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# Mizuho Economic Outlook & Analysis

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December 27, 2017

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## *Will the BOJ shift its monetary policy?*

*We need to watch how the Bank of Japan responds when interest rates start rising*

### < Summary >

- ◆ Bank of Japan Governor Haruhiko Kuroda said in the press conference held on December 21 that he sees no need to change the current monetary policy out of concern that the prolonged low interest rates may negatively affect the financial intermediation function. He shrugged off market speculation that the Bank will modify its monetary policy triggered by his reference to the “reversal interest rate” in an earlier speech.
- ◆ The yield curve control policy takes into consideration the financial intermediation function and the life insurance and pension fund management environment. But with the yield curve not steepening enough, there is no change to the difficult fund management conditions for both life insurance companies and pension funds.
- ◆ We hold that the potential impact on the financial intermediation function alone is insufficient to trigger a change in the Bank’s monetary policy. Nonetheless, we should continue to pay attention to the possibility that the Bank may try to steepen the yield curve when interest rates start rising.

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## 1. BOJ Governor Kuroda dismissed speculation that the Bank will modify its policy triggered by his reference to the “reversal interest rate”

Bank of Japan Governor Haruhiko Kuroda remarked in the press conference after the Monetary Policy Meeting on December 21 that “I see no problem emerging in the financial intermediation function. I had no intention to signal that the Bank would need to review or change its current monetary easing policy when I simply referred to an academic analysis of the ‘reversal interest rate,’” ruling out the possibility that the central bank will change its monetary policy out of concern that the current easing may impair the financial intermediation function (**Chart 1**). Governor Kuroda introduced the “reversal interest rate” theory advocated by professor Brunnermeier at Princeton University in his November 13 speech given at the University of Zurich in Switzerland titled “Quantitative and Qualitative Monetary Easing and Economic Theory.” This raised market expectation that the Bank of Japan would modify its policy framework in light of the potential side effects of prolonged low interest rates.

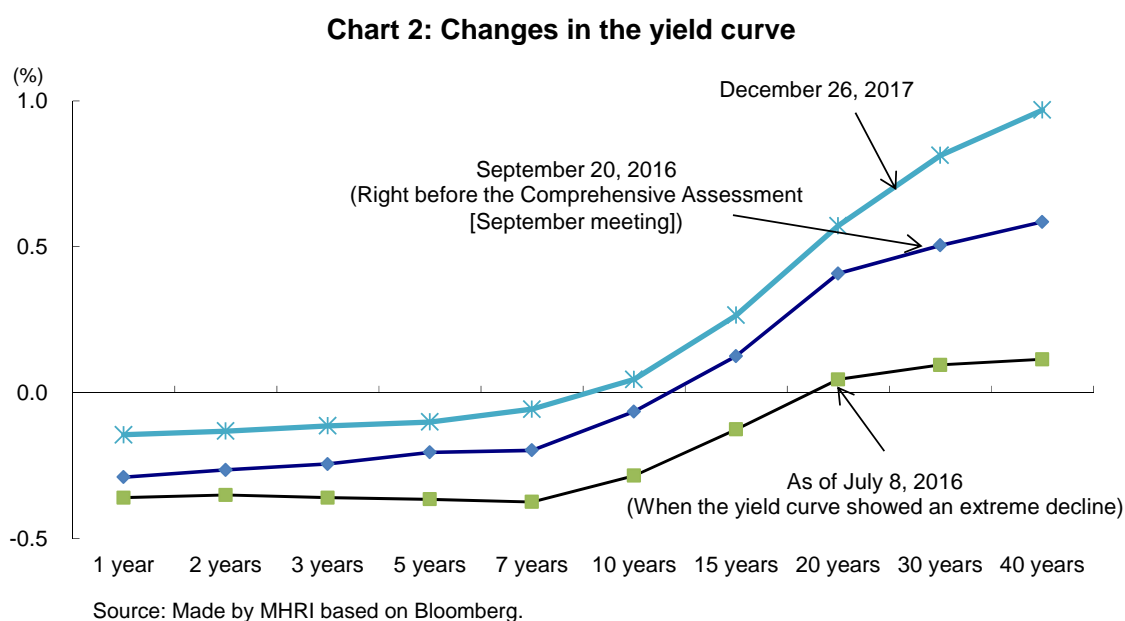
**Chart 1 Summary of Governor Kuroda’s statements (December 21)**

