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Macro Note

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BANK OF JAPAN INTO 2020: WITH FISCAL STEPPING UP, MONETARY POLICY CAN BE THE FULCRUM RATHER THAN THE LEVER

A run of weak recent data challenges the view that Japan's economy can remain resilient to the global manufacturing downturn and consumption tax hike. But with large scale fiscal stimulus en route the Bank of Japan can hold off squeezing out further stand-alone monetary stimulus and focus on the interaction between fiscal and monetary policy.

The central bank's ten year yield target of zero invites fiscal policy to take the lead in responding to weakness by providing a fulcrum against which fiscal stimulus can push without crowding out private spending via the interest rate channel – a form of monetary-fiscal cooperation that should increase the fiscal multiplier and could be adopted by other economies in future downturns.

Japan's government is set to deliver a package with a headline value of 2 to 2.5 per cent of GDP in public commitments and more including claimed associated private spending. We assume roughly 1 per cent of GDP genuine net new stimulus spending out over two to three years, enough for the BoJ to keep rate cuts in reserve in the base case, though we continue to view its easing bias as genuine if not now imminent.

We also expect that the BoJ and the government will cooperate to modestly steepen the yield curve and support ultra-long yields in 2020, with the BoJ continuing to reduce the volume of QE purchases overwhelmingly by reducing longer dated purchases while the government issues more ultra-long term debt. This will likely have some global spillovers in the same direction (yields slightly higher / steeper in particular beyond ten years).

We expect continued pragmatic implementation of the ten year target range and flexible application of equity ETF purchases. We see no adoption in 2020 of a set of curiously timed policy proposals from the IMF that point prematurely to the exit door.

RECENT DATA UNDERLINES STRAIN ON JAPANESE ECONOMY FROM GLOBAL WEAKNESS, CONSUMPTION TAX HIKE

Japan's domestic economy exhibited greater resilience to global weakness in 2019 than has generally been the case in recent decades, with a different growth mix than in most other economies – stronger investment spending, more subdued consumption.

The BoJ can take some credit for this resilience which in our view reflects at least in part the beneficial effects of QQE / YCC era monetary policy on the labor market, productivity and expectations.

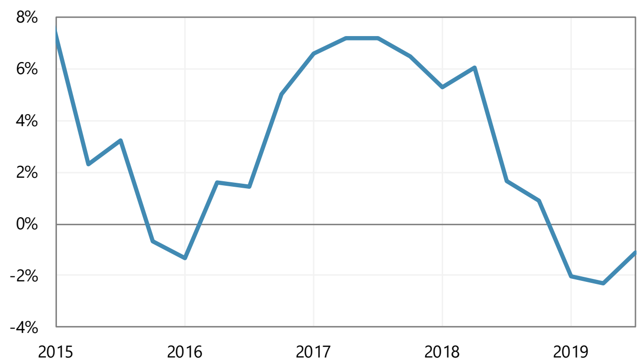
However, the latest data underline the strain on growth, with machine tools orders remaining extremely weak on depressed capital goods spending worldwide, industrial production weak and retail sales plunging by more than the BoJ had anticipated following the consumption tax increase.

With manufacturing under substantial pressure and corporates generally cautious, household income growth has slowed sharply on very weak summer bonus payments and consumer confidence has deteriorated significantly.

We draw little comfort from the relative stability of consumer spending going into the consumption tax increase, which was muddied by emergency spending and disruptions relating to the typhoon, and suspect the underlying trajectory of consumption is weaker than the BoJ thinks. This will not be helped going forward by renewed attention to shortfalls in pension savings.

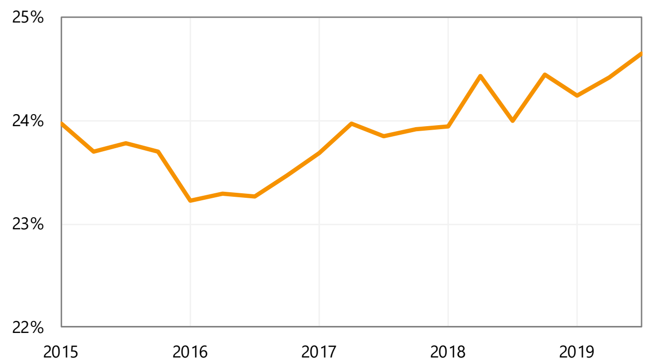
Consequently we expect a prolonged period of weak activity that will significantly weaken pressure on the output gap.

Japan Real Exports
Y-Y%



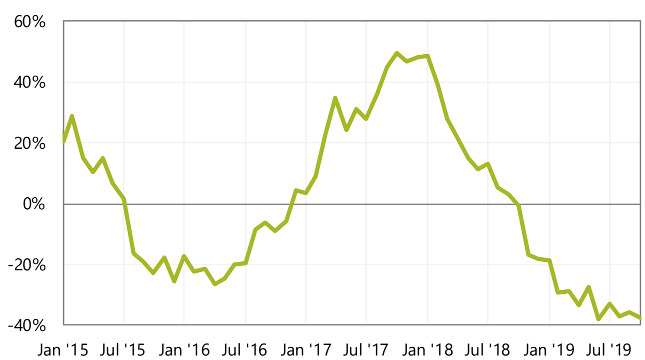
Source: CAO.

