

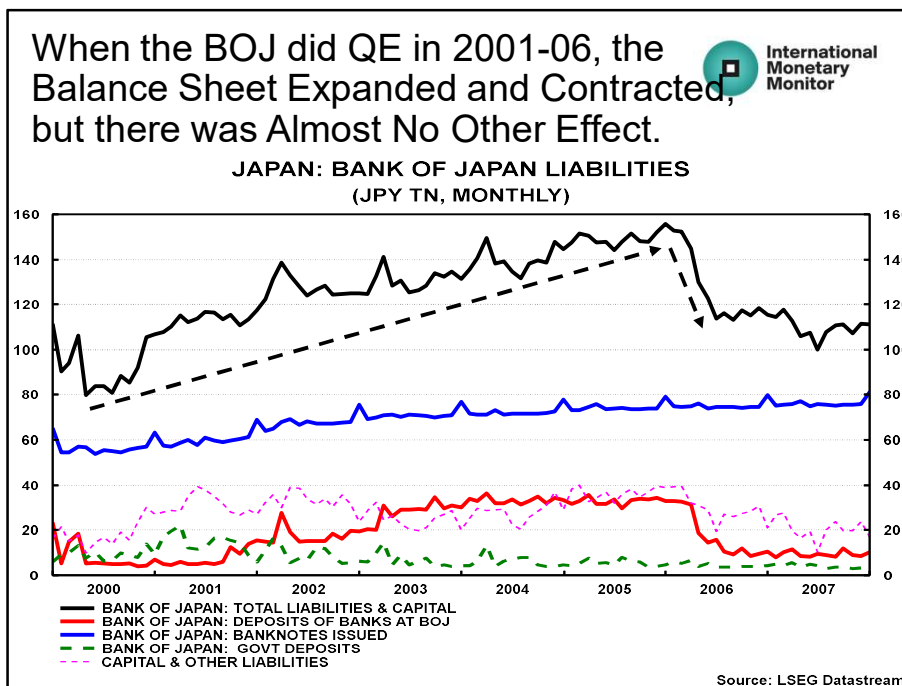
Japan - Implications of the BOJ's Balance Sheet Contraction

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International Monetary Monitor

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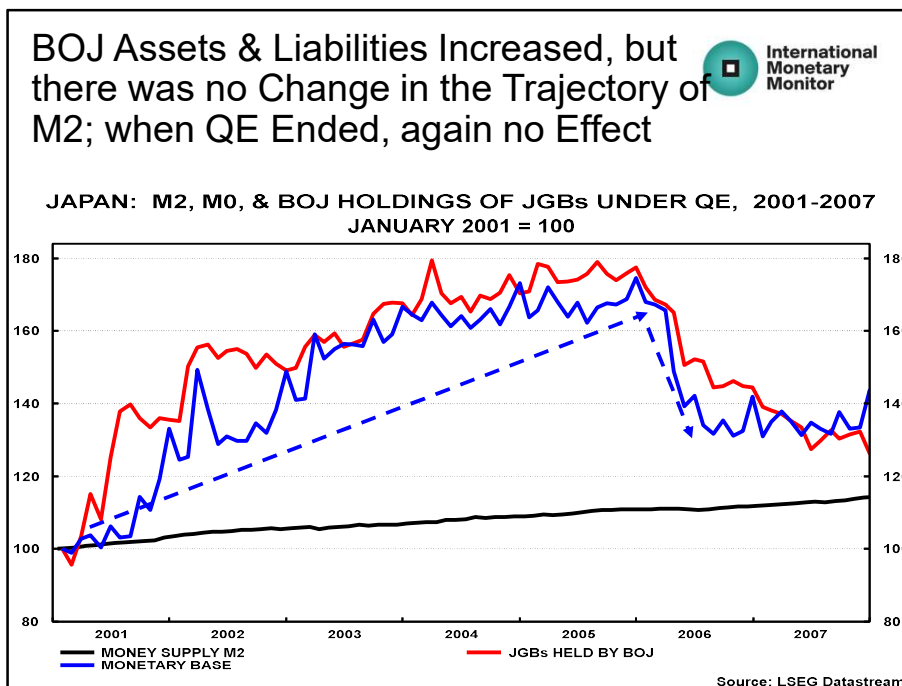
"Monetary policy is not about interest rates. It is about the rate of growth of the quantity of money." Milton Friedman, interviewed on NBC's Meet the Press, October 24, 1976.



