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Economic Research:

Japanese Reflation Is In Play, But Hurdles Galore Stand In The Way

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Table Of Contents

Deflation Outlier

Fiscal Enemy Number One

Joined At The Hip: Monetary Policy And The Consumption Tax Hike

The BOJ On Deflation: Not Guilty

Monetary Policy: It's All About What's Expected

The BOJ's Limp QE

A Change Of The Guard

High Hopes: A Reality Check

Endnotes

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Economic Research:

Japanese Reflation Is In Play, But Hurdles Galore Stand In The Way

Japan's macro economy exhibits a startling and worrying feature: chronic deflation. The landslide election of the Liberal Democratic Party (LDP) on Dec. 16, 2012, and the return of Shinzo Abe as prime minister (PM) have raised hopes that Japan finally may be able to get out of its long-term deflation. Japanese policymakers could and should aggressively implement monetary and fiscal policies to end deflation, doing so in a determined and sustained fashion. It is positive that the Japan reflation(1) issue is in play again and, with the change in government, Japan is likely entering a period of both policy and market action. However, the hurdles to a policy-induced reflation are many, and they are high. Given the circumstances, hopes for a deflation game-changer are warranted, but they need to be heavily tempered.

Overview

- Japan's new prime minister, Shinzo Abe, has pledged to take bold action to combat long-term deflationary conditions.
- Past actions by the Bank of Japan have not been sufficient to reverse this trend. But the end of the terms of the current governor of the BOJ and two deputy governors presents an opportunity for change.
- Nonetheless, despite strong statements from Mr. Abe and new leadership at the BOJ, it is unlikely that the bank would take the kind of sweeping actions necessary to bring about reflation.

Deflation Outlier

How unusual is Japan's deflation? Extremely. The broadest measure of the price of goods and services produced in the economy--the GDP deflator--in Japan's case has been on a declining trend for the past 18 years and is down a cumulative 17.8% from its second quarter 1994 peak.(2) The GDP deflator in the U.S. is up by 45.3% in the same period, and in the U.K. it is up by 51.5%. Central banks usually target an index of consumer price inflation rather than the GDP deflator, although the two are closely correlated. The year-on-year rate of change in the consumer price index (CPI) in Japan has averaged -0.2% in the past 15 years, compared with 2.4% and 2.1% in the U.S. and the U.K., respectively. The "core core" measure of CPI inflation, which excludes food and energy, has averaged -0.4% year-on-year over the past 15 years, versus 2.1% and 1.6% in the U.S. and the U.K. (see table 1).

Table 1

Inflation And Related Economic Indicators: Japan Vs. U.S. And U.K. (% Year-Over-Year)

	CPI inflation (five-year average)	CPI inflation (15-year average)	CPI inflation, excl. food & energy (15-year average)	GDP deflator (15-year average)	Nominal GDP growth (15-year average)	Real GDP growth (15-year average)	Unemployment rate (15-year average) (%)
Japan	(0.2)	(0.2)	(0.4)	(1.2)	(0.6)	0.6	4.6

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Table 1

Inflation And Related Economic Indicators: Japan Vs. U.S. And U.K. (% Year-Over-Year) (cont.)							
U.S.	2.1	2.4	2.1	2.1	4.4	2.2	6.0
U.K.	3.3	2.1	1.6	2.2	4.3	2.1	6.0

Source: Bloomberg.

Japan's deflation is noteworthy because it has gone on for so long. That is not supposed to happen. One of the key jobs of a central bank is to prevent deflation and, in modern times, most central banks have been successful. After all, governments establish central banks and give them the goal of controlling the rate of change of the overall price level and the independence to pursue that goal for two reasons: Governments regard achieving price stability as a desirable macroeconomic goal and they assume central banks can do the job.

Against that backdrop, leader of the LDP and new Prime Minister Abe made a big issue in the election campaign of the need for the Bank of Japan (BOJ) to adopt a much more aggressive stance to overcome deflation. He floated such ideas as the BOJ adopting a 2% inflation target, undertaking unlimited quantitative easing (QE), and directly underwriting government bond issuance as part of a coordinated fiscal and monetary expansion. In the election campaign and in the past, Mr. Abe and other politicians in both the ruling and opposition parties have also floated the idea of amending the Bank of Japan Act, if necessary, to force the BOJ to take more aggressive anti-deflation action. Mr. Abe has continued with his aggressive rhetoric since the election, threatening to amend the BOJ Act if the BOJ does not accede to a 2% inflation target when it conducts its annual review of its "price stability goal in the medium-to-long term" at its Jan. 23-24, 2013, meeting.

The fact that Japan has had long-term deflation and a new government has been elected in a landslide with what can be viewed as a mandate to end it is a noteworthy development. No wonder financial markets--the equity and foreign exchange markets in particular--have made substantial moves in anticipation of an Abe-led LDP victory and in response to it.

