Economics

BOJ Carves Out More Flexibility for Longer Inflation Fight

By Toru Fujioka and Sumio Ito
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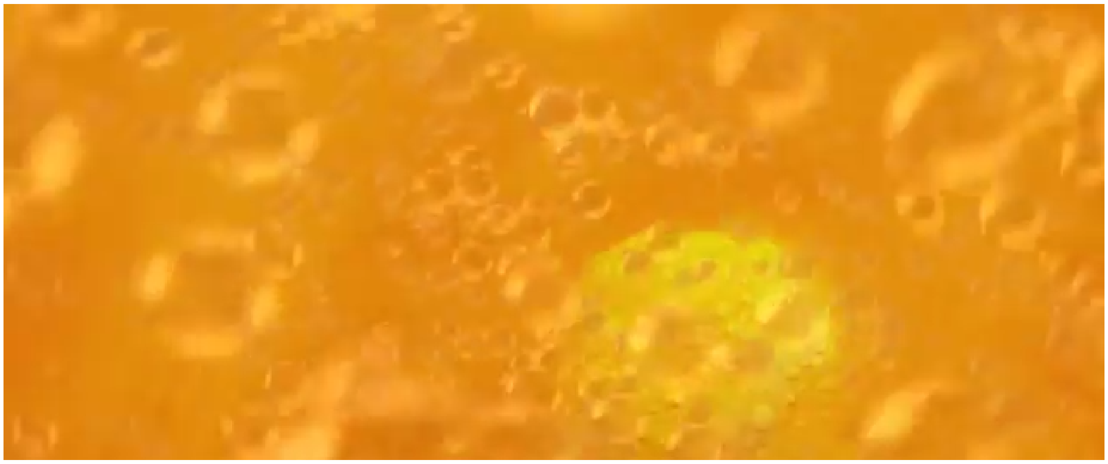
- Scraps 6 trillion yen ETF buying target, will focus on TOPIX
- ‘Clarifies’ 25 bp yield band; to offer incentives if cuts rate

BOJ Carves Out More Policy Flexibility

The Bank of Japan unveiled a set of carefully crafted policy tweaks aimed at giving itself more flexibility to keep up its long quest to revive inflation.

The bank set out a wider-than-previously-thought movement range for bond yields and scrapped a buying target for stock funds at the end of a three-month policy review.



While the currency and bond markets largely took the moves in stride, the BOJ's decision to focus its purchasing of exchange-traded funds on the wider Topix index drove down shares on the Nikkei 225.

Read More: Bank of Japan Brings End to Decade-Long Buying of the Nikkei 225

Many of the tweaks will give the BOJ greater scope to buy fewer assets and could be viewed as a stepping back from stimulus, but the central bank characterized the changes as shoring up the effectiveness and sustainability of its measures over the longer run.

The BOJ also tried to show its readiness to add stimulus if needed by offering lending incentives that would increase in size if it lowered interest rates.

