invest. Fiscal policy is also inflating household and corporate savings because of concerns over future growth and tax hikes. Helicopter money could be a promising way to help overcome these issues.

The plan to set up a special bank account at the BoJ exclusively for MoF usage mentioned by Mr. Bernanke involves allowing the BoJ to lend to this special account, funded by JGB purchases. The important point is that there would be no demands to repay these funds in future. In this case JGBs equivalent to the amount of loans extended to such an account would effectively be treated in the same way as perpetual bonds. The MoF could create a situation effectively the same as deploying helicopter money by using funds in these accounts for fiscal policy measures to support companies and households. However, although the BoJ would effectively hold perpetual bonds, any increase in JGB issuance would worsen the primary balance and government debt, possibly stoking concerns about future tax hikes. Possible measures the BoJ could take to prevent concerns over future tax increases would include not booking the JGBs it acquires to lend to the special accounts as government debt.

The benefits of this policy would include avoiding having to actually introduce perpetual bonds, as well as keeping independent control over fiscal and monetary policy decisions at the government and BoJ respectively (the BoJ would decide whether to lend funds to the special account, while the government/Diet would decide how to use funds lent to the special account). However, a special BoJ account for the MoF would be intrinsically similar to direct underwriting, and doubts linger about how far the BoJ's independence would be assured. This policy would not be politically easy to introduce, but could be a more realistic option than perpetual bond issuance.

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