Japan Gross Domestic Fixed Capital Formation
Percent of GDP



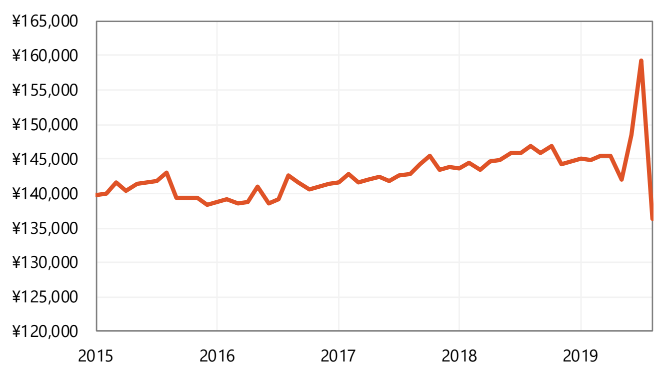
Source: CAO.

Japan Machine Tools Orders
Y/Y%



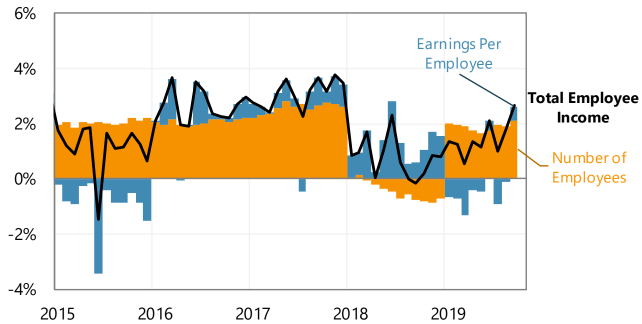
Source: JMBA.

Japan Retail Sales
¥billions, SAAR



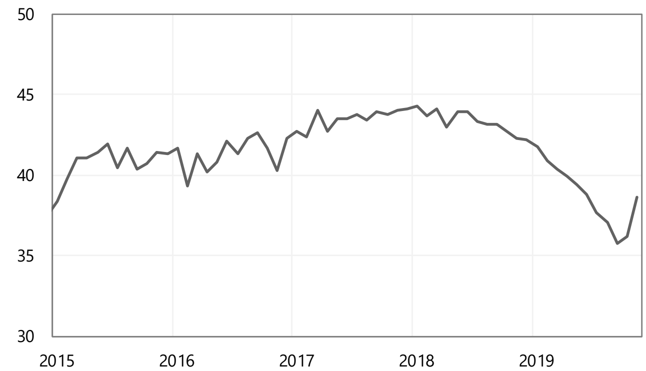
Source: METI.

Japan Employee Income Growth by Component
Y-Y%



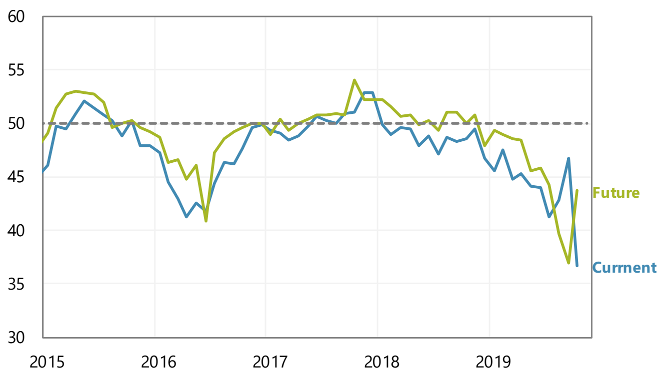
Source: Ministry of Health, Labour & Welfare, Ministry of Internal Affairs and Communication.

Japan Consumer Confidence Index



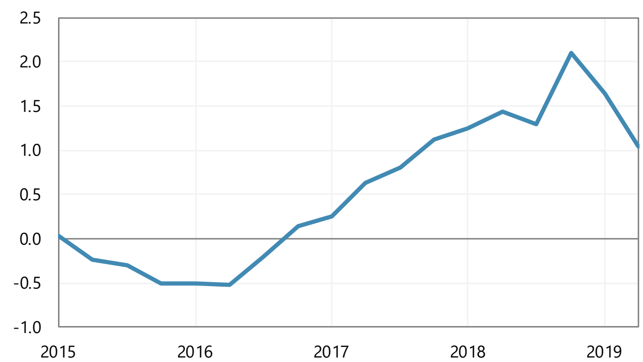
Source: CAO.

Japan Economy Watchers Survey of Conditions
Direction, 50+ = improving



Source: CAO.

Japan Output Gap
Percentage points of potential GDP



Source: BoJ.

