

Q&A

April 2006

Tomoya Masanao Discusses the End of Quantitative Easing in Japan



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Mr. Masanao is an Executive Vice President, portfolio manager, and a member of PIMCO's international team. He joined PIMCO in 2001, previously having been associated with Goldman Sachs Asset Management in London. He held the position of executive director/global fixed income and currency management, where he was a senior portfolio manager responsible for Japanese strategies. Prior to that, he was associated with Sumitomo Bank as a proprietary trader in London and a credit analyst in Osaka. Mr. Masanao has fifteen years of investment experience, and holds a bachelor's degree and a master's degree in engineering from Osaka University and an MBA from Boston University.

In March 2001, the Bank of Japan (BoJ) began an historic new monetary policy known as "quantitative easing" in an effort to revive Japan's economy and end the deflationary decline in consumer prices. Five years later, on March 9, the BoJ ended the quantitative easing policy, satisfied that the Japanese economy was on the path to stable, reflationary growth. In the interview below, Tomoya Masanao, PIMCO's head of portfolio management in Tokyo, discusses why the BoJ ended quantitative easing and what he expects for the future.

Q: What did the Bank of Japan's "quantitative easing" policy entail?

Masanao: In setting monetary policy, central banks normally target a specific short-term interest rate, such as the Fed funds rate in the U.S or the uncollateralized overnight call rate in Japan. The central bank sets a target level for the interest rate and then controls it on a daily basis, injecting money into the financial system or withdrawing money from the system as needed to keep the interest rate at the targeted level.

Under quantitative easing, the BoJ stopped targeting the level of the overnight call rate, which had already been lowered to zero in an effort to end deflation and stimulate the Japanese economy. Instead, the BoJ set the level of its current account as the operating target and raised the target level of its current account to \$250 to \$300 billion, which was far in excess of the roughly \$40 billion level needed when the operating target was the overnight call rate at zero percent.

Operationally, the quantitative easing policy required the BoJ to purchase trillions of yen of financial securities, including about \$120 billion per year of Japanese government bonds in an operation known as "Rinban." The BoJ also purchased asset-backed securities and equities, and extended the terms of its commercial bill purchasing operation up to 12 months. The combined effect of these operations was to effectively flood the Japanese financial system with excess liquidity.

The BoJ also explicitly pre-committed to maintain the quantitative easing regime at least until year-on-year changes in the consumer price index excluding fresh foods (the core CPI) became positive in a stable manner. With quantitative easing tied to the core CPI, the BoJ's explicit commitment to its policy regime was much stronger than the

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Fed's commitment to maintain easy monetary policy for a "considerable period" or its commitment to being "patient" in raising rates.

Q: Why did the BoJ decide at the March 8-9 meeting to end the quantitative easing policy?

Masanao: Quantitative easing worked; the Japanese economy is recovering and core consumer prices are rising. Before the BoJ's March meeting, the year-on-year change in Japan's core CPI had been positive for three consecutive months, and the core CPI has now increased for four consecutive months. Most importantly, BoJ policymakers expect a sustained recovery and continued increases in core consumer prices, fulfilling the conditions laid out in the commitment to maintain quantitative easing.

Q: How did the quantitative easing policy help to revive Japan's economy?

Masanao: The BoJ's pre-commitment to quantitative easing was an important element of the policy's success. The market was able to expect that the BoJ's zero interest rate policy would continue for months or even years by just looking at core CPI prints, allowing not only money market rates but also two-year and even longer rates to stay close to zero. The effect of the BoJ's pre-commitment strategy was also evident in stabilizing the banking system and tightening credit market spreads in general. The availability of term financing at a level close to overnight financing rates enhanced borrowers' credit. In other words, the quantitative easing policy made easy money available for many borrowers in Japan.

Excess liquidity in the financial system was another key element of the quantitative easing policy. The BoJ officially downplays the role of excess liquidity, concluding that excess liquidity only helped to stabilize the banking system and did not stimulate the economy. I doubt this conclusion.

It is true that bank lending did not improve until recently despite the excess liquidity provided by the BoJ. But bank lending did finally improve. It just took a long time for excess liquidity to work because the banking system was weak and the corporate sector was busy cleaning up its balance sheet. The BoJ just needed to wait for the banking sector to become healthier before the liquidity started to work.

I also believe that assets that the BoJ purchased in large size, i.e., money market instruments and JGBs, benefited by reducing their risk premium. Simply put, when the central bank becomes a large buyer of specific assets as a non-economic agent, supply of those assets to the private sector is smaller than it otherwise would be.

Altogether, the recovery in the banking system, the sustained low rates and the reduction in risk premiums have led to rising business activity and investment. In turn, the expansion in the corporate sector is driving real wages higher, supporting the consumer sector. External demand from the U.S. and China also aided Japan's recovery, but the BoJ's quantitative easing policy played a large role in helping to stimulate internal demand.

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Q: What do you expect from the BoJ now that the central bank has ended quantitative easing?

Masanao: With the end of quantitative easing, the BoJ's policy framework will be less transparent but more flexible. The BoJ shifted gears back to targeting the overnight call rate and will need to substantially reduce excess liquidity in its current account to around \$40 billion before starting to hike policy rates from the current zero percent. The outright purchase of Japanese government bonds under the Rinban program will also have to be scaled back at some stage in the future.

Future policy decisions will now be based on two perspectives the BoJ recently outlined. The first perspective is the outlook for prices and economic activity one to two years into the future, with an "understanding" that medium- to long-term price stability means an inflation rate of 0% to 2%. The second perspective is an examination of longer-term risks that are most relevant to monetary policy aimed at generating sustainable growth with price stability.

This two-perspective framework is both good news and bad news. The good news is that the new framework will give the BoJ flexibility in monetary policy that is based on an "understanding," not a "target," of price stability, while still ensuring some degree of transparency. The bad news is that the BoJ may end up tightening monetary policy too early, and by too much, under the new framework.

Q: Why do you worry the BoJ might tighten too much and too soon?

Masanao: I have three concerns. First, I think the 0% to 2% range for the inflation rate is too low. The lower the level of price stability is, the faster the BoJ is likely to hike rates to prevent inflation risks.

Second, when addressing a forward-looking approach, the BoJ already seems too concerned about an asset price bubble at this stage. Right after the end of quantitative easing, the BoJ released a document titled, "The Bank's Thinking on Price Stability," that explained the lagged effect monetary policy has on general prices and detailed the Bank's own experience during Japan's asset price bubble in the late 1980s. I think this illustrates that the asset bubble that arose during the 1980s and then popped, leading to the long period of stagnation in Japan's economy, remains a traumatic experience for the BoJ. It is true that land prices have already seen double-digit growth in primary areas of the large cities in Japan. But I think it is way too early to worry about an asset price bubble and its future negative impact on the real economy.

And third, the BoJ does not believe that its outright purchase of Japanese government bonds under the Rinban operation had an impact in reducing risk premiums in long-term bonds, which suggests that the Rinban operation may be scaled back sooner than later. I worry that the BoJ might be overconfident in downplaying the role of the Rinban. The Japanese government bond market, unfortunately, is much too spoiled to properly function without the BoJ's kindness as the "buyer of last resort."

But I still trust that the BoJ took as the most significant lesson of the last decade that the risk for the central banks is extremely asymmetric when the economy is only at mild

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inflation or disinflation. More than any other central bank, the BoJ understands the lack of policy tools that are immediately effective when the economy slips into deflation. Japan's economy is no doubt recovering. But it is only just emerging from deflation. Let's not forget it.

Q: Thank you, Tomoya, we look forward to speaking with you again as the BoJ's new policy regime develops.

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