Bank of Japan Suffers Stimulus Fatigue as Policy Costs Mount

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Executive Summary

- Policy debates within the BOJ has shifted toward making the QE programs more sustainable, for policymakers acknowledged it may take longer than expected to reach policy objective as rising costs become "hard to ignore"
- Possible policy changes may include tweaking the yield-curve control program to allow for a more natural rise in long-term interest rates to ease pressure on banks, and to shift ETF buying toward stocks linked to the Topix index
- The policy considerations highlighted growing concerns over unconventional programs' side effects on both the real economy as well as market disruptions, for the BOJ has become the top shareholder for some big corporations
- Despite policymakers' hesitance to connect social impacts to low interest rates, research by the BIS noted higher saving by indebted Japanese households to meet end-of-life objectives, as income overcomes substitution effects
- While concerned about policy sustainability, the BOJ will likely look to prevent an uncontrolled rise in bond yields, but the on-going debates highlighted that QE is not costless, and BOJ officials are forced to re-examine policy path

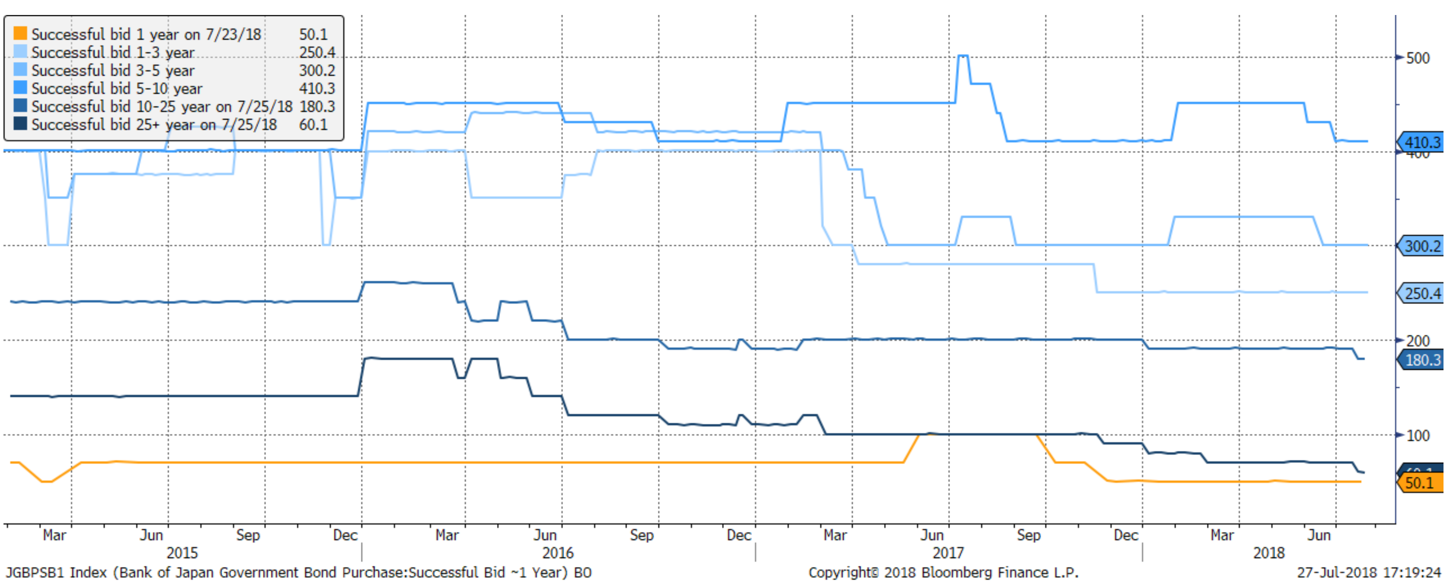
Bank of Japan's stealth taper and concerns over policy sustainability

Internal debates within Bank of Japan have focused on two of its key policy tools: the yield curve control (YCC) program and the ETF purchases. With inflation continue to trend below the central bank's policy objective, policymakers are facing a grim reality that it may take far longer than expected to reach the 2% inflation target, and that the central bank's policy tools are incurring rising costs that are becoming "hard to ignore." These costs include the considerable pressure on Japanese banks' profitability and BOJ's dominant presence as a top shareholder of major Japanese companies.