BOJ HOPES PINNED ON GLOBAL BOTTOMING, NON-MANUFACTURING INVESTMENT AND CONSUMER RECOVERY

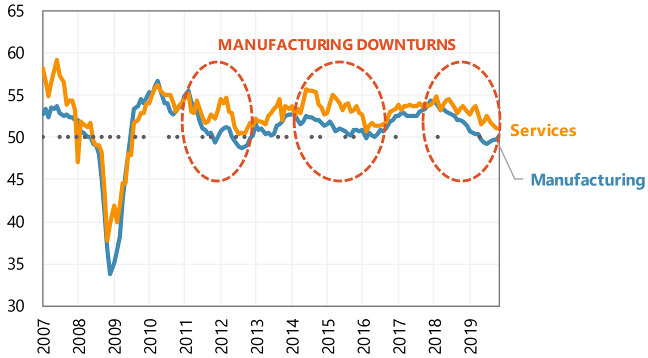
The Bank of Japan's relatively constructive October 2019 Outlook – which does not include the expected additional fiscal stimulus - relies on the notion that global growth is bottoming, non-manufacturing investment will remain strong and consumer spending will recover relatively quickly from the consumption tax hit.

The central bank is optimistic that global growth may be in the early stages of stabilizing – as indicated by manufacturing PMIs bottoming out and resilient data in the US – while the IT cycle is already starting to turn up, providing some prospective support for an important subset of Japanese manufacturers.

The BoJ sees investment as remaining quite strong with strength in non-manufacturing investment driven by capital-labor substitution in a labor market that remains very tight, while manufacturing investment does not weaken as much as feared since companies are still operating at high reported levels of capacity utilization having not ramped up too aggressively in the prior phase, as suggested by the September Tankan survey (but subject to revision in future Tankans).

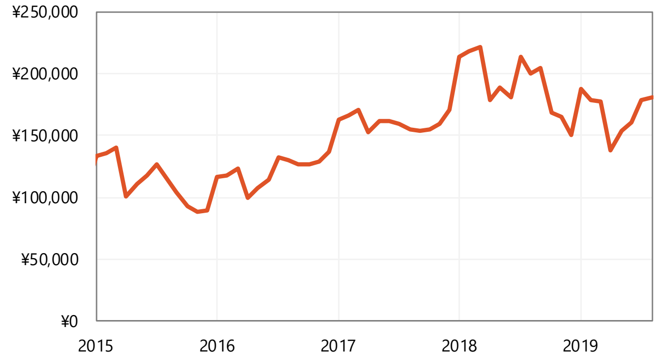
Household spending is anticipated to quickly pick up to a near 1 per cent type growth rate consistent with household income growth, with consumer confidence recovering after the tax hike as it did in 2014, given the many offsets in prior budgets and a much smaller decline in real income.

Global PMIs
50+ = Expansion



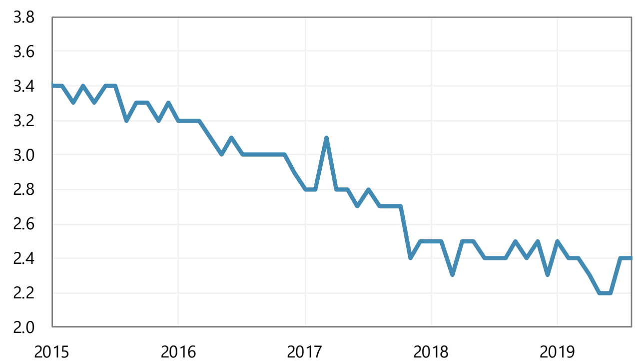
Source: JPMorgan, IHS Markit, Evercore ISI.

Japan Semiconductor Sales
¥millions, 3MMA



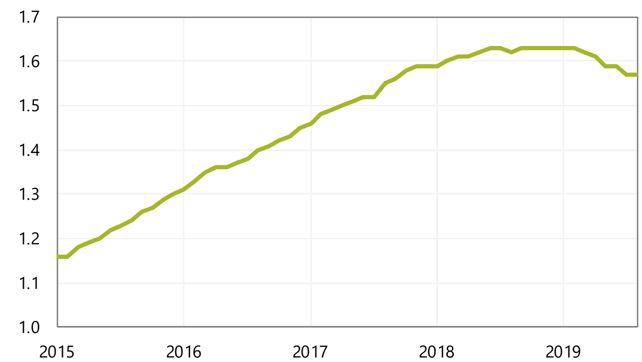
Source: METI.

Japan Unemployment Rate
Percent of Labor Force



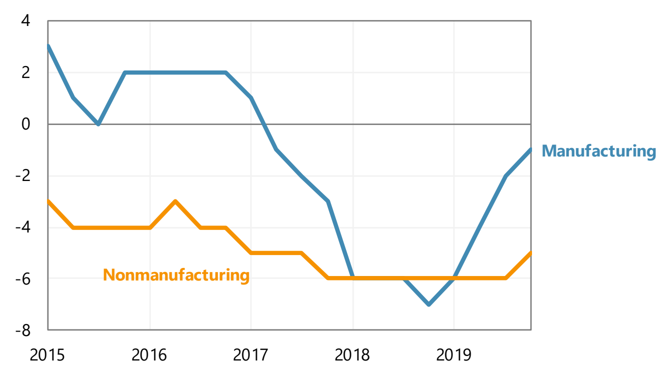
Source: MIC.

