



Can Japan Exit Negative Rates?

By John Greenwood

Overview

- Can Japan abandon negative rates? What effect would raising rates have on the equity bull market in Japan?
- There will be huge focus on these topics following the upcoming Bank of Japan Policy Board meetings and their rate decisions on March 19 and April 26.
- Statements by the BOJ's leadership (Governor Ueda and Deputy Governor Uchida) that Japan is getting near to ending negative interest rates have heightened expectations of a hike in rates for the first time since 2006. Given its current level of -0.1%, the BOJ's official rate could be raised to 0% or to 0.1%.
- Superficially the background for raising rates might seem favourable. CPI inflation has been above 2% since April 2022, and the effects of higher price levels are in the process of being transmitted into wage growth.
- Although in the final quarter of 2023 consumption was weak, real GDP increased by 0.1%. The "shunto" (annual spring wage offensive) is in full swing. With positive growth, wages buoyant, and inflation meeting the 2% target, why not proceed?
- The problem is that these signposts are the temporary result of a brief episode of higher inflation that is now passing into history. As the symptoms of inflation fade, Japan will revert to its previous no-inflation, zero interest rate "bad equilibrium".
- This conclusion has big implications for Japanese equities and the yen.

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*The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor. A pioneer of monetary research in Asia, John was also the publisher, editor and lead author of **Asian Monetary Monitor**, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. From 1999 to 2021 he was Chief Economist at Invesco, based in London. To access my research please email your request to IMM@eri-c.com*

Introduction

In the past four years following the outbreak of Covid, observers of the global financial scene should have learned that rapid broad money growth¹ - such as was generated by major central banks between March 2020 and March 2022 - ultimately led not to low interest rates but to high interest rates.

Why? Because rapid money growth brought inflation, and lenders reacted (in the US and elsewhere) in late 2020 and 2021 by demanding higher yields on bonds and long-term loans such as mortgages.

In Japan's case, inflation as measured by the National CPI moved above 2% for the first time since the Consumption Tax hike of 2014, rising to 2.4% in April 2022, peaking at 4.4% in January 2023. But under Yield Curve Control (YCC), introduced in September 2016 (because QQE was not succeeding adequately), JGB yields remained suppressed.

Later, central banks other than the BOJ raised policy rates to tighten monetary conditions, starting in 2021 with a number of EM central banks such as Brazil and Mexico and later, mostly in 2022, the central banks of US, UK, Eurozone etc.

In other words, high money growth ultimately brought high interest rates.

If this lesson is still not clear, consider countries like Turkey, Argentina, Venezuela, or Zimbabwe. In two of these cases (Venezuela and Zimbabwe) there have been episodes of hyperinflation during the past two decades, and in the other two cases (Turkey and Argentina) inflation has been persistently high.

Very high inflation has resulted in very high interest rates.

In all four cases, domestic monetary growth has been excessively high, resulting in high inflation and high interest rates.

For Japan, what matters is that the converse is also true. Low money growth has produced low inflation - and at times deflation - and very low interest rates.

With the brief exception of the Covid period, inadequate monetary growth over the past three decades has led to deflation, and zero or negative interest rates.

In order to hit its 2% annual CPI inflation target, the BOJ should have been ensuring a broad money (M2) growth rate of approximately 5% p.a. This calculation derives from the quantity theory of money which specifies that changes in overall prices ultimately result from the difference between the rate of growth of money and what

¹ Note that money here refers to money in the hands of the public, or M2, not money on the books of the central bank, or the monetary base or MO. It was a mistake ever to think that an increase in MO would create inflation in Japan.

is required to finance real GDP growth plus the additions to money holdings that tend to occur naturally each year as people grow richer.

Arithmetically, and expressing the quantity theory of money (QTM) in rate of change form, $\Delta M + \Delta V = \Delta P + \Delta y$.

To reach a 2% inflation target QTM requires that ΔM is large enough to ensure that, after financing ΔV and Δy , there is enough money remaining to finance ΔP at 2% p.a. Re-arranging the variables,
 $\Delta P = \Delta M + \Delta V - \Delta y$.

