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Economic Research:

Change Of The Guard--And The Deflation Storyline--At The Bank of Japan

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Table Of Contents

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The press conferences of the outgoing governor of the Bank of Japan (BOJ), Masaaki Shirakawa, on March 19, and of the new governor, Haruhiko Kuroda, and deputy governors, Kikuo Iwata and Hiroshi Nakaso, on March 21, provided both interesting contrasts and encouraging signs for those banking on a successful reflation by the BOJ. Put simply, the governorship of the BOJ has passed from a central banker who professed not to believe that the BOJ has the ability to end deflation in Japan to one who argues that it does. That does not guarantee deflation-fighting success, but it establishes the most important precondition for it. A central bank whose core view is that ending deflation is beyond its direct control is almost bound to fail (to end deflation) and thereby have its pessimistic assumptions reinforced. One that rejects that view at least has a chance.

Overview

- The change in the leadership of the BOJ, in the context of Prime Minister Abe's push to reflate and revitalize the Japanese economy, represents a watershed.
- Whereas former governor Masaaki Shirakawa saw appropriate monetary policy as a necessary condition for ending deflation, new governor Haruhiko Kuroda and new deputy governor Kikuo Iwata see aggressive monetary policy as a sufficient condition.
- It is unclear yet whether the Abe-inspired reflation push is what it seems, or whether it is part of a larger, complicated set of maneuvers to help fiscal hawks keep on track the consumption tax hikes slated for 2014 and 2015 and the Ministry of Finance to reassert influence over the Bank of Japan.
- If the former, it is highly positive; if the latter, less so. Policymakers may care more about appearing to focus on ending deflation than actually doing so.

A Battle Of Words--And Ideas

At his press conference, Mr. Shirakawa reiterated his view, which had become the pillar of BOJ orthodoxy and its core message under his governorship, that the BOJ alone could not end deflation: "For my part, I have made every effort towards ending deflation and securing sustainable growth under price stability, but in order to achieve these objectives powerful monetary easing by the Bank of Japan and efforts by a wide range of agents to strengthen competitiveness and growth potential is essential" (1). He went on: "What we want to bring about is a picture where the real economic growth rate rises--although in a declining population society that may be the growth rate of per capita real GDP or GNI--and as a result the rate of inflation rises." In other words, monetary easing alone is not sufficient-- only with the help of the government in implementing growth-enhancing structural reforms, and of the private sector in making use of them, can deflation be brought to an end.

Mr. Kuroda appears to reject this line of reasoning and, importantly, is prepared to let that be known. He began his press conference with a clear message: "In assuming the governorship, let me say one thing. The Japanese economy has been suffering from deflation during nearly the past fifteen years. I think the most important mission of the Bank of Japan is to end deflation and to achieve its price stability target of 2% as soon as possible." He went on: "It all boils down to the Bank of Japan achieving its 2% price stability target as soon as possible. In that case, looking at conditions in various countries, many central banks regard about two years as one kind of time span for achieving their price stability target. Taking this kind of thing into account, I think it is extremely desirable for the price stability target to be achieved in about two years. Next, there is the question of what means to use, but I think this really just boils down to implementing further quantitative and qualitative easing. Quantitative easing is certainly indispensable, but we should achieve the 2% price stability target--and I am confident it can be achieved--not just by increasing the monetary base, but by implementing aggressive monetary easing from both the quantitative and qualitative angle, on the asset side [of our balance sheet] by lowering the whole yield curve and as necessary eliciting a lowering of risk premia."

Deputy Governor Iwata (2), a long-time critic of the BOJ and advocate of inflation-targeting and aggressive quantitative easing to end deflation, was even more forthright. Not mincing words, he stated: "In order to achieve 2% inflation or to escape from deflation, I think two conditions are necessary. The first is that the Bank of Japan should commit to roughly by when it will take responsibility for achieving its 2% inflation target. Committing to this is extremely important. … Averaging [the results of various research] the inflation target is [sought to be achieved] in about two years so I am saying ['within two years'] from that experience. Second, in that sense, because we are committing and taking responsibility to achieve [2% inflation] within about two years, in the event that we cannot achieve it, it is best not to make excuses such as 'it is not our fault,' 'the causes lie elsewhere.' Unless we adopt this kind of stance, the market will not put faith in our monetary policy. If the market does not put faith in monetary policy, no matter how much you cut the interest rate or do quantitative easing there will not be much effect--that is my stance."