Japan Ratio of Active Job Openings to Applicants
Ratio



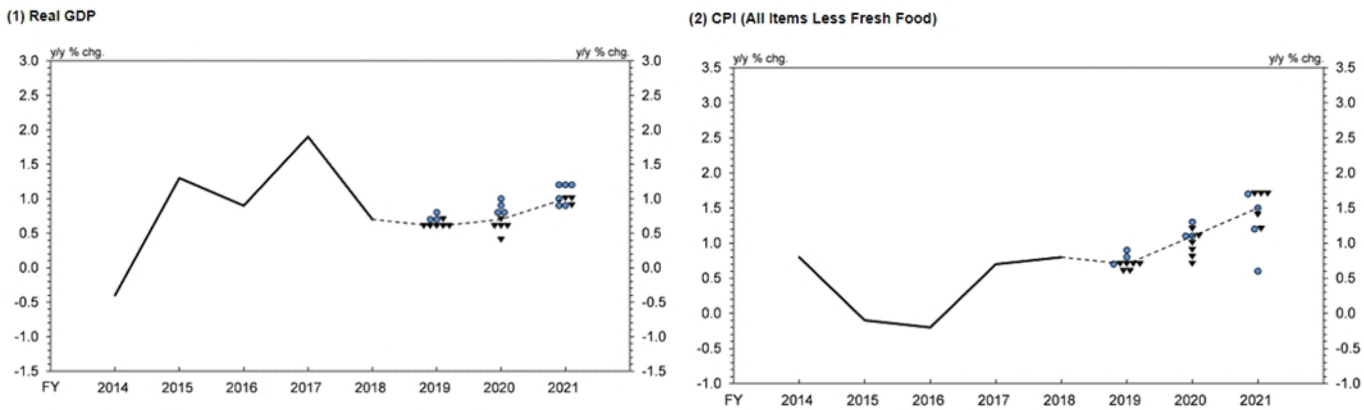
Source: MHLW.

Japan Forecast Production Capacity
Tankan Survey, + = Excess, - = Tight



Source: BoJ.

Japan BOJ Policy Board Members' Forecasts and Risk Assessments: October 2019



Notes:

1 Solid lines show actual figures, while dotted lines show the medians of the Policy Board members' forecasts (point estimates).

2 The locations of ●, △, and ▼ in the charts indicate the figures for each Policy Board member's forecasts to which he or she attaches the highest probability. The risk balance assessed by each Policy Board member is shown by the following shapes:● indicates that a member assesses "upside and downside risks as being generally balanced," △ indicates that a member assesses "risks are skewed to the upside," and ▼ indicates that a member assesses "risks are skewed to the downside."

3 The CPI figures for fiscal 2014 and 2015 exclude the direct effects of the consumption tax hike in April 2014.

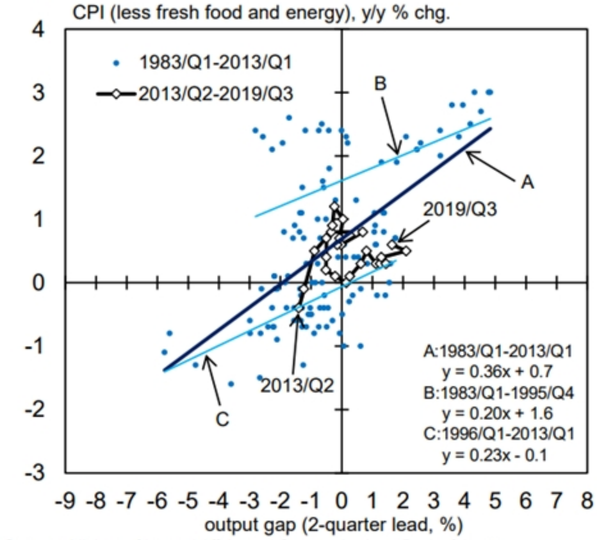
INFLATION PROGRESS STALLED AT LOW LEVELS AND IN DANGER OF SLIPPING BACK

The BoJ's hopes of raising inflation from around 0.5 per cent on an underlying basis towards its eventual 2 per cent target by maintaining a very tight (positive) output gap long enough to grind wages and prices higher and slowly raise adaptive inflation expectations that proved relatively insensitive to pure monetary policy shocks are in any event firmly on hold. There is virtually no prospect of making progress absent a more benign shift in the external environment.

Instead, the central bank is playing defense – trying to prevent the output gap from weakening to the extent that the limited gains in wage and price pressures realized to date fade away. We think there has already been some slippage across both wages and prices – with more limited wage gains making households prospectively less willing to accept price hikes – though diffusion indices suggest the share of products with rising prices continued to increase in 2019.

