What Is The BoJ Up To With Its QQE? What Else Can It Do?

On September 21st there were two central bank meetings, the Fed and the Bank of Japan, both closely watched but both garnering very little expectations.

The Fed was expected to do nothing and to signal a December rate hike, which it did. The market reaction was positive, not because this was unexpectedly good news but because investors had taken risk off the table, despite having no big expectations for this FOMC. Some of these investors put capital back to work in the anti-climax. The buying, although relatively muted was indiscriminate as investors bought equities, credit, duration, oil and gold.

The BoJ was perhaps even more closely watched and with similarly low expectations. Investors had expected the review to justify current efforts and recommend more negative interest rates. They also expected a targeted effort to steepen the long end of the JPY yield curve. What the BoJ delivered was a promise to raise inflation expectations, perhaps beyond 2%, to be flexible about its bond buying, to maintain a cap on the 10 year JGB yield and an effort to steepen the yield curve. It was a lacklustre package, maybe even a disappointing one. The initial reaction was a rise in equities and a fall in JPY. It is too early to tell where they go from here but if the market was unimpressed by the BoJ's negative rate debut in January it is hardly going to be impressed this time.

One view is that the BoJ's lack of determination is a sign that the government should shoulder some of the burden. The Prime Minister has publicly welcomed the "new policy" and will "coordinate closely with the BoJ to accelerate Abenomics." Quite how new the policy is and how Abenomics is to be accelerated remains to be seen. As long as rates and JPY do not rise too quickly or far, the economy appears to have a chance to muddle on, and there are some signs of material progress in Abenomics' Third Arrow. Economic immigration, for example, has been growing as regulations have been relaxed and businesses begun to hire foreigners.

On current demographics and reasonable growth forecasts, Japan will not be able to repay its national debt in the foreseeable future. It has already amended its 2016 debt issuance by 3.7% or +60 billion USD, paltry, but a start.

It needs to keep issuing debt. The debt must be bought by private investors, such as the private commercial banks. The BoJ will then buy the seasoned bonds from these private investors. It could buy the bonds directly from the government but this would merely finance the fiscal deficits, which would be direct debt monetization or helicopter money, which is apparently frightening and illegal. Passing through private hands has an advantage. It is Chinook helicopter money, two rotors. First, it still monetizes the national debt, indirectly but effectively. But second, it generates a profit for the initial buyers, and thus puts money in their pockets. Now, if bond yields decline continuously, this generates a capital gain for the investor, but is not sustainable since eventually you get to negative rates at long maturities and undermine the entire savings, banking and insurance industry. A more sustainable strategy is to steepen the yield curve, particularly at long maturities. In February 2016, investors who held on to 20 year JGBs for 5 years say, would have made 1.5% p.a., on top of a 0.5% – 1% coupon just from the rolldown. This ROA is quite substantial given current interest rates. For a bank which can leverage the position, and since JGBs consumer zero capital, the impact on ROE is significant. This works best at long maturities as duration multiplies the roll down which is otherwise too small at shorter maturities. By September the yield curve has flattened so that the same trade would earn 0.95% p.a. This strategy only works with a steep yield curve.

There are a couple of loose ends to this strategy. At some point the national debt will simply get too big. One way of addressing this issue is for a selective debt forgiveness whereby the BoJ converts its holdings of JGBs to zero coupon perpetuals. Or cancels them altogether.

This just leaves the persistent strength of JPY. This is troublesome for an export economy like Japan. When the BoJ cut rates into negative space in January, JPY weakened for less than 24 hours before appreciating some 16% to September. One way would be for the government or the BoJ to buy USD and USD assets such as US treasuries.

This strategy supports the following measures:

BoJ keeps buying JGBs in secondary market. Check

BoJ keeps the yield curve steep. Check.

BoJ keeps short rates low, perhaps further into negative space. Maybe.

BoJ converts debt to perpetual zeros or cancels its JGBs. Maybe.

Japan government increases issue of JGBs. Check.