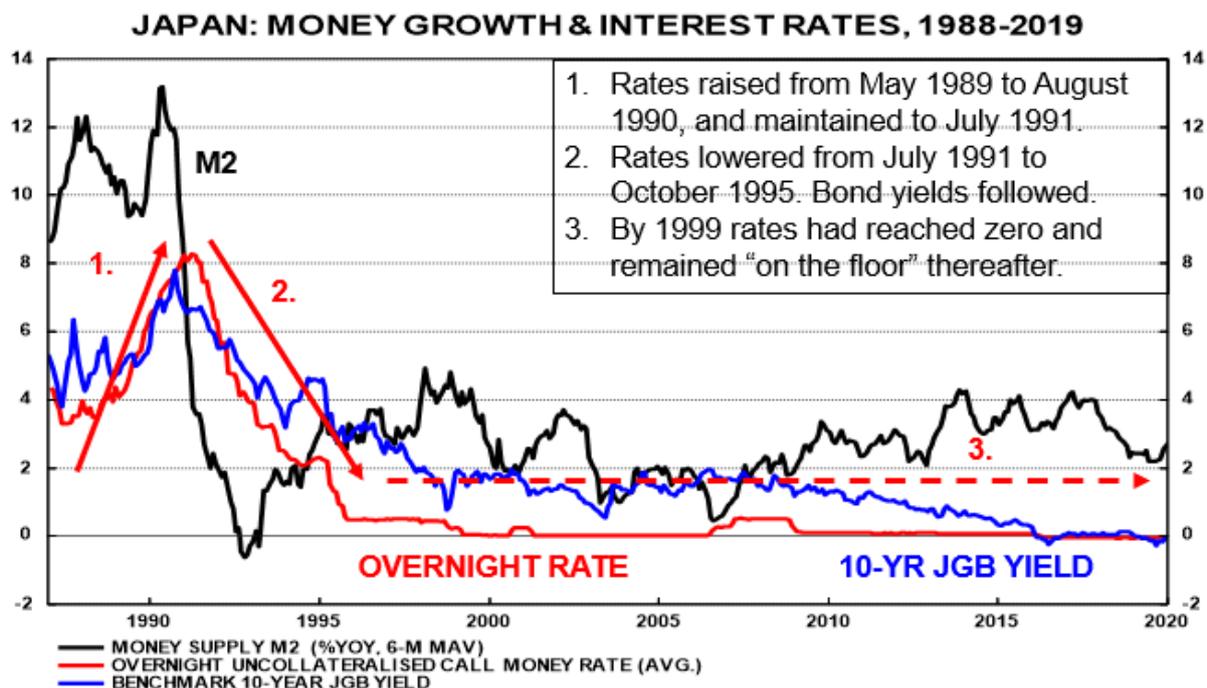
For Japan, this translates into: $\Delta P = 5 + (-2) - 1$. That is, M2 money growth of 5% p.a. would be adequate to provide additional money balances (the inverse of velocity) of 2% per year (the trend observed in Japan since the 1980s) while financing real GDP of 1% p.a. and still leaving about 2% for prices to increase.

In spite of QQE and YCC, and Japan being characterised as “a lone supplier of massive cheap money”, or supplying “massive monetary stimulus” (Reuters, March 13), the truth is that broad money growth has been persistently too low. The following pages explore the origins of Japan’s low rates, the underlying economic theory that has been overlooked, and how to break the current impasse.

Section 1. Broad Monetary Background to Japan’s Low Inflation

How did Japan end up with such exceptionally low interest rates?

Figure 1. Squeezing M2 in 1989-95 First Raised Rates, then Lowered them.



Monetary theory hypothesizes a 2-stage effect of large changes in money growth on interest rates. If money growth is tightened by a significant amount over a sustained period, the **first** effect is to raise interest rates. (The effects are shown in Figure 1 by the red digits.) The **second** effect is that asset prices, the economy and inflation slump – as happened in Japan between 1991 and 1993 – and market interest rates fall. Note how bond yields started falling before the official BOJ rate was lowered.

