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# The 'Three inconvenient discontinuities' for Kuroda 2.0 look like becoming a reality

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Mizuho Research Institute issued a report in April 2018 about the prospective issues to be confronted during Governor Kuroda's second term of office at the BOJ (Kuroda 2.0)[1]. The main storyline concerned the 'Three inconvenient discontinuities' for Kuroda 2.0. Whereas Governor Kuroda's first term in office (Kuroda 1.0) enjoyed a good environment fostered by favorable winds, we discussed the disruptions likely to affect the favorable winds at some point during the five years of his second term in office. Our message since last year has been that the first steps towards normalization should be taken during the grace period before the favorable conditions are confronted by headwinds and that there should at least be a shift from ultra-accommodative monetary policy akin to a powerful medicine accompanied by side effects to sustainable measures. **Chart 1** summarizes three areas of discontinuity. First, is the political discontinuity in having to deal with a post-Abenomics era, which will occur even though Prime Minister Abe was elected to a third three-year term in

**[ Chart 1: Discontinuities from 'Kuroda 1.0' to 'Kuroda 2.0' ]**

| | Kuroda 1.0 (March 2013 to April 2018) | Kuroda 2.0 (April 2018 to April 2023) |
|---|---|---|
| Politics | ・At one with Abenomics backed by high approval rating for the ruling party | ・Request for policy action to take account of the prospect of a post-Abenomics era |
| Economic and market environment | ・Favorable wind from the weak yen fostered by the global economic recovery and the US shift to interest rate hikes | ・The US economic recovery has already continued for 115 consecutive months, so it will be difficult for the recovery to continue for another five years. This means there is likely to be exposure to the risk of a strong yen |
| Monetary conditions | ・The contraction of the loan-deposit interest spread exerts downward pressure on financial institutions' income, but credit costs are also down due to the economic recovery. Unrealized profits on bonds have increased with lower yields | ・Deterioration in balance sheet due to protracted low interest rates (2023 problem). Unrealized profits on bonds to decline<br>・Deterioration in the BOJ's balance sheet (2025 problem) |

Source: Made by Mizuho Research Institute Ltd. (MHRI)

[1] MHRI Market Insight (April 10, 2018), *'3 inconvenient discontinuities' and '7 recommendations' for Kuroda 2.0*
https://www.mizuho-ri.co.jp/publication/research/pdf/mi/MI180423.pdf

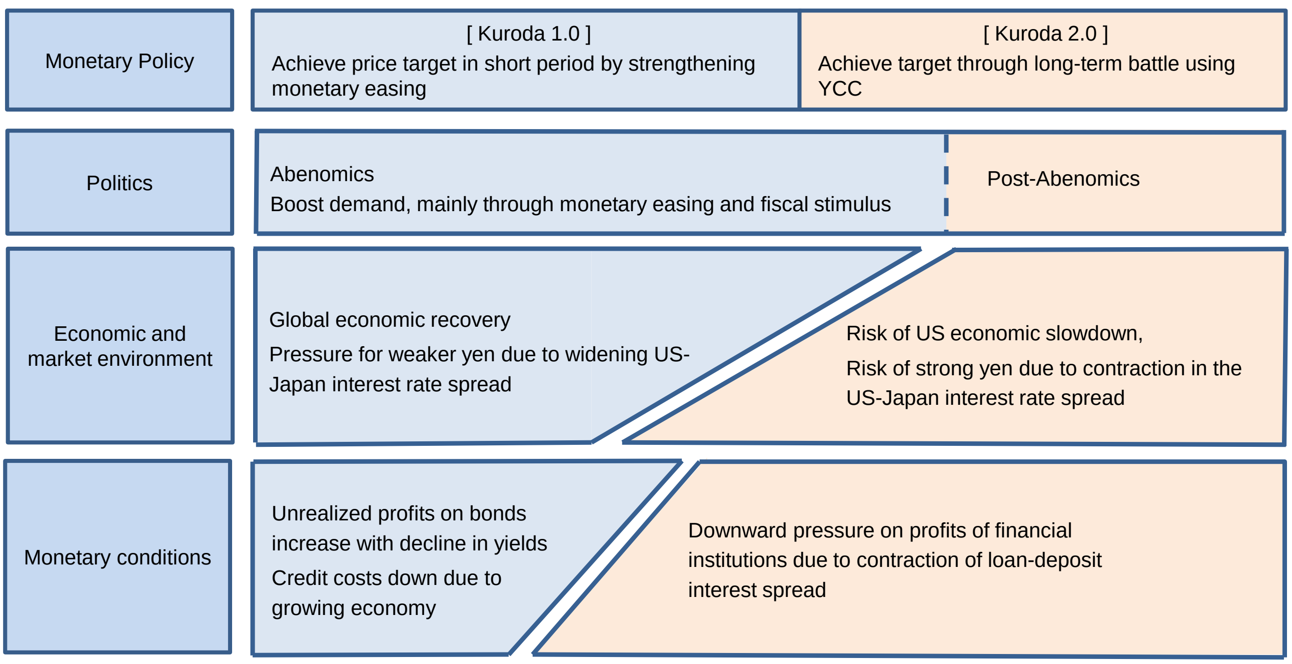
September 2018. Second, is the prospect that the favorable winds that have continued from external environments such as the US could turn into headwinds during the next five years. Third, is the possibility of severe deterioration in the balance sheets of financial institutions, particularly regional financial institutions, during the next five years as a side effect of the ultra-accommodative monetary policy that includes negative interest rates.