The Bank of Japan (BOJ) first embarked on Quantitative Easing (QE) in March 2001. The policy was adopted in an attempt to overcome weak real GDP growth and to stabilise prices in a deflationary environment, following the failure of a two-year period of zero interest rate policies (ZIRP) in 1999-2000, and an abortive hike in rates between August 2000 and February 2001.

The QE policy was implemented mainly by BOJ purchases of JGBs **from banks**. The effect was to increase both the size of the BOJ's balance sheet (black line), and, correspondingly, the reserves of banks at the BOJ (red line). As shown in the chart above, banks' current account deposits (reserves) at the BOJ increased from around JPY 5 trillion in early 2001 to JPY 36 trillion by March 2004.

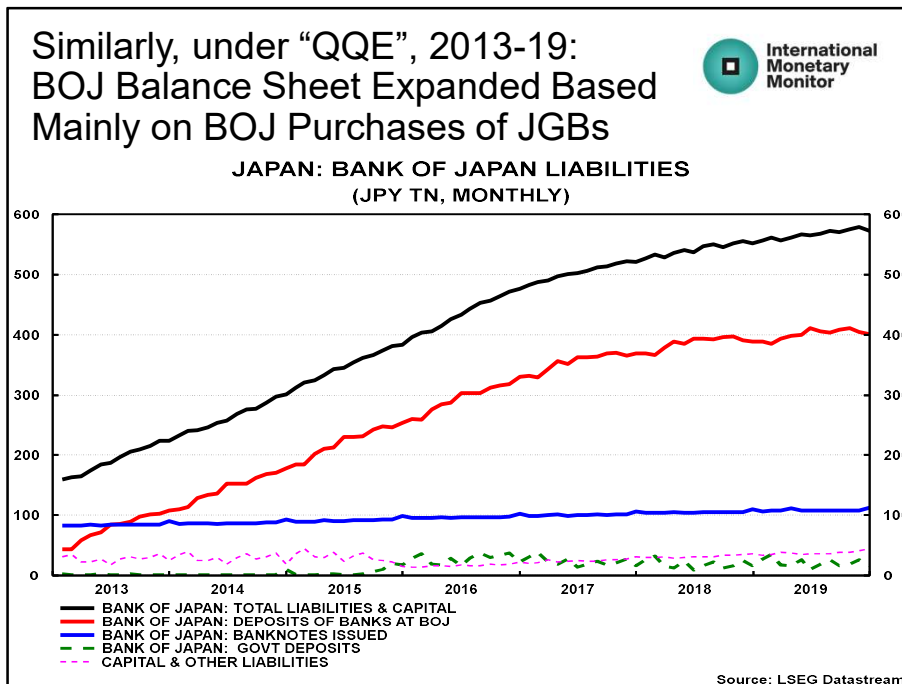
Importantly, the QE policy, as conducted by the BOJ, completely failed to increase the broad money supply (M2+CDs) – see next page. Although the monetary base (cash currency held by the public plus banks' deposits at the BOJ) increased, as shown by the blue line in the chart overleaf, M2+CDs (shown by the black line) continued its previously low-growth trajectory. [In the chart on p. 3, all series are indexed to 100 at January 2001.] JPO2A



This failure of M2+CDs to increase was not a result of the types of security that the BOJ was purchasing, but a direct result of the fact that the BOJ's purchases of JGBs and other short-term government securities (Financing Bills or "tegata") were from **banks**, not **non-banks**. If the BOJ had purchased from **non-banks** (as the Fed and the Bank of England did from 2009), the deposits of these entities in the banking system would have increased, directly increasing the money supply. However, by purchasing from banks, the BOJ was merely exchanging bills or short-term securities held by the banks for deposits at the central bank. Since market interest rates were virtually zero and since the banks were risk averse, the extra reserves did not encourage the banks to lend, so the deposits simply accumulated as excess reserves at the BOJ.

Consequently, when the BOJ reversed its QE policy in March/April 2006, the central bank was able to dispose of a portfolio of around JPY 30 trillion securities within three months. There was no effect on money market rates. There was no effect on the broad money supply (M2+CDs) -- as shown by the black line. The BOJ had once again merely swapped assets with the banks.

The BOJ's policy had been misdirected, or at least poorly designed.
JPO2EE



When the BOJ embarked on the grandiosely titled Quantitative and Qualitative Easing (QQE) in March 2013 under Governor Kuroda, recently appointed by Prime Minister Abe, the policy adopted was essentially the same, only more ambitious in scale. This was part of PM Abe’s “three arrows” policy of (1) aggressive monetary easing, (2) flexible fiscal stimulus, and (3) structural reforms to boost long-term growth. These policies aimed to end deflation, jump-start demand, and raise Japan’s growth potential.