As an aside, initially M2 growth started to slow (from 12.7% to 9.4% by October 1989), but then accelerated again (to 13.2%) as corporate borrowers realised that rates were going to stay high, and they scrambled to ensure they had loans in place for the coming squeeze. Subsequently, M2 slumped from its 13.2% peak in May 1990 to -0.6% by October 1992.

Once money growth had slumped and inflation had fallen to negligible levels, Japan was trapped in a low equilibrium stasis.

The 10-12% M2 growth rate during the closing stages of Japan's asset bubble was too rapid, but the 1.8% average between 1991 and 1994 was too low. However, instead of correcting the monetary policy, the Japanese authorities focused for the next several years on fiscal expansion, running large fiscal deficits. As can be seen in Figure 1 (stage 3) M2 growth remained on the floor, averaging just 2.6% p.a. until 2019. Unless money growth accelerated to 5% or above the economy would remain in this extended second or third stage (labelled 3 in Figure 1).

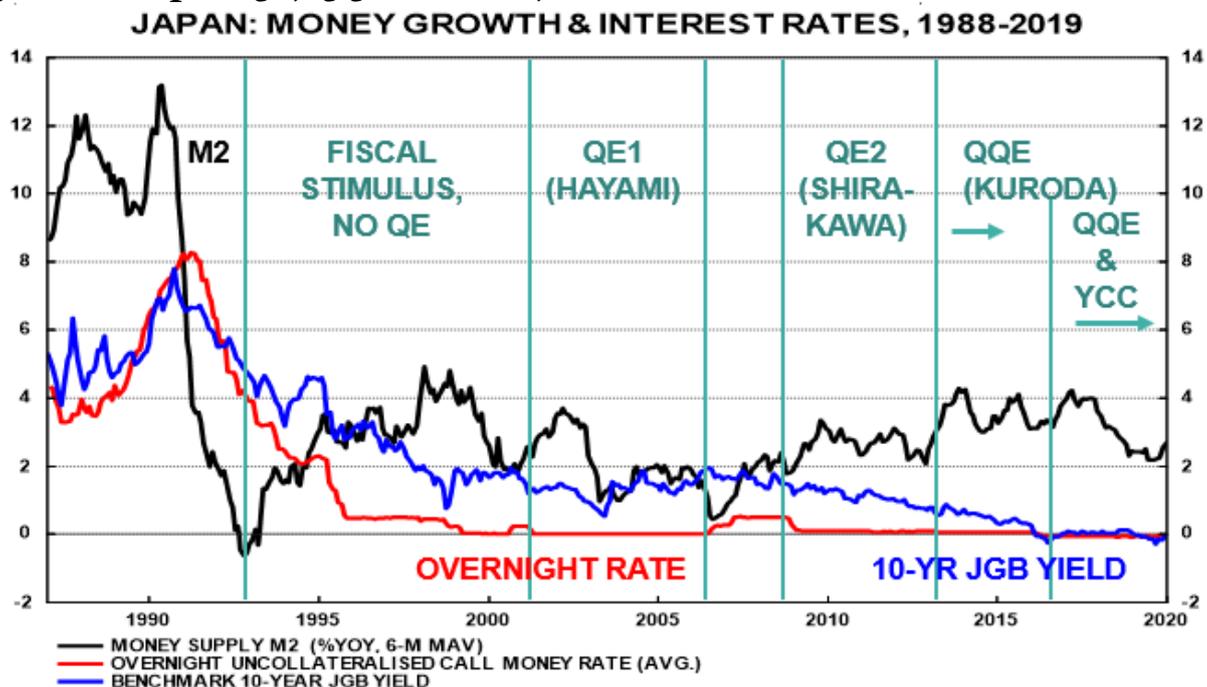
Section 2. The Failure of QE, QQE and YCC

In monetary terms the next big events were: (1) the BOJ's abortive attempt to raise rates between August 2000 and March 2001 (when they were humiliatingly returned to 0%), (2) the implementation of QE between April 2001 and its abandonment in April-June 2006, (3) the half-hearted renewal of QE under Governor Shirakawa (2008-13), and (4) the implementation of the grandiosely named QQE by Governor Kuroda (from April 2013 together with the introduction of Yield Curve Control (YCC) from September 2016.

