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Mixed and Marginal Messages From the Bank of Japan

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Summary

- In a widely anticipated announcement, the Bank of Japan (BoJ) announced the results of its policy strategy review at today's monetary policy announcement. In the event, the central bank made only modest tweaks to its policy framework, and we see no clear signals that a further policy adjustment is imminent.
- The BoJ modestly widened the tolerance range for its 10-year Japanese government bond yield target to +/- 25 basis points. The BoJ also removed the previous floor for its purchases of exchange-traded funds, and established an interest rate scheme to promote lending that could make it easier for the central bank to lower its already negative policy interest rate.
- We view the changes to the policy framework as balanced, with valid arguments that today's changes could contribute to either more or less monetary easing. The yen is modestly stronger versus the greenback, though we believe that has more to do with a slight decline in U.S. Treasury yields than the changes announced by Japan's central bank.

Bank of Japan Signals a Wider Tolerance Range for Japanese Bond Yields

In perhaps the most closely scrutinized element of today's policy strategy review, the Bank of Japan (BoJ) announced a wider tolerance range for 10-year Japanese government bond (JGB) yields. In terms of the current policy stance, the central bank kept the target for the JGB yields at zero percent. However, the BoJ announced that it would tolerate a range around that zero percent target or +/- 25 basis points, compared to a previous tolerance range of +/- 20 basis points.

Policymakers had offered varied comments on the tolerance band ahead of today's announcement. BoJ Governor Kuroda had previously said there was no need to widen the band at this time, but a deputy central bank governor had said widening the band would be fine as long as monetary easing was not compromised. In the context of Kuroda's prior comments, in particular, one might argue that the widening of the tolerance band could be perceived as a mild surprise. Moreover, by allowing for higher yields the adjustment could also be perceived as a hawkish shift that is yen positive. That is not an argument we subscribe to, however. The fact that the widening of the tolerance range was so modest at just five basis points, in our view, mitigates that influence. In addition, the BoJ announced the introduction of "fixed-rate purchases for consecutive days," which should allow it to more strongly enforce the edges of its tolerance range in response to sharp yield moves. Should U.S. Treasury yields continue to move up, is seems unlikely Japanese bond yields will follow higher in any meaningful manner given only the slight widening of the tolerance range.

Creating Scope for Further Policy Interest Rate Reductions

The BoJ announced an **interest rate scheme to promote lending**, a move designed to allow the central bank to cut interest rates more nimbly should it see such a move as desirable. The scheme lessens the impact on financial institution profitability at the time of rate cuts, by applying incentives to cash balances of those institutions held at the BoJ, corresponding to the amount of funds provided through fund-provisioning measures to promote lending.

These funds provisioning measures had previously been implemented by the central bank to promote lending to the real economy. Thus, to the extent financial institutions have utilized those measures and lent to other areas of the economy, the negative impact on profitability from rate cuts will be mitigated. The applied interest rate on cash balances held at the central bank will be categorized into three groups, depending on the specific nature of funds on-lent to the economy.

Governor Kuroda was careful to emphasize that it is not difficult for the BoJ to cut its negative policy interest rates, and reiterated that the BoJ would not hesitate to lower its negative policy rate if needed. Overall that is a dovish and potentially yen negative signal. However, while the introduction of the interest rate scheme clearly makes it easier to cut interest rates by lessening the side effects on banks' profitability, there was little sense from today's announcement that any such move was imminent. In terms of current policy, the BoJ maintained its policy interest rate at -0.10%.

Adjusting Exchange-Traded Fund Purchases

A third key element of the policy strategy review were adjustments to the Bank of Japan's purchases of equity exchange-traded funds(ETFs). The BoJ said it would maintain its annual cap for ETF purchases at 12 trillion yen and, that although that 12 trillion yen cap was initially a temporary measure in response to the pandemic, it will now be maintained even after COVID subsides. The continuation of the higher annual cap could be perceived as a dovish signal. On the flip side however, the BoJ removed a pledge to buy at least six trillion yen of ETFs annually, thus also opening up scope for lower purchases, potentially a hawkish signal. Finally, the BoJ said that going forward purchases would be for ETFs linked to the broader TOPIX index, rather than those linked to the narrower Nikkei 225 index, where purchases have been linked to date. That technical change is aimed at improving policy traction.

Bottom Line: More of the Same for Monetary Policy, Softer Yen Still Likely

The changes announced at today's policy strategy review were relatively modest overall, though it still represents a significant event. Given the varied changes announced, we see no clear dovish or hawkish signal from the strategy review. Importantly, we also do not perceive any signal that imminent further rate cuts will be forthcoming. Indeed, our view remains that BoJ monetary policy is likely to remain on hold for an extended period and that, with the new tolerance range, Japanese bond yields are likely to edge only gradually higher over time. Given our global scenario involves higher U.S. Treasury yields, and improvement in global growth and market sentiment, we remain comfortable with our outlook for moderate weakness in the Japanese yen versus the U.S. dollar over the medium-term.

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