Fiscal Enemy Number One

When it comes to deflation continuing or being brought to an end, the long-term stakes are high for Japan. Japan's deflation is closely related to its fiscal condition. In Japan's case, at least to date, chronic deflation and chronic budget deficits (and the associated mounting stock of outstanding government debt) can be viewed as two sides of the same coin. Ending deflation is one of the keys, if not the key, to putting Japan's fiscal finances on a long-term sustainable path.

One way to see this is intuitive, the other a bit more theoretical. Intuitively, it is not hard to see that prolonged deflation will worsen government fiscal positions. Because it is associated with a weak economy and particularly weak nominal GDP growth, deflation tends to lead to lower tax revenue (net of transfers, which tend to rise when the economy is weak), whereas government spending tends to keep increasing even in a weak economy. Voila: widening budget deficits. Japan's nominal stagnation is acute. The latest level of nominal GDP is 9.5% below its peak, in fourth quarter 1997. In the same period, and by way of comparison, nominal GDP in the U.S. has increased by 86% and in the U.K. by 83%. Tax revenues in Japan peaked (on a fiscal year [FY] basis) at ¥60.1 trillion in FY 1990 but, at ¥42.8

trillion, were 29% lower in FY 2011.

The government deficit can also be viewed in terms of the national savings-investment balance, which necessarily (on a flow basis) equals the current account balance. Net national savings (i.e., net of investment) break down into net savings by the public sector (the government) and net savings by the private sector, which further breaks down into household and corporate sector net savings. In a chronic deflationary state, net private savings are likely to go up, particularly because private-sector investment (business investment and residential housing investment) tends to be weak. For a large economy like Japan, the current account is determined mainly by the rest of the world's net savings decisions, which will not change much just because Japan's private sector wants to save more. So, absorbing most of the excess net savings in the private sector necessitates government dis-saving (i.e., running a large budget deficit). From the macro savings-investment identity of GDP accounting, we know that if Japan is running a budget deficit of 7% of GDP and a current account surplus of 3% of GDP (roughly what it has been doing), the private sector must be running a net surplus of 10% of GDP.

Moreover, if the chronic deflation accompanies a trend of asset price deflation, as has been the case in Japan, households and investors will have a bias against holding risky assets and toward holding principal-protected assets, that is, government liabilities (like government bonds or cash) or government-guaranteed assets (like bank deposits, which are likely to have government bonds as the corresponding asset on the bank's balance sheet). That means that (until something goes wrong) the government will easily be able to finance its persistent deficits because the public will be willing to deploy its net savings into the asset that the government generates in doing so. In Japan, 10-year Japanese government bonds (JGBs) yield about only 70 basis points (bps) in nominal terms (more in real terms), despite the ratio of gross general government debt to GDP being about 235% (and the net debt ratio being about 133%).

This "happy" deflationary equilibrium--in which the government runs huge deficits and the Japanese public finances them at low rates--may not last forever, however, in the face of ever-mounting debt. Naturally, Japanese policymakers would like to put the fiscal finances on a long-term sustainable trajectory, before the bond market possibly reaches a de-stabilizing tipping point, and ending deflation is an important prerequisite.

Joined At The Hip: Monetary Policy And The Consumption Tax Hike

In fact, ending deflation is a legal precondition, of sorts, for the government to implement the hikes in the consumption tax rate slated for 2014-2015. The singular achievement of the Noda government was to pass legislation in August to hike the consumption tax rate from 5% to 8% in April 2014 and to 10% in October 2015. Hiking the consumption tax rate, which was last done in April 1997 (from 3% to 5%), has long been seen in Japanese policy circles, particularly at and around the Ministry of Finance, as necessary to broaden the tax base and raise tax revenue to help fund ever-rising social welfare and health expenditures as Japan's population steadily ages.

The tax hike legislation passed only after a tortuous debate and only after opponents had their qualms salved by the insertion of a "conditionality clause" into the legislation that linked the implementation of the tax hikes to the economic conditions prevailing at the time. In particular, the debate recognized that economic conditions would need to be

much better, and policies would need to be implemented to make them so, in order for an economy that has long been in deflation to be able to withstand the fiscal tightening associated with the tax hikes. After much debate and linguistic maneuvering, the compromise wording that was inserted in the legislation (as Article 18) is (my translation; the original Japanese is only marginally less convoluted):

"When it comes to hiking the consumption tax, because implementation is dependent on bringing about an improvement in economic conditions, with a view to escaping from a situation where the price level is continuously falling and to revitalizing the economy, as well as taking other necessary steps, comprehensive policies will be implemented in order to soon approach a state of desirable economic growth aiming for nominal economic growth of about 3% as well as real economic growth of about 2%, on average, over the decade from FY 2011 to FY 2020.

After this law is promulgated, from the viewpoint of responding flexibly to sudden changes in economic and fiscal conditions as well as carrying out a judgment of economic conditions pertaining to the hikes of the consumption tax rate, before putting into effect the respective hikes in the consumption tax rates stipulated in articles two and three, with regards to the improvement in economic conditions, nominal and real growth rates, price trends, and various economic indicators will be checked, and, after a comprehensive consideration of economic conditions in the light of the measures stipulated in the previous section, necessary steps, including suspending putting it into effect, will be taken".

