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# Mizuho Economic Outlook & Analysis

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April 28, 2017

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## *The Bank of Japan continues playing the endurance game*

*Hurdles for the exit policy and issues facing the  
BOJ's Governor Kuroda*

### < Summary >

- ◆ The Bank of Japan continues playing the endurance game to achieve its price stability target. In the Outlook for Economic Activity and Prices, the Bank lifted its economic forecast and maintained the timing to achieve its inflation target at around 2018, but at the same time suggested that the downward risk is high.
- ◆ While the ECB is expected to head toward exit following the FRB, we believe the Bank of Japan's policy actions in the future will be the focus of attention; but the hurdles to implement an exit policy are high.
- ◆ The Bank of Japan has improved the sustainability of its policy and is about to back off on additional easing. What the Bank needs now is to eliminate uncertainty in the market toward future implementation of its exit policy.

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## **1. The Bank of Japan's endurance game continues under yield curve control**

The Bank of Japan continues to play the endurance game, trying to achieve its price stability target by taking advantage of the recovery trend of the world economy, under the yield curve control policy set at its Monetary Policy Meeting held last September. The Bank raised its economic forecast in the Outlook for Economic Activity and Prices (Outlook Report), but the achievement of its 2 percent price target will continue to be difficult in the immediate future.

The Bank of Japan decided to maintain its policy in the Monetary Policy Meeting held on April 26 and 27. In the Outlook Report (**Chart 1**), although the Bank lowered its inflation outlook in FY2017 to +1.4% from +1.5%, the Bank raised its real GDP forecast for both FY2017 and 2018. The newly added forecast for FY2019 suggests that the economic growth rate will lower from FY2018 due to such factors as the accumulation of capital stock caused by the prolonged economic expansion and the slowdown in capital investment as Tokyo Olympic Games-related demand comes to an end. The inflation outlook for FY2019 is +1.9% (excluding the effects of the consumption tax hike), and the period to achieve the price stability target has been maintained at around FY2018. However, when looking at the Policy Board members' economic and price outlook and risk evaluation (**Chart 2**), two members believe the CPI increase will not reach +1.0%. Furthermore, four members presently see a high downward risk for the price forecasts for FY2018 and 2019. This means that of the nine Policy Board members, including the Governor and Deputy Governors, six members, or more than half the board, judge the feasibility of the inflation forecast to be low. Governor Haruhiko Kuroda stated in the press conference that "although momentum for achieving the price stability target is maintained, risks are skewed to the downside." It is highly likely that the price forecasts presented in the Outlook Report will be repeatedly revised downward in the future, but if the judgment remains unchanged that the momentum toward achieving the price stability target is being maintained, we do not believe the Bank will consider implementing additional monetary easing. We no longer see expectations for additional monetary easing in the market. Moreover, the OIS curve that represents the market's policy interest rate forecast does not reflect a further reduction in negative interest rates.

**Chart 1: The Bank of Japan Outlook for Economic Activity and Prices (April 2017)**

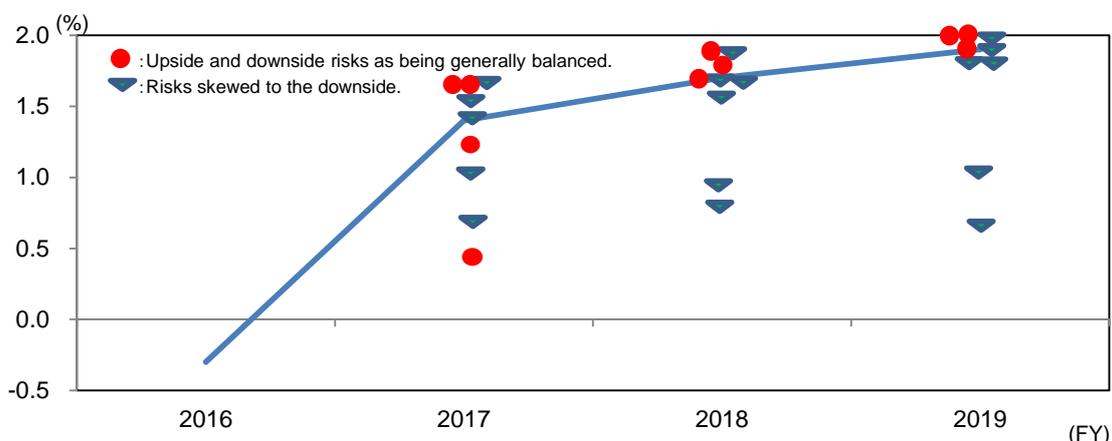
(Y-o-y % change)

	Real GDP	CPI (all items less fresh food)	
			Excluding the effects of the consumption tax hike
FY2016	+1.4 to +1.4 (+1.4)	-0.3	
Forecasts made in January 2017	+1.2 to +1.5 (+1.4)	-0.2 to -0.1 (-0.2)	
FY2017	+1.4 to +1.6 (+1.6)	+0.6 to +1.6 (+1.4)	
Forecasts made in January 2017	+1.3 to +1.6 (+1.5)	+0.8 to +1.6 (+1.5)	
FY2018	+1.1 to +1.3 (+1.3)	+0.8 to +1.9 (+1.7)	
Forecasts made in January 2017	+1.0 to +1.2 (+1.1)	+0.9 to +1.9 (+1.7)	
FY2019	+0.6 to +0.7 (+0.7)	+1.4 to +2.5 (+2.4)	+0.9 to +2.0 (+1.9)

Note: Figures in brackets indicate the forecast medians of the Policy Board members.