Impact on the financial intermediation function	<ul style="list-style-type: none"> <li>• <u>I see no problem emerging in the financial intermediation function.</u> The lending attitude of financial institutions continues to be aggressive with lending on the rise.</li> <li>• Making reference in a speech to an academic study on the reversal interest rate <u>does not signal that the current monetary easing policy needs to be reviewed or revised.</u></li> </ul>
Long-term interest rate target	<ul style="list-style-type: none"> <li>• The specific interest rate target will be decided in relation to the price target. <u>We will not raise interest rates just because the economy is improving.</u></li> <li>• <u>The current shape of the yield curve is the most appropriate.</u> I believe an appropriate yield curve shape will be clarified further through actual experience.</li> </ul>
Decline in regional banks' profit	<ul style="list-style-type: none"> <li>• As pointed out in the Financial System Report, the number of employees and outlets may possibly be excessive in view of the declining population and businesses in the respective regions.</li> <li>• To perform the financial intermediation function appropriately, regional banks need to differentiate services by leveraging their respective strengths and also enhancing their operating efficiency.</li> </ul>

Source: Made by MHRI based on the Bank of Japan and various media coverage.

The “reversal interest rate” theory refers to the possibility that if a central bank lowers interest rates too far, capital constraints on the banking sector will tighten through a decline in net interest margins, impairing the intermediation function of financial institutions, thus contradicting and reversing the effects of monetary easing on the economy. Although Governor Kuroda said in his lecture that “at present, Japan’s financial intermediation function is not impaired,” market consensus was being formed that the Bank had started preparing for a policy change in view of the lowering of Japan’s financial intermediation mechanism.

It must be added, however, that the Bank of Japan made clear in its comprehensive assessment in September 2016 that it would manage its monetary policy by taking into account not only the economy and prices but also financial conditions. The yield curve policy, which was implemented later on, can be viewed as a policy that considers the potential impact of a loose monetary policy on financial institutions. In its comprehensive assessment, the BOJ examined the most appropriate yield curve to achieve the price stability target, concluding that lower short and middle term yields would have the most favorable impact on the economy. The Bank also explained that excessive lowering or flattening of the yield curve would reduce investment revenues of life insurance firms and pension funds and possibly exert a negative impact on economic activities by dampening the business sentiment. After the introduction of the yield curve control policy, the yield of ultra-long-term bonds has been rising, prompting a steepening of the yield curve (**Chart 2**).

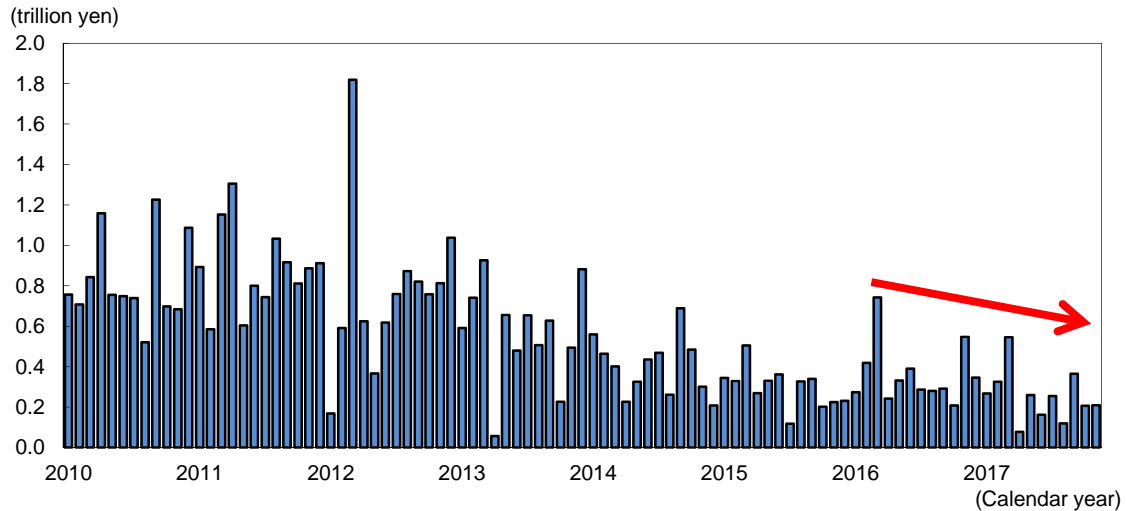


## 2. Life insurance firms do not increase their investment in ultra-long-term bonds

Despite the introduction of the yield curve control policy, we believe the investment environment has remained challenging for life insurance companies and pension funds. Life insurance companies are reluctant to invest in ultra-long-term bonds under the current level of interest rates, and their net purchases of ultra-long-term bonds continue to be low (**Chart 3**). Their investment plans for the latter half of FY2017 suggest they intend to increase their investment in foreign bonds aggressively, and their bond investment return seems to be sluggish due to such factors as the redemption of

high-yield Japanese Government Bonds (JGBs).