If this does not deserve a prize for syntactic contortion and muddying of the linguistic waters, it is hard to know what would. But, penetrating the fog, the obvious intent is: Before hiking the consumption tax, policies to definitively end deflation need to be in place and to be working. Nominal GDP growth of 3% and 2% real GDP growth annually together imply the GDP deflator increasing at the rate of 1% per year. The average year-on-year rate of change in the GDP deflator in Japan in the past decade is -1.3% and in latest four quarters is -1.1% (the equivalent numbers for the domestic demand deflator are -0.8% and -0.5%, respectively). That would imply that a more than two percent "swing" is required. That hardly seems plausible, at least without something dramatic happening on the monetary policy front between now and 2014-2015. Hence, one can surmise, Mr. Abe's sudden monetary activism.

The BOJ On Deflation: Not Guilty

A third key context for the Abe reflation push is the BOJ's stated position on deflation. Over time, the BOJ has gradually developed a narrative about deflation, which essentially absolves it of primary or direct responsibility. The BOJ argues that Japan's deflation is not the result of insufficiently aggressive monetary easing. Rather it identifies real factors, notably the decline in Japan's potential growth rate and its continued expected decline in the future, as the cause of deflation. Hence the solution is not much more aggressive monetary policy but rather a shared effort among the government and the private sector to raise the potential real growth, with support from the central bank.

For instance, on Feb. 14, 2012, when it introduced its "price stability goal in the medium to long term," the BOJ stated that: "The goal of overcoming deflation will be achieved through […] efforts to strengthen growth potential and support from the financial side. With this in mind, it is important for business firms, financial institutions, the government, and the central bank to continue making efforts in their respective roles." According to the Oct. 30, 2012,

statement issued by the BOJ and the government on "Measures Aimed at Overcoming Deflation": "[T]he Bank recognizes that the challenge [of overcoming deflation as early as possible] will be met through the combination of (i) efforts by a wide range of economic agents to strengthen the economy's growth potential and (ii) support from the financial side. The Bank strongly expects the Government to vigorously promote measures for strengthening Japan's growth potential." In other words, the BOJ will provide monetary support, but the onus for establishing the conditions for deflation to end rests with the government and the private sector. The Noda government seemed to fall into line with the BOJ's view: "In order to overcome deflation, the Government recognizes that reforming the economic structure predisposed to deflation is essential in addition to appropriate macroeconomic policy management." It appears that the Abe government will not be so obliging.

The BOJ's position is a very strange one because most economists and monetary policymakers see inflation and deflation as "monetary phenomena"--and ultimately under the control of monetary policy--not as something driven by real factors. But on reflection it is not surprising that the BOJ would argue in this way. After all, were the BOJ to admit that inflation is under its control and deflation could have been overcome with a more aggressive monetary stance it would beg the question of why the BOJ failed to do so--and is failing to do so now.

However, the more that the BOJ argues in this way, the more it undermines its ability to overturn deflation and makes deflation a self-propagating phenomenon. And the longer that deflation goes on in this way, the more the BOJ can point to the ongoing deflation as evidence of how impervious deflation is to monetary policy and the more entrenched it becomes in its view--and the more convincing its arguments may seem to much of its audience--that it is powerless to overcome deflation and that the cause of deflation lies outside the monetary sphere. The BOJ appears to have created and to be caught in a trap of its own making.

Monetary Policy: It's All About What's Expected

How does a central bank target price stability? The traditional theory emphasized the output gap: If output fell below potential output, there would be disinflationary pressure, which the central bank would try to counter by easing monetary policy, and if output was running above potential output, and the economy "overheating" as a result, the central bank would try to quell the inflationary pressure by tightening monetary policy. There is something to this.

Modern theory and practice, however, put the management of the public's inflation expectations at center stage. Inflation has a large self-fulfilling component: Future inflation is determined largely by what the public expects inflation to be. If the central bank can control (or "anchor") those inflation expectations, it can largely control future inflation. To do that, the central bank needs to convince the public that the inflation rate it is targeting is the one that the public should expect. The central bank should be able to do this if it can convince the public that it has both the tools to target a given inflation rate and the determination to use them to that end. If it can, it may not actually have to use those tools very aggressively, as the expectations effect will do most of the work. But it is absolutely critical that the central bank project that it has the tools and is prepared to use them. The BOJ has fallen down in this regard.

The central bank needs only two kinds of tool: one to suppress high inflation and one to counter disinflation or deflation. Suppressing high inflation is relatively easy: just tighten financial conditions by hiking the policy rate. Given

that there is no limit on how high the interest rate can be hiked, a "threat" to hike the interest as high as necessary to quell inflation should be both credible and effective.

