Daily Note

BOJ POLICY – END OF THE ROAD, NO EXIT

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- **Normalisation without exit: yield curve control is here to stay**
- **BoJ turning more pragmatic even as inflation disappoints**
- **Fiscal policy to assume the burden as macro risks mount going into 2019**

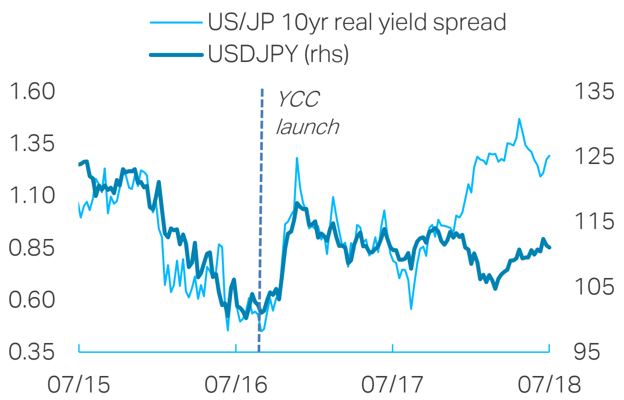
The market was looking for tweaks in BoJ policy at this week's meeting, and Governor Kuroda delivered. Those expecting the BoJ to raise its target for 10-year JGB yields and/or to shift to buying bonds with shorter maturities were disappointed. But what was announced still amounts to the most important adjustment since the introduction of yield curve control (YCC) in September 2016.

The changes are essentially baby steps towards policy normalisation – we discuss the details below. However, they are perhaps more significant from a communications standpoint, being the clearest official acknowledgement to date that the 'first arrow' of Abenomics cannot fly any higher. It is telling that the Bank has decided to 'tighten' despite again lowering its inflation forecasts: the 2% objective is further away than ever.

To be sure, unlike with the Fed or the ECB, this does not mark the start of an exit process. On the contrary, the new configuration is intended to make extraordinarily loose monetary policy more robust for the long haul. It is no coincidence the BoJ kept the target for JGB purchases at 80trn yen a year even though it has been buying at a much slower pace for some time. In Japan, QE is no longer a measure of monetary accommodation but simply a tool to control interest rates. YCC is here to stay "for an extended period of time", in line with the Bank's newly minted forward guidance. In other words, this is the end of the road but no exit is yet in sight.

New 'initial conditions'

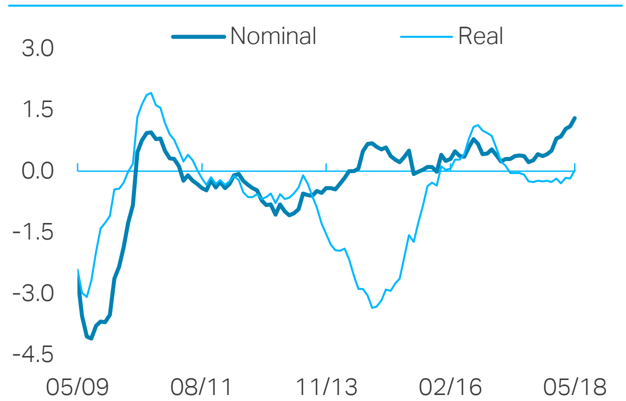
Per cent



Source: Bloomberg, TS Lombard

Japanese wages on the mend

YoY %, 6m MA



Source: Datastream, TS Lombard

Bank officials have been hinting at a more flexible policy stance since the autumn, so a bit of fine-tuning should not come as a surprise – not least as the macro 'initial conditions' have changed markedly since the launch of YCC in 2016. Japan's growth/inflation mix has improved, underpinned by strong external demand. The 10-year US Treasury yield has risen from 1.6% to just shy of 3%. Dollar-yen is around 10% higher, so the BoJ can lower its guard on the currency. With the Fed in tightening mode and the ECB turning the corner, monetary policy divergence remains in place.

The key tweak involves the long end of the curve. The BoJ will continue to guide the 10-year JGB yield to "around zero", which in practice has meant 10 basis points on either side. July's statement has made this flexibility explicit ("yields may move upward and downward to some extent") and in his news conference Kuroda said he now sees the range doubling to 20bp. Obviously, the band's upper limit is what is most relevant, hence the inclusion of a footnote reminding us that "in case of a rapid increase in the yields, the Bank will purchase JGBs promptly and appropriately" to prevent disorderly moves. Viewed in this light, last week's three offers by the BoJ to buy an unlimited amount of bonds were meant to reinforce this message.

But why act now, when underlying price pressures are showing signs of exhaustion? On the one hand, almost two years of YCC have produced adverse side-effects that are starting to bite. Trading in JGBs has become very thin, rendering market signals of questionable value. Negative short-term rates are weighing on banks' margins; to alleviate the strain, the -0.1% rate will apply to a smaller share of financial institutions' reserves from now on. Sustained large-scale ETF purchases have made the BoJ a major shareholder in nearly 40% of the constituents of the Nikkei average, causing a stir in the domestic equity market. There could also be political considerations at play. With September's LDP leadership election fast approaching, Prime Minister Shinzo Abe might want to project a more sober economic policy stance. What is more, the appearance of scaled-back monetary easing might help avert fresh Trump trade threats.

Then there is the BoJ's credibility. It goes without saying that Kuroda would have preferred to start adjusting policy against a backdrop of inflation strengthening towards 2%. But with inflation lagging far behind and the perception that it is more likely to fall further than to rise, it looks like the Bank has decided to start 'cutting its losses'. Its July Outlook includes a section on why inflation has been slow to respond to quicker growth and a tighter jobs market. There is nothing really new in the analysis: factors such as firms' and households' entrenched cautiousness; the impact of technology; and the drag on CPI from certain 'sticky' price categories (rent, healthcare) have all been discussed in the past. Yet it points to a more pragmatic central bank and a reluctance to keep policy hostage to forces largely beyond the BoJ's direct influence – something first signalled in April, when it dropped the timeframe for hitting its 2% inflation goal.

Looking ahead, what complicates matters is that the Bank sees the risks to growth – not just prices – as tilted to the downside beyond the near term because of slowing domestic demand. Maintaining positive macro momentum will therefore hinge even more on sustained export strength, leaving the economy vulnerable to a deterioration in global macro conditions, trade wars, etc. With monetary firepower all but exhausted, fiscal stimulus could be left to pull the economy along. The government has already pushed back its target for achieving a primary budget balance from 2020 to 2025. Sustained deterioration in the budget could ultimately take Japan – already highly indebted – closer to the financial rocks, exposing the fatal flaws of Abenomics. Using large-scale monetary easing to address domestic financial imbalances (i.e. excess business savings) was always going to end up increasing Japan's external surplus instead of boosting private demand in a sustainable fashion.

The BoJ's latest move shows prudence, but this does not mean the risks are not building – quite the contrary.