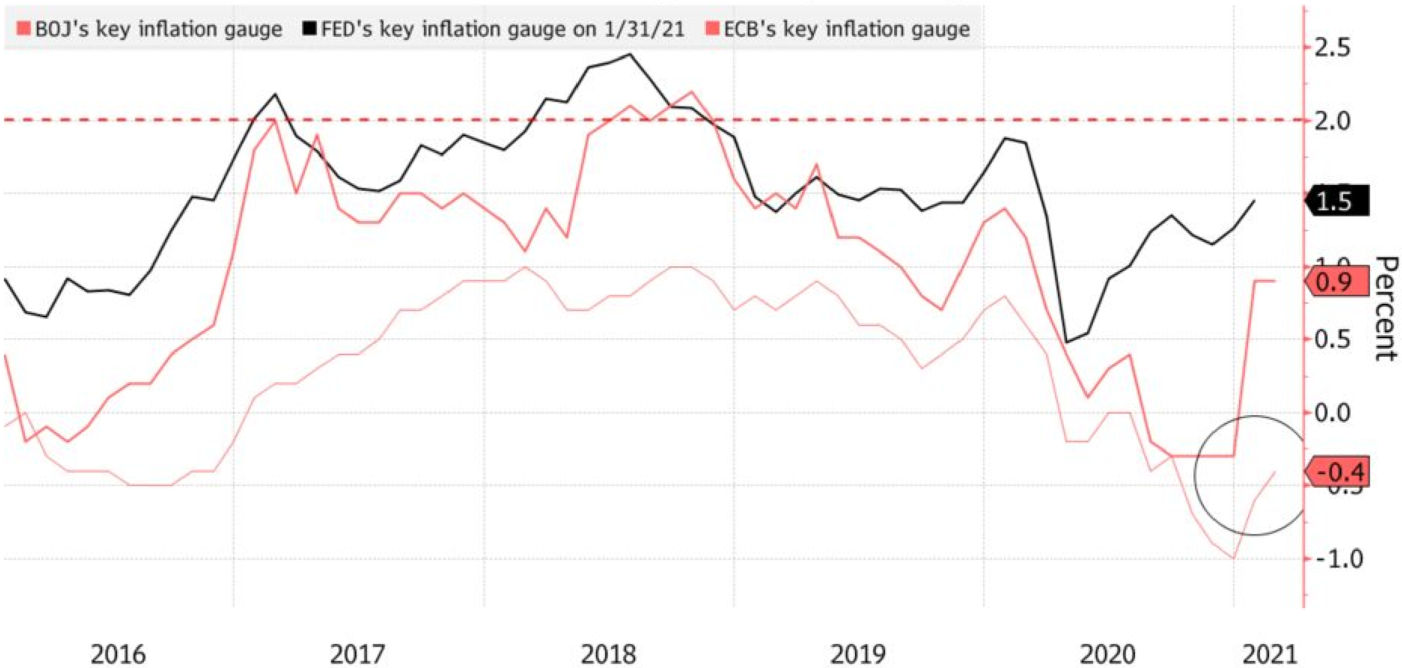
At a press briefing, Governor Haruhiko Kuroda reiterated that the BOJ's existing framework was the right one for the job of lifting prices in Japan and shouldn't be written off because the 2% goal has yet to be reached.

Kuroda's task of building more support for his stimulus while avoiding the impression that he's backpedaling hasn't been made any easier by global peers that have kept the pedal on stimulus.

The European Central Bank last week made clear it plans to buy more bonds and the Federal Reserve on Wednesday projected near-zero rates at least through 2023, despite improved forecasts for inflation, employment and growth.

Below Target

The BOJ remains much further from its price target than peers



Source: Japan's ministry of internal affairs, Eurostat, U.S. bureau of economic analysis

"The BOJ is trying hard to strike a balance on a very tight rope between side effects and the need to continue easing," said Tetsufumi Yamakawa, head of Japan economic research at Barclays PLC and a former BOJ official. "Even though its easing commitment is clear, by trying to reduce the side effects of stimulus, the BOJ clearly differs from the Fed and the ECB."

While leaving its main policy rates unchanged, the bank said the band around its 10-year bond yield target was around 0.25% either side of zero, according to a statement Friday. Until now the range had been assumed to be around 0.2% based on Kuroda's comments.

> ## What Bloomberg Economics Says...
>
> "The new scheme to soften the blow to bank lending from a cut to the negative short-term rate is a step in the right direction in helping banks cope were it to take the rate further down. That said, the BOJ hasn't demonstrated how negative interest rates are an effective means to boost inflation and the economy."
>
> --Yuki Masujima, economist
>
> To read the full report, click here .

Kuroda said the bank had become increasingly concerned about the functioning of the bond market given that yield movements had become much smaller than the BOJ's range. The bank felt a need to specify where the guardrails were, he said, denying that they'd been widened.