Things are not so simple in the other direction because when the central bank cuts interest rates to ease financial conditions it cannot do so without limit. Under some (unusual) circumstances, it will run into the zero interest rate boundary. But there, the central bank still has a tool that it can "threaten" to use without limit to ease financial conditions: the size of its balance sheet. At zero, the central bank can expand its balance sheet without limit by buying assets financed by the creation of bank reserves (deposits at the central bank). In principle, the central bank could buy any assets (or lend against them as collateral), although in practice central banks are usually limited by statute to buying safe assets such as government bonds. This is quantitative easing (QE).

Sufficiently aggressive QE should be able to counter deflation. For instance, in the limit, the central bank could acquire (or bid for) all of the marketable assets (financial and real) the public holds, meaning that the only assets the public held would be cash or bank deposits (it could buy foreign assets in an unlimited fashion too). This saturation of private sector portfolios with money should cause inflation expectations to rise as the holders of money attempted to re-balance their portfolios into yielding financial and real assets and as the unlimited money created "chased" the limited available goods. As long as the public thought that the central bank had such a tool and was prepared to use it, the central bank would never have to resort to such dramatic action because deflationary expectations would never take root. The "threat" would be enough.

The BOJ's Limp QE

For the expectations-management approach to work, the central bank needs to communicate strongly and back up that communication with sufficiently convincing action. Specifically, the central bank needs to signal strongly to markets and to the public that it believes it has the tools to achieve its mandate and is determined to use them, and it has to be prepared to take policy actions that are commensurate, that is, that are calibrated to maintaining the public's confidence. For central banks, credibility is king.

Unfortunately, the BOJ systematically has failed on both counts. It has pulled the rug from under its own feet, for years now, sending the message that it does not believe that it has the ability, acting as a central bank operating monetary policy, to move the economy out of deflation in a reasonable time frame (say 2-3 years). From an expectations-management perspective, the BOJ has thrown in the towel before it has stepped into the ring.

What about the BOJ's policy actions? Did not the BOJ pioneer QE in 2001-2006, and is it not undertaking what it terms "powerful monetary easing," comprising "virtually zero interest rate policy" and expanding its balance sheet via an Asset Purchase Program? And isn't the BOJ purchasing risk assets, such as corporate bonds, Japan equity ETFs, and Japanese REITs under this program? And hasn't the BOJ just introduced a Stimulating Bank Lending Facility to provide up-to-three-year loans to banks, limited only by the net increase in lending by the banks? All true. Just last week, the BOJ, under clear pressure from Mr. Abe, announced a further increase of ¥10 trillion in its Asset Purchase Program, taking the program to ¥76.13 trillion by the end of 2013, implying another ¥37 trillion of asset purchases between now and then.(3) But on closer inspection, there is less to the BOJ's "powerful monetary easing" than meets

the eye.

We can assess the "aggressiveness" of a central bank's QE using two metrics: size and content. "Size" refers to how much it expands its balance sheet as a deliberate policy action by acquiring assets (including claims on the banking system) financed initially by creating excess reserves (over time some of the excess reserves should leak into banknotes-in-circulation). "Content" refers to what assets and claims it acquires. The aggressiveness of the central bank's QE stance depends on how far it is deviating from attaining its goal. Logically, a central bank that is not achieving its goal needs to be more aggressive than one that is.

On all scores, the BOJ's QE record and current stance come up short. It has been aggressive neither on size nor content, given that Japan has been in deflation for at least a decade and on some measures (the GDP deflator) for more than 18 years. Under its 2001-2006 five-year experiment with QE, the BOJ increased the size of its balance sheet by only about 41% at the maximum point (after four years and nine months) even though Japan was deep in deflation during much of that period and ending deflation was a high priority of stated government policy, with the government frequently declaring that "the government and the BOJ are united in their determination to end deflation." From a QE logic point of view, this was clearly an insufficiently aggressive quantitative stance. In just one month after the September 2008 financial crisis erupted (admittedly under different circumstances), the Federal Reserve increased its balance sheet by 72% and the Bank of England (BoE) its by 114%.

Similarly, in terms of content. The main asset the BOJ purchased to expand its balance sheet during its 2001-2006 QE was long-term Japanese government bonds (JGBs). It did purchase some equities as a banking system--not a monetary policy--measure and some asset-backed securities (ABS) as a monetary policy measure, but the amounts were small: up to ¥3 trillion and ¥1 trillion authorized, respectively (actual purchases were less, ¥2.023 trillion and ¥0.291 trillion, respectively, at their maximum, on a month-end basis). When the BOJ started its QE, its balance sheet was about ¥110 trillion so even if the full amount of equities and ABS had been purchased this would have amounted to less than 4% of the starting point balance sheet size. A symbolic but not deflation-game-changing amount.

