Telephone call between Prof. Sayuri Shirai, professor of economics, Keio University, former policy board member at the Bank of Japan, Frederic Neumann, co-head of Asian economic research at HSBC, and Brandon Chye, economist, OMFIF Singapore, 17 March 2020

Brandon Chye: Welcome to the OMFIF podcast with Sayuri Shirai, professor of economics at Keio University and former policy board member at the Bank of Japan, as well as Frederic Neumann, co-head of Asian economic research at HSBC. We will be talking about the Bank of Japan's additional monetary easing to blunt the impact of Covid 19 on financial markets. Japan's experience is a portent for other developed economies. The country has grappled with moribund growth and persistently low inflation for decades. Japan has pioneered experimentation with unconventional monetary policies such as quantitative and qualitative easing, yield curve controls, and negative interest rates. With developed economy rates headed close to or already past the zero bound, we'll be exploring options. One distinctive aspect is that the Bank of Japan purchases not only bonds but stocks through ETFs. Some say this leads to long-term distortions in domestic equity markets. The monetary policy announcement from the Bank of Japan on Monday details a commitment for the BoJ to double its current target for ETF purchases to Y12tn, keeping an upper ceiling for JGB purchases at Y80tn. What are the long-term effects of this decision to massively expand the BoJ balance sheet? Are lines drawn on the bond and ETF purchases?

Professor Shirai: I'd like to clarify the BoJ's policy decided yesterday. You said that the Bank of Japan doubled their current target for ETF purchases to Y12tn. But actually what the BoJ did is not really doubling. They maintain basic annual ETF purchases at Y6tn. They said the maximum can be up to Y12tn. It's not really doubling. The Bank of Japan would maintain quite a large amount of ETF purchases, maybe for a couple of months but not permanently. So this suggests the Bank of Japan tries to show that they are doing lots of monetary easing policy to show that they are doing a bold approach, but in reality, you can see there is a limit.
Governor Kuroda mentioned that the breakeven point for the BoJ's balance sheet moving into deficit will be 19,500 on the Nikkei 225. So now, the Nikkei 225 is moving around 17,000 so that means that the Bank of Japan is having a kind of unrealised loss in their ETF holdings. So it's very difficult for the BoJ to continue massive ETF purchases with this deficit. This is why the Bank of Japan yesterday didn't really say it's doubling. So there is a constraint there. Now the question about the difference between bonds and ETFs is that a bond has a maturity. So if you waited say 20 or 30 years until maturity comes, you can change it to cash. But unless the Bank of Japan sells an ETF, they have to keep it on their balance sheet. So the impact on their balance sheet risk is tremendous. That is a difference.

30% of the Japanese stock market is owned by foreigners. And if you look at the daily transaction sales and purchases, it's almost all dominated by foreign investors. So under this situation, the Bank of Japan together with the Government Pension Investment Fund are major stable and constant investors. So what would happen if the Bank of Japan starts to sell their stocks? The impact on the Japanese stock market would be tremendous. Nobody really can imagine how the Bank of Japan can exit. So that is a long-term issue. Also, if the Bank of Japan continues to buy a significant amount, then the public float on the stock market will be squeezed, and that creates a lot of problems in terms of liquidity, and also whether the prices are really fair value. So the long-term impact is tremendous.

Furthermore, if the Bank of Japan keeps stocks for a long time, the impact on corporate governance would be quite bad. At this moment, Prime Minister Abe has tried to change Japanese corporate governance to improve profitability, which is low compared to the US and US companies. But if the Bank of Japan stays there as a very quiet, large shareholder, the impact on the corporate governance can be tremendous. So that's a long-term point.

BC: Any further insights on the emergency monetary policy decisions?

Frederic Neumann: It's important to distinguish between emergency measures and long-term monetary policy tools. What's called for is a signal by the central bank: 'These are the tools we have available. These are the options we're willing to take'. What the BoJ in fact did yesterday is to highlight that it could if necessary expand its purchases. It doesn't necessarily say it will do so but it's designed to essentially provide a confidence boost to financial markets to showcase the tools available. And in this environment when you have such an acute stress in financial markets, liquidity dries up. It is really essential that we inject liquidity and do all we can in the short run to kind of stem any potential stress in financial markets.

But that is somewhat distinct from some of the long-term implications. So increasing ETF purchases may not be a valid tool to kind of get inflation back on track for a normally operating economy. But in this environment it is valid emergency measure. There is another question mark over how much should a central bank own in terms of individual company stocks. The more ETFs the central bank buys, the more it becomes an indirect holder of the equity of individual companies. It raises the question about the ownership of capital in the economy and should really a public sector entity own all the equity in the particular company?