Underlying this difference in views between Mr. Shirakawa on the one hand and Mr. Kuroda and Mr. Iwata on the other as to whether the BOJ has it within its power to end deflation is a difference in opinion regarding whether the central bank can or should try to directly influence the public's inflation expectations. That a central bank should try is a central tenet of the modern inflation-targeting approach adopted by most central banks. If the public believes that the central bank has the tools to achieve its inflation target and is determined to use them to that end, it is rational for the public to expect future inflation roughly in line with the rate of inflation that the central bank is saying that it wants to achieve. This potentially virtuous expectations-influencing cycle--if it can be harnessed--makes the central bank's job that much easier. This is why central bankers such as Ben Bernanke, Mervyn King, and Mario Draghi are always banging on about the importance of "transparency," of "good communication" and, most notably, of "anchoring inflation expectations."

Mr. Kuroda clearly buys into this paradigm. Asked about the transmission channel of aggressive quantitative and qualitative easing to the real economy, he noted: "In addition, the influence of 'expectations' or 'forecasts' cannot be ignored. Particularly under zero interest rates, when short-term rates are pegged almost at zero, in undertaking quantitative and qualitative easing the role that expectations play and [the central bank] working on expectations is actually extremely important. … In the case of deflation, by weakening deflation expectations the effect of monetary policy is greatly enhanced."

Contrast this with Mr. Shirakawa's dim view of the central bank trying to achieve its target by acting directly on the public's inflation expectations: "When it comes to exiting from deflation, what we want to achieve is not just a rise in the price level, but, as I have repeatedly said, 'achieving an early end to deflation and sustainable growth under price stability.' The living standards of the Japanese people are hardly going to improve just because the price level goes up 2% and incomes go up at the same rate." And later: "If 'working on expectations' is taken to mean 'the central bank moving the market at will by its words,' I feel danger in that kind of market view or policy view."

For his part, Mr. Nakaso did not go as far as Mr. Kuroda and Mr. Iwata in drawing a line between the new and the old leadership; that is a difficult balancing act for a 35-year BOJ veteran and most recent assistant governor. But he signaled that he was on board with the "new BOJ." He opened by saying: "I will earnestly try to contribute to achieving the mission of the Bank of Japan of maintaining price stability and financial stability by supporting Governor Kuroda and joining forces with Deputy Governor Iwata." He reflected: "I think we have to take seriously the fact that we still have not overcome deflation, we have not achieved that result. In that sense, there may have been room for additional adjustments on the policy front. … We implemented many different policies but as a result I think the overall policy framework and objectives became complicated and there was an element of their being hard to understand."

The difference between Mr. Shirakawa and Mr. Kuroda can be viewed in terms of necessary and sufficient conditions. Mr. Shirakawa seems to believe that appropriately calibrated monetary policy is a necessary but not a sufficient condition for ending deflation. Mr. Kuroda (and Mr. Iwata, but not necessarily Mr. Nakaso) seems to believe that properly crafted and aggressively implemented monetary policy is a necessary and sufficient condition for ending deflation and maintaining operational price stability. If Mr. Kuroda is right, then Mr. Shirakawa's approach was wrong and counterproductive, akin to a boxer who had a fighting chance throwing in the towel before he stepped into the ring. In that case, Mr. Kuroda's appointment is a godsend. If Mr. Shirakawa is right, then Mr. Kuroda's approach will fail. But even if that were to be the case, it is probably still worth trying. In either case, the Bank of Japan will have continued to fail to meet its statutory mandate: "achieving price stability, thereby contributing to the sound development of the national economy." Better to try and perhaps succeed than not to try and to fail with near certainty.