Once more the BOJ purchased JGBs and later other securities **from Japanese commercial banks**, increasing their reserve or current account deposits at the central bank. The increased scale of the purchases is evident from the chart: BOJ holdings of JGBs increased almost tenfold -- from JPY 43.9 trillion in February 2013 to over JPY 410 trillion by October 2019.

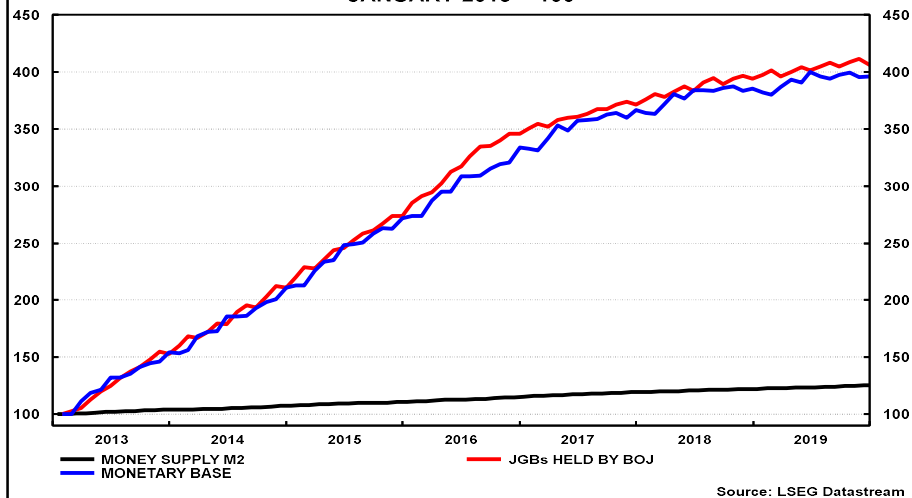
The only other significant difference with the earlier 2001-06 episode of QE was that this time the BOJ adopted an inflation target of 2%. For those economists who believe that expectations have a large impact on the effectiveness of monetary policy, this was regarded as an important innovation. Personally, I am sceptical.

JPO2A

But Again, there was Almost No Effect on the Trajectory of M2



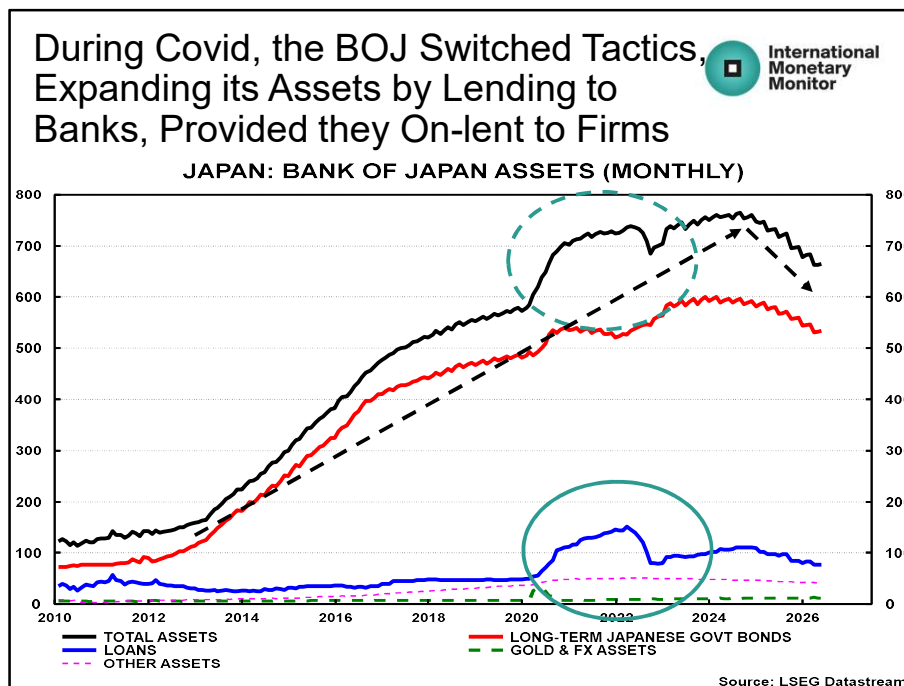
JAPAN: M2, M0, & BOJ HOLDINGS OF JGBs UNDER "QQE", 2013-19
JANUARY 2013 = 100



However, as in the previous episode of QE, because of the way the BOJ's policy was designed and conducted (making purchases of JGBs and other securities from the **banks** instead of **non-banks**), it had no effect in boosting broad money (M2+CDs). This is shown by the black line in the chart above. [In this chart, all data are indexed to 100 at January 2013.]