Almost one year after Kuroda 2.0 commenced in the spring of 2018 the probability of the aforementioned 'Three discontinuities' has increased. Although the BOJ has indicated a first step towards normalization with the flexibility of Yield Curve Control (YCC) decided at last July's Policy Board meeting, the window of opportunity for further measures is closing due to discontinuities. Moreover, given the sharp appreciation of the yen since the beginning of 2019, there is an undeniable possibility that the BOJ may be forced to introduce additional easing that is completely contrary to normalization. Issues for 2019 will depend on how to respond to the realities of the 'Three discontinuities' that were, from the outset, feared to determine the fate of Kuroda 2.0. In particular, a major change since the end of last year has been in the economic and market environment. The possibility of change in the environment for US rate hikes has led to the realization of the risk of a stronger yen.

**Chart 2** is a diagrammatic representation of the discontinuities that are likely to occur sometime during Kuroda 2.0. In terms of politics, although nothing has yet happened to cause such discontinuity, this change is set to occur by 2023. In terms of the economic and market environment, there is risk of heading into headwinds. In addition, the environment for financial institutions, particularly regional banks is certainly suffering severe conditions.

We proposed 'Seven recommendations' in our April 2018 report. The 'Seven recommendations' are (1) shared acknowledgement by the government and the BOJ, as well as others, that there is a shift from a crisis, where the shock treatment referred to above was used, to normal circumstances; (2) boost the metabolism of the side reforms

**[ Chart 2: Discontinuities for 'Kuroda 1.0' and 'Kuroda 2.0' ]**




Source: Made by MHRI

under the ‘Japanese version of the accord’; (3) foster external consensus for the BOJ to adopt a new economy based on there being ‘normal circumstances’ with a shift in focus from demand side policies to supplyrealistic price target in line with the new state of the global economy as the ‘BOJ version of the OK rule’; (4) suggest a path towards the exit in a ‘BOJ-style roadmap’; (5) escape from the ‘curse of a strong yen’ that has been a constant since World War II; (6) restore the market function given the return to normal circumstances; and (7) avoid experimenting with the use of unlimited fiscal policies through ‘unconventional fiscal policies’ despite the effective loss of scope for monetary policy. These views also apply today as the discontinuities to Kuroda 2.0 are starting to eventuate.

Since the ongoing negative interest rate policy is a powerful medicine, the side-effects on the financial system are large. The use of such powerful medicine is warranted for the period necessary in a crisis where ‘procedures’ take a certain length of time to be effective. However, continuation of such procedures can end up becoming like morphine in the treatment of a terminal situation. Moreover, the risk of headwinds, particularly from the US, during ‘Kuroda 2.0’ and a shift from the favorable weak yen environment towards a strong yen is coming to fruition. We once again expect there will be calls for additional monetary easing to counter the excessive reaction to a strong yen. This has occurred repeatedly during close on half a century since the 1970s. An issue for 2019 is how to draw a line under monetary policy based on the ‘curse of a strong yen’. Since monetary policy has already been tested to its limits, there are concerns that there will be experimentation by next testing fiscal policy to its limits. In fact, there was discussion about expanding unconventional fiscal policies in 2016 such as helicopter-type fiscal stimulus and the Fiscal Theory of the Price Level (FTPL). A certain degree of discipline in fiscal policy is required to avoid such extreme policies. The likely policy mix under a post-Abenomics regime is currently unclear. However, the BOJ will require high level political strength under ‘Kuroda 2.0’ to obtain the consensus for an all-out-war that is focused on a growth strategy and a reduction in the excessive reliance on monetary policy. We have reached a period for patience with four years remaining for Kuroda 2.0.