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BOJ's policy decision: Operational Independence

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Expected action:

The Bank of Japan announced to enhance the scale of the fund provisioning measure to support strengthening the foundations for economic growth ("the Growth-Supporting Funding Facility"(GSFF)). This decision appeared to be somewhat disappointing to the market participants, although some Japanese press had accurately expected.

Such disappointments are in a sense reasonable when we remember the BOJ introduced the price stability goal in February and declared its intension to pursue 1% inflation for the time being. With the current rate of inflation virtually zero, it may be rational to expect an additional quantitative stimulus. In this note, I discuss the implications of such diversified views between the BOJ and the markets.

Time horizon:

As is apparent in the title of the policy statement by the BOJ in February, the BOJ maintains medium- to long-term perspectives with regard to its price stability goal. This kind of long time horizon is common to the monetary policy among major economies. A central bank under the typical scheme of inflation targeting is required to control the inflation rate within the designated range in a few years' time.

Based on this common practice, the BOJ may like to review its current policy stance in late April when the BOJ is scheduled to make semi-annual revision of its economic outlook. If the expected rate of inflation in FY 2013 is still below 1% according to the revised outlook, it would be rational for the BOJ to enhance its accommodative stance.

Nevertheless, the policy intension by the BOJ may look unclear. According to the section 7 of the policy statement today, the BOJ already expects that the year-on-year change in CPI would remain around zero percent. Moreover, during the recent session of the Parliament, Governor Shirakawa was reported to mention that the BOJ would actively pursue the goal. Thus, the markets had a good reason to expect some quantitative stimulus today.

In light of the miscommunication, the BOJ should have revised and released its economic outlook in February when the BOJ introduced the "goal". Alternatively, the BOJ could try to explain the timeframe and magnitude of the expected effects of the policy decision in February (¥10tn addition to JGB purchase operations). If either of them were possible, the markets could have clearer views of monetary policy in coming months. With regard to the latter option, however, the BOJ would face the tough challenges of quantifying the effects of an "unconventional" policy.

Cause of deflation:

More important issue concerning the communication gap is generated from the diversified understanding of the cause of our persistent deflation.

In the first section of the policy statement today, the BOJ clearly claims (and may emphasize) that the core challenges for our economy are the long-term structural problems including the accelerated pace of aging and the diminishing prospects of economic growth. And it reiterates their idea that the deflation should be overcome by the efforts for faster economic growth as well as monetary stimulus. It should be noted that the same sentences were also found in the policy statement in February, but in the final section (6) . Therefore, based on their understandings, it would be straightforward to enhance the Growth-Supporting Funding Facility (GSFF) rather than to increase in the scale of the asset purchase program this time.

While this line of argument is familiar to the domestic players in our markets at least, the markets may still be confused at such policy option today. The markets must have thought that the BOJ finally accepted (or even yielded to) the long-term claim by their opponents that the deflation has been the monetary phenomenon and it should be addressed by further expansion of fund provision. From their viewpoints, this must be the reason why the BOJ decided to expand the scale of JGB purchase at the time of introduction of the inflation goal in February.

All in all, it has become all the more evident that the BOJ and the markets still maintain diversified views of the root cause of our deflation, although they share the idea that the battle against the deflation is a key issue of the economic policy. Ironically, the BOJ might have utilized their "operational independence" in the choice of policy measures this time, regardless of the preference in the markets.

In order to avoid further miscommunication of the monetary policy, the BOJ and the markets need to restart the discussion on the fundamental causes of our deflation and to share its understandings. In this respect, it may be important to review any stylized facts from our experiences in late 1990's and calibrate our thoughts to the current economic environment.

Frontier of monetary policy:

Lastly, a technical but potentially important aspect of the expansion of the GSFF today deserves proper attention.

Among the elements of the enhancement, the BOJ announced to launch the lending program denominated in the USD as part of the GSFF. While its details will be finalized at the next monetary policy meeting after consultation with the markets, the framework itself has something quite unique. In comparison with the USD fund operations by the major central banks as the coordinated crisis measure, the new loan will have a longer duration (tentatively set as one year) and the program will be funded with the BOJ' own USD funds (rather than the USD funds supplied by the FED through currency swaps).

We are reminded of a foreign bond purchase as a measure of unconventional monetary policy, because they have something in common (in terms of the duration and the funding). There are indeed some hurdles (including those regarding legislative mandate of the BOJ) for introducing such policy option; but it still seems to me that the BOJ might have made a small but important step forward.

Author: Tetsuya Inoue
General Manager and Chief Researcher
Financial Technology and Market Research Department
Nomura Research Institute