Potential issues with BOJ’s exit from unconventional monetary policy

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Introduction – how ‘hot’ is the debate on an ‘exit’?

It is obvious that the introduction of YCC policy in September 2016 provoked more heated discussion on ‘exit’.

Number of mentions of the word "exit" in the regular press conferences of BOJ governor Haruhiko Kuroda.

Source: Nomura based on the Bank of Japan data.
A template for the exit from unconventional monetary policy – the case of US Federal Reserve

May. 2013  Fed Chair Bernanke suggested the end of QE3

Dec. 2013  Start ‘Tapering’ of asset purchase program

Oct. 2014  FOMC decided complete end of APP

Dec. 2015  The first lift of FF rate target (the end of ZER)

Sep. 2017  Start of gradual reduction in reinvestment of redeemed assets (gradual shrinkage of B/S)
A brief history of the Bank of Japan’s unconventional monetary policy

Jan. 2013  Joint accord with govt. on 2% inflation goal

Apr. 2013  Start of Gov. Kuroda’s 1st term and QQE

Oct. 2015  QQE2 (‘Bazooka 2’)

Jan. 2016  QQE with Negative Interest Rate Policy

Sep. 2016  Comprehensive assessment and introduction of QQE with Yield Curve Control Policy
           ->de facto start of a normalization

Jul. 2017  Enhancement of YCC policy (with introduction of forward guidance)
Investors sometimes ask me when BOJ will start stealth tapering, but in fact, the tapering has already started in a not stealthy manner.

**Amount of JGBs purchased via BOJ operations**

- Amount of JGB redemption (12 mo trailing cumulative totals, inverted; B)
- Gross amount of JGB purchased (annualized; A)
- Net JGB purchases (A+B)
- Target/guideline amount of JGB purchase

Source: Nomura based on the Bank of Japan data
Remaining issues arising from the idiosyncrasies of BOJ’s monetary easing (1)

International comparison of total assets at central banks

(ass % of nominal GDP)

Source: Nomura, based on BOJ, Fed, and European Central Bank (ECB) data
Remaining issues arising from the idiosyncrasies of BOJ’s monetary easing (2)

While not-really-stealthy tapering goes forward, average maturities and durations of JGBs held by BOJ still continue to get longer.

JGBs outstanding held by BOJ and their average maturities

Note: Variable rate JGB and JGBi-s are excluded from the calculation.
Source: Nomura based on the Bank of Japan data
A simulation of BOJ net interest earnings in exit phase

Key variables:

1) JGBs outstanding at the beginning stage of the exit (depends on the length of time it continues to pursue monetary easing)

2) Average maturities of JGBs held at the stage

How would the above factors affect net interest earnings of BOJ in exit phase?

Other assumptions

✓ Short term policy rate will be raised to 0.5% in three years after exit
✓ Cash in circulation will grow at the average rate during 2013-17
Assumption (1): the length of time it continues to pursue monetary easing

The longer monetary easing continues, the larger outstanding JGB holdings in BOJ’s book will be.

Assumptions for outstanding JGB holdings used in our simulation for exit from monetary easing

Source: Nomura based on the Bank of Japan data
Assumption (2): varying path of effective long term yields, depending on the average maturities of JGBs

The longer the average maturities at the beginning of exit, the slower the rise in effective long-term yields on JGBs held in BOJ’s book

Assumptions for the effective yield on long-term JGBs used in our simulation of an exit from BOJ monetary easing

- Monetary easing continues for five more years, flat average residual maturity scenario
- Monetary easing continues for five more years, declining average residual maturity scenario
- Monetary easing continues for three more years, flat average residual maturity scenario
- Monetary easing continues for three more years, declining average residual maturity scenario

Simulation assumptions

Source: Nomura based on the Bank of Japan data
The results of the simulation

Net interest income loss could double if monetary easing continues two more years and BOJ fails to shorten average maturities of long term JGBs.

Results of simulation of BOJ earnings (net interest income) during the exit phase

Source: Nomura based on the Bank of Japan data
Based on its characteristics as a special corporation defined in the Bank of Japan Act, the BOJ's financial strength as seen in its income and capital ratio does not have an impact on monetary policy management, and a system is in place so that this does not happen.

What would be problematic would be if the government has not achieved fiscal consolidation at the exit phase; then a decline in the BOJ's payments to the national treasury, or a significant increase in the government's interest payments, would create additional risk for the government’s fiscal management.
The idiosyncrasies of BOJ’s monetary easing, compared with other central banks, could make net interest loss larger at the exit phase.

What would be problematic, would be neither the loss itself nor the volume of the loss, but the fiscal dominance and deprivation of BOJ’s political independence that it might cause.
Thank you very much!