As a result, policymakers are considering the following policy adjustments to make the policy easing more sustainable:

- Tweak the existing yield-curve control (YCC) program to allow for a more natural rise in long-term interest rates
- Shift the $54.08 billion per year ETF QE to increase the amount of buying for Topix-linked ETFs over Nikkei constituents, as to distribute buying across a wider range of companies

Moreover, BOJ has persisted with its "stealth taper" to reduce long-maturity QE purchases:



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Costs of prolonged unconventional easing

BOJ's bond buying is closely linked to the on-going global term premium suppression by major central banks, and recent speculation of policy shift has naturally triggered a wave of duration shedding across sovereign bond issuers. Nevertheless, such impact is dwarfed by ramifications from BOJ's ETF purchase program, for the central bank has become a major stock holder in nearly 40% of listed companies with $277 billion in equities holding.

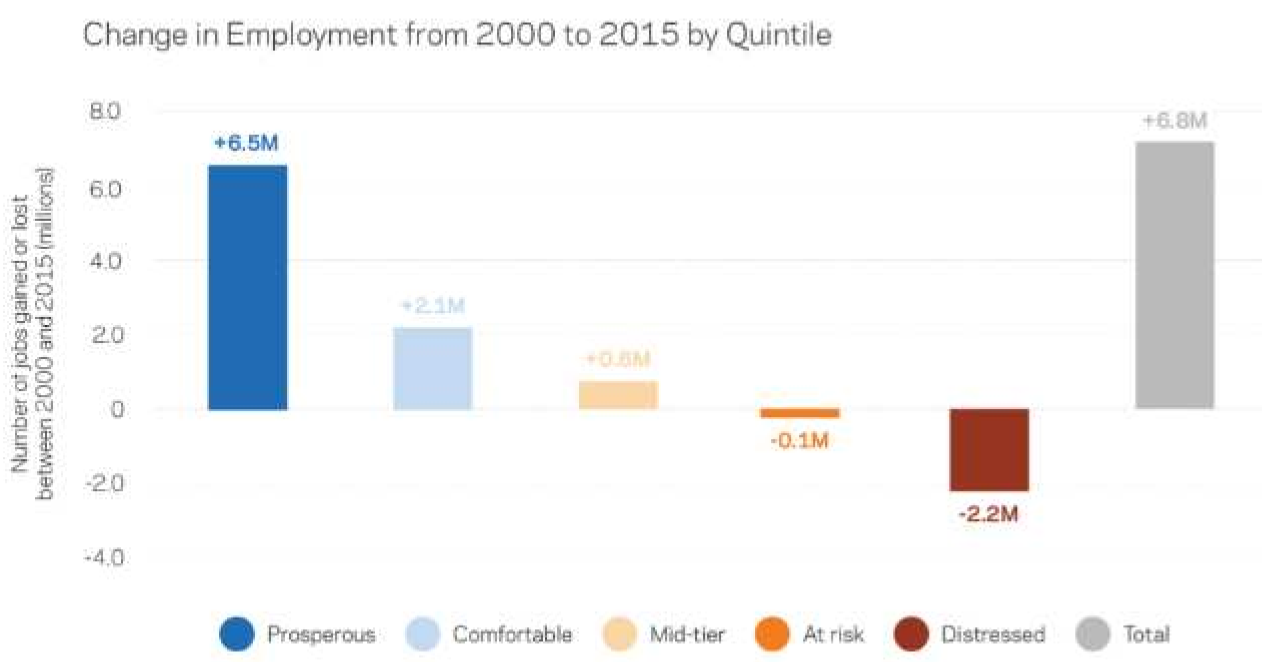
BIS recently noted that Japanese households tend to save more when they have a higher level of debt (an expected outcome of prolonged credit easing), and concerns over latter stages of life is a key motive for household precautionary saving – a development likely exacerbated by policy-induced low interest rates. This thesis is reinforced by former RBI Governor Rajan's view that as interest rates decline past a certain point, the income effect start becoming greater than substitution effects:

> The usual point is I push down interest rates – I say, "Wow, it is better to consume now than to save," and I consume. But what if I have an end-of-life goal in terms of savings and I push down interest rates really low and I say "wow, I really can't meet my savings goal. I am going to be on the streets when I am old, so I better save some more." That is the perverse effect of low interest rates.

This is consistent with the thesis that ultra-accommodative monetary policy can exert an unintentional drags on consumer spending, and the impacts can be seen across economies that have implemented aggressive monetary easing.