So while the BOJ holdings of JGBs increased massively and the monetary base increased by a similar amount from March 2013, there was no impact on the growth rate of broad money (M2+CDs) which continued in its previous trajectory, growing at an average of 3.3% p.a. between 2013 and 2019.

JPO2EF

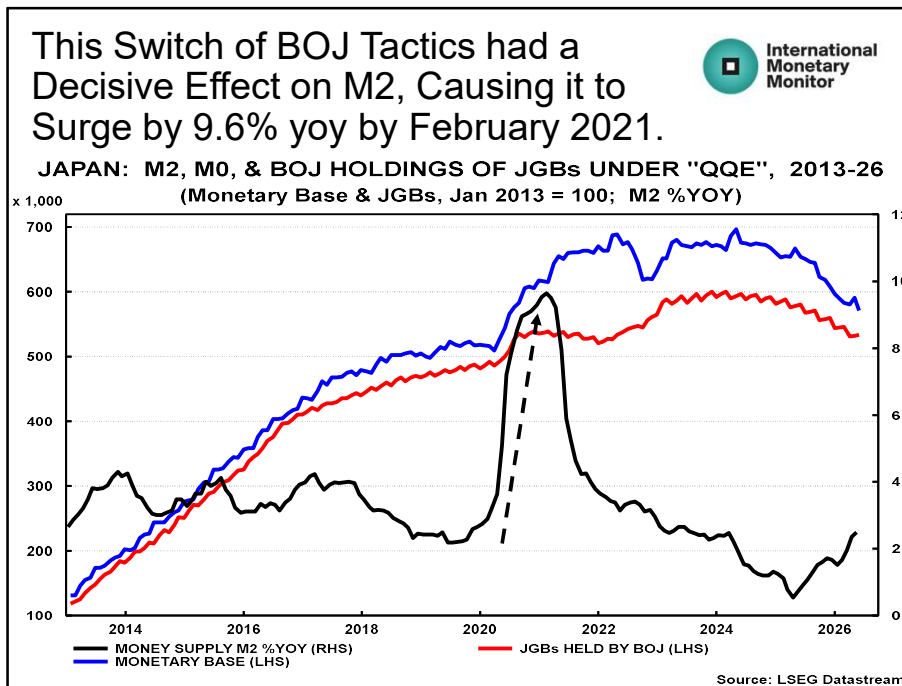


Readers will have noticed that the previous chart covered the period 2013 up to and including 2019.

The reason is that during Covid the Bank of Japan switched its tactics for the conduct of monetary policy. In March 2020, at the start of the pandemic, the BOJ announced a Special Funds-Supplying Operation or Fund Provisioning Scheme, whereby it would lend to banks on condition that they extended loans to companies. Loans were provided against corporate debt as collateral, with each loan having a maturity up to one year and an initial interest rate of 0 percent. The facility was explicitly temporary and initially scheduled through end-September 2020 but later repeatedly extended.

As indicated by the circled blue line in the chart above (which includes some other loans), the fund provisioning program built up to JPY 77 trillion in January 2025 (about 10% of the BOJ balance sheet). On January 24, 2025, the BOJ announced it would be offering no new lending. All the outstanding loans under the Fund Provisioning scheme are set to expire by early 2028.

