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<Flash Report>

Surprise Supplementary Measures for QQE Announced

— BOJ plays down Concerns over JGB Purchasing Limits?

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On 18 December 2015, the Bank of Japan (BOJ) introduced its "Supplementary Measures for Quantitative and Qualitative Monetary Easing", which includes extending the average maturity of its long-term government bond holdings that it buys under its monetary easing program ***(Figure 1)***. The BOJ also announced that it would accept foreign currency-denominated loans on deeds and financial institutions' housing loans portfolio as eligible collateral for the Bank's provision of credit.

Figure 1. Supplementary Measures for QQE

Facilitating smooth operation of QQE	• Accepting foreign currency bonds and housing loans as collateral, which enables banks to sell their government bonds more freely.
Extending duration of bonds and increasing real estate investment	• Buying govenment bonds with a remaining maturity of 7- 12 years, compared with the current 7-10 years, from January 2016. • The maximum amount of each issue of J-REIT to be purchased shall be increased from the current 5 percent to 10 percent of the total amount of that J-REIT issued.
Supporting firms' investment and compensation for employees	• Buying shares issued by "firms that are proactively making investment in physical and human capital" at an annual pace of 300 billion yen. To start with, purchases of ETFs which track the JPX-Nikkei Index 400 will be made from April 2016 onward.

Source: Prepared by authors based on the BOJ's "Introduction of Supplementary Measures for Quantitative and Qualitative Monetary Easing" attachment to "Statement on Monetary Policy" (18 December 2015)

The JCER Financial Research Team released a report titled ***"Limits to the BOJ's Quantitative and Qualitative Monetary Easing and Issues concerning its Exit Strategy"*** on 17 December, which pointed out if the BOJ continues buying massive amounts of Japanese Government Bonds (JGBs) from the market, private financial institutions will soon face a shortage of collateral needed for financial transactions and BOJ's money market operations. This will make it difficult for the BOJ to maintain its current scale of JGB purchases.

The expansion of eligible collateral included in the BOJ's Supplementary Measures announced on Friday last week will loosen the supply-demand balance of JGB market indirectly. The BOJ's Measures also incorporated 1) increasing the maximum amount of each issue of Japan real estate investment trust (J-REIT) to be purchased, and 2) establishing a new program for purchases of exchange-traded funds (ETFs) that comprise companies investing in fixed or human capital. As the annual target amount of increasing monetary base by 80 trillion yen was maintained, these Measures were mapped out as merely "supplementary" for QQE.

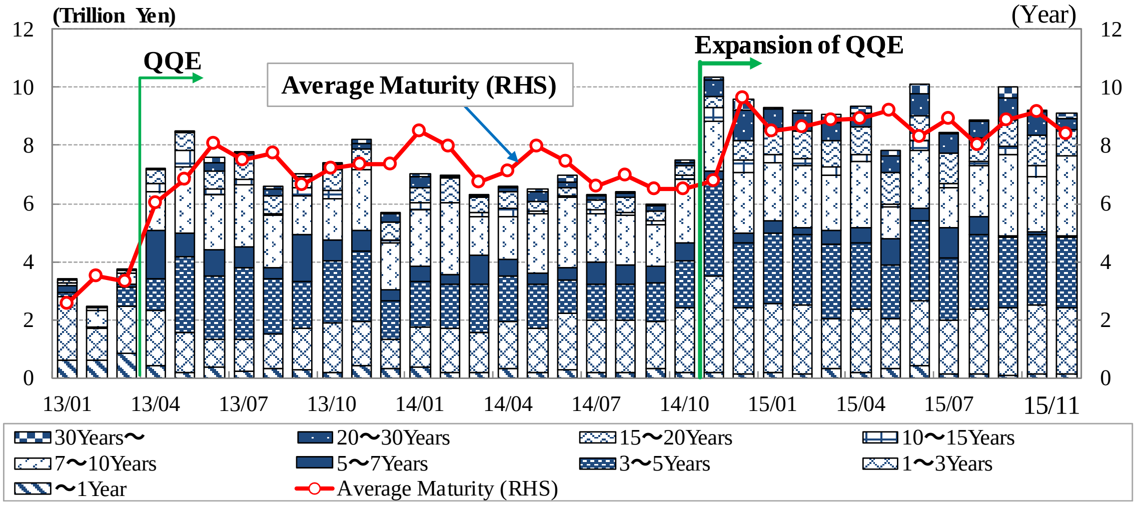
Governor Haruhiko Kuroda said in a press conference held after monetary policy meeting that "These supplementary measures are not a response to downside risks for the economy. They do not themselves constitute additional easing. The move today is aimed at ensuring the smooth implementation of QQE, and to further spread its effect to the real economy". However, the BOJ's massive JGB purchases seemed to have been in a gridlock. Although Gov. Kuroda continuously insisted that the BOJ would dodge an incremental approach i.e. to adopt gradualism, one could argue that the latest supplementary measures were "incremental."