BC: Digging deeper on this short-term vs. long-term trade-off debate: the BoJ is making larger book losses through its ETF purchases yet also gains because of the further fall in Japanese yields. Has anyone actually done the arithmetic on this or does anyone actually care about the possible implication of negative equity?

PS: The Bank of Japan the balance sheet doesn't work in that way. For example, the Bank of Japan has huge holdings of Japanese government bonds, but those are really not on a marked-to-market basis. So just because the yield goes down, it doesn't mean that the value of their assets will go up, because basically the Bank of Japan's accounting system is that when the Bank of Japan purchases JGBs prices higher than face value, there's a loss. Suppose that remaining maturity is 10 years, you divide it by 10 years then this loss will be put into each year as a sort of expenditure.

So just because the yield is going down, it doesn't get reflected in the balance sheet. Some central banks do this kind of approach. But that's not valid here. About the ETF holding, it's also not on a mark-to-market basis. So suppose the stock prices starts to go down below purchased prices, first, the Bank of Japan has to set aside allowances. So that would be a sort of expenditure. So that leads to a decline into their profit. Now if the stock prices really go down substantially, a substantial decline, then the Bank of Japan will have to do impairment. So what I can say is that this declining yield really doesn't matter for the Bank of Japan's balance sheet. But in terms of ETFs, the stock prices are going down. That has an impact on the Bank's profit.

BC: Japan's financial markets have developed a reputation as a global safe haven in times of market stress. Can the yen still be considered a safe haven?

FN: We saw the yen behaved again as a safe haven and appreciated. In the past month, it went as low as almost 102 against the dollar. It's now a bit higher as 106 but it's still lower from when we started the year. But generally we saw in this particular crisis that most major FX pairs didn't move as much as during the global financial crisis. So if we look at the euro, for example, it's around 111. It's not too far off from where we started. So volatility has not been quite as high as it was in the past. But the yen certainly has rallied. It's still plays as a safe haven and that has to do a lot with

Japanese investors holding a lot of foreign assets and essentially calling this money back into Japan to the safety of the home country. And that's despite very low yields in Japan. And so from a Japanese investor's perspective, if there is global risk aversion, there's still a desire to bring money home. That particular aspect of the yen is still intact.

PS: I feel that the yen against the dollar is quite resilient these days. It's different behaviour from just after the Lehman shock when the yen rose sharply. The reason is that Japan is no longer a trade surplus country. We run a deficit. Another point is that because Japanese yields are so low. Up to 10 years, that yield is in negative territory. Also Japan doesn't have a very large securities market other than Japanese government bonds. Pension funds such as the GPIF and insurance companies have no choice but to invest in foreign countries. So now there is a very strong move from Japanese institutional investors to invest abroad. That helped the yen to depreciate. While some people still think the Japanese yen is a safe haven currency, there are counterforces. That explains why the yen remains resilient. Resilience means that we don't see sharp appreciation pressure.

BC: We definitely see a lot more major Japanese institutional investors in foreign markets, but if there is a repatriation of capital, do you think the Bank of Japan will have enough capacity to mitigate any of the effects of yen appreciation?

PS: It's very difficult for BoJ to cope with a sharp yen appreciation if that happens. The BoJ can influence interest rates, but it's very difficult to deepen the negative deposit rate on part of excess reserves from the current minus 0.1%, and lower the 10 year yield from current 0%. For example yesterday they didn't do it. Why? Because it would have a very adverse impact on the banking and insurance sectors, already suffering from negative rates. So, in terms of monetary policy, it's very difficult to cope with the yen's appreciation. And in Japan, the ministry of finance is the body that intervenes in FX markets. Yesterday, at the press conference, Governor Kuroda said, when asked about a possible yen sharp appreciation, he said this should be an issue covered by the finance minister, not the Bank of Japan. So there's a limit on what the BoJ can do in dealing with appreciation.

FN: One thing that's also changed is the political reality globally regarding intervening in FX market. Given the Trump administration's dislike for anybody managing the currency to US disadvantage, I'm sure that would also weigh on policy-makers' minds.

PS: Under the G20 agreement, we are not supposed to promote competitive devaluations. People have China in their minds. That agreement means that other advanced economies should not intervene in FX markets to support their manufacturing sector and economy. So it is also very difficult for the minister of finance in Japan to make a direct intervention in the foreign exchange market. So that is a problem. If a sharp Japanese yen appreciation occurs, the Japanese government and the Bank of Japan face great limitations.

BC: The Bank of Japan has been the first G7 central bank to respond to the Fed rate cut. Will this rate cut leave regional central banks in Asia more breathing space for more rate cuts? Will we see a race to the bottom among Asian central banks?