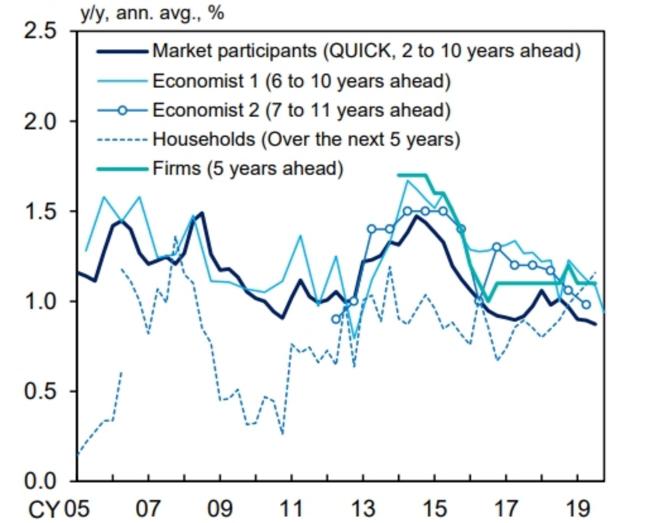
We also see some erosion of indicators of inflation expectations, though only moderately to date, with the weakness most marked in market breakevens; the BoJ putting less weight on these market measures sees expectations as broadly stable.

Chart 49: Phillips Curve



Sources: Ministry of Internal Affairs and Communications; Bank of Japan.
Notes: 1. The CPI figures are adjusted for changes in the consumption tax rate.
2. The output gap is based on staff estimations.

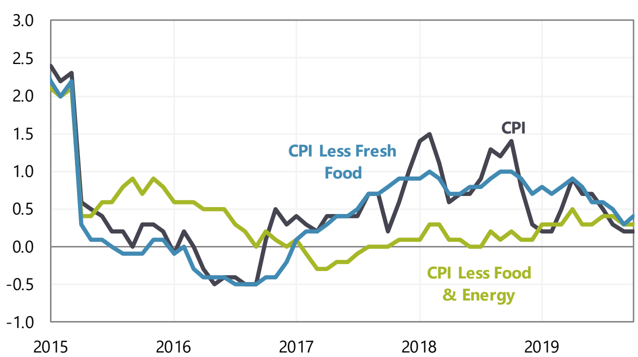
Chart 46: Inflation Expectations (Survey)



Sources: Bank of Japan; QUICK, "QUICK Monthly Market Survey (Bonds)"; JCER, "ESP Forecast"; Consensus Economics Inc., "Consensus Forecasts."
Notes: 1. Figures for the economist 1 are from the "Consensus Forecasts." Figures for the economist 2 are from the "ESP Forecast."
2. Figures for households are from the "Opinion Survey on the General Public's Views and Behavior," estimated using the modified Carlson-Parkin method.
3. Figures for firms are "Outlook for General Prices (*Tankan*, all industries and enterprises, average)."

Japan Inflation

Y-Y%



Source: MIAC, Evercore ISI.

Japan Inflation Diffusion

Percent of Items with Increasing v Decreasing Prices

Source: BoJ.

Japan 5y5y Inflation Swap

Source: Bloomberg, Evercore ISI.

¥10-¥13 TRILLION FISCAL STIMULUS + TEN YEAR YIELD TARGET UNDER YCC = INCREASED MULTIPLIER

Against the current economic backdrop the BoJ has welcomed proposals for a ¥10-¥13 trillion fiscal stimulus that ease the pressure on the central bank to provide additional monetary accommodation. This is exactly how fiscal-monetary cooperation is supposed to operate under yield curve control with the ten year yield softly pegged at zero plus/minus a roughly 20bp comfort zone.

Under this model the central bank invites fiscal stimulus to combat economic weakness. The ten year target / soft rate peg acts as the fulcrum against which the fiscal lever operates, ensuring that it does not crowd out private spending via the interest rate channel in the macro-sensitive section of the yield curve between the overnight and ten year tenors. The BoJ assesses that this will increase the fiscal multiplier – perhaps above 1.

The purported headline number ¥10-¥13 trillion of public commitments (plus additional claimed associated private spending) is roughly 2 to 2.5 per cent of GDP. However, more than half the headline public commitments are likely to be rebadged funding and/or allocated to real estate purchases and other activities that do not contribute to GDP.

So we (and we think the BoJ) are operating on the conservative assumption that there is something in the order of ¥5 trillion or 1 per cent of GDP in effective public spending stimulus. The ten year target / soft peg ensures that the multiplier on this will not be materially reduced by interest rate crowding out but it still be reduced by some Ricardian effects and constrained by shortage of workers, in particular in construction.

This will likely slow implementation of public projects across several years – we think the BoJ likely expects a GDP contribution in the region of 40-50bp in year one and two perhaps with a bit less in year three for a cumulative multiplier of 1 to 1.5 per cent on the 1 per cent or so of true stimulus, we would see a bit less for a cumulative multiplier of around 1. But fiscal may be a relatively effective backstop since in the event that the labor market weakens by more than expected with greater weakness in private construction spending could be implemented on a more front-loaded basis

BOJ TO REDUCE QE PURCHASES OF LONGER DATED BONDS IN CONCERT WITH ADDITIONAL GOVERNMENT ISSUANCE AT ULTRA-LONG END TO MODESTLY STEEPEN YIELD CURVE

In parallel we see further monetary-fiscal cooperation with the intention of modestly steepening the yield curve and increasing ultra-long yields beyond ten years to ease pressure on life insurers and pension funds (while also maintaining a very slight slope between the overnight and ten year horizon).

