OBSERVATION
TD Economics

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LATEST BANK OF JAPAN MOVE PROVIDES A JOLT TO MARKETS

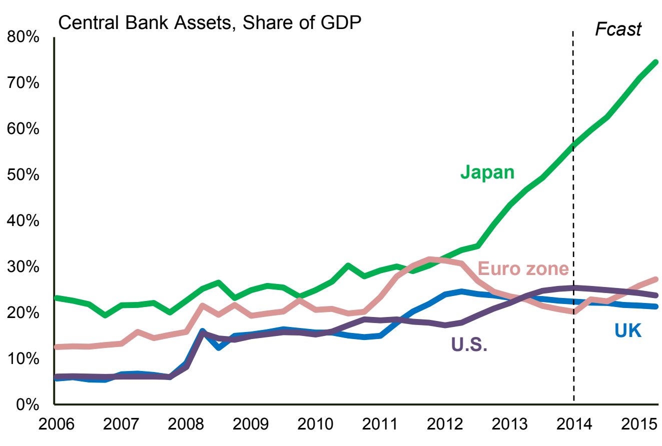
Highlights

- At its monetary policy meeting on October 31st, the Bank of Japan announced an expansion of its "quantitative and qualitative monetary easing" program. It will now increase its monetary stimulus to the tune of ¥80 trillion annually, up from ¥60-70 trillion previously.
- The market reaction was swift, with risk appetites invigorated. In FX, the yen depreciated from around 109 to 113.5 today, relative to the USD. Japanese bonds rallied, particularly at the long-end of the yield curve. Global equities were also buoyed, with the Nikkei surging and the S&P500 hitting a new record on Friday.
- The latest move is unlikely to be a game-changer for Japan economically. Real GDP growth is expected to come in below 1% this year, and at around 1% next year. However, it will help arrest the decline in inflation expectations and limit some of the downward pressure on inflation due to lower oil prices.

At its monetary policy meeting on October 31st, the Bank of Japan announced an expansion of its "quantitative and qualitative monetary easing" program. Previously, the bank of Japan had been conducting market operations with the goal of increasing its monetary base by ¥60-70 trillion annually. It will now increase its monetary base by ¥80 trillion annually, an increase of roughly 20%.

At the current exchange rate, the annual size of this monetary stimulus will be roughly $700bn U.S. dollars. In comparison, the Fed's recently completed third round of quantitative easing, at its peak, expanded its balance sheet by just over $1.0 trillion annually. As a share of GDP, however, the Bank of Japan's QE program dwarfs the Federal Reserve's, bringing the size of the BoJ's balance sheet to over 70% of GDP by the end of next year, compared to only 25% for the Federal Reserve (see chart 1).

CHART 1. SIZE OF JAPANESE MONETARY STIMULUS DWARFS THAT OF OTHER MAJOR ECONOMIES



Source: National Central Banks, Bloomberg, TD Economics forecast.

As part of this newly-announced stimulus, the Bank of Japan will purchase ETFs and Japan real estate investment trusts (REITs) to the tune of ¥3 trillion and ¥90bn, both of which are triple the amounts it was purchasing previously. The remainder of the monetary stimulus will be provided via purchases of Japanese government bonds (JGBs), to the tune of roughly ¥80 trillion annually. The Bank of Japan will also extend the average maturity of its JGB purchases from 7 to 10 years, in order to reduce interest rates across the entire spectrum of the yield curve.

The decision to expand the program passed by a tight 5-4 majority vote. The argument for expanding the program was that domestic demand had remained weak following the implementa-

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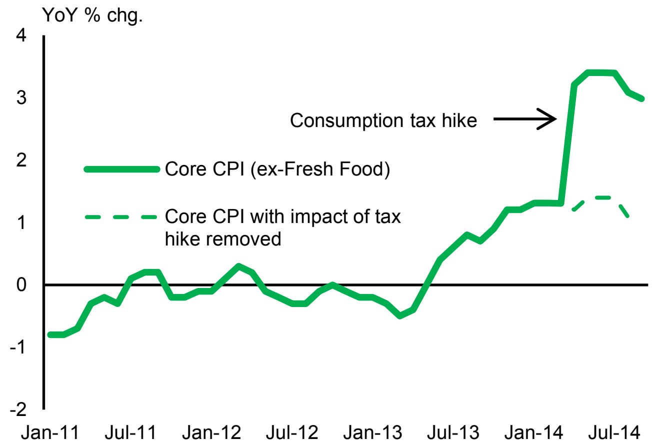
CHART 2. INFLATION HAD STARTED TO FALL AGAIN IN JAPAN



Source: MIC, Cabinet Office.

tion of the consumption tax hike on April 1st. Furthermore, with the recent fall in crude oil prices weighing on headline inflation, the BoJ did not want lower prices to feed into inflation expectations (or as they put it, to delay the "conversion of [a] deflationary mindset"). In updated forecasts published the next day, the BoJ cut its forecasts of Real GDP growth from 1.0% to 0.5% for FY 2014, while leaving its forecast for FY2015 unchanged at 1.5%.

In a near simultaneous move, the Japanese Government Pension Investment Fund decided to make a major shift in its asset allocation mix, with a far smaller emphasis on domestic bonds, and a greater weighting for domestic and foreign equities. This effectively frees up JGBs to be purchased by the BoJ, while providing a boost to risk assets.