FN: This makes it easier for Asian central banks to contemplate monetary easing as well. I have in mind the emerging markets in Asia which always have to consider interest rate differentials with the West. And so it does open the door for say the Malaysian or Indian central banks or even the Bank of Korea to lower interest rates as well without fear of undue capital outflows. I wouldn't say this is a race to the bottom which implies something negative. Very quickly central banks across the region have followed the Fed. The BoK yesterday, 50 basis point cut, very strong out of the gate. We saw the Reserve Bank of New Zealand with a 75 basis point cut. This week, we have central banks meeting across the region, Bank Indonesia for example. And to some extent their job is made easier by the Fed taking rates down so quickly. In this environment, we need a central bank response. Everywhere there is extreme stress on cash flow positions, from the company's debtors running into cash flow problems because of the sudden fall of economic activity. And so every single central bank will try to maximise its ability to ease financial conditions.

BC: Governor Kuroda and his board mentioned that interest rate cuts were still a potential policy option. Albeit, they were reluctant to use it. At what point would the BoJ envision taking its interest rate deeper into negative territory?

PS: So last September the yen appreciated against the dollar. At that time, Governor Kuroda said they were willing to deepen the negative interest rate or 10 year yield if necessary. And in the following October monetary policy meeting, they added forward guidance related to the interest rates, suggesting that they're willing to lower the interest rate if it's necessary. Also this view was repeated yesterday by Governor Kuroda. Now BoJ would never say they are reluctant to deepen the negative interest on the 10 year bond. Because that is an essential part of their monetary policy so they would never say that.

The BoJ considers the banking sector and the insurance companies under severe stress. And part of the reason is because of the very low interest rates and the very flattened yield curve. These are issues and they are closely watching. So there is a dilemma here. On the one hand, the Japanese government and the Bank of Japan really think maintaining the Japanese yen against the dollar around Y108 or above is good for the manufacturing sector. On the other hand, if the yen's depreciation has to be maintained by lowering interest further, they worsen the banks' problems. So when you look at what happened over these past one to two years, depending on market conditions, the BoJ tries to emphasise one of these two issues (stopping exchange rate appreciation and achieving financial stability) within this dilemma. So, when the market is under stress they tend to say they're willing to lower interest rates, but if the exchange rate is not appreciating that much as currently, then the BoJ would not take any action. And then when we have a very stable exchange rate environment moving at 108 or 110, then Bank of Japan emphasises concerns over the banking sector and the insurance sector.

Under what circumstances will the Bank of Japan deepen its policy rates? I think the only case is when the yen appreciates, to around Y100 and stays there persistently. Then I think the Bank of Japan would be really tested about what they communicated to the market so far. The BoJ would really have to decide about priorities. Now, the Bank of Japan already did a lot of things yesterday. There is not much more they can do. So if the virus and its impact on the global economy continues, maybe the Bank of Japan will have to do a couple of additional things and then, eventually, the Bank of Japan may end up only with this choice of lowering the policy rate.

FN: Some market participants are concerned about the limits of BoJ policy. In general I would agree that there are incremental steps the BoJ can do under its mandate and these may well become necessary in the coming one or two months, given the extensive dislocations for the world economy and for Japanese growth. There is a bigger question whether these incremental measures will be sufficient to drive up demand. In principle monetary policy has some limits and one of the potential next steps could be some more explicit fiscal monetary policy coordination. And there are mandate issues in Japan, central bank independence for example, the inability to directly finance government deficits and so on. We are testing the limits of the policy framework. At some point in Japan and elsewhere, maybe we'll have to think about a central bank providing a certain amount of money for direct fiscal spending without undermining monetary policy independence. It is a very tricky path.

But I think we'll get to that point. The key aspect is to implement such measures so they can't be abused politically at some point in the future. But it's probably time to think hard about these measures because lowering policy rates in Japan could still bring some marginal benefit but we can see the end of that effectiveness coming into view.

PS: Some people may say that Japan should adopt helicopter money. I think the Bank of Japan and the government are doing policy coordination since 2013. So I don't think they will want to say that they would adopt helicopter money or modern monetary theory [printing money to sustain much higher deficits]. Because that will invite a lot of criticism and questions. So I think what they might do is what the Bank of Japan is already doing with yield curve control, stabilising 10 year yields at zero percent. That has created very low-cost funding for the government. It is up to the government now whether they increase more spending, or decide tax cuts. I don't think the Bank of Japan wants to really make this explicit, that they are supporting the government spending or tax cuts. I'm pretty sure the government and the Bank of Japan would continue to say BOJ's mandate is price stability and 2% and the BOJ would continue to do it until they achieve the 2% target.