Abe-Nomics And Bureaucratic Politics

On the surface, recent developments in Japan look clear and very encouraging. After some 15 to 19 years of the economy being mired in deflation (3), a decisive and now seasoned prime minister has emerged who wants to end deflation and has used a once-in-a-five-year opportunity to appoint a new governor and two deputy governors to hold the central bank accountable for doing so. The equity market, driven by foreign investors, has applauded in a way that increases the likelihood of policy success. Foreign investors turned into net buyers of Japanese equities in the week (ending Nov. 16) that then Prime Minister Yoshihiko Noda announced a lower house election (for Dec. 16); they were net buyers for eighteen consecutive weeks after that, clocking up ¥5.58 trillion of net purchases in the process (they became small net sellers for the first time since then only last week). The TOPIX index has risen by 43% in that period, compared with a rise of 14% in the S&P 500 index.

However, things may not be quite as simple as they appear. An alternative interpretation of recent policy developments in Japan, one that places the Abe reflation push in a broader context, would put more weight on bureaucratic politics, in particular the interests of the powerful Ministry of Finance (MOF). Surveying the battle field of Japanese politics and policymaking, the MOF would appear to have scored two important victories in the past seven months or so: the passage of legislation last August to raise the consumption tax rate to 8% in April 2014 and to 10% in October 2015 from the current 5% and regaining the governorship of the BOJ. The two are closely linked and both relate to the need to change the course of policy at the central bank.

Paving The Way For The Consumption Tax Hikes

For the MOF, consumed as it is with serious concerns about the sustainability of Japan's fiscal finances, hiking the consumption tax to help offset the country's rising social welfare expenditures has been a long-term goal. Getting the legislation passed by the Noda administration, a policy act that precipitated its subsequent down fall, was a monumental policy achievement. But passing the legislation was just the first step; hurdles to implementing the tax hikes on schedule remained and still do. The legislation contained an important clause that required the government, before bringing the tax hikes into effect, to verify that the economy was in a fit state to absorb the impact. Specifically, policies need to be in place that are judged conducive to bringing about an average of 3% nominal GDP growth over the fiscal year 2011 to fiscal year 2020 decade, comprising 2% real growth and a 1% GDP deflator (that is, positive GDP-based inflation) (4). In the prior decade, nominal GDP growth real growth averaged -0.6%, comprising 0.8% real GDP growth and a -1.3% GDP deflator.

So-called "Abe-nomics," comprising the three pillars of monetary easing, fiscal stimulus, and structural reform, can be seen as providing the policy shift and backdrop enabling the government to tick the boxes when it comes to deciding whether to implement the consumption tax hikes on schedule or not. Viewed differently, had there been no policy shift at the BOJ and had the prospect of Japan remaining in deflation more or less indefinitely continued, it is hard to imagine that the government could have pushed ahead to implement the consumption tax hikes in good faith, and it would likely have met widespread opposition had it tried to do so (and it may still).

While the December election resulted in a change in government and a new policy thrust, there is a high degree of intertemporal consistency in the key policy tenets of the Noda (DPJ) and the Abe (LDP/Komeito) administrations. The Noda government (with the support, in the end, of the LDP and Komeito) laid the legislative groundwork for the consumption tax to be hiked. The Abe government is articulating policy goals that make the case for carrying through on the implementation of the hikes at least somewhat plausible.

A Big Bureaucratic Prize

There is an important subtext to the appointment of Mr. Kuroda as governor of the Bank of Japan: for the first time since the revised BOJ Act, giving the BOJ more independence, came into effect in 1998, an official from the Ministry of Finance has been appointed governor. The appointment of Mr. Kuroda breaks the emerging trend of the governor position being occupied by a BOJ official (see table 1). From a narrow institutional perspective, the BOJ may have paid dearly for failing to meet its price stability mandate since gaining independence in 1998.

Table 1

Background Of The Top Trio Of The Bank of Japan's Policy Board Since The New BOJ Act Came Into Effect In 1998

Term	Governor	Deputy governor	Deputy governor
1998-2003	BOJ	BOJ	Journalist
2003-2008	BOJ	MOF	Cabinet Office/academic
2008-2013	BOJ	BOJ	Academic
2013-	MOF	BOJ	Academic

Sources: Bank of Japan and Standard & Poor's Ratings Services.

