



BOJ's New Governor Ueda: Still Focused on the Wrong Indicators

By John Greenwood

Introduction and Overview

- Last Monday, April 10th, the new Bank of Japan Governor, Kazuo Ueda, gave his inaugural press conference.
- The Governor was at pains to emphasise that Japan's monetary policy settings—including the two pillars of negative interest rates and yield curve control—were correctly set for current economic conditions. Open-ended QQE with YCC were not going to be jettisoned.
- The 2% target for “core” CPI inflation (i.e., CPI less fresh food), set in 2013 by Governor Ueda's predecessor Haruhiko Kuroda, remains in place.
- All this implies that the BOJ will continue to operate on the basis of the inflation model adopted over the past decade. That model was set out in the BOJ's “Comprehensive Assessment” published in September 2016.
- The problem is the model is fundamentally wrong: it is interest rate centric.
- Inflation – and deflation – are monetary phenomena driven by the amount of broad money held by the non-bank public (M2), not by the amount of base money on the books of the central bank, and not by interest rates.
- Yet the BOJ and its research teams maintain that inflation is driven fundamentally by inflation expectations and the BOJ's influence on real interest rates. They view these two forces as driven by BOJ purchases of JGBs and by forward guidance. Nowhere in their formal “Comprehensive Assessment” (Sept. 2016) did they mention the quantity of money.
- Currently M2 money growth in Japan is falling back from its peak of 9.6% in February 2021 to its pre-Covid range of 2-4% p.a. which implies that, after peaking at 4.4% in January, the national CPI inflation rate will fall back from its current rate of 3.3% to negligible levels in 2024 and 2025.
- Unless M2 growth accelerates to about 5-6% p.a. and remains close to that growth rate, the 2% inflation target will not be achieved under Governor Ueda – even if the BOJ's balance sheet doubles again and QQE with YCC are maintained. This has clear implications for the JGB market.

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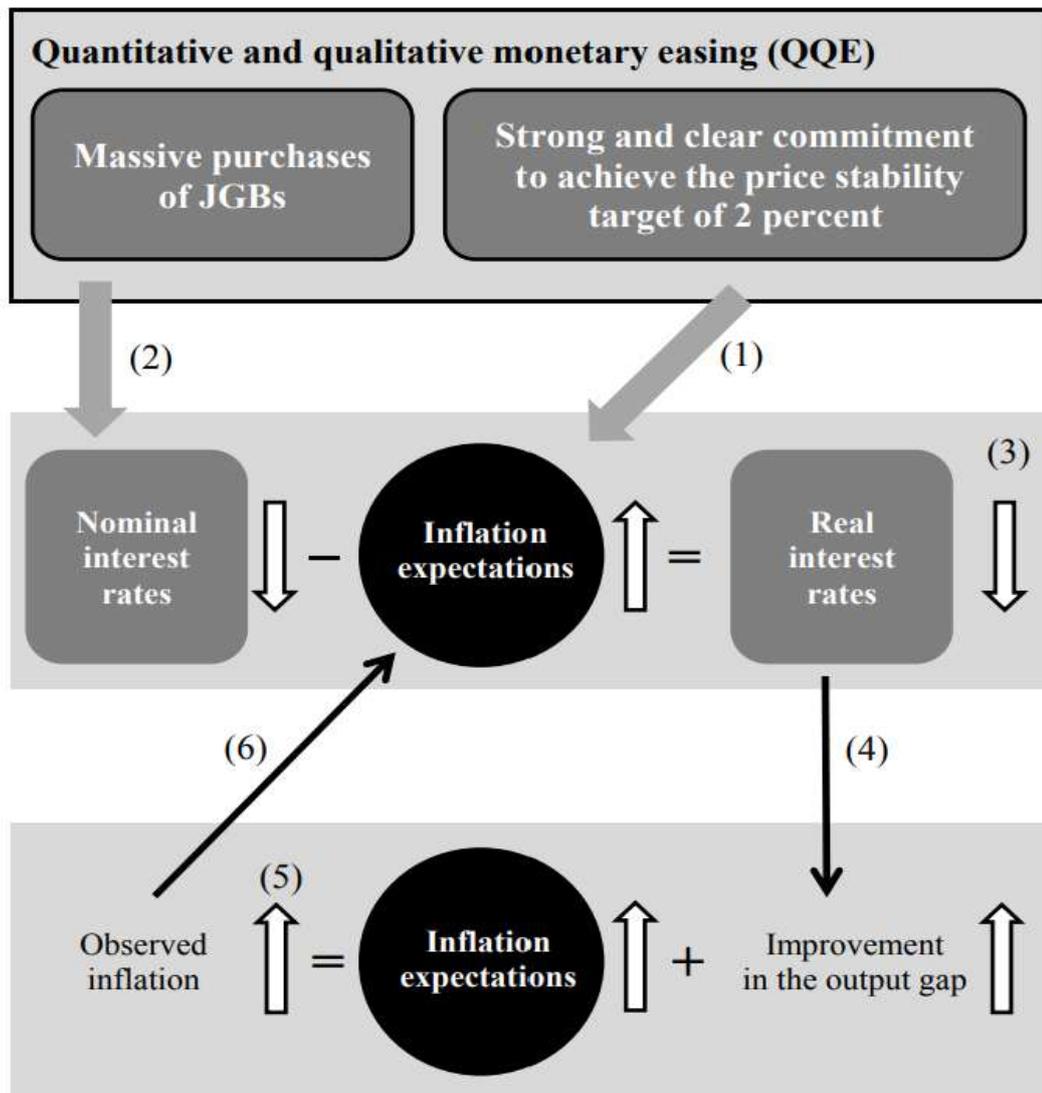
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1. Gov. Ueda’s Inherited Framework: Target and Implementation