While policymakers generally do not comment on possible connections between policy accommodation and impacts on social and political developments, there are increasing signs that higher living costs as a result of policy-induced inequality (QE programs lift property prices while wage growth being constrained by structural factors) is weighing on young families and contributing to demographic changes – a policy issue that is affecting a number of developed economies' growth potential, including both U.S. and Japan.

Finally, more media outlets have recognized the uneven recovery following the Great Recession, such as the co-existence of an "eviction crisis" and record low unemployment. Economic prosperity across advanced economies (including South Europe) are increasingly conditional to one's class, and they are becoming hard to ignore in the U.S.:



Thus, it would not be surprising to see policymakers beginning to view current form of "QE forever" as unsustainable.

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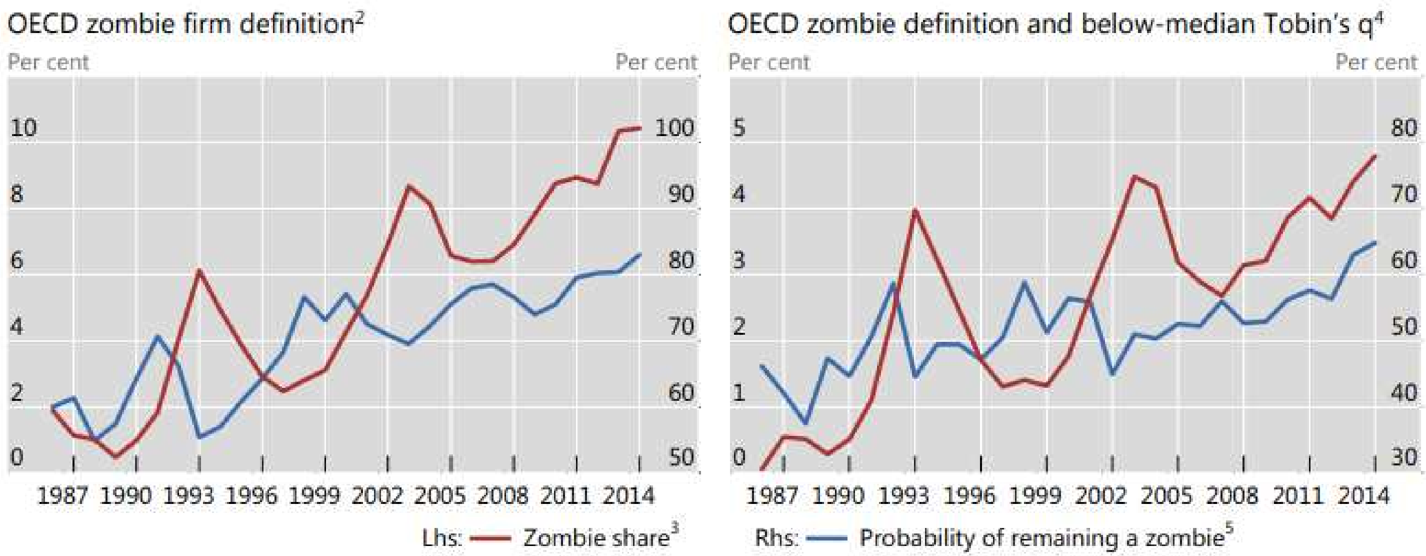
BOJ to tread lightly on communication to avoid "tantrum"

Even though the BOJ had provided informal guidance on possibilities of policy adjustment to make present QE programs more sustainable, Governor Kuroda (and similar President Draghi with ECB QE) would be less willing to tolerate a market "tantrum" with an uncontrolled rise in term premium, for the present "low [long-term] rates for longer" environment has fostered the growth of uncompetitive "zombie" firms sustained by easy funding by non-bank financial institutions (asset managers and liability-driven investors):

Zombie firms on the rise and surviving for longer[1] Graph 4



[1] Sample includes listed non-financial firms in Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. [2] Zombie firm defined as a firm whose EBIT is below interest payments and is over 10 years old. [3] Ratio of the number of zombie firms to all listed firms. [4] Zombie firm defined as a firm whose EBIT is below interest payments, is over 10 years old and has below-median Tobin's q in its two-digit SIC sector in a given year. [5] Probability of a firm remaining a zombie in the following year, conditional on it being a zombie in the current year.

Source: Banerjee and Hofmann (2018).

With the global "debt-trap" at stake, BOJ will be unlikely to pledge a hawkish policy pivot to risk elevating global volatility, for major monetary authorities would be biased to accept rising policy costs in exchange for volatility control (via term premium suppression).

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