Prior to the revised BOJ Act coming into effect, for most of the post-war period, in a delicate bureaucratic balancing act, the governorship of the BOJ rotated between a BOJ official and a former MOF official (see table 2). The first governor appointed under the new BOJ Act, appropriately enough, was a former BOJ official, Masaru Hayami. The BOJ-MOF "rotation" pattern was broken in 2003, when a former BOJ official, Toshihiko Fukui, was appointed. But at that time the outgoing vice minister of finance, Toshiro Muto, the MOF's highest ranking official, was appointed deputy governor of the BOJ, even though going from MOF vice minister to BOJ deputy governor was a considerable decline in perceived rank in the hierarchy of Japanese administrative politics. In BOJ-watching circles, it was widely assumed that the MOF was cleverly positioning Mr. Muto to take over from Mr. Fukui when the latter's term ended in 2008. Indeed, the LDP-Komeito coalition government at the time did nominate Mr. Muto as governor, but his nomination was rejected by the upper house of the Diet. Undeterred, the government nominated another former MOF vice minister, Koji Tanami, only to have his nomination rejected by the upper house of the Diet, too. In an apparent attempt at "third time lucky," the government then nominated former vice minister of finance for international affairs, Hiroshi Watanabe, but his nomination was rejected by the upper house of the Diet, too. At that point, the government nominated then deputy governor Shirakawa, whose nomination was approved by both houses of the Diet. Even Mr. Shirakawa has jokingly referred to himself as the "accidental governor." In that regard, Mr. Kuroda's appointment may be no accident.

Table 2

Background Of Bank of Japan Governors In The Post-War Period

Career background	Highest prior position	Name	Term	Comment
Bank of Japan	Deputy governor	Eikichi Araki	Oct. 1945 to June 1946	
Bank of Japan	Executive director	Hisato Ichimada	June 1946 to Dec. 1954	
Bank of Japan	Governor	Eikichi Araki	Dec. 1954 to Nov. 1956	
Ministry of Finance	Vice minister	Masamichi Yamagiwa	Nov. 1956 to Dec. 1964	
Mitsubishi Bank	President	Makoto Usami	Dec. 1964 to Dec. 1969	Only post-war governor not from the BOJ or the MOF

Table 2

Background Of Bank of Japan Governors In The Post-War Period (cont.)				
Bank of Japan	Deputy governor	Tadashi Sasaki	Dec. 1969 to Dec. 1974	
Ministry of Finance	Vice minister	Teiichiro Morinaga	Dec. 1974 to Dec. 1979	
Bank of Japan	Deputy governor	Haruo Mayekawa	Dec. 1979 to Dec. 1984	
Ministry of Finance	Vice minister	Satoshi Sumita	Dec. 1984 to Dec. 1989	
Bank of Japan	Deputy governor	Yasushi Mieno	Dec. 1989 to Dec. 1994	
Ministry of Finance	Vice minister	Yasuo Matsushita	Dec. 1994 to March 1998	Resigned to "take responsibility" for a scandal involving BOJ officials.
Bank of Japan	Executive director	Masaru Hayami	March 1998 to March 2003	First governor appointed under revised BOJ Act promoting independence and transparency of the central bank
Bank of Japan	Deputy governor	Toshihiko Fukui	March 2003 to March 2008	
Bank of Japan	Deputy governor	Masaaki Shirakawa	April 2008 to March 2013	Appointed governor after upper house of the Diet blocked successive nominations of two former MOF vice ministers and a vice minister of finance for international affairs for governor
Ministry of Finance	Vice minister of finance for international affairs	Haruhiko Kuroda	from March 2013	First MOF official appointed governor not to be a former vice minister

Sources: Bank of Japan and Standard & Poor's Ratings Services.

Some Other Tidbits

Mr. Kuroda made some other interesting comments in his press conference, notably on purchases of foreign bonds, on the issue of financing fiscal deficits, and on the BOJ's "banknotes rule."

