Comment on Tomo Kinoshita's Paper "In Search of Post-QQE Monetary Policy for Japan" by A. Rozanov

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Diagnosing the Problem with QQE

- Open-ended commitment to grow monetary base by ¥80 trillion per year
- By 2018, BOJ demand for JGBs will run into supply constraints
- BOJ may run out of ammunition before it hits 2% inflation target
- Monetary policy sustainability and credibility are at stake
- So what can be done about that?

Three Logical Solutions

- Option #1: increase supply of JGBs (fiscal monetary cooperation)
- Option #2: decrease demand for JGBs (BOJ tapering)
- Option #3: rebalance QQE from JGBs to various risk assets
- The paper focuses on Option #2 via a change in monetary policy regime
- Proposal: move away from monetary base target to real yield framework…
- …while maintaining the beneficial effect of QE on real yields
- “On-demand QE” / “QE on Tap”

My Three Concerns

- The proposal ignores 'portfolio substitution' effect, where size matters
  - QE programme in 2001-06: buy *short-term* government bonds from *banks*
  - QQE programme: buy *long-term* bonds + *risk* assets from *non-banks*
- There are risks to inflation expectations and potential impact on nominal yields
  - In 2 years of QQE, 10-year 'natural' vs. real rate gap expanded from 20 bps to 110 bps
  - Two forces at work: rising inflation expectations and declining term premium
- There are questions about BOJ's 'new' ammunition to fight deflationary shocks
  - Two hard constraints: JGB supply and/or zero lower bound on the whole yield curve
  - Raising inflation expectations remains the only option, but how?

The Other Two Options

- Increasing JGB supply via fiscal monetary cooperation
  - This can only be part of a broader political decision to rebalance Abenomics
  - Requires BOJ-MOF coordination (but so does the author's proposal!)
  - Additional issues: Japan's debt sustainability, fiscal space for more expansion, etc.
  - Deserves a mention and perhaps a brief discussion, but outside the scope of paper
- Rebalancing QQE from JGBs to a variety of risk assets
  - Two standard objections: (1) potential losses for BOJ and (2) market capacity
  - (1) is not about real economic or solvency risks, but accounting and political risks…
  - …so can be mitigated by proper communications strategy and gov't assurances
  - (2) is only an issue if risk asset universe is limited to ETFs and J-REITs…
  - …but there are at least four creative ways to broaden the universe

Four Ideas for Expanding Risk Asset Universe

- Buy stock baskets underlying ETFs and convert into ETF shares
  - Market capitalisation is larger and liquidity is deeper than ETF shares on their own
  - Mechanism similar to HKMA's purchase of HSI stocks and conversion into TraHK

- Purchase real estate directly to use as the basis for launch of new J-REITs
  - Implementation possible in partnership with existing J-REIT sponsors
  - Injecting new liquidity into property market + J-REIT market development

- Include gold bullion in the QQE risk asset purchasing programme
  - Legitimate asset to hold on central bank balance sheet
  - Japan's holding of 2.4% of FX reserves is way below G-7 average of 41% (WGC, 2014)

- Expand BOJ's current lending facilities to include two new agencies
  - Mortgage lending to households *at negative rates*
  - Corporate lending to SMEs *at negative rates*
  - Negative rates to reflect BOJ income, adjusted for a credit cushion for default risks

Conclusion

- BOJ has 2-3 years before it starts running into JGB supply constraints
- BOJ can start expanding risk assets while buying JGBs at current pace
- Once risk assets grow to a certain size, BOJ can start tapering JGB purchases
- The author’s new monetary policy regime can be implemented with less risk