Every central bank operates using a framework of analysis that is intended to deliver a policy outcome that is usually mandated by the government or political authority to which it is answerable. In the case of the Bank of Japan (BOJ) the desired policy target was agreed in an “accord” in 2013 between former Prime Minister Abe and BOJ Governor Haruhiko Kuroda. The aim was to achieve 2% inflation (measured by the year-on-year change in the headline national CPI less fresh foods) within two years and to double the size of the BOJ’s balance sheet (known as the “2-2-2 policy”).

The details of the implementation were left entirely to the central bank. Governor Kuroda started by setting up a variant of the QE policies adopted first by the Bank of Japan itself in 2001-06 and then by the Fed and the Bank of England in early 2009. However, there was one critical difference between the BOJ’s approach and the policies adopted by the Fed and the Bank of England. While the Fed and the Bank of

Figure 1. The BOJ’s “Comprehensive Assessment” of QQE, Sept 2016



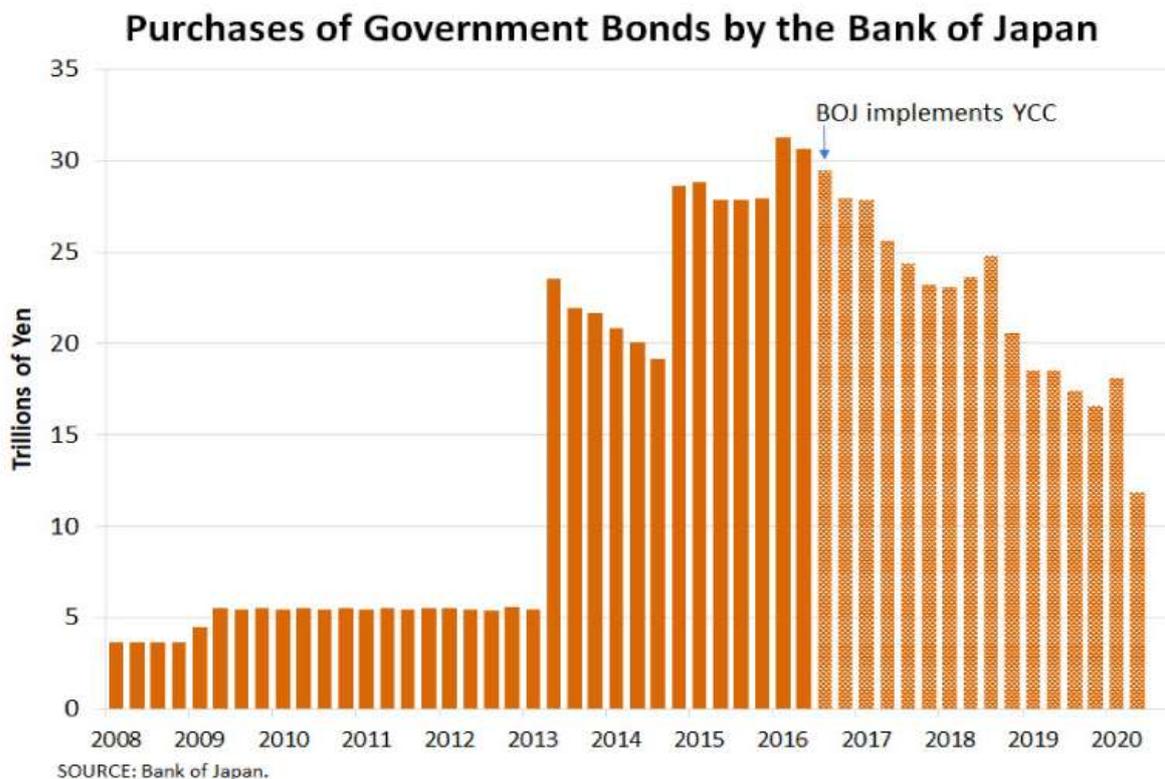
Source: Bank of Japan

England purchased securities from the non-bank sector, the BOJ purchased securities almost entirely from the banks, as it had done in 2001-06. This meant that instead of directly creating new money and thereby boosting nominal spending in the economy, the BOJ’s policy was dependent upon commercial banks stepping up to create loans in sufficient volume to ensure an acceleration of Japanese M2 growth.