When asked about the need to buy foreign bonds, Mr. Kuroda gave the strong impression that he is not contemplating adding foreign bonds to the menu of assets that the BOJ is buying. He said: "Regarding the purchase of foreign bonds, if this is done with the aim of influencing foreign exchange [rates], this is foreign exchange intervention. Among the G7 and G20, [the understanding is that] foreign exchange rates in principle should be left to the market, even if in unusual circumstances there may be individual or joint interventions. I think this kind of international agreement should be adhered to." In subsequent Diet testimony, he appeared to pour even more cold water on the idea.

However, Mr. Kuroda also acknowledged that, other things being equal, monetary easing should lead to a lower exchange rate value of the currency and that the correction of the strong yen is facilitating efforts to end deflation. His careful choice of words leaves open the possibility that the BOJ could, at a stretch, seek to include foreign bonds in its asset purchases as a quantitative/qualitative easing measure aimed at ending deflation, something that would come under the remit of the BOJ, rather than as foreign exchange intervention, something that would fall in the MOF's bailiwick.

As flagged by Mr. Kuroda, the BOJ has much scope to expand the size of its balance sheet, which it could do by buying a lot more Japanese government bonds (JGBs), particularly of longer maturity than hitherto. Since the financial crisis erupted in September 2008, the BOJ has expanded its balance sheet by 51%, compared with 333% by the Bank of England, 253% by the Federal Reserve, and 82% by the ECB (all calculations using end-August 2008 as starting date) (5). And it could do a "twist operation," extending the maturity of the current portfolio of JGBs that it holds.

But, arguably, if the BOJ is to implement "quantitative" and "qualitative" easing that is to be effective in overturning the public's deflation expectations, it will have to venture much further out of its comfort zone in terms of the assets that it buys than it has to date. Certainly, given the portfolio rebalance logic of quantitative easing, that would increase its chances of success. In principle, there are two ways to do this: 1) stay in domestic yen assets but venture much more aggressively into risk assets such as corporate bonds, equities and real estate investment trusts; 2) stay in government bonds but venture into foreign currencies.

It remains to be seen whether Mr. Kuroda will be so bold as to surprise both market participants and policymakers worldwide with an initiative of the second kind. If anyone can navigate the treacherous territory of trying to explain to the world and to his G7 and G20 colleagues that the BOJ buying foreign bonds is not foreign exchange intervention, of the kind traditionally frowned upon, but the decisive antideflation action of a central bank determined to meet its mandate after failing to do so for 15 years (on Mr. Kuroda's reckoning), it is a former vice minister of finance for international affairs like Mr. Kuroda.

Mr. Kuroda's relaxed comments on fiscal financing contrasted with more cautionary ones by Mr. Shirakawa. To Mr. Kuroda, "central banks, not just the BOJ but the Fed, the ECB and others, autonomously buying government bonds as a means of monetary easing is not fiscal financing at all and there is no such problem whatsoever." In contrast, Mr. Shirakawa reflected thus: "In circumstances of Japan's fiscal finances being in an extremely severe condition, I have taken care not to have monetary policy developments become constrained by fiscal conditions or [be subject to] so-called fiscal dominance. The Bank of Japan has undertaken extremely aggressive monetary easing in order to escape from deflation, but I think this has been a narrow path between boldness and caution."

Not surprisingly, in light of the above, Mr. Kuroda gave short shrift to the BOJ's longstanding "banknotes rule." Envisaged as providing a credible brake on any tendency toward fiscal dominance, this self-imposed rule of the BOJ limits the amount of JGBs to be within the amount of banknotes in circulation. But given that quantitative easing involves the central bank expanding the size of its balance sheet by buying government bonds (and other assets) financed by the creation of excess reserves, the banknotes rule is tantamount to a self-imposed commitment by the BOJ not to engage in aggressive quantitative easing (6). Such a policy makes no sense--in fact it is counterproductive and damaging--if the central bank is operating at the zero bound and needs to ease monetary policy more in order to achieve its price stability goal. Why would the central bank tie its hands in this way?