Stimulus buoys financial markets

The market reaction to the move was swift and strong, reflecting the fact that it had been largely unanticipated (only 3 of the 32 economists polled by Bloomberg were expecting an expansion in stimulus at the meeting). Japanese bonds rallied, particularly at the long-end of the yield curve, where 30-year sovereign yields fell by roughly 20bps from last Thursday. In FX, the yen depreciated from around 109 to 113.5 today. It has now fallen almost 28% since November 2012.

Globally, the BoJ's move led to rising equity prices, with the Nikkei surging and the S&P500 hitting a new record at Friday's close.

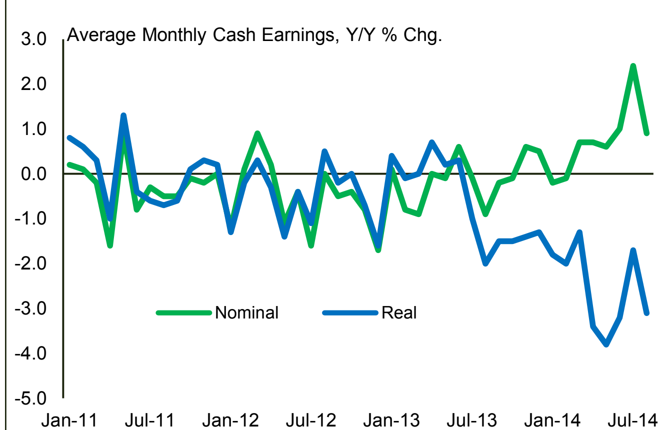
Economic impact is likely to be limited

The latest move is unlikely to be a game-changer for Japan economically. One of the factors hampering economic activity in Japan is the fact that wage growth has not kept up with the rise in inflation (see chart 3). While wage growth has at least turned positive, with the exception of July, monthly cash earnings have not grown by more than 1% year-over-year. As inflation currently sits above 3%, real earnings are substantially negative, severely depressing consumer spending power. As a result, even in the context of decent employment growth, consumer spending has only modestly picked up since the tax hike. In this sense, in the immediate term, the BoJ move may be counterproductive if it raises inflation without a simultaneous increase in wages. However, greater wage growth is not something that occurs overnight.

Beyond consumer spending, recent data on business investment has been mixed, as domestically-oriented firms face higher input costs, while export-oriented firms contend with sluggish global demand. As a result, machinery orders have only risen modestly after a sharp fall following the tax hike. Business sentiment also remains mixed, with the last Tankan survey reporting more positive sentiment among manufacturers, but weaker sentiment among non-manufacturers.

In the absence of robust domestic demand growth, Japan needs its export sector to provide support to its economy. On this front, the data has been slightly more encouraging of late. The further fall in the yen should help exports, although the magnitude is likely to be small, given its already extreme decline over the past two years. At this point, exports would benefit more from stronger global demand than from a fall in the yen. Unfortunately, the global backdrop will likely

CHART 3. NOMINAL WAGES HAVE RISEN BUT NOT ENOUGH TO KEEP UP WITH INCREASE IN INFLATION



Source: Ministry of Healthy, Labour and Welfare (Japan).

remain muted over the near future, with every other country seemingly also hoping to growth through exports.

The bottom line is that in terms of lifting economic growth, there is only so much the Bank of Japan can do. Raising the growth trajectory further will require structural reforms to be enacted – the third arrow of Abenomics that has yet to really be unleashed. Labor market and targeted sectoral reforms would help boost productivity, which in turn, should lead to greater incomes. Additionally, allowing for higher immigration would be a boon to a generally declining labor force, and would likely serve to stimulate demand.

None of these measures appear likely to occur, at least not in the near term. Moreover, Prime Minister Shinzo Abe still has to decide in December whether to proceed with the second round of the consumption tax hike, from 8 to 10% in October 2015. If Abe does proceed, this will provide a further headwind on the economy.

Better chance of success on the inflation front

While the further expansion of monetary stimulus may not show up noticeably in near-term growth numbers, the success of the program may be better judged in terms of raising inflation expectations out of a deflationary mindset. The BoJ move should help limit downside risks to inflation expectations, while also offsetting some of the downward impact of lower oil prices on inflation. At time of writing, market-based ten-year inflation expectations, as measured by breakevens – the difference between the yield on a nominal bond and an inflation-linked bond - had rebounded to 1.17%, still down from the 1.3%+ level in April, but up from the sub-1% level at the beginning of the year. The further fall in the yen will also marginally boost corporate profits, providing more of an impetus for Japanese companies to raise wages.

Bottom Line

Overall, we expect Japan's economy to continue to muddle through, with growth below 1% this year and roughly 1% next year. Inflation is expected to remain positive but below target, at around 1%.

Market attention will now turn to other central banks. For the European Central Bank, whose own measures have yet to deliver much additional liquidity, the pressure to do more is likely to rise as lower energy prices put further downward pressure on already very low inflation. For China, whose economy is slowing and who has seen its currency rise alongside the value of the USD, additional devaluation on the part of Japan, its third largest trading partner, may cause a rethink of its current monetary policy stance.

Even as the Federal Reserve has ended quantitative easing, greater stimulus from the BoJ, and speculation of additional easing from other central banks should continue to support asset prices. However, amidst these global divergences, volatility in financial markets will remain elevated.

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