Source: The Bank of Japan.

**Chart 2: Policy Board members' price forecast and risk evaluation**



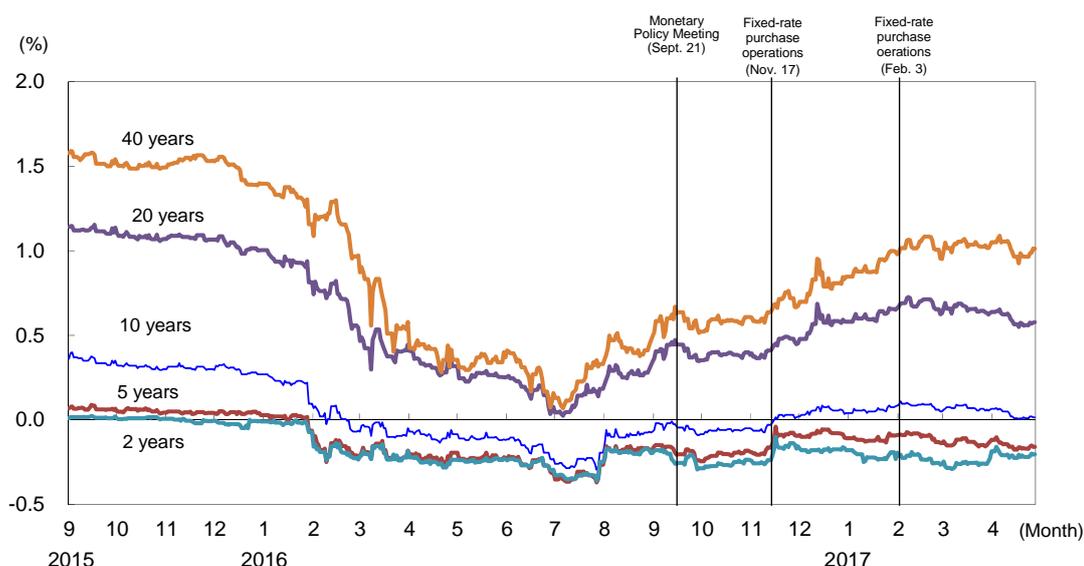
Source: Made by MHRI based on the Bank of Japan.

With the introduction of the yield curve control policy, the main pillar of the Bank's monetary policy has shifted from "quantitative" expansion centering on the purchase of Japanese Government Bonds (JGBs) to "interest rate" control. While the Bank of Japan has promised to maintain the pace of its annual increase in JGB holdings at around 80 trillion yen, the Bank's JGB purchase plan reviewed each month reveals that the purchase amount has been gradually reduced, mainly in the short-term zone. The main reason for the Bank's decision to reduce the amount of JGB purchases is the tightening supply and demand situation in the JGB market, driven by the Bank's massive JGB purchases. The Bank conducted the purchase/sale of JGBs with a repurchase agreement

in March for the first time in about eight years and also substantially increased the amount of securities lending facilities by which the Bank temporarily lends the JGBs it owns to the private sector. If the Bank continues purchasing JGBs at the current pace, the net increase in the Bank's JGBs is estimated to decline to about 60 trillion yen in 2017. The Bank's 80 trillion yen target will likely be reviewed in the latter half of the year.

The 10-year JGB yield, whose target is set at around 0 percent, once rose to over 0.1 percent this February, affected by the increase in the US Treasury bond yield following the US Presidential election. But with the Bank of Japan moving to restrain further interest rate hikes through fixed-rate purchase operations and the US Treasury bond yield going down, the 10-year JGB yield has been hovering at around 0 percent in recent months (**Chart 3**). There was also an increase in upward pressure on the ultra-long-term JGB yield, which is not subject to the Bank of Japan's control, but the pressure has eased off recently. Amid rising uncertainty over the US administration's policies and geopolitical risks such as the North Korea issue, Japanese investors are now refraining from investing in overseas bonds, and part of these funds may shift to the purchase of ultra-long-term JGBs. The primary purpose of yield curve control is to maintain low interest rates. In the case where the US Treasury bond yield rises due to the recovering US economy, upward pressure is usually placed on the JGB yield. In this case, if the interest rate difference between the US and Japan widens as a result of keeping the JGB yield low, the value of the yen will fall and the impact on the Japanese economy will be positive. We can expect to increase the effects of monetary easing by waiting for the recovery of the global economy and reaping its benefits.

**Chart 3: JGB yield**



Source: Made by MHRI based on Bloomberg.