In fact, when the BOJ introduced its "comprehensive monetary easing" framework, centering on an "Asset Purchase Program," in October 2010, it removed these self-imposed shackles by announcing that purchases of JGBs for the Asset Purchase Program would not count for the purposes of the banknotes rule. This allowed the BOJ to expand its balance sheet by buying JGBs beyond what it would have been able to do had it stuck to the rule (7).

With a tinge of irony, Mr. Kuroda noted: "I don't think that, if there is not something like the BOJ banknotes rule, fiscal financing will result or that there is such a concern. I am not aware that the Federal Reserve or the ECB currently has such a rule."

Prepare For Action

While Mr. Kuroda was at pains in this press conference to avoid specifics and pay abundant homage to the need to deliberate on the necessary easing measures at upcoming policy board meetings, everything points to Mr. Kuroda starting his term with a flurry of activity. This is what Governor Toshihiko Fukui did in 2003, under circumstances that are reminiscent in many ways (see table 3). However, Governor Fukui's hyperactivity petered out after about 10 months, and eventually the BOJ ended up exiting from quantitative easing before the deflation dragon had been slain. Having raised the rhetorical ante, it is vital that Mr. Kuroda not just start strongly but maintain momentum until his mission is accomplished.

Table 3

Key Monetary Policy Developments Around The Start Of The Fukui-Led Bank of Japan: 2003-2004 And Beyond

Date	Event	CPI inflation in prior month (year-over-year %)*	GDP deflator in prior quarter (year-over-year %)*
March 20, 2003	Governor Toshihiko Fukui and the two deputy governors assume office.	(0.2)	(1.6)
March 24, 2003	Governor Fukui calls ad hoc monetary policy meeting for March 25 to "review the prevailing severe economic and financial conditions ...and consider necessary steps with respect to monetary control matters."	(0.2)	(1.6)
March 25, 2003	Governor Fukui instructs Bank staff "to examine a wide range of issues related to the enhancement of monetary policy transparency and the strengthening of the monetary policy transmission mechanism ...and report back to the next [Monetary Policy Meeting]." The governor "particularly [instructs] Bank staff to explore possible measures to strengthen the transmission mechanism of monetary easing in the areas of corporate finance and money market operations and report back to the [Monetary Policy Meeting] as soon as possible."	(0.2)	(1.6)
March 25, 2003	The BOJ decides to increase the maximum amount of equity holdings it will purchase from commercial banks from ¥1 trillion to ¥2 trillion.	(0.2)	(1.6)
April 8, 2003	The BOJ decides to promote "smooth corporate financing by nurturing the asset-backed securities market" and decides to "examine the possible purchase of asset-backed securities (ABSs), including asset-backed commercial papers, mainly backed by those assets related to small and medium-sized enterprises".	(0.1)	(2.6)
April 30, 2003	The BOJ increases its target balance of current accounts held at the Bank from "around 17 to 22 trillion yen" to "around 22 to 27 trillion yen".	(0.1)	(2.6)
May 20, 2003	The BOJ increases its target balance of current accounts held at the Bank from "around 22 to 27 trillion yen" to "around 27 to 30 trillion yen".	(0.1)	(2.6)
June 11, 2003	The BOJ announces scheme for the outright purchase of up to ¥1 trillion of asset-backed securities.	(0.2)	(2.6)
Oct. 10, 2003	The BOJ raises the upper limit of the target balance of current accounts from around 30 trillion yen to around 32 trillion yen.	(0.2)	(1.3)
Oct. 10, 2003	The BOJ announces measures "to enhance the transparency of monetary policy".	(0.2)	(1.3)
Jan. 20, 2004	The BOJ increases the target balance of current accounts held at the Bank from "around 27 to 32 trillion yen" to "around 30 to 35 trillion yen".	(0.4)	(1.8)
March 9, 2006	The BOJ decides to end quantitative easing and return to interest rate targeting, setting the target overnight rate at "effectively zero percent".	(0.1)	(1.5)
July 14, 2006	The BOJ raises the target overnight rate to "around 0.25%".	0.5	(1.4)

Table 3

Key Monetary Policy Developments Around The Start Of The Fukui-Led Bank of Japan: 2003-2004 And Beyond (cont.)			
Feb, 21, 2007	The BOJ raises the target overnight rate to "around 0.5%".	0.0	(0.7)
March 19, 2008	Term of Governor Fukui and Deputy Governors Iwata and Muto ends.	1.0	(1.4)
Reference: Latest		(0.3)	(0.7)

*Data are as revised and as currently available--not necessarily as they were announced at the time. Sources: Bank of Japan and Bloomberg.