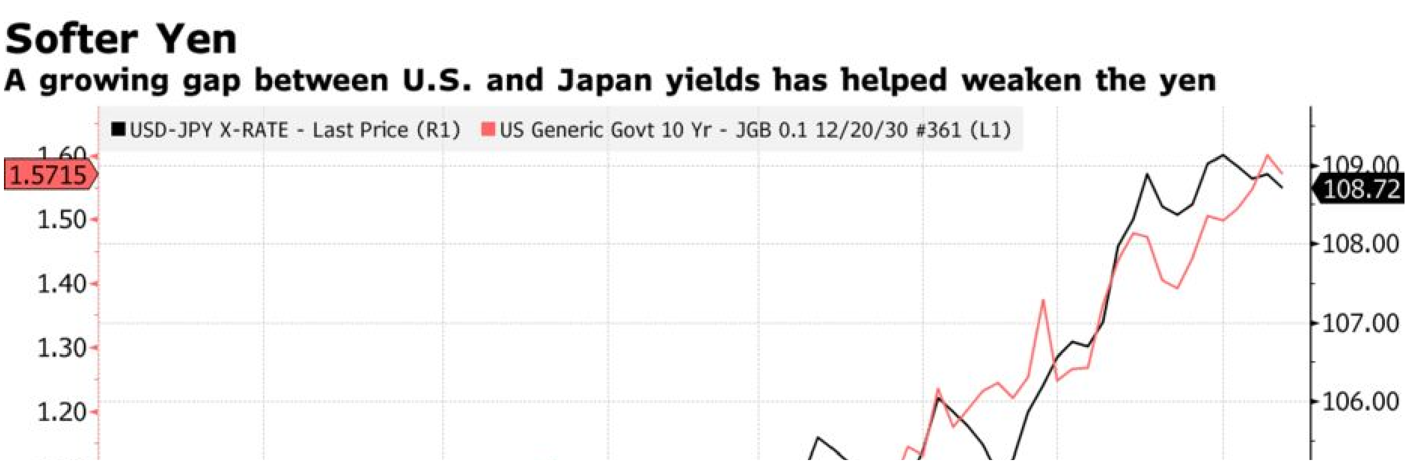
"We merely clarified what we've already said in the past in slightly broader terms," Kuroda said.

In a lengthy analysis of the impact of interest rate fluctuations on business investment, the BOJ concluded that capital spending is largely unaffected by moves that don't go beyond 0.5 percentage point. That led Tom Learmouth at Capital Economics to conclude that the bank would widen its band further going ahead, though Kuroda said there were no such plans.

The BOJ also ditched its 6 trillion yen ($55 billion) guide for annual purchases of exchange-traded funds, while sticking with an upper limit of 12 trillion yen so it can still step into the market if sentiment takes a turn for the worse. The switch to the broader Topix index was aimed to avoid ownership of too much stock in individual companies, Kuroda said.

One casuality of the move was Fast Retailing Co., which has been the largest stock on the Nikkei for the last decade. Shares of the Uniqlo operator tumbled after the announcement.

The BOJ's new lending incentives and a plan to adjust its three-tier reserve system if it cuts its target rates were aimed at changing the perception it cannot lower its negative rate due to the impact it would have on struggling regional banks. Kuroda said the BOJ still hadn't reached a limit on how low it could go.



Source: Bloomberg

Utlimately, the scope for ekeing out Friday's changes owes much to a recent weakening of the yen, as recent jumps in U.S. Treasury yields far outran those in Japan, where they are held down by the central bank. The wider difference in rates contributed to the yen reaching the 109 mark against the dollar compared with a much stronger 102.7 at the start of the year.

A weaker yen helps boost the profits of Japan's exporters while generating some upward pressure on prices via more expensive imports.

"The BOJ couldn't really hope for much better timing," said Yuichi Kodama, chief economist at Meiji Yasuda Research Institute ahead of Friday's decision. "The yen isn't gonna break through the symbolic 100 mark against the dollar, even if the result of the review is seen as backtracking from stimulus."

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- Tinker, Tailor, Soldier On: the BOJ's Policy Review: Daniel Moss
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- Investors Pile Pressure on Yield Curve Pioneers Japan, Australia
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- ECB Ramps Up Bond-Buying Speed to Contain Rising Bond Yields

While the pandemic unleashed a huge wave of central bank and government support for economies, businesses and households, it caught the BOJ already at full stretch after years of stimulus to ignite price growth. The pile of assets accumulated by the BOJ in its inflation fight was already bigger than the world's third-largest economy when Covid-19 struck.

The urgency for the BOJ to create extra breathing space to run stimulus for longer became more apparent at the end of last year as prices fell at the fastest pace in a decade and the bank became the largest holder of Japanese stocks as well as bonds. Extra flexibility created now could also make an eventual tilt toward the exit door from easy money a fraction easier.

"The BOJ's difficult contortions around its policy settings show the broader difficulty of exiting from unconventional policy measures without alarming the market," said Alvin T. Tan, head of Asia foreign-exchange strategy at RBC Capital Markets in Hong Kong.

– With assistance by Yuko Takeo, Yoshiaki Nohara, and Enda Curran

(Updates with Kuroda's comments from briefing)

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