In brief summary, here is why each of these policies of the BOJ over has failed:

- (1) Following ZIRP (Zero Interest Rate Policy) the brief rate rise of 2000-01 was prompted by the one of the BOJ Policy Board members who lobbied strongly for pensioners' savings to be rewarded with positive deposit interest rates. The economy slumped following the rate rise and the Policy Board was left with no option but to implement a stronger easing policy. Hence the genesis of QE.

Figure 2. Despite QE, QQE and YCC, M2 Growth did not Accelerate.



- (2) The first episode of QE (QE1 in Figure 2) conducted in Japan under Governors Hayami and Fukui between 2001 and 2006 increased the size of the balance sheet of the BOJ, but it had almost no effect on broad money, M2. Although the growth rate of M2 picked up slightly in the first year, peaking at 3.7% year-on-year in March 2002, from then onwards it weakened to below 2% p.a. between 2003 and 2006. The fundamental reason for its failure was that it the BOJ purchased securities (mainly short-term financing bills) from banks, not from non-banks. The result was essentially an asset-swap between the banks and the BOJ. The banks acquired a credit balance at the BOJ, while the BOJ acquired the “*tegata*” or short-term securities. But banks did not increase their lending, and there was no increase in deposits held by the public at large. When the experiment was terminated, the positions were unwound in three months (the approximate maturity of the securities) with almost zero effect on M2, the money markets or the equity market.
- (3) Under Governor Shirakawa the BOJ recognised that the economy was still very weak and inflation too low, but they were reluctant to engage again in “unorthodox” measures. Nevertheless, BOJ holdings of JGBs and loans to banks increased modestly between 2008 and 2013. In the post-GFC environment it was not surprising that these half-hearted efforts failed to produce any sustained acceleration of M2 (see QE2 in Figure 2).
- (4) In late 2012, Shinzo Abe was elected Prime Minister and he appointed Haruhiko Kuroda to be Governor of the BOJ from March 2013. Governor Kuroda immediately announced a stronger version of QE, pretentiously named QQE (Qualitative and Quantitative Easing) with the aim of doubling the size of the BOJ’s balance sheet, increasing the inflation rate to 2%, and



achieving this in two years (the so-called 2-2-2 policy). However, there was no mention of any broad money supply target, although the policy was implemented with purchases of JGBs and some other instruments (mainly ETFs and J-REITs). Once again, the BOJ's purchases were predominantly from banks, not non-banks, and as a result M2 growth remained sluggish at best.

In September 2016 a Comprehensive Review of QQE was undertaken, as a result of which it was decided that interest rates were not being pushed down far enough – especially at the long end of the yield curve – to generate the necessary stimulus for the economy. The Bank would therefore introduce Yield Curve Control. The idea was to place a ceiling on JGB yields in the hope that this would somehow stimulate investment together with new lending and borrowing sufficient to revive the economy. Two years later another Comprehensive Review was conducted, and it was decided to double down on the existing policy. In the words of Executive Director Amamiya, “Our yield curve control policy ... actively manipulates the long- and short-term interest rates in order to achieve the price stability target.”² Sadly, this was another futile policy with no serious hope of success because it did not pay any attention to increasing broad money (M2).

Fundamentally, the problem with YCC is that interest rates (and the shape of the yield curve) are the outcome of past monetary growth, not the driver of growth and inflation. Interest rates are symptoms, not causes. It is true that interest rates can be used as an instrument by central banks, but in a situation where they are already very low – perhaps due to low inflation or deflation -- they sometimes cannot be lowered any further. In this case the central bank needs to create more money (not try to push rates lower) to generate stronger spending growth which will eventually drive inflation and interest rates upwards. In Japan's case, the BOJ policy of buying securities from banks instead of non-banks virtually guaranteed that this escape route – creating more broad money -- was blocked for policymakers.

Section 3. How did Japan Engineer Faster M2 Growth During Covid?