As well as the very important expectations channel, QE works through the complementary channel of what economists call the "portfolio rebalance effect." This channel of QE works because by acquiring assets at will, financed by the creation of excess reserves (central bank money credited to bank accounts at the central bank), the central bank can change the composition of the aggregate portfolio of financial assets the public holds. The point of doing so is to disturb the composition of that portfolio in the direction of it being more liquid and having less duration or less risk, so that (at least some) individual portfolio holders have an incentive to rebalance their portfolios in search of yield by trying to redeploy cash into assets that have more duration or risk or less liquidity. A fallacy of composition effect is at work because the central bank can control the aggregate amount of reserves it supplies to the banking system, and at the point of QE action the stock of available assets is fixed. But this is precisely what helps to produce a monetary easing effect and thereby elicit a higher level of economic activity than otherwise would have occurred.

The portfolio rebalancing theory suggests that more bang for the buck of QE is to be gained by having the central bank purchase assets that are "imperfect" substitutes for the asset supplied (central bank reserves) and that the more imperfect, the more potent the QE. Thus, the portfolio rebalance effect of a given dollar or yen of QE should be more potent if a 10-year government bond is purchased than a three-month government bill and more potent if a 10-year

corporate bond is purchased than a 10-year government bond and more potent if corporate equities are purchased than a 10-year corporate bond, and so on. From this perspective, the BOJ's 2001-2006 QE, focused as it was on JGBs of not particularly long duration (the run-off of JGBs purchased was quite rapid), was just nowhere near potent enough.

Central banks are generally limited by the law that governs them in terms of what assets they can acquire.(4) In the BOJ's case, however, Article 43 of the BOJ Act allows the BOJ to seek permission from the government to purchase any asset that it deems that it needs to in order to achieve its objectives. This gives the BOJ many more degrees of freedom than the Fed, for instance, in taking aggressive monetary policy actions.

How does the BOJ's current monetary policy stance measure up in this regard? Disappointingly, yet again. The BOJ seemed to learn the wrong lesson from its 2001-2006 QE experience, namely that QE did not work--a conclusion which, if drawn, is almost guaranteed to result in QE not working--whereas the lesson should have been that it needs to use QE much more aggressively, both in terms of communication and action.

The eruption of the financial crisis in September 2008 is a good starting point from which to benchmark how aggressive central banks have been in expanding their balance sheets. Since the end of August 2008, the BOJ has expanded its balance sheet by 43.7%. This is much less than the other major central banks: the BoE: 340%; the Fed: 221%; the ECB: 108% (see table 2). Size disappoints.

Table 2

Central Bank Balance-Sheet Expansion Since 2008 Financial Crisis: BOJ Vs. The BoE, Fed, And ECB

	Size of balance sheet, end of August 2008	Latest size (December 2012)	Percent increase	Amount of bank reserves, end of August 2008	Latest amount of bank reserves	Number of times increase	Percent increase in banknotes-in-circulation in same period
Bank of Japan (¥ trillion)	109.89	157.88	43.7	8.30	48.17	5.8	11.4
Bank of England (£ billion)	93.23	410.38	340.2	28.49	271.15	9.5	40.3
Federal Reserve ($ billion)	908.99	2,921.78	221.4	19.38	1,482.70	76.5	40.4
ECB (€ billion)	1,449.14	3,011.20	107.8	204.30	927.56	4.5	33.2

Source: Respective central bank websites.

The BOJ does not accept the argument that it has not been "aggressive" with its balance sheet. It points out that its balance sheet as a percent of GDP is bigger than other central banks. Latest comparative data (for end of third quarter 2012) for this metric are as follows: Japan, 31.7%; U.S., 17.7%; U.K., 26.0%; eurozone, 32.5%. So it is true that the BOJ's balance sheet, scaled by nominal GDP, is bigger than that of the Fed and the BoE (although about the same as the ECB). But this metric, in and of itself, says nothing about how aggressively a central bank has been using its balance sheet as a tool to achieve its mandate.

The two main determinants of the size of a central bank's balance sheet on the liability side are reserves and banknotes-in-circulation. A central bank's balance sheet can be "big" relative to GDP at any point in time because the

central bank has purposefully expanded the balance sheet by buying assets or providing credit and thus has expanded the amount of reserves (because it pays for the assets or provides the credit by creating reserves) or because the public demands a lot of banknotes. The former is a measure of whether and how aggressively (in a quantitative sense) the central bank is doing QE. The latter reflects institutional aspects of the financial system and economy and habits and preferences of the public.

The BOJ's balance sheet is big relative to GDP mainly because the Japanese public likes to hold a lot of banknotes, the Fed's and the BoE's because they have done QE on a big scale (see table 3). To avoid this potential fallacy in interpretation, it is better to look at how the balance sheet has increased over time (as cited above) or, even better but a bit more work to calculate, the amount of excess reserves the central bank creates as a percent of its balance sheet. Latest data show this measure to be 50.3% for the Fed and 17.8% for the BOJ, compared with 0.2% and 0.2% respectively at the end of August 2008, just before the financial crisis erupted in full force. Ergo, the Fed has been much more aggressive than the BOJ in acquiring assets financed by creating excess reserves, even though the Fed has been much closer to achieving its target than the BOJ has been to achieving its.(5)

Table 3

Banknotes-In-Circulation As Percent Of GDP: Japan Vs. U.S. And U.K.