Importantly, the Bank of Japan did not consider the growth of M2 to be central to the operation of the policy. We know this because, after three years of failure to boost M2 growth or to reach the 2% inflation target, the BOJ conducted a “Comprehensive Assessment” of the grandiosely named QQE policy in 2016. Figure 1, extracted from the 2016 BOJ report, shows how the BOJ thought QQE was supposed to work.

The key features of the policy were (1) the “massive purchases of JGBs” in pre-defined quantities of about 100 trillion-yen p.a. until 2016 (Figure 2), which were intended to push yields downward across the length of the yield curve, and (2) strong forward guidance on the commitment to achieve 2% inflation. Together these two were supposed to lower real interest rates and thereby strengthen economic activity (by generating an “improvement in the output gap”). There was no mention of M2.

Figure 2. QQE and YCC in action (Quarterly data).

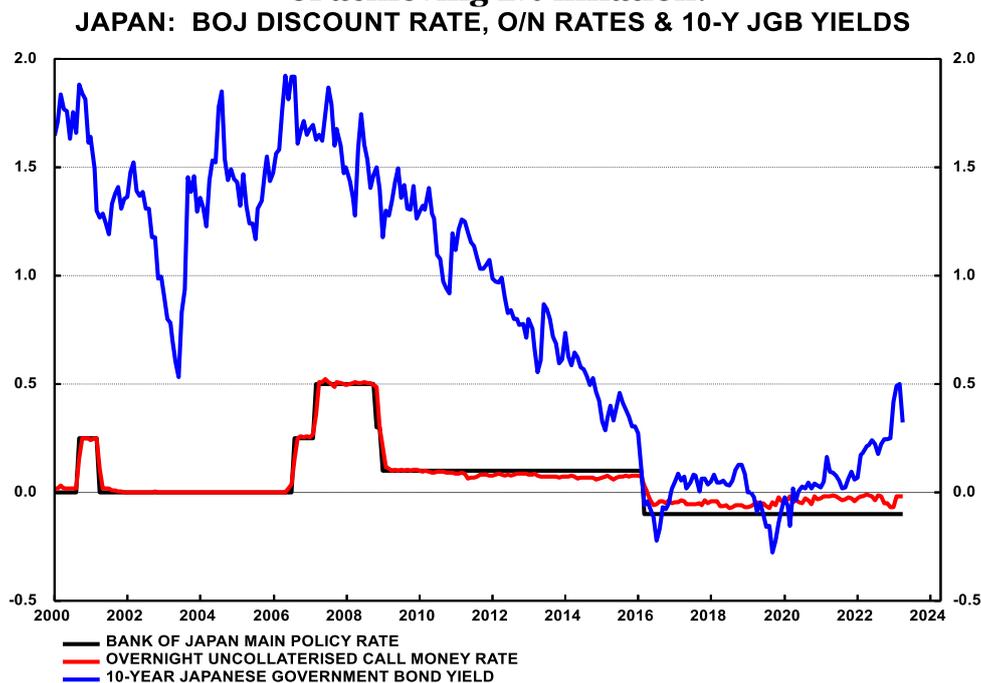


In essence, the BOJ’s asset purchases amounted to little more than an asset swap with the banks: the BOJ acquired securities while the banks acquired additional reserves. But M2 did not increase. In the light of the failure of QQE to boost either M2 growth, economic activity or inflation by 2016, far from changing tack, the BOJ doubled down on the strategy. As a result, Governor Kuroda and his Policy Board decided to set limits for JGB yields by means of YCC. Short-term rates were also

pushed into negative territory (Figure 3). If financial markets and the economy were not responding to low rates, the BOJ would push yields even lower!