JP02



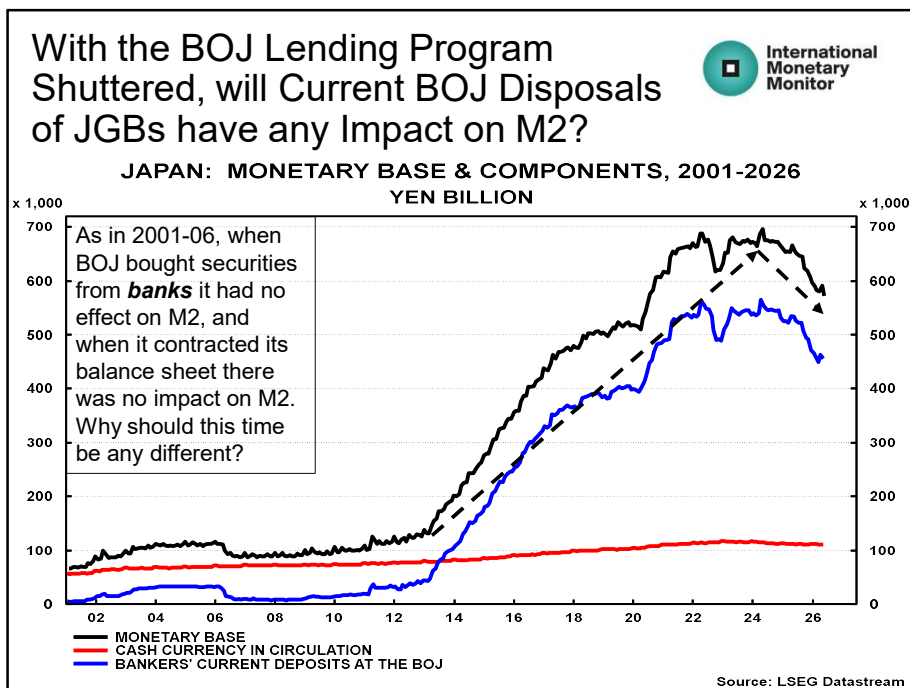
In contrast with the BOJ's anaemic QQE plan, the Fund Provisioning Plan had a direct effect on broad money (M2+CDs).

When a commercial bank makes a loan, it adds to its assets (the loan) and to its liabilities -- it simultaneously adds an equal sum to the credit of the borrower in his/her deposit account. The effect of the Fund Provisioning Plan was therefore to boost M2+CDs in a way that the BOJ's QQE had completely failed to do.

As shown by the black line in the chart above, broad money accelerated from 2.9% annual growth in February 2020 to 9.6% by February 2021, returning to 3.1% by May 2022. It averaged 5.3% annual growth between January 2020 and December 2022.

The results were very clear. Japan's Nikkei stock market index surged from 17,000 to just over 30,000 by February 2021, real GDP expanded by 3.6% in 2021, and CPI inflation went from -1.2% in December 2020 to 4.4% by January 2023, averaging 3.0% in 2023 and 2024.

JP02EG



Since the BOJ's QQE programme was ineffective in boosting broad money (M2+CDs) , what can we say about the decision to unwind the programme, or the decision to taper purchases of JGBs announced on 31 July 2024?

We know that the earlier QE programme was unwound in about four months between April and July 2006 with barely any effects on Japan's money markets and no effect on the growth rate of broad money. The reason, of course, was that just as the purchases of JGBs had been from **banks**, so too were the sales of JGBs.

On this occasion (2024 onwards), however, the BOJ appears to be merely tapering its purchases and allowing securities held on its balance sheet to mature.

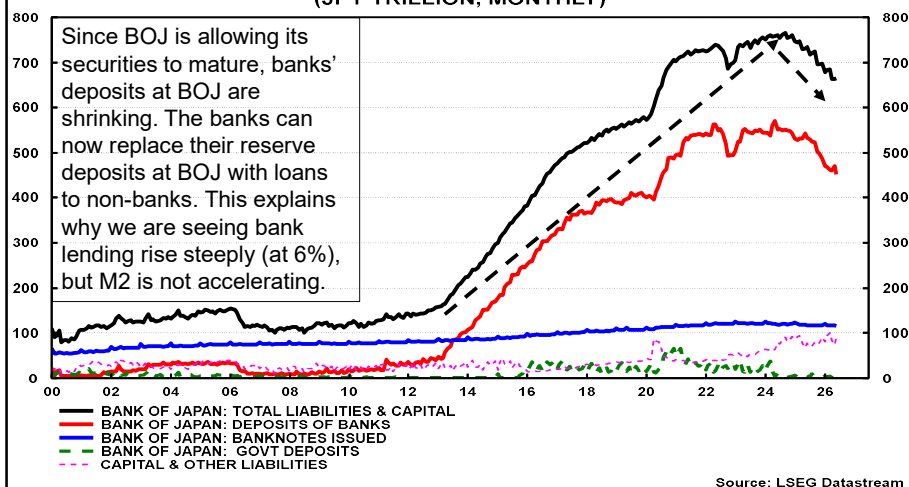
As the chart above shows, the monetary base (the black line) has already started to shrink. Does this mean that the money supply will also shrink? Analysts who emphasise the significance of the monetary multiplier would say "Yes." However, if the effect of the BOJ's operations is simply to reduce commercial bank holdings of (excess) reserves at the BOJ, and banks are able to replace these reserves with loans, then far from reducing broad money, the effect could be to increase broad money!

