

Not for turning

Despite nearly three years of aggressive monetary easing, the Japanese economy is flatlining. Such a weak outcome has unsurprisingly raised questions about the efficacy of the government’s policy package, with some pointing to Japan as confirmation that central banks have run out of ammunition. We are not yet ready to throw in the towel. **Indeed, there are a number of additional monetary policy actions that could yet prove supportive for efforts to bring inflation back to target.**

In the first instance, we see further scope for the portfolio rebalancing effects of QE. Unlike some of the other transmission mechanisms, we see little evidence of diminishing returns through the portfolio rebalancing channel. Even more aggressive bond buying is likely to further restrict the supply of long-term bonds available to domestic investors, reducing the term premium still further and forcing even reluctant sellers to eventually rebalance – it is worth noting that banks and insurers still own more than 50% of outstanding JGBs. This process could also be sped up by an increased targeting of risk assets. While the BOJ has already accumulated assets worth an impressive 77% of GDP, this is still less than a quarter of total domestic securities (see Chart 8). Secondly, **we think the scope for a move to more deeply negative interest rates remains. The BOJ’s tiering system on reserve deposits dampened the blow from negative rates on the banking sector.** However, it also created more policy levers, allowing the NIRP to be dialled up and down accordingly. While we accept that there is an ultimate limit to the effectiveness of this policy due to the ability of households and corporates to swap to cash (a decision which could not be penalised by the central bank) there remains moderate scope for the BOJ to further cut interest rates. If these measures themselves prove insufficient, more drastic action such as currency intervention or an explicit recognition that a part of the balance sheet expansion will be permanent remains possible, even if the political calendar appears to rule out such action in the near term.

While we think a retreat from the full frontal monetary assault is unlikely, a renewed coordination effort with fiscal policy is feasible. The most obvious conflict of interest relates to the government’s plan to hike the consumption tax in April 2017. While a delay appears expedient given the devastating impact of previous VAT hikes on aggregate demand, it would not be possible without an acceptance that the government will not meet its current fiscal goals. While tax revenues have been boosted by both higher nominal growth, helped by higher total employee compensation and a noticeable decline in loss-making companies, spiralling social security costs mean that even with the scheduled VAT hike, the government is not on course to meet either its 2018 or 2020 aims (see Chart 9). A scrapping of these long-term goals would engender a political backlash and trigger a double election in July. While we see this scenario as increasingly likely, a less confrontational approach may include a supplementary budget. Here the funding questions may be easier to answer, especially as interest payment costs continue to fall. However, the fiscal multiplier in Japan has proven weak in the past and if corporates and households fail to respond to further government spending, it would simply mean a return to the cycle of private sector deleveraging funded by ever-rising public debt.