There is one other way to ensure faster M2 growth. Fortunately, this is what the BOJ did during Covid. The surge in money growth illustrated in Figure 3 had nothing to do with QQE or YCC. Those policies had been in force during the 3-4 years prior to Covid but had had no effect on the growth of M2.

What made the difference during Covid was that the Bank of Japan adopted a policy of lending to the commercial banks only on the basis that they on-lent those funds to corporate customers. This policy was an amalgam of the Bank of England's Funding

² “History and Theories of Yield Curve Control”, Speech by Masayoshi Amamiya on January 11, 2017. https://www.boj.or.jp/en/about/press/koen_2017/data/ko170111a1.pdf

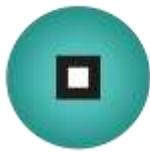
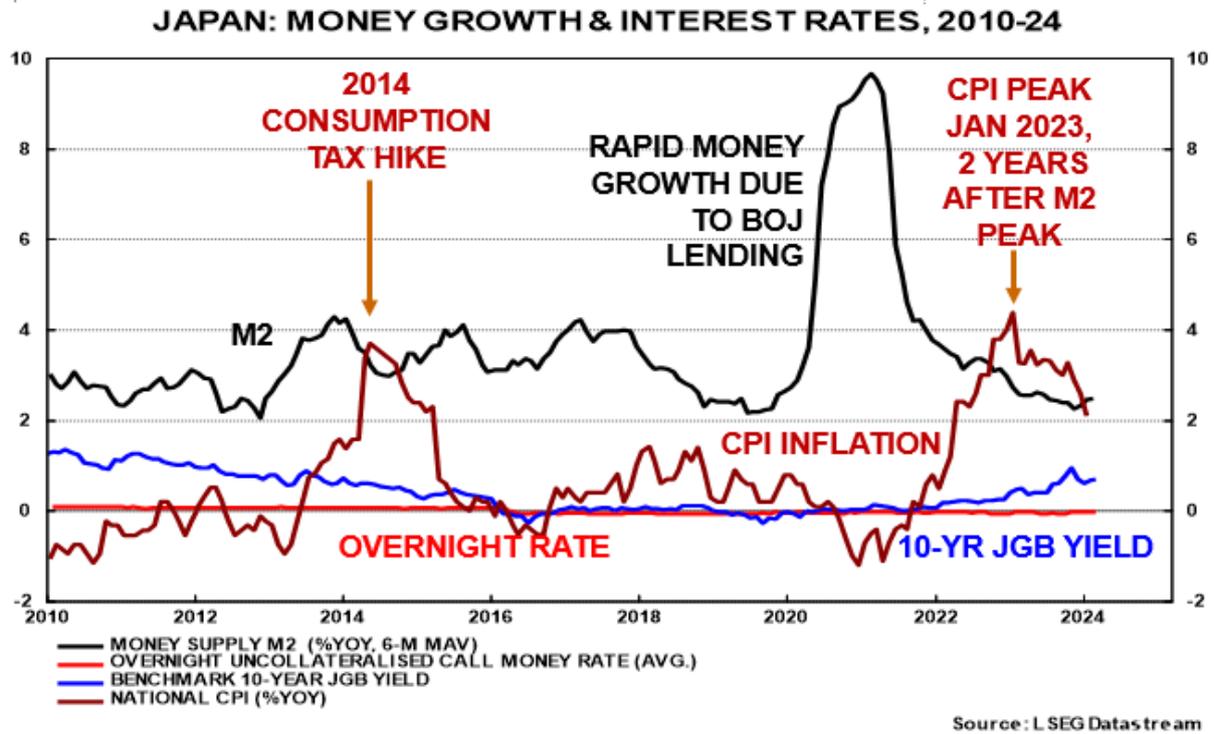


Figure 3. The Current Episode of Inflation is a Flash in the Pan.



for Lending scheme and the ECB’s Targeted Long-Term Refinancing Operations (T-LTROs). It ensured that any BOJ loans would be translated into new credits to borrowers’ deposit accounts – i.e., it created money against new loans, something that had not happened when the BOJ purchased securities from the banks.