**Chart 3: Net purchases of ultra-long-term bonds by life insurance companies**



(\*) Purchase amount - sale amount, ultra-long-term bonds  
 Source: Made by MHRI based on the Japan Securities Dealers' Association.

One of the factors explaining why steepening of the yield curve will not proceed further, from the demand perspective, is the persistently bad investment performance of domestic financial institutions. The loan-deposit ratio of financial institutions is hovering at a low level, and regional banks are increasing their purchases of ultra-long-term bonds to extend their average duration and ensure a steady return. According to the Ministry of Finance, out of all JGB holdings at the end of FY2016, the share of JGBs whose remaining maturity is over 10 years was 5.0% for city banks and 11.7% for regional banks. This figure at the end of FY2012 was 1.6% for city banks and 4.0% for regional banks, showing that holdings of JGBs with longer maturity have risen. Foreign bond investment, which expanded after the introduction of negative interest rates, has stopped growing recently because the procurement cost of US dollars remains high. With the Bank of Japan postponing its target date to achieve the price stability target six times, the market expects monetary loosening to be extended even further, and this is restraining the anticipated rise in interest rates. On the other hand, the supply of JGBs also seems to be a factor in restraining the hike in interest rates. According to the JGB issuance plan for FY2018 announced on December 22, the issuance of 30-year and 40-year JGBs has been reduced. This would be the first reduction in the issuance amount of 40-year JGBs, which has increased each year since their first issuance in 2007. Although the government has been working to make the average redemption period on a flow basis longer, the period is expected to be shortened from 9 years and 2 months in FY2017 to 9

months and 1 month in FY2018.

### **3. We need to be alert to the BOJ's policy response when pressure to hike interest rates heightens**

While the Bank of Japan continues to monitor the impact of prolonged low interest rates on Japan's financial intermediation function, there is little possibility that the Bank will modify its policy framework based solely on its potential impact on the financial intermediation function. As mentioned earlier, the Bank of Japan believes there is no problem emerging in Japan's financial intermediation mechanism for the time being. Furthermore, even if the BOJ raises long-term interest rates in consideration of financial institutions, its effect on pushing up their earnings will likely be limited. The Financial System Report compiled by the BOJ's Financial System and Bank Examination Department in October 2017 points out that the primary factors behind the sluggish revenues of financial institutions are structural problems, such as the nation's declining population and intensifying competition. Such problems cannot be solved by monetary policy alone.

But if the level of interest rates remains unchanged, the revenues of financial institutions will continue to fall, bringing no change to the difficult investment environment currently afflicting life insurance companies and pension funds. Governor Kuroda stated that "the impact of the low interest rate environment on the management of financial institutions is cumulative in nature." With mega banks and regional banks now moving toward raising their exchange and remittance fees, it is highly likely that banks will continue their efforts to secure appropriate income from financial services in the future.

The Bank of Japan is expected to keep its monetary policy steady while watching the development of wage increases in the coming spring wage negotiation. However, if upward pressure on yen interest rates rises on the back of future interest rate hikes in the US, the Bank may be forced to respond by steepening the yield curve. In this case, the Bank is expected to explain that its policy change is the result of the recovering global economy and that the degree of monetary loosening remains unchanged. The Bank's Deputy Governor Hiroshi Nakaso said in the press conference in February 2017 that "in the case where the outlook on the economy and prices has improved, raising the long-term interest rate target in line with such improvements would not automatically decrease the degree of monetary easing." The Bank of Japan seems cautious about the risk of yen appreciation, since raising the target interest rate could be viewed as backing away from its monetary easing policy. But at a time when interest rates in the US and Europe are on an upward trend, thanks to the recovery of the global economy, it is more

likely that the value of the Japanese yen will fall. If the Bank of Japan intends to modify its policy stance, we believe the Bank will reveal its intention in incremental steps through the Governor's speeches. This would allow the market to factor in such policy changes gradually. The most likely scenario is that the Bank will raise the target yield of 10-year JGBs, though the Bank may change this from 10-year to 5-year JGBs to avoid being perceived by the market as an interest rate hike. The Bank may also raise the yield of ultra-long-term JGBs to trigger a steepening of the yield curve.