CPI Inflation Falls back to pre-QQE Rates

Due to the drop in crude oil prices that started last summer, Japan's Consumer Price Index (CPI) has been under downward pressure. The core CPI, excluding fresh food, fell 0.1% from the previous the year in August, dipping into negative territory for the first time in 28 months. Year-on-year rates have turned negative for three consecutive months, falling right back to pre-QQE rates. In the Outlook for Economic Activity and Prices ("Outlook Report") released in October 2015, the BOJ pushed back the time frame for achieving its 2% inflation target to the second half of fiscal 2016, through March 2017, rather than the first half. The recent US lifting of the 40-year ban on oil exports could lead to further decline of oil prices.

With the implementation of QQE, the BOJ started buying about 7 trillion yen (US$58 billion) worth of JGBs monthly from the secondary market. Since the expansion of QQE announced in October 2014, it has been purchasing more than 9 trillion yen (US$74 trillion) of JGBs ***(Figure 2)***. Along with this, the volume of JGBs reaching the maturity has been increasing rapidly. In order to achieve its target of annual increment of JGBs, the BOJ will have to make a 10 trillion yen's (US$82 billion) worth purchase in 2016. This may further tighten the balance between supply and demand of JGB market and increase the risk of market liquidity.

Figure 2. BOJ makes monthly JGB Purchases of 9 Trillion Yen



Note 1: The increase in the outstanding amount from the end of the previous month was calculated for each JGB issue and this was taken as the flow of purchases. However, since adjustment for reduction in the outstanding amount as a result of redemption, and buyback/retirement is made, the amount of purchases is on a gross basis.

Note 2: Jan 2013 to March 2013 data includes JGBs purchased through the asset purchase fund.

Source: Author's calculations based on the Bank of Japan's Issue-by-Issue Holdings of JGBs by Amount Outstanding published by the BOJ and Auction Results for JGBs and Buyback Auction Results published by the Ministry of Finance.

Expansion of Eligible Collateral signals QQE Limits?

According to our estimation, when considering the supply and demand of JGBs, there is not much time left for the BOJ. The Bank will be able to purchase 9~10 Trillion Yen's worth (US$74~82 billion) of JGBs for no longer than one and a half years. Since this time limit is not long away from the BOJ's time frame for achieving its 2% inflation target, it may jeopardize financial stability, especially in JGB market. At the press conference on 18 December, Governor Kuroda let slip by saying "I do not think there is a limit to QQE. But some financial institutions have already sold off all the JGBs they can".

When eligible collateral for the BOJ's provision of credit expands, financial institutions' foreign currency-denominated loans on deeds and housing loans portfolio will also be pledged as collateral. This will gear up the BOJ's purchasing of JGBs which were set aside as collateral by financial institutions. The amount outstanding of foreign currency-denominated loans and housing loans held by financial institutions at the end of September 2015 were 10 trillion yen (US$82 billion) and 130 trillion yen (US$1 trillion) respectively. The foreign currency-denominated loans are held mainly by large financial institutions including mega banks, whereas regional banks have been expanding the amount of housing loans in the past several years. The expansion of eligible collateral for the BOJ could facilitate management of collateral for banks.

Qualitative Easing!

In addition to the expansion of eligible collateral, the BOJ extended the average remaining maturity of JGB purchases from about 7-10 years to 7-12 years. Since the expansion of QQE in October 2014, the Bank has been purchasing government bonds with an average remaining maturity of 8.6 years (the line chart of Figure 2), which will further increase from January 2016. This in fact appears to be a measure of qualitative easing. When the maturity of BOJ's assets lengthens, the duration mismatch between assets and liabilities extends. The BOJ, holding long-term JGBs on the asset side of its balance sheet, uses its current account deposits to pay for purchased JGBs. To put it in different way, both the long-term JGBs on the asset side, and the excess reserves[1] on the liability side have been expanding since the introduction of QQE. While receiving interest from holding JGBs, the Bank pays 0.1% interest for those banks maintaining excess reserves[2].

When exiting from the QQE, the BOJ is expected to raise the interest rate on excess reserves. Consequently, the BOJ's interest payments will increase and may squeeze its current account surplus. If the BOJ's surplus declines, this may also lead to increased public burden through the decline in national treasury payments.

Furthermore, in FY2004 (ending March 2005), the BOJ changed the long-term JGB valuation method to the "amortized cost method"[3]. As a result, even if the market value of JGB holdings falls due to a rate rise, there is no valuation loss. However, if the BOJ buys JGBs with the price far exceeding their face values, the amount of amortization may increase, thereby reducing the Bank's interest receipt even before the QQE exit. From January 2016, the BOJ will start buying JGBs with longer remaining maturities, but this may make it more difficult for Japan to maintain fiscal discipline.

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[1] The excess reserve is the bank reserves in excess of a reserve requirement set by a central bank.
[2] Under the supplemental reserve facility, the BOJ pays 0.1% interest on the excess reserves exceeding legal reserve requirements.
[3] Under the amortized cost method, the Bank records the face value of long-term JGBs on the asset side of the balance sheet and amortizes the difference between the acquisition cost and the face value equally every period until maturity.