

Japan. Will The BoJ Ease? How Big Is The Fiscal Package? What Else Can Japan Do?

Observations:

The BoJ's discount rate, 9% in 1980 has fallen steadily to 0.3%. The 10 year JGB yield has dropped consistently from 8% in 1990 to -0.28%.

The BoJ's asset purchase programs have seen its balance sheet grow from 110 trillion JPY in 2010 to 436 trillion JPY expanding at 30% per annum.

BoJ ownership of JGBs rose from 9% in 2010 to 34% today. It owns 55% of Japan's ETFs and about 1.6% of the listed market capitalization. The BoJ's current plan involves buying 3 trillion JPY of ETFs per year. The GPIF owns about 5% of market cap.

Japan's national debt to GDP ratio has increased steadily from 50% in 1980 to 251%. The annual rate of increase is only 4.5% but it has been increasingly almost monotonically for the last 36 years.

Inflation is still negative and not showing signs of any revival. Growth has slipped from 1.8% in Q3 2015 to 0.1% Q1 2016. Sentiment and confidence indicators are showing more weakness.

Since the imposition of negative interest rates on excess reserves JPY has strengthened from 120 to 100. It trades at circa 105 today. Also, bank deposits at the central bank have reportedly risen 20% since.

Expectations:

On July 29, the BoJ meets. Various analysts assign a significant probability to some kind of increase in QE in the form of increased asset purchases from the current rate of 80 trillion JPY p.a. as well as a rate cut from the current -0.10%.

On the fiscal front, the government has announced an eagerly awaited 28 trillion JPY stimulus package. The details as to how much will be spent when, how much will be direct (expenditure) and how much indirect (tax), and how much are existing and how much are is additional, are still not available. Rumours suggest that the direct spending portion will be small with the bulk of the package in the form of loans and subsidies.

So far the market has regarded the BoJ and the fiscal package with caution. JPY and JGBs have rallied while the Nikkei has come off.

The BoJ has a track record of disappointing the markets and expectations have become increasingly uncertain. The lack of details in the announcement of the fiscal package have also left the market sceptical.

Thoughts:

While the Prime Minister's advisers have spoken about 'helicopter money', technically Monetized Fiscal Policy (MFP), Mr Kuroda has said that there was "no need or possibility" of doing it. Given that 'helicopter money' requires close coordination between the Ministry of Finance and the BoJ, Mr Kuroda's thoughts should be taken at face value. No 'helicopter money.'

Monetized Fiscal Policy is likely to be ineffective in the long run and would introduce too many new and innovative problems anyway.

A sizeable fiscal package will in any case need to be financed

and given the pace of the BoJ's QQE, it will effectively be indistinguishable from MFP. The difference is a mere technicality where under QQE the bonds are passed through private sector intermediaries and under MFP the BoJ faces the state directly. Never underestimate the propensity of public servants for pedantry when they practice to obfuscate.

In the long run, the demographics of Japan will likely prove insurmountable. And in any case, the Keynesian view of the long run is probably true. In the short term Japan needs an infusion of confidence which would involve a rising equity market, stable, positive interest rates and bond yields, and a stable currency. A monotonically decreasing currency is too high a price to pay for a rising equity market. A modest recovery in inflation is also necessary.

Adding an outsized fiscal program to the currently loose monetary policy will likely stabilize interest rates and bond yields, put a floor under inflation and give a boost to demand. QQE will be needed not only to moderate any rise in yields but to finance the budget deficit and roll over the national debt. The size of the package will need to surprise the market to be effective.

The above solution is sufficiently conventional for the BoJ and the government. It provides temporary respite, but it will not address the underlying issues in the Japanese economy.

More innovative solutions:

If we are allowed to speculate, we might consider some less conventional cures for the slow growth and weak inflation. More money, debt and spending can boost demand temporarily and even give the economy sufficient momentum for the appearance of escape velocity. However, it results in chronic dependency and ultimately, policy fatigue.

In the long run, amputation could be better than analgesic. Bankruptcy law needs to be upgraded, in particular Corporation

Reorganization Law, which prolongs resolution, needs to be aligned to the Civil Rehabilitation Law (equivalent to US chapter 11.) Interest rates need to be normalized and put back up to cull unprofitable enterprise and excess capacity. Negative rates cannot persist for long without detrimental impact on the banking and insurance sector. Japan also needs to encourage immigration and labour mobility to better match labour to land, capital and technology. The stock of national debt held by the BoJ could be written down.