Yet despite the BOJ's balance sheet reaching 100% of nominal GDP in 2019, the results of YCC under the post-Comprehensive Assessment policy between 2016 and December 2019 were – broadly – reduced purchases of JGBs but no material progress towards the goals of stronger economic growth or 2% inflation. Such was the policy framework in operation at the start of the Covid pandemic.

Figure 3. Negative short rates and falling JGB yields were no guarantee of achieving 2% inflation.



2. Serendipity: 2% Inflation Achieved by Bank Lending, *not* by QQE

During the Covid outbreak in 2020-22 the Bank of Japan continued with its existing QQE and YCC policies without significant change. However, there was one major shift in policy: the BOJ adopted in addition a form of lending to banks based on the Bank of England's Funding for Lending scheme. This meant that BOJ would lend to Japanese commercial banks only on condition that they lent funds to corporate borrowers. The surge in BOJ lending under the so-called "Funds Provisioning Measures" or "Fund Supplying Operations" shown by the blue line in Figure 4 (PTO) was clearly responsible for most of the increase in the size of the BOJ's balance sheet between 2020 and late 2022.

Now since commercial bank lending in this sense "creates money" (i.e., deposits), there was an immediate response in the monetary statistics. From a growth rate of 2.9% year-on-year in February 2020, M2 growth accelerated to 9.6% a year later, as shown by the red line in Figure 5 (see p. 5). At last, and with no thanks to QQE or YCC, the monetary growth rate – as measured by M2 – was fast enough to create an

episode of inflation. A year and a half later – exactly as one would expect from monetary theory – the national consumer price index began rising from -0.4% in August 2021 to 2.4% by April 2022 and peaking at 4.4% in January 2023, almost exactly two years after the peak in M2 growth.

Figure 4. It was the BOJ's Lending Policy during Covid that Boosted M2.

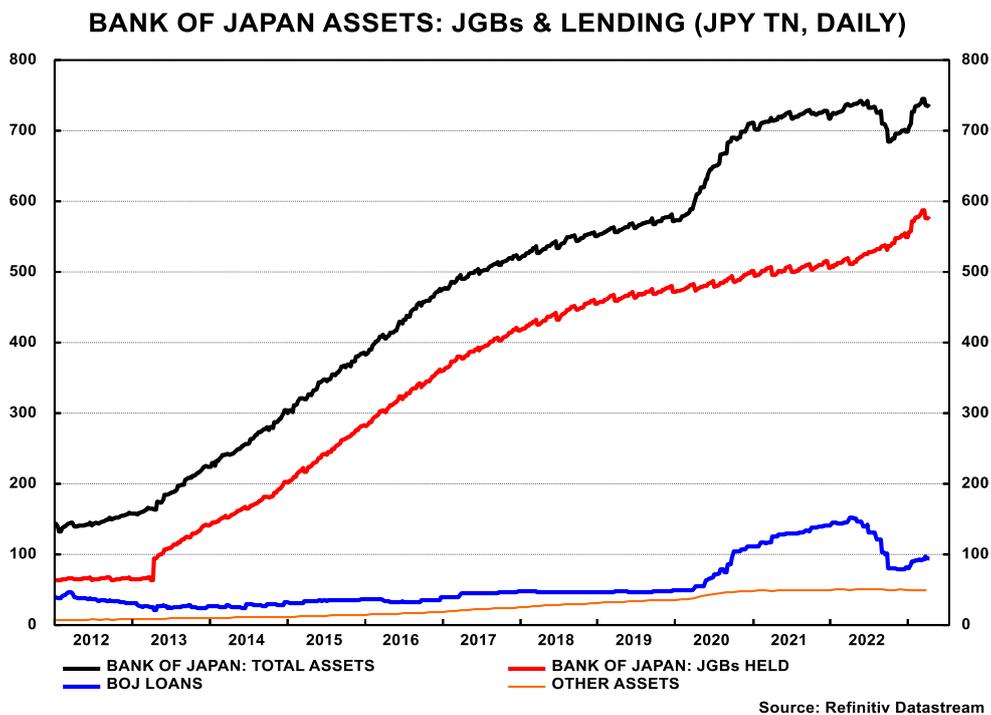
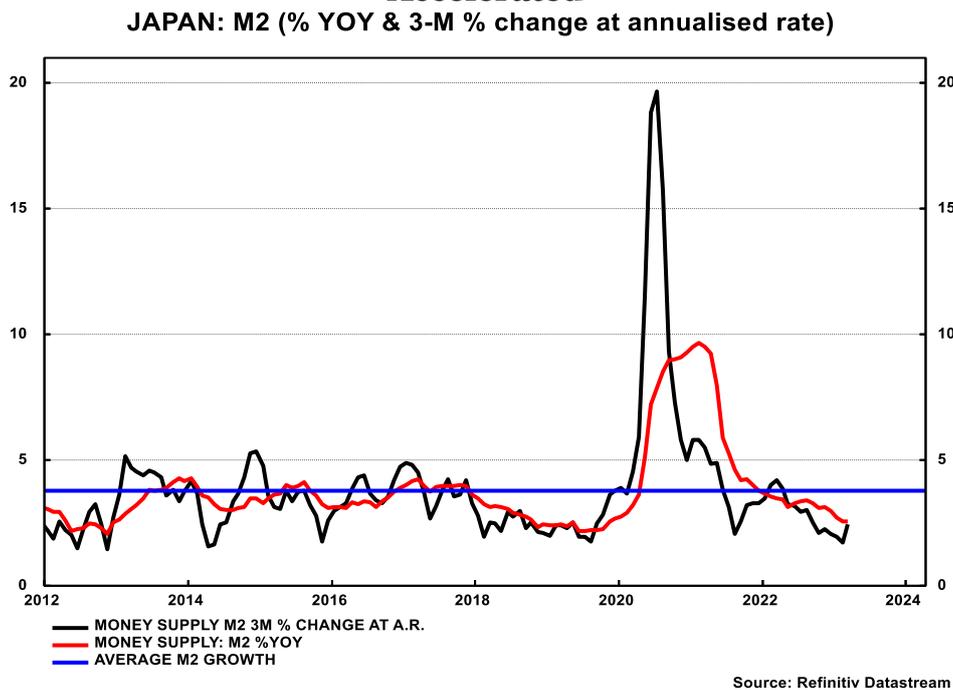