JP02G

BOJ Balance Sheet Shrinkage Unlikely to Have any Impact on M2 as Shrinking Bank Reserves are not part of M2



JAPAN: BANK OF JAPAN LIABILITIES
(JPY TRILLION, MONTHLY)

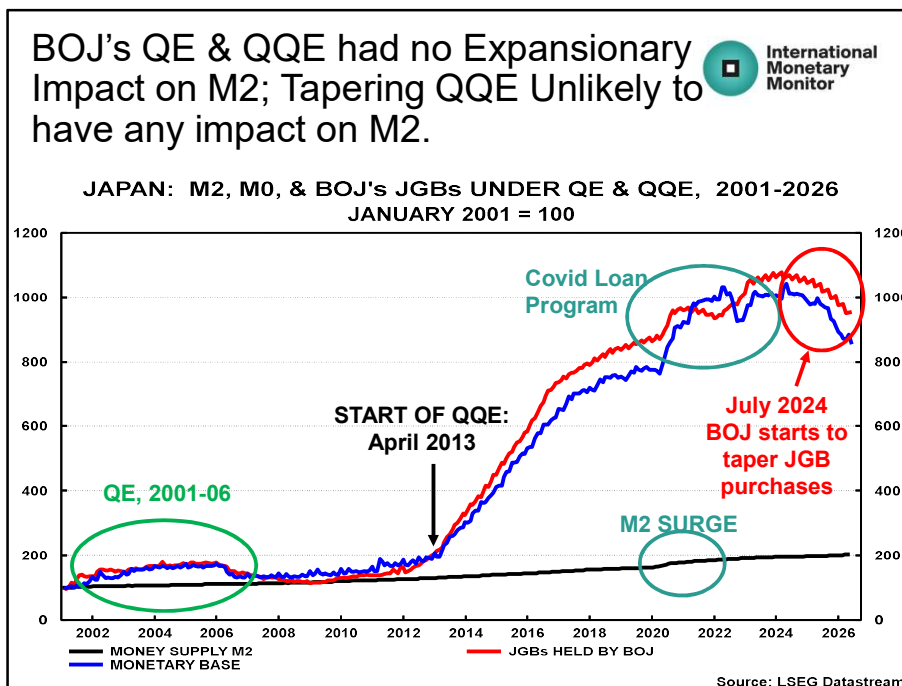


We can outline the issue discussed in this paper in a different way.

When the BOJ conducted QE and QQE, it expanded its own balance sheet (by its purchases of securities), but the balance sheets of the commercial banks were not expanded. The commercial banks merely swapped holdings of short-term securities for holdings of deposits at the Bank of Japan. Moreover, their risk preferences were such that they decided not to expand their lending in response to the increase of their reserve balances at the BOJ.

By contrast, in a normal QE operation by the Fed or the Bank of England, the balance sheets of the **central bank** and **commercial banks** were both expanded, while the **non-bank** public's consolidated balance sheet was not increased. The non-banks acquired new deposits in exchange for their sales of securities to the central bank. It was the excess liquidity that they acquired which prompted them to rebalance their asset portfolios, later triggering more spending. More money equals more spending.

But given the way the BOJ has conducted its QE and QQE, these effects did not occur. My prediction is that the unwinding process will also have minimal effects on broad money. However, because banks will see their deposits at the BOJ decline, they will be able to make new loans, replacing the deposits they previously held with the BOJ.



In summary, the BOJ actions in conducting QE (2001-06) and QQE (2013-2024) were designed and implemented in such a way that they had minimal effects on broad money. The only exception was an interlude during the Covid pandemic when the Bank of Japan created a lending programme that caused commercial bank lending and hence deposits to increase, in turn boosting broad money.

The Bank of Japan's balance sheet and the monetary base have already started to decline following the BOJ's announcement in July 2024 that the QQE purchases would be tapered by JPY 400 billion per quarter, reducing gross purchases on a progressive basis.

However, these actions by the BOJ, like their counterparts during the expansions of the BOJ's balance sheet under QE & QQE, have had almost no effect on broad money which has continued to grow at a modest 2.5% year-on-year (as of May 2026).

Unless the BOJ changes its *modus operandi*, making the non-bank public its main counterparty for QE or QT operations, there will continue to be minimal effect on the growth of broad money.

JP02EH