1 August 2018

BOJ adjusts monetary policy for the first time in 2 years to allow for more flexibility

Event

- At the monetary policy meeting on the July 30 -31, the Bank of Japan (BOJ) decided to keep policy rate steady at -0.1% but made moderate adjustments to the monetary policy framework for the first time in 2 years to enhance flexibility. Such adjustments were expanding the target range of 10-year Japanese Government Bond (JGB) yield, which has been maintained around 0% since introducing Yield Curve Control (YCC) in September 2016. The bank also announced changes to the proportion of its Japanese Exchange Traded Fund (ETF) purchases.
- BOJ additionally introduced a forward guidance that commits to maintaining low policy rate in order to stimulate growth and inflation, as well as help ease impact of consumption tax hike in October 2019.

Analysis

- Towards more flexibility, BOJ changed monetary framework in 2 areas;
  1. **Widening movement range of 10-year JGB yield** from between -0.1% to 0.1% (±10 bps from 0%) to -0.2% to 0.2% (±20 bps from 0%). This move will allow more flexibility in BOJ's purchases of JGB and to better align with increasing trend of interest rate among major economies around the world. As BOJ's JGB purchases remain at an annual pace of JPY 80 trillion, the adjustment will allow higher yields of 10-year JGB and longer tenor bonds (Figure 1), supporting a steepening yield curve. This will in turn lessen the burden on Japanese financial sector that have suffered from an extended period of low interest rates, especially businesses in banking sector, insurance and provident funds.
  2. **Changing ETF purchase proportions** by increasing purchases of ETFs related to TOPIX (Tokyo Stock Price Index) and lowering share of purchases in Nikkei 225-related ETF, while maintaining an annual accumulation pace at JPY 6 trillion (Figure 2). The move reflects BOJ's aim to lower price distortions in the long run as large-cap stocks in TOPIX have an advantage over Nikkei 225 in terms of both large-cap stock liquidity and proportion of free-float.
- BOJ lowered core inflation expectation for the next 3 years that is for the fiscal year of 2018, 2019 and 2020 from 1.3% to 1.1%, from 1.8% to 1.5% and from 1.8% to 1.6%, respectively. The rates, which are still below its 2% target, signal that the BOJ will pursue further monetary easing, despite having made adjustments to let long-term yield go

higher and making YCC more flexible to better respond with increasing interest rates worldwide. The market somewhat anticipated such announcement after a long period monetary easing that saw little improvement on inflation. As of June 2018, core inflation stood at 0.8%YOY. Furthermore, in the April's policy meeting, BOJ removed its timeframe of achieving inflation target within fiscal year 2019 owing to slower-than-expected increase in wages, which were held back by structural labor market problems and small wage increments among Japanese companies.

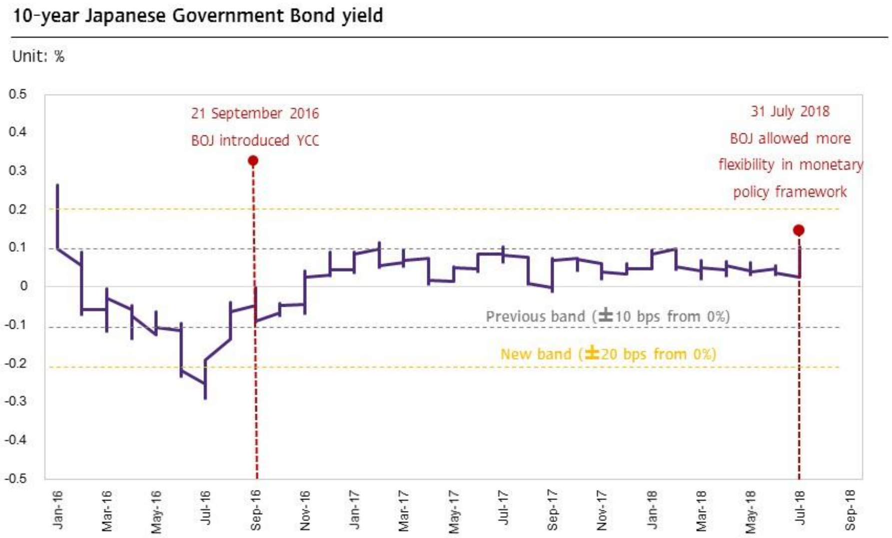
- **The yen depreciated against the U.S. dollar after the BOJ signaled to maintain low policy rate going forward.** On the July 31 following BOJ's decision to hold policy rate, the Yen depreciated by 0.7% against the U.S. dollar, reaching 111.86 yen per U.S. dollar. Meanwhile, the 10-year JGB yield dropped lowest to 0.05% but recovered quickly to 0.11% by the morning of August 1, thus overall having mild effect on the bond market. Nonetheless, the BOJ's decision to pursue further monetary easing is opposite to the U.S., where 2 more rate hikes is expected this year. Therefore, the US government bond and JGB yield spread are likely to rise further, causing the yen to weaken in line with other Asian currencies given continued strengthening of the U.S. dollar. Nevertheless, the yen may at times see temporary appreciations as it is a safe haven investors resort to during risk-off market conditions.

Implication

- **Adding flexibility to monetary policy is BOJ's solution amid increasing global interest rates and possible uncertainties arising from consumption tax hike in 2019.** Widening of long term JGB yield target range will allow yields to move more freely with market mechanism, whilst creating policy space for future asset purchases of assets if needed to stimulate the economy. Meanwhile, the change in BOJ's ETF purchases will reduce stock price distortion as the economy begins to recover. Removing inflation target timeframe and keeping the size of asset purchases unchanged, helps to reassure that BOJ will continue to boost liquidity through asset purchases in order to accelerate inflation if needed after the consumption tax is raised from 8% to 10% in October 2019.

- **EIC expects the BOJ to pursue further easing to stimulate economic growth into the next year** as relaxed monetary policy and low interest rate conditions have been partly supported inflation and economic acceleration. In 2019, the Japanese economy is likely to expand on the back of household consumption, domestic investments and improving trade thanks to the Japan-EU Economic Partnership Agreement. The agreement -- expected to take effect in March 2019 -- will enable Japan to take advantage of lower tax rates on almost all exports to the EU. As such, Thai exporters to Japan will have indirect gains from increased demand of goods.

Figure 1: BOJ widens target rate of 10-year JGB yields.



Source: EIC analysis based on data from Bloomberg

Figure 2: BOJ increase share purchases of TOPIX-related ETFs.

Changes of BOJ's ETF purchase plan

Unit: JPY trillion (%)

Changes of ETF purchase plan	TOPIX	Nikkei 225	JPX & Others	Total
Raise ETF purchase to JPY 6 trillion As of 29 July 2016	2.4 (40)	3.1 (52)	0.5 (8)	6.0 (100)
Revise composition of ETF purchase As of 21 September 2016	4.0 (67)	1.6 (27)	0.4 (6)	6.0 (100)
Prior to BOJ meeting As of 26 July 2018	4.3 (72)	1.3 (22)	0.4 (6)	6.0 (100)
Revise composition of ETF purchase towards more TOPIX-related As of 31 July 2018	5.0 (83)	0.6 (10)	0.4 (7)	6.0 (100)

Remark: JPX = Japan Exchange Group

Source: EIC analysis based on data from BOJ and J.P. Morgan

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