On the BoJ side, we expect that the central bank will continue to reduce total QE purchases, which are already down in the ¥20-25 trillion range relative to a notional target of ¥80 trillion a year, reflecting the (correct in our view) belief that prices (yields) dominate quantities in determining the stance of policy.

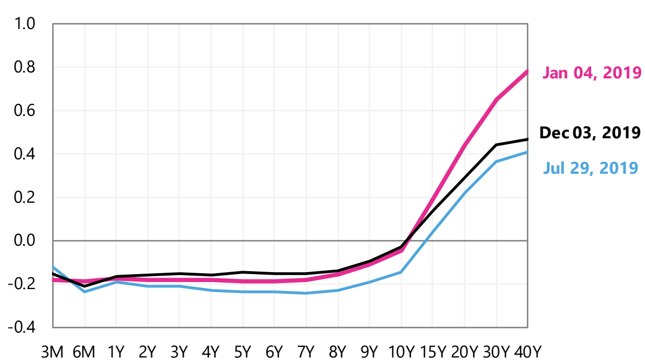
We think the BoJ may well reduce its remaining purchases of ultra-long JGBs with a tenor of more than ten years to zero, though it would resume them if yields rise too much. We also think it will shave purchases between five and ten years, again subject to stepping up if yields rise too much.

The effect will be to reduce the central bank's total takedown of duration and raise the share of purchases in the zero to five year segment of the curve. The central bank will have the option of actually increasing the amount of purchases for instance in the two to three year segment as a form of stealth easing under YCC, though we do not expect large-scale net transfer of purchases from longer to shorter dated tenors, if only because this would tend to pull down the path of rates through to the ten year horizon anyway.

Meanwhile, the government is likely to accede to BoJ requests to increase the share of issuance at ultra-long tenors (40 years if not new 50 year bonds) – though perhaps not to the full extent the BoJ desires given the Ministry of Finance's desire to minimize debt service charges and concern that investors who buy ultra-long dated debt at today's ultra-low yields may suffer capital losses and withdraw from the market.

The net increase in duration ought to somewhat steepen the curve and may generate at least mild spillovers globally.

Japan Government Bond Yield Curve
Percent



Source: Bloomberg, Evercore ISI.

PRAGMATIC MANAGEMENT OF THE TEN YEAR TARGET BAND IN 2020

At the key ten year target horizon we think the BoJ will – having considered whether to enforce the band more strictly – continue to take a relatively pragmatic approach in 2020 which in practice means that (within reason and on a temporary basis) the floor will remain a soft floor as was the case in Q3 2019 when yields traded significantly below the +/- 20bp comfort zone around the zero yield target.

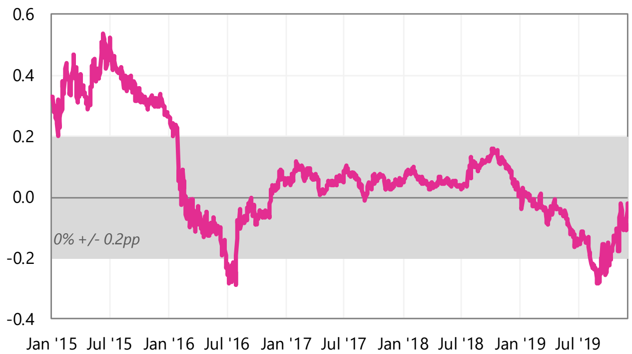
The BoJ sees some buffer around the declared comfort zone – perhaps extending to more of a 25-30bp range (at least to the downside).

Policymakers recognize that the architecture of YCC with the ten year target is procyclical in the sense that if implemented rigidly it would limit the endogenous decline of yields in response to an adverse shock that might result in a global move lower in yields (which might not only be inappropriate in terms of the original shock but may also, by changing yield differentials between Japan and the rest of the world, fuel currency appreciation.)

The architecture is procyclical to the upside as well, but this is potentially helpful to the BoJ's distant mission of raising inflation to 2 per cent, so the policy implication is asymmetric.

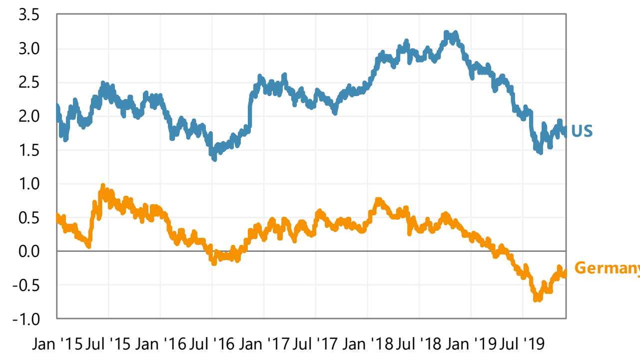
The central bank will continue to shuffle QE purchases around different tenors to try to prevent yields falling too low, but is extremely cautious about the idea of selling bonds at the low end of the target range, for fear that this would be a shock to expectations that might have outsized and hard to predict expectations. At a minimum any such move would be extensively telegraphed in advance.