Figure 5. At last, under the BOJ's Covid Lending Policy, M2 Growth Accelerated



Although there are economists and analysts who claim that Japan has finally escaped from the straitjacket of low rates and low inflation and the BOJ should therefore abandon QQE and YCC, this has not happened and cannot happen as long as the BOJ persists with its interest rate centric model of monetary management. The reason is clear from Figure 5 (above): the BOJ has curtailed its lending program (see Figure 4 above) and monetary growth has therefore returned to pre-pandemic norms of just 2-3% p.a. In February 2023, for example, M2 growth slowed to 1.7% year-on-year. This means that the recent upswing of CPI inflation was a one-off event due to rapid money growth during Covid, but inflation will slump back to negligible rates during 2024 and 2025.

Why is this? Fundamentally interest rates and yields are unreliable indicators of the stance of monetary policy. For example, rates can be high due to past rapid growth of money, or high due to currently tight policy (lower money growth than previously). Conversely, as in Japan today, they can be low due to past low growth of money (and hence expectations that deflationary conditions will persist) or low if money growth accelerates. But simply keeping them low does not guarantee faster money growth. It is therefore better to regard money growth as the cause and interest rates as the symptom. Or, as Milton Friedman famously put it, **“Monetary policy is not about interest rates; it is about the rate of growth of the quantity of money.”**

