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TRENDMACRO LIVE!

On the April BOJ Policy Meeting

Thursday, April 4, 2013

Donald Luskin

A proud central bank sacrifices its independence for the sake of reflation and growth.

Today the Bank of Japan's Policy Board under the new leadership of Governor Haruhiko Kuroda announced a sweeping new program of "quantitative and qualitative monetary easing." There was one dissent among the board's nine members.

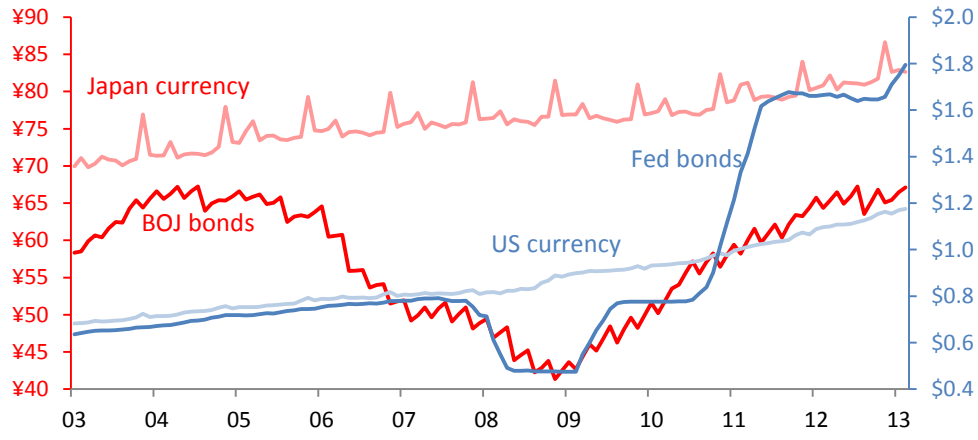
- The BOJ committed to achieving its 2% inflation target in two years.
- It will double the monetary base, and double the amount and maturity of Japan Government Bonds it holds.

This is very much what we expected from Kuroda (see "On Kuroda and Iwata at the BOJ" February 25, 2013), as this policy revolution has enjoyed the explicit support of popular new Prime Minister Shinzō Abe. It comes after weeks of intense and relentless skepticism that such policies would be undertaken promptly -- if at all -- by the stodgy BOJ, and that they could possibly work in a nation mired in mild deflation for 15 years.

- Doubt that the BOJ would undertake this revolution was a political judgment -- proven wrong today. Doubt that it can reverse Japan's deflation is an economic judgment -- one that fails to appreciate how bad BOJ policy has been for years, and thus underestimates

Currency in circulation versus central bank government bond holdings

Japan **US** Local currency, trillions



Source: BOJ, Federal Reserve, TrendMacro calculations

Update to strategic view

BOJ, ASIA MACRO, ASIA STOCKS, FX: The Bank of Japan under new Governor Kuroda announced aggressive "quantitative and qualitative monetary easing," overturning intense skepticism that it could act quickly or at all. The BOJ commits to reach its 2% inflation target in two years, and will double the amount and maturity of its government bond holdings. In a significant symbolic gesture of setting aside its independence, it waived its longstanding rule