Japan 10Y JGB
Percent



Source: Bloomberg, Evercore ISI.

Global 10Y Sovereigns
Percent



Source: Bloomberg, Evercore ISI.

EASING BIAS IN PLACE WITH THE BOJ INSISTANT THAT IT IS NOT AT THE LOWER BOUND WITH POLICY RULE BASED ON OUTPUT GAP AND INFLATION EXPECTATIONS AND SUBJECT TO DYNAMIC COST-BENEFIT ASSESSMENT

The BoJ articulated a generic easing bias in general terms over the summer / early fall of 2019 and reinforced with explicit guidance that the Bank “expects short- and long-term interest rates to remain at their present or lower levels as long as it is necessary to pay close attention to the possibility that the momentum toward achieving the price stability target will be lost” in October.

We read this sequence of guidance as a) intended to assert that the central bank is not at the lower bound on rates / limit of potential asset purchases or other easing measures so ensuring a downward sloping OIS curve with some ongoing endogenous stabilization effects in markets b) to prepare the ground for relatively imminent action in the event that sufficient fiscal stimulus was not forthcoming, trade wars continued to escalate and the global economy weakened further necessitating ongoing easing in the US and Europe that risked Yen appreciation.

The fiscal stimulus will be flagged up in the BoJ December statement then incorporated into policymaker projections in January and provides a substantial buffer against further downgrades. In this context – and with some better news on global growth – we think the BoJ easing bias is serious but not imminent and not in the base case for 2020, with rate policy reverting to more of a backstop.

The October formula however does go some way to pre-committing the BoJ to act if the outlook for inflation deteriorates significantly again with explicit emphasis on developments in the output gap and inflation expectations – which are, to some degree at least, externally verifiable indicators.

The BoJ claims that indicators of inflation expectations have not weakened, though this is largely the result of putting considerable weight on household indicators relative to market breakevens that the central bank views as too illiquid to provide any reliable signal (though there may be some signal to the fact that the government is reducing issuance of inflation protected securities due to lack of demand).

In any event, we think inflation expectations are so low and poorly anchored that the BoJ would need to move on signs that a prospective (negative) output gap was starting to opening up and projected to remain open for some time, without needing to wait for confirmation from the expectations indicators.

Unlike some therefore, we think the BoJ is not entirely bluffing when it claims a readiness to do more if needed. In our view BoJ policy continues to be subject to a dynamic cost-benefit assessment and further easing remains quite possible in 2020 though not in the base case and would not come simply in response to a period of deeper weakness that is expected to prove transitory as fiscal ramps up and the global economy firms a bit.

We also see the central bank as sensitive to currency appreciation at lower levels than most with monetary policy potentially active at an exchange rate materially above ¥105 – even around current early December levels.

FOUR EASING OPTIONS ARE REALLY TWO – LOWERING THE OVERNIGHT POLICY RATE AND INCREASING EQUITY ETF PURCHASES

Kuroda has talked about four easing options if easing turns out to be needed: a reduction in the overnight policy rate, a reduction in the ten year yield target, an increase in the money base target and an increase in purchases of equity ETFs and other risky assets.

In our view however, two of these options – reducing the ten year target and increasing the money base target (and implicitly therefore QE purchases) – are not plausible in the current context as they would flatten the yield curve and lower ultra-long rates in contradiction to the BoJ's desire to modestly steepen the curve and raise ultra-long rates as part of the effort to ensure sustainability (the higher QE quantity implied by a higher money base target is more broadly inconsistent with YCC focus on prices – the BoJ is already only buying a fraction of the declared ¥80 trillion a year quantity).

The viable policy options are lowering the overnight policy rate and buying more equity ETFs.

BOJ BELIEVES IT CAN CUT THE OVERNIGHT RATE FURTHER WITH OFFSETS BUT THE PUSHBACK HAS BEEN STRONG INCLUDING ON OFFSETS

The BoJ satisfied itself in the summer / early fall of 2019 that it can if needed cut the overnight policy rate more deeply negative while mitigating the cost to banks through some combination of more generous tiering and (perhaps) more generous term funding, avoiding shock effects by communicating in advance and preventing a flattening of the yield curve by shifting purchases under YCC (in the limit case, it could sell securities if needed to maintain a desired yield curve, though as discussed above the BoJ is understandably wary of doing so).

There is no evidence that bank lending has been weakened by the slightly negative overnight rate with loan growth strong. And, the policy rate continues to effect financial conditions and the economy via the FX and capital markets channels in addition to lending.

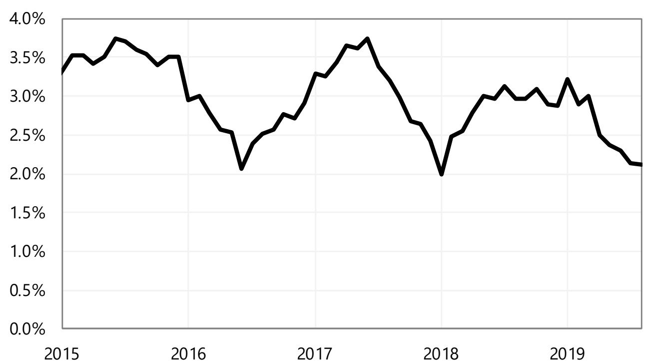
But the pushback from banks against the idea of a further rate cut even with offsets was ferocious and in our view even stronger than the BoJ had anticipated. Bankers were particularly anxious to keep the TIBOR rate that trades with a moderate premium over the marginal deposit rate and against which many floating rate loans are priced above zero.