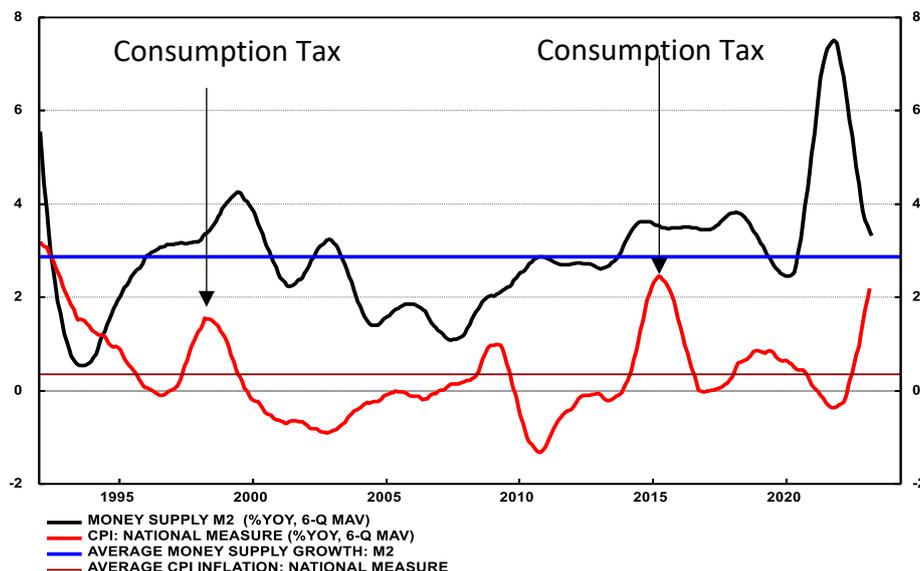
The return to low M2 growth in Japan therefore implies that JGB yields will rise only temporarily, even if YCC is lifted or abolished by the new Governor and his team at the Policy Board. Continued low money growth will eventually drive yields and interest rates back down again. Later this year or perhaps in 2024 JGB yields will ultimately fall back to the kind of yield levels seen during the YCC era. Inflation or deflation are the ultimate drivers of bond yields.

3. A Proper Framework for BOJ Policy and Governor Ueda’s Press Conference

As discussed previously (in IMM Newsletters #4 and #12) the appropriate M2 growth rate for Japan to reach and sustain 2% CPI inflation is roughly 5-6% p.a. The absence of any attention to M2 growth on any Bank of Japan dashboard has been the fatal flaw in monetary policy for the past 30 years.

To reach the 2% target the BOJ needs to adopt a proper framework for monetary policy – one that includes M2 growth of 5-6% p.a. as an explicit intermediate target. As we have seen from the discussion of BOJ policies during the pandemic, there are two ways to achieve the ideal money growth rate. **First**, the BOJ could change its way of doing QE by ensuring that all BOJ purchases of JGBs are conducted with non-banks as its counterparties – just as the Bank of England and the Fed do. **Second**, the BOJ could resume lending to commercial banks on the same conditions that it lent during Covid – i.e., on condition that banks lent the funds to corporate or other borrowers. Once the momentum of M2 growth had built up to a 5% or 6% growth rate, the demand for loans could be expected to rise, eliminating the need for the BOJ to engage in further active QE or Funds Supplying Operations.

Figure 6. To Maintain 2% Inflation, BOJ Needs to Grow M2 at 5-6% p.a.
JAPAN: MONEY GROWTH & INFLATION (% YOY, 6-Q MAVs)



Source: Refinitiv Datastream

The chart shows inflation averaged 0.4% between 1992 and 2022, aided by increases in the Consumption Tax. During this period M2 averaged 2.9% p.a. To be sure of achieving a 2% inflation target, Japan's M2 growth would need to be raised to about 5% p.a. Data averaged over 6 quarters.

What are the prospects for such a radical shift in policy by Governor Ueda? Unfortunately, to judge by his inaugural press conference, the omens are not good.

Last Monday, April 10th, the new BOJ Governor, Kazuo Ueda, gave his first press conference. The Governor was at pains to emphasise that Japan's monetary policy settings—including the two pillars of negative interest rates and yield curve control—were correctly set for current economic conditions. Open-ended QQE with YCC were not going to be jettisoned. The 2% target for “core” CPI inflation (i.e., CPI less fresh food on the national measure), set in 2013 by Governor Ueda's predecessor Haruhiko Kuroda, also remains in place. Fortuitously this target is currently being slightly exceeded (at 3.3% in February), but as explained above, inflation will likely fall in the months ahead.

All this implies that the BOJ will likely continue to operate on the basis of the inflation model adopted over the past decade. That model was set out in the BOJ's “Comprehensive Assessment” published in September 2016. The problem, as explained in this report, is that the model is fundamentally wrong.

Summary and Conclusion

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- Unless M2 growth accelerates to about 5-6% p.a. and remains close to that growth rate, the 2% inflation target will not be achieved under Governor Ueda – even if the BOJ’s balance sheet doubles again and QQE with YCC are maintained.
- In the bond market, investors should be ready for a temporary rise in JGB yields, to be followed by a fall back to pre-Covid levels. This will follow from a renewed downturn in Japanese inflation in 2024 and 2025.
- When JGB yields fall back, be prepared for a brief period of weakness in the Japanese yen, even though fundamentally low money growth and low inflation in Japan should – on a purchasing power parity basis – spell a stronger yen over the medium to long-term.

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