A Matter Of Priorities

The thesis that the reflation push by Mr. Abe and the appointment of reflation advocates to the governorship and one of the deputy governorships at the BOJ can be woven into a more complex tapestry of bureaucratic politics, driven particularly by the MOF's fiscal consolidation agenda and likely interest in reasserting influence over the central bank, is not inconsistent with the thesis that the Japanese economy is being steered onto a path out of deflation. The MOF presumably would like to see an end to deflation and likely considers a controlled reflation as an important ingredient in achieving longer-term fiscal consolidation. It likely judges that the chances of the BOJ ending deflation are much higher with one of its own "ace" officials running the bank than if the job is left to a succession of BOJ officials. That said, if it is the desire to hike the consumption tax in 2014 and 2015 that is driving policy in Japan and the consumption tax hikes do go ahead before the economy has achieved reflation lift-off, the associated fiscal tightening may provide an unwelcome headwind, thus complicating the process of exiting from deflation.

The question is: how high up on the priority list of Japanese policymakers is ending deflation? Is it the number one priority, a "must-have," as implied by the content of Abe-nomics and the policy mantra of the "new BOJ?" Or is it a "nice-to-have," the real significance of which lies in its providing the policy fig-leaf for the hike in the consumption tax to go ahead and for the MOF to reassert control over what it may have regarded in recent years to be a somewhat errant BOJ?

Only time will tell. The greater certainty is that the window of opportunity for positive change in Japan is open and the stakes correspondingly high.

Endnotes

(1) All English renditions of the original Japanese quotes from the press conferences are mine. The press conferences are conducted in Japanese, and the BOJ does not publish an English translation.

(2) Not to be confused with former deputy governor Kazumasa Iwata, who held that position from 2003-2008, and was seen as a leading contender for the governorship this time around.

(3) Judged by the CPI, Japan has been in outright deflation since 1998; judged by the GDP deflator, since 1994.

(4) For details, see "Japanese Reflation Is In Play, But Hurdles Galore Stand In The Way," Jan. 3, 2013, p.5., published on RatingsDirect.

(5) Rather than say "the central bank has expanded its balance sheet by X%" it would be more accurate to say "the central bank's balance sheet has expanded by X%" because part of the expansion is driven by an increase in demand for banknotes by the public. However, given the special circumstances of these central banks operating monetary policy at or close to the zero (interest rate) bound, most of the expansion is driven by "QE-like" policy decisions of the central banks.

(6) This point follows from the nature of a central bank's balance sheet. Banknotes in circulation are a liability of the central bank. The amount at any point in time is determined by the public's desire to hold cash and is not a variable under the direct control of the central bank, unlike bank reserves (another central bank liability), which can be created at will. Under a BOJ-style banknotes rule, the central bank's ability to undertake QE is capped by the amount of banknotes. Take the Federal Reserve, for instance. According to latest figures, the Fed has issued $1.133 trillion of Federal Reserve notes to satisfy the public's demand for banknotes. The Fed holds $1.695 trillion of U.S. Treasury securities. If it had a BOJ-style banknotes rule, it would not have been able to accumulate $562 billion of these securities, not to mention the $1.158 trillion of mortgage-backed securities and federal agency debt securities that it holds, had these been deemed as equivalent to a Treasury security.

(7) According to the latest figures, the BOJ holds a total of ¥94.01 trillion JGBs (of which ¥26.88 trillion are held under the Asset Purchase Program), which exceeds banknotes in circulation of ¥82.62 trillion. Thus, on an aggregate balance sheet basis, the banknotes rule is violated to the tune of ¥11.39 trillion.

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