However, that phase is now over. The BOJ announced in December 2021 that it was scaling back the economic support programme that it had implemented since March 2020, consisting of the purchase of JPY 20 trillion of corporate bonds and commercial paper, but that it would continue with its loan scheme (“funds-supplying measures”) for smaller companies until September 2022.

Predictably, following the closure of the BOJ’s lending scheme, M2 has decelerated back to its pre-Covid growth rate of just over 2% – too low to sustain inflation at 2%.

Section 3. How Japan can Escape from its Low Interest Rates Trap

The Bank of Japan’s new Governor, Kazuo Ueda, is very familiar with the thinking at the BOJ. He was a Policy Board member from April 1998 until April 2005, whereupon his term was renewed until April 2005. His approach to policymaking has therefore been exactly in line with the prevailing orthodoxy at the Bank. Like others on the Policy Board, he wishes to end the dependence on unorthodox policies (i.e., QQE and YCC). In his eyes the present opportunity of core CPI inflation in excess of 2% must look like a very tempting moment to try to escape the straitjacket

of the past two and a half decades and return to a more traditional interest rate mechanism to guide policy.

The problem, however, as we can see very clearly from Figure 3, is that the inflation which has been prevalent in Japan since late 2021 was evidently a result of the surge in M2 growth between the onset of Covid in March 2020 and May 2022, by which time M2 growth had reverted to 3.1% year-on-year. Now that the loan-supported surge is over, M2 has decelerated further to 2.5% year-on-year as of February 2024. This is the figure that will determine inflation in early 2026. Based on the track record of the recent past, this implies inflation will be falling towards 0% or even lower. What will the BOJ policymakers do then?

Most likely, the BOJ will call up its playbooks from the past. Some form of QE or QQE with – possibly – yield curve control will be restarted. But we know that this formula has not worked in the past and will not work in future unless it is re-shaped to ensure faster growth of broad money (M2).

To guarantee faster growth of M2 – something close to 5% p.a. – the BOJ needs to purchase securities from non-banks, at least until commercial banks take up the baton and start lending so that commercial banks once again become the main creators of money.

Summary and Investment Conclusions

- The answer to the question in the title, “Can Japan Exit Negative Rates?” is, definitely yes. The BOJ can raise rates at one of its up-coming meetings, but already inflation looks as though it will fall below 2%, and catch-up wage increases alone will not be sufficient to ensure that aggregate spending stays buoyant. The Bank will express caution even if it does raise rates.
- The problem is that unless M2 growth accelerates to around 5% p.a. (which will not be helped by a rise in rates), it is likely that inflation will gradually fall back to zero over the next two years, requiring the BOJ to cut interest rates once again.
- Treating Japan’s “low-flation” or deflation only with interest rates is simply not adequate. This is treating the symptoms, not the causes of low inflation. Inflation is a monetary phenomenon, meaning that the restoration of 2% CPI inflation on a sustained basis requires a faster rate of growth of the M2 money supply.
- In this paper and elsewhere I have argued that this in turn requires a change to the *modus operandi* of the BOJ’s asset purchases. Like the Fed or the Bank of England (neither of which has had to resort to negative rates), the BOJ needs to purchase securities from non-banks, directly injecting new deposits into the banking system when it conducts such asset purchases.
- As Mervyn King, former Governor of the Bank of England, says, “Quantitative Easing is an expansion of the money supply, although most central banks are reluctant to describe it as such, which has made calibration of changes to QE difficult and seemingly arbitrary.” (In other words, instead of measuring it by



its impact on money growth, there is a tendency to measure its impact on interest rates.) In Japan's case there has been no attempt to link QE or QQE to M2.

- In the short-term, financial markets may welcome the supposed return to normality if the BOJ raises interest rates as expected on either March 19 or April 26. The yen will no doubt rally, as it is already doing, and yields on the 10-year JGB may well exceed the 1% ceiling to which they have been limited by YCC. Equities will likely pause the rally they have enjoyed since December.
- In the longer-term, however, extended sluggish growth of M2 will limit purchasing power in Japan, slow nominal GDP growth, and bring inflation back to near-zero. These pressures will, over the next two years, restrict the upside for equities, while conversely re-igniting a rally in JGBs.

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