

Summarizing the Points of BOJ's Theory of Monetary Policy

- There are observations that BOJ has already shifted their theory of Monetary Policy towards achieving its price stability target in a medium-term.
- However, it seems that their basic theory to set the timing of achievement and act upon people's expectations is maintained.
- There is a possibility that a new theory of Monetary Policy may be introduced in future to change the operational targets and the timing of achieving them.

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BOJ decided to maintain their current monetary policy at the Monetary Policy Meeting (MPM) held on 18th and 19th of November, 2015. The market had a unanimous view there would not be any additional monetary easing as only 13 working days had passed since the last MPM held on October 30th. Meanwhile, weaker-than-expected Japanese Jul.-Sep. real GDP growth was not a strong factor to urge BOJ's additional easing, as its main reason was a decrease in inventory and both stock and currency markets remained stable after the GDP figures were released.

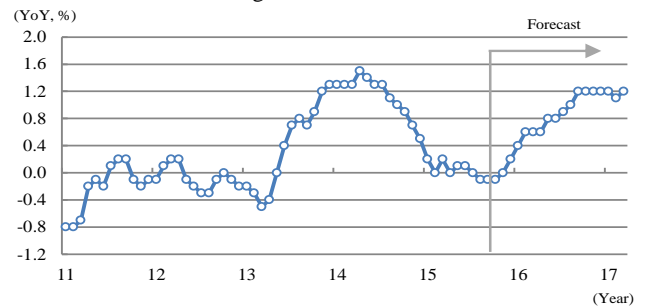
According to the Outlook for Economic Activity and Prices (Outlook Report) released on the same day as MPM, outlook on economic growth and prices were revised down and timing of achieving the price stability target was postponed. Nevertheless, additional easing by BOJ has been left over since the previous MPM. Because of this, there are observations that BOJ has already shifted their theory of Monetary Policy towards achieving the inflation target in a medium-term. Now, I would like to review BOJ's policy theory to think over the future direction of its policy management.

"Diagram 1: The Basic Theoretical Framework of the Reflationists"



(Note) The above diagram is intended to illustrate the basic theoretical framework of the Reflationists, therefore does not cover every detail of the theory.
(Source) SMAM, based on the BOJ and publicly available data

"Diagram 2: CPI Trend"



(Note) Consumer Price Index (CPI) is All Items excluding fresh food. Data period is from January 2011 to September 2015. Figures from April 2014 to April 2015 are adjusted by excluding impact of the consumption tax hike. Figures from October 2015 to March 2017 are SMAM's forecast as of November 16, 2015.
(Source) SMAM, based on Bloomberg L. P. data.

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Basic theoretical framework of the “Reflationists” adopted by BOJ is along the following flow; i) BOJ will act upon expectations in the market by setting an inflation target and making a commitment on ample supply of monetary base, ii) inflationary expectation will rise even in a zero real interest rate environment, iii) the real interest rate will fall and total demand will increase and iv) inflation will rise. BOJ had set a price stability target of 2% and clearly stated that they will accomplish the flow from i) to iv) “in the earliest possible time with around 2 years in mind”.

As you can see, “acting upon expectations” plays an extremely important role in BOJ’s current policy theory. Therefore, BOJ Governor Kuroda himself supports the theory that making a commitment on the specific timing of achieving the inflation target is a strong measure to exit deflation. In other words, what is important for BOJ is to indicate concrete timing and actively implement policy rather than achieving the target on the set date itself. Therefore, even if the timing of achieving the target were to be postponed due to the drop in crude oil price, as long as the flow from i) to iv) continues to work, additional easing is not required and the basic framework of their current theory is considered to be maintained.

There is a possibility that a new theory of Monetary Policy may be introduced in future to change the operational targets and the timing of achieving them.

In Governor Kuroda’s speech on November 6th, he showed his expectations on capex and wage hike by corporations, as corporate earnings are at their record highs and the labor market is at full employment. Since their pace of growths is slow, he expressed his concern that the broad “deflationary mindset” is not yet fully cleared. I can sense the possibility of additional monetary easing from Governor Kuroda’s speech as BOJ aims at not only achieving the price target but also bringing up the economy as a whole, including wage growth, in a balanced way.

Prices are expected to accelerate their growth pace YoY as the low crude oil price factor will diminish (Diagram 2). I think it is wise to take into account the possibility that additional monetary easing will be postponed because of price growth acceleration and BOJ’s stance to wait for the result of spring wage negotiations in year 2016. Thinking about the future outlook of BOJ’s policy management, there is a possibility that they will announce a new theory of monetary policy changing their operational target from monetary base to interest rates and the timing of achievement from “around 2 years” to “medium-term”, as early as next year when price growth stabilizes. Therefore, I

believe that the market's focus on BOJ's monetary policy will become even higher in next year than in this year.

*** Please note that this report is a translation of Japanese report written on November 19th, 2015.**

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