## **2. Possibility of raising the 10-year JGB yield target**

With the Bank of Japan unable to project the achievement of its price stability target in the near future, we expect the Bank to leave its policy unchanged in the immediate future while watching the development of the Japanese economy, prices and financial conditions. If the Bank considers lifting the 10-year JGB yield target in the future, we hold that it will be under one of the following two scenarios: (1) when the financial intermediation function weakens due to a reduction in the lending and deposit profit margins of financial institutions, and (2) when the JGB yield rises following the implementation of the exit strategy by central banks in Europe and the United States.

Scenario (1) is the situation where a decline in the financial institutions' earnings due to low interest rates weakens the financial intermediation function, exerting a negative impact on the Japanese economy. The Bank of Japan, in last year's Comprehensive Assessment, adjusted its policy stance to include the potential impact on financial conditions, in addition to the economic and price circumstances. With the introduction of negative interest rates last year, the profit margin between lending and deposits of financial institutions has been substantially reduced, and their operating environment has become ever more challenging. If the finance intermediation function is hampered as a result of financial institutions taking excessive risks to maintain their profits, the possibility of achieving the price stability target may become distant. With a view to expanding the profit margin of lending and deposits, the Bank may consider raising the level of the 10-year JGB yield target. However, the Bank seems to have judged that the finance intermediation function has not been damaged at present. In the Financial System Report published in April the Bank of Japan stated: "If the downward pressure on profits persists, a decline in their loss-absorbing capacity could lead to a weakening of the financial intermediation function." But it also judged that "at present, financial institutions have sufficient capital bases, which will allow them to continue risk-taking even if profitability remains subject to downward pressure for the time being." The report pointed out other factors behind the fall in profitability of Japanese financial institutions, namely, low labor productivity and similar business models that tend to intensify their competitive environment more easily, in addition to the tightening of deposit and lending profit margins. The Bank of Japan states that Japanese banks need to improve their profitability on their own, and therefore it is less likely that the Bank of Japan will revise its policy just because financial institutions' earnings are worsening.

Next, scenario (2) represents the situation where upward pressure on the JGB yield will heighten as a result of interest rate hikes in Europe and the United States following

their monetary policies moving toward exit. If the expected price increase rate climbs driven by the economic recovery, it will lower real long-term interest rates, which will strengthen the degree of monetary easing. In such case, the Bank will be allowed to lift the 10-year JGB yield target while maintaining its massive monetary stimulus. Deputy Governor Hiroshi Nakaso said at the February 10 press conference that in the case where the Bank sees an improvement in the economy and price situation, and raises its long-term interest rate target in line with this improvement, it does not mean a reduction in massive monetary easing. While the Bank of Japan is alert to the risk that raising the interest rate target could be interpreted as moving away from its monetary easing stance, thereby fueling the yen's appreciation, we believe that under the circumstances of rising interest rates in Europe and the United States, driven by the recovery of the world economy, it is more likely that the yen will weaken. Nonetheless, it is difficult to imagine this scenario occurring in the immediate future. In the situation where inflation rates do not rise globally, we expect the exit policies of the European and US central banks to be implemented slowly. In addition, there will be no change in Japan's situation where the expected inflation rate is unable to rise easily due to the adaptive expectations formation mechanism.

### **3. Hurdles for the exit policy and remaining issues facing Governor Kuroda**

With the recovery of the world economy, the ECB is expected to move toward an exit policy following the FRB. Looking at past phases of Japan, the US and Eurozone interest rate hikes, we can see that the Bank of Japan has followed the FRB and ECB when raising interest rates, thus we expect the Bank of Japan to be the focus of attention in the future. Nevertheless, it is not easy for the Bank of Japan to implement a full-fledged exit policy. Sustainable interest rate hikes by the Bank of Japan seem challenging until some progress is made on the Abe administration's objectives of eliminating deflation, fiscal consolidation and structural reform. Reduction of the 2 percent price stability target to a more realistic level also seems difficult without the consent of the government, since the present target was announced in the joint statement by the Japanese government and the Bank of Japan in January 2013. It seems that the Bank of Japan is in no rush to exit, unlike in past cases when it wanted to raise interest rates. In the Monetary Policy Meeting in December last year, some members commented that based on the past experience of moving too quickly away from a 0 percent interest rate and quantitative monetary easing, the Bank should continue with the current interest rate level for a considerable period of time.

Governor Kuroda's current term of office ends in April next year, a deadline fast

approaching. While there is a possibility that he will be reappointed, it is highly likely that specific measures on the exit policy will be discussed under a new BOJ governor. We project that the Bank of Japan will maintain its policy while watching the development of geopolitical risks and the political situation in Europe and the United States. With the Bank seemingly no longer in the situation where whenever it lowers its inflation forecast the market demands additional monetary easing, the Bank is required to eliminate uncertainty in the market toward adopting an exit policy in the future. For example, we believe it is important for the Bank to discuss a potential yield target change during the Monetary Policy Meeting and indicate the Policy Board members' outlook on the 10-year JGB yield in order to avoid dislocation in the bond market under circumstances where interest rates are rising. Furthermore, if the Bank presents its outlook on how the balance sheet expansion could impact the Bank of Japan's financial position, it may dispel market concerns over the extension of monetary easing and the future exit policy.