As long as lending volumes remain strong, the BoJ is cautious about fueling excesses in credit via more aggressive term funding. This would change if loan growth slowed / lending conditions tightened appreciably. But bank representatives insist they do not want term funding at negative rates as they already have excess funding and fear that negative rate term loans from the BoJ would only encourage clients to ask for negative rate loans too.

We think there are workarounds here. For instance, rather than provide negative rate term funding the BoJ could provide bonus renumeration under tiering for banks that meet certain criteria for lending, an idea we will develop in future notes.

However, the result of this pushback seems to have been a more sober assessment of the benefit and popularity of negative rate offsets inside the BoJ than prevailed a few months ago. This in no way vetoes further easing, but it does feed into the dynamic cost-benefit assessment and the hurdle for further easing.

Japan Growth in Loans Outstanding
Y-Y%, Domestically Lincensed Banks



Source: BoJ.

EQUITY ETF PURCHASES AVAILABLE IF MACRO WEAKNESS IS ACCOMPANIED BY INCREASED RISK PREMIA ON PRIVATE ASSETS

The BoJ is operating equity ETF purchases very flexibly under purchase rules that attempt over time to proxy loosely for the notion that purchases should increase when the equity risk premium is high / rising and decline when the equity risk premium is low / falling.

In 2019 with the equity risk premium overall declining the BoJ will likely end up buying less than the targeted amount. In 2020 we expect the BoJ will follow the same basic approach of dialing up or down the implementation of equity ETF purchases relative to market conditions within a fairly wide band without feeling the need to adjust the target.

If the economy weakens sufficiently to motivate a rate cut at a time when markets remain buoyant due to easy global monetary policy the BoJ is unlikely to ramp up equity ETF purchases, in part because the marginal benefit would be seen as small and in part because of a concern that it could end up driving financial excesses.

But if the economy weakens sufficiently at a time when market risk premia widen we think the central bank would add an increase in the target / guideline for equity ETF purchases to a policy rate cut. There is substantial scope to ramp up with BoJ holdings still a relatively low share of the total equity market and ETF lending likely to ease liquidity concerns. But unease about the sizeable stock of ETFs on the central bank balance sheet – that are marked to market unlike its bond holdings – continues to be a drag on more aggressive use of this instrument.

NO ADOPTION IN 2020 OF THE IMF'S PROPOSALS CURIOUSLY TIMED PROPOSALS FOR BOJ POLICY

In late November 2019 the IMF Article IV consultation for Japan delivered a set of proposals for shifts in BoJ policy for the central bank to consider, including reviewing the 2 per cent inflation target / shifting to a target range for inflation, moving the focal point of the yield target from ten years to a shorter horizon such as five years, putting greater weight on staff forecasts and responding systematically to changes in these forecasts, and de-linking its inflation overshooting commitment from the money base target (presumably applying it in general to instruments including the overnight rate).

These proposals were curiously timed – these are in the most part exit / normalization ideas that would represent an admission of defeat on inflation and tighten financial conditions if implemented today – and we do not expect the BoJ to move on them in 2020. Kuroda has already in testimony rejected the idea of a target range of 1-3 per cent (correctly) pointing out that this would simply be viewed as a backdoor way of lowering the target to 1 per cent and – at the margin at least – raise real rates at the wrong moment.

We think it is essential that the BoJ maintains the 2 per cent target, even if there is a case for being more realistic about the horizon it can be achieved over. The call for greater weight on the staff forecasts is reasonable, but the Policy Board is unlikely to turn policy over to the staff forecasts.

The idea of shortening the horizon at which the BoJ targets yields is also premature and inappropriate today in our view and likely to be viewed as such by the BoJ as well. When the BoJ ultimately decides to start exiting from YCC we do expect it will do so by stepping in the tenor of the yield target, perhaps initially to five or seven years and then gradually walking it in from there in additional steps. But to do this today would be unambiguously a tightening and one that would weaken fiscal-monetary cooperation and we think the central bank will judge that this is not appropriate policy today.

Similarly, the idea of de-linking the inflation overshooting commitment from the money base target (implicitly QE) and presumably tying it to rates is also a policy option that the central bank will view as for another stage in the policy process.

Policymakers (correctly in our view) think the BoJ is so far from its inflation target that an overshooting commitment tied to rates today would deliver few benefits in terms of credibility while constraining policy in too many states of the world.

We do think that shifting the inflation overshooting commitment from the money base to the overall stance of policy including rates would likely make sense when overshooting (if ever) comes closer in view, but this too is something that is unlikely to get seriously considered by the BoJ until / unless the inflation target ever draws plausibly close.

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