	Latest (September 2012)	September 2008*	March 2005§	December 1994†
Japan	17.3	15.4	14.9	7.6
U.S.	6.8	5.4	5.7	4.9
U.K.‡	4.1	3.5	3.5	3.1

*Date of major eruption of financial crisis. §End of official Japanese banking system workout.†Month when two Tokyo-based credit associations failed, marking beginning of systemic phase of Japanese banking crisis. ‡Including coins. Source: Bloomberg.

What about content? The BOJ is currently conducting its monetary policy within the "comprehensive monetary easing" framework it announced October 2010, the center-piece of which is the Asset Purchase Program. Under this program, the BOJ purchases JGBs, T-bills, commercial paper (CP), corporate bonds, exchange-traded equity funds (ETFs, linked to the Japanese stock market indices), and Japan real estate investment trusts (J-REITs) with the aim of "[encouraging a] decline in longer-term interest rates and various risk premiums to further enhance monetary easing." The BOJ launched the program with an announced ¥5 trillion of purchases (equivalent to about 4% of its balance sheet at the time) and with the ¥10 trillion increase announced last week, the total amount outstanding by the end of 2013 is slated to be ¥76.13 trillion. (The cumulative increment of purchases announced but yet to be made is equivalent to about 23% of the BOJ's balance sheet; it is about 47% if the regular monthly JGB purchases the bank makes(6) and its estimate of the reserves to be supplied under the new Stimulating Bank Lending Facility and the existing Growth-Supporting Funding Facility are included, assuming no balance sheet run-off from any of these programs.)

Eyes starting to glaze over? The point remains that, impressive though this plethora of schemes and asset purchases may appear on the surface and as much as the BOJ may be able to "milk it" for incremental monetary policy easing announcement effects, the content is not up to the Herculean task of bringing about an end to deflation. The ¥76.13 trillion Asset Purchase Program is overwhelmingly concentrated in JGB and T-bill purchases (latest: 83%, heading for 90%), where the portfolio rebalance effect is minimal, and ETFs and J-REITs, potentially very fertile ground for

deflation-fighting QE, are only 4.3% of the total (headed for 2.9%) (see table 4). And what about foreign bonds? Their imperfect substitutability with domestic bonds and likely reflationary effect via a weakening effect on the nominal value of the yen exchange rate would make their purchase a potentially effective form of anti-deflation QE. There is a zero allocation to them. To add insult to injury, the "longer term" JGBs (¥44 trillion announced) are limited to bonds with 1-2 years left to maturity (as is the case too for corporate bonds). Again, this short duration limits what is already likely a muted portfolio rebalance effect from JGB purchases under the prolonged liquidity-trap-like conditions that have prevailed in Japan.

Table 4

Breakdown By Type Of Asset Purchased By Bank Of Japan's Asset Purchase Program

Asset purchased	Initial amounts annouced (October 2010; ¥ trillion)	% of total	Latest amounts purchased (end November 2012; ¥ trillion)	% of total	Announced amounts to be purchased (by end of 2013; ¥ trillion)	% of total
Japanese government bonds (1-2 years remaining to maturity)	1.5	30.0	22.1	58.8	44.0	57.8
Treasury discount bills	2.0	40.0	9.0	23.9	24.5	32.2
(government debt subtotal	3.5	70.0	31.1	82.7	68.5	90.0)
Commercial Paper	0.5	10.0	1.9	5.1	2.2	2.9
Corporate bonds (1-2 years remaining to maturity)	0.5	10.0	3.0	8.0	3.2	4.2
Exchange-traded funds	0.45	9.0	1.5	4.0	2.1	2.8
Japan real estate investment funds	0.05	1.0	0.11	0.3	0.13	0.2
Total	5.0	100.0	37.6	100.0	76.13	100.0

Source: Bank of Japan.

A Change Of The Guard

A fourth important factor in the Japan reflation story is the turnover at the top of the BOJ that is set to occur next year. Governor Masaaki Shirakawa's five-year term ends in April 2013 and the five-year terms of the two deputy governors end in March and October(7), respectively. The appointment of a new governor in particular will give the Abe administration an important opportunity to influence the future course of the BOJ's monetary policy.

The ability of the government to influence the BOJ and hold it accountable for its actions by the choice of the nine policy board members, including the governor and the two deputy governors, is an important part of the institutional framework for conducting monetary policy as it operates in Japan. The BOJ Act gives the BOJ "autonomy" in the conduct of monetary policy. But that autonomy in conducting monetary policy is tied to the BOJ being given the job of "pursuing price stability" (Article 2). And Article 4 makes it clear that the BOJ has to maintain a close relationship with the government.(8) Government representatives, specifically the Minister of Finance and the Minister of State for Economic and Fiscal Policy, can attend policy board meetings and express opinions, submit proposals regarding monetary policy matters and request that the board postpone a vote on a monetary policy matter until the next meeting; however, they cannot vote (Article 19).