FN: How would you explain the reluctance to use more extensively the Bank of Japan's offer of free money up to 10 years. The government seems reluctant to use it. Is it perhaps just a more conservative fiscal philosophy? Or are there other constraints?

PS: The government is already carrying out some economic stimulus policies, from last December. Because we had a consumption tax hike last October, and that created the economic slowdown. So the Japanese government decided a large economic package last December. The budgetary cost is about 2-3% of nominal GDP. That's why, at this moment, the government is not announcing another big economic stimulus package by issuing debt (they try to use budget reserve funds). Another issue is that the government is wondering about keeping government debt at current 250% of nominal GDP. That is huge. Because the interest rate is so low, there's no problem on funding cost, so can the government increase it more? The government hasn't made up their mind yet. We need more understanding about what should happen to our debt to GDP ratio and whether it's okay to continue to expand it.

BC: What can other central banks, the Fed for example, learn from the Bank of Japan's experience with fiscal-monetary coordination, with yield control policies?

PS: I think the Federal Reserve is very interested in YCC. It's possible that they might even introduce some kind of YCC this year. But the difference between their approach and Bank of Japan's is the BoJ, at this moment, is trying to stabilise 10 year yields. That is quite long maturity. Whereas the Fed appears to be more interested in stabilising shorter-term maturities like five years. Although I know there's a lot of support from the US central banking circles, but in terms of impact on aggregate demand and inflation, there is no difference between YCC and what the BoJ has done with the previous approaches such as QQE. YCC like others didn't really generate any significant aggregate demand, increase in credit demand and inflation. So in that sense it's not so effective. But I think the US is interested in YCC because of last September's hike in the short-term money markets. Maybe they think that it's good to stabilise the shorter maturities. YCC could be a one way to do it. That is understandable, but at the same time if the central bank tries to stabilise a certain range of maturities then you are moving away from market discipline. So, if you look at Japan's experience after YCC, you more or less eliminate important market-makers. So there is very limited volatility. If the Fed is going to introduce YCC, if they can do it just temporarily. But it's very difficult to exit. So I really hope that others think very seriously and carefully about the pros and cons based of Japan's experience.

FN: I would agree that the Fed is looking at YCC. The US is more market-based than Japan with a lot more non-bank financial institutions participants in the market. The repo market, for example, extremely important in the US and short-term money markets and so there is a risk I think that Sayuri-san highlighted, which is that declining liquidity. If we see the same collapse in liquidity of the JGB market happening in the Treasury market, that could lead to problems in the plumbing in the US system, where I think I would argue it's probably slightly more important than in Japan. That doesn't mean it's not something we can solve, but there is a risk in transferring a YCC policy wholesale to the US. There may have to be some sort of adjustment, we can maybe shorten the tenor but I would add that the Fed probably will look at policies that try to shore up more directly non-bank financial institutions. For example, through direct access to the Fed's discount window, but also through short-term emergency steps.

BC: Shifting gears a bit, would you have any opinions about the implications of a possible postponement of the Tokyo 2020 Olympics?

PS: This is a very big issue. It may be a cancellation. This is a worst-case scenario, cancellation is still feasible. But the problem is that, suppose Japan is able to host the Olympics this year, we may not have any people coming from abroad to watch. So then that still damages the Japanese economy in the tourism sector. There are lots of lots of hotels, restaurants and shopping centres built counting on the Olympics - a lot of investment. So if there nobody comes here, that creates losses and some smaller company are not able to pay debts. So cancellation could create the worst problem. And also having the Tokyo Olympics without any audience is also another problem. Another feasibility is postponing it to the next year. But then still the Japanese economy will suffer this year. It also depends on whether Tokyo is able to gain a good reputation. If people associate the Tokyo Olympics with a bad memory coming from Covid-19, Japan will lose a so-called positive legacy effect. The Tokyo metropolitan government made some estimates in 2017 to calculate this legacy effect. Legacy means after having a big event like the Olympics in the world, people remember about the hosting country well, so they continue to go to the country. This helps Japan as a business centre or financial centre, and there's lots of tourists coming. So the Tokyo Metropolitan government made that estimate over the next 10 years that can generate another Y30tn in additional demand. Suppose Japan can host this Tokyo 2020 Olympics, but people remember it as a negative event, then we completely lose this legacy impact. So the impact on the Japanese economy would be tremendous.

BC: Sayuri, Frederic it's been a pleasure to speak to both of you today. Please check us out on the OMFIF channel on both Spotify and ITunes. Many thanks and goodbye!