To help secure the BOJ's autonomy in monetary policy decision-making, the BOJ Act restricts the ability of the government to dismiss the governor and other policy board members, once they are appointed (Article 25). If the government is dissatisfied with the BOJ's track record, it can reflect that dissatisfaction in its choice of governor and other policy board members. Given how vocal Mr. Abe has been on the BOJ, there is a growing hope or expectation among market participants that, as prime minister, he will do just that, helping to kick-start a long-awaited reflation in Japan. Such a course of action should not necessarily be construed as the government "putting political pressure" on the BOJ but rather as the government exercising its legitimate rights to hold the BOJ accountable and influence its actions within the legal framework of monetary policy that operates in Japan.

High Hopes: A Reality Check

Hopes may be running high that Japan is about to set sail on a reflationary course, but there are a number of reasons to be skeptical. Generating political rhetoric is easy; translating it into policy action and results is another thing altogether.

Skepticism starts with the observation that "we have been here before." Ending deflation was a major policy plank of the Koizumi administration from 2001-2006, a period that overlapped with the BOJ's first foray into QE. The government and the BOJ have been saying for years that they were working together to bring an end to deflation, and they have not been successful. Turning up the volume on that kind of talk does not guarantee success.

It is also not clear how deep Mr. Abe's understanding of the complex, controversial, and subtle issues of monetary policy is; how much policy attention and focus he is going to give to this issue; and how persuasive he will able to be. Does Mr. Abe have a clear view of the role that monetary policy can play in overcoming deflation or, at the end of the day, will he succumb to some version of current monetary policy orthodoxy in Japan? That orthodoxy--again, according to the BOJ--is that ongoing deflation in Japan is not due to insufficiently aggressive monetary policy but to a declining trend in the real growth rate and that overcoming deflation will require both a combination of efforts by a wide range of economic agents to strengthen the economy's growth potential (business firms, financial institutions, and the government) and support from the financial side (BOJ monetary policy). The central bank being the monetary experts in the country, many Japanese opinion-leaders and market participants have signed on to this view, as presumably has much of the general public (which from an expectations-drive-inflation point of view is a big part of the problem).

Even if Mr. Abe has a clear view, will he be able to find a candidate for governor who shares those views and his vision? Even if he finds such a person, who, by definition, is likely to be a radical and controversial candidate in the Japanese context, will he be able to get that person appointed, given that both houses of parliament need to give their approval, in effect giving the upper house a veto, and the coalition ruling parties, the LDP and Komeito, do not have a majority in the upper house? The lack of a majority in the upper house suggests that there may be some pressure on Mr. Abe to produce a "consensus" or "establishment" candidate.

Even if a potentially "game-changing" candidate is appointed, will he or she be able to exercise enough leadership to command a majority of votes on the policy board to adopt radical proposals and establish a new radial change in

direction and overcome the likely opposition within the BOJ? The governor of the BOJ is the most important person at the Bank, but even the governor has just one vote on the nine-member policy board. Even the most radical of possible candidates may find it difficult to overcome institutional resistance and inertia.

The biggest cause for skepticism is simply the scale of the policy moves that would likely be required. The BOJ should be able to use monetary policy to bring an early end to deflation. But the BOJ failed to do so in the past and therefore has a serious credibility deficit when it comes to fighting deflation. And having gone on for so long, deflation expectations have become "hard-wired" into the economy and in the mindsets of economic agents. So the scale of the policy action (QE) required to change the equilibrium behavior of the economy and dislodge deflation expectations would likely be dramatic and literally "off the charts." For a society and political culture that favors consensus and incrementalism, and for an institution as inherently conservative as the BOJ (at the best of times central banks tend to be conservative institutions), the required actions may just not fall within the set of practically feasible options.

For instance, for the sake of argument, not as a specific proposal per se, consider the following example of an approach the BOJ could take to ending deflation. Having a literally unlimited ability to expand its balance sheet by purchasing assets (any kind, under Article 43 of the BOJ Act, if the government would approve), the BOJ could announce that it:

Had revised its thinking on deflation and now rejected its earlier position that monetary policy alone could not overcome deflation; rather it was now convinced that it has the tools (a balance sheet) to bring about an end to deflation on a 1-3 year horizon;

Was determined to end deflation and henceforth would be targeting a 2% consumer price inflation rate and, because there had been so much slippage on the attainment of price stability in the past, it would allow the inflation rate if necessary to move to the upside of 2% temporarily (in the band of 2%-3%);

To that end, would start expanding its asset purchases at the rate of 10% of the balance sheet per month until it achieved its inflation target and would purchase a combination of foreign bonds and domestic equity ETFs and J-REITs (but no JGBs); and

Would ratchet the policy up further if it appeared not to be working.

Making the monthly asset purchases a percent of an ever-expanding balance sheet would mean that the amount of purchases would steadily increase over time, so that at the end of a year the balance sheet would have increased by 214%. If the BOJ started such a policy now, given that its balance sheet is about ¥160 trillion, in a year it would increase to about ¥500 trillion. Dramatic sounding stuff, but if the BOJ had increased its balance sheet since the September 2008 financial crisis by the same percentage as the Bank of England has its balance sheet, it would be just shy of that size (¥489 trillion). By buying domestic equities and real estate and foreign exchange, the potency of the QE would be maximized. By saying it was rejecting its earlier position on deflation, and now believed that it could end deflation and was absolutely determined to do so, the BOJ should be able to reset the public's price expectations at around 2%, thus facilitating its achievement of that inflation rate. Because the new policy would be launched under a new governor and deputy governor leadership, the change in position, as long as accompanied by action by the BOJ of a kind and on a scale not seen before, hopefully would be seen as being credible and therefore should be effective.

Again, this is meant just to be an illustrative example of the kind of radical approach by the BOJ that should work in ending deflation in Japan, the kind of radical approach that the BOJ has never taken. I have no doubt that such a radical policy would cause the yen to weaken and the stock market to rise dramatically, triggering strong economic growth and a ratcheting up of inflation expectations (from around slightly negative to around 2%) and permanently changing the equilibrium of the economy. This reflation would not solve all of Japan's problems, but that is not the point. Monetary policy is not supposed to be a cure-all policy for all economic and societal ills. It is supposed to deliver operational price stability.

However, this kind of radical approach seems like a bridge far too far for Japan and for the BOJ in particular. Japanese policymakers and politicians are not known for throwing caution to the winds. This kind of plan is probably not what Mr. Abe has in mind and, even on the slim chance that it is, it is probably not the outcome he will be able to bring about.

Japan has entered a period of policy flux and market excitement; however, it seems more likely to end in disappointment yet again than in the long-awaited reflation.

Endnotes

(1) I use the term "reflation" to mean "getting the economy out of a sustained deflation and putting it on a path of sustained operational price stability," using the usual central bank interpretation of "operational price stability" as a positive, measured consumer price inflation rate of around 2%.

(2) The domestic demand deflator fairs a little better: It is down a cumulative 12.5% from its second quarter 1997 peak.

(3) The structure of the Asset Purchase Program is a bit confusing. The BOJ describes it as having two components: asset purchases (¥76.13 trillion total announced) and fixed-rate funds-supplying operations against pooled collateral (¥25 trillion announced; ¥27.84 trillion implemented, as of Dec. 10, 2012).

(4) In a world in which central banks may need to undertake QE, from a monetary policy framework design perspective, this is actually quite problematic, but that is another topic.

(5) In this period, the CPI inflation rate in Japan, the BOJ's favored inflation measure, has averaged -0.4% against a "goal" of 1%, while the core PCE inflation rate, the Fed's favored measure, has averaged 1.6% against a target of 2%.

(6) The BOJ buys ¥1.8 trillion of JGBs per month or ¥21.6 trillion per year, but because of the short duration of these bonds--and perhaps other transactions that it conducts with the government--its net holdings of JGBs do not increase at anywhere near that rate. For instance, according to the latest balance sheet of the BOJ (as of Dec. 10, 2012), the BOJ had ¥67.375 trillion of JGBs compared with ¥63.988 trillion a year earlier. In other words, even though it purchased ¥21.6 trillion of JGBs during the year, its holdings increased by only ¥3.387 trillion.

(7) The term of Deputy Governor Hidehiro Yamaguchi ends on Oct. 26, 2013, but it may be that he steps down with the governor on April 8, and that the replacement for Deputy Governor Kiyohiko Nishimura, whose term ends on March 19, does not take up his or her appointment until April 9, thus synchronizing the terms of the governor and

deputy governors again. The current discrepancies in the end dates of the terms stem from the fact that the appointments of the governor and deputy governors in 2008 were disrupted by the failure of the upper house to approve several of the candidates for governor and deputy governor put forward by the government at the time (the Fukuda administration).

(8) The English translation of the BOJ Act on the BOJ's website is a translation "prepared by the Japanese Government," but it is an unofficial translation, only the original Japanese version having legal effect. Article 4 of this unofficial translation states: "The Bank of Japan shall, taking into account the fact that currency and monetary control is a component of overall economic policy, always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy shall be mutually compatible." This makes it sound like the BOJ's monetary policy and the government's economic policy stance are on an equal footing. But the original Japanese version is subtly different. More accurately translated it would read: "The Bank of Japan shall, taking into account the fact that currency and monetary control is a component of overall economic policy, always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control shall be compatible with the basic stance of the government's economic policy" [my translation]. This makes it clearer that the government is the "first mover" and the BOJ must accommodate the government's policy stance. The government's policy stance is contained in the Cabinet Office's Monthly Economic Report and for years has made reference to the need to overcome deflation. The BOJ governor attends the monthly ministerial meeting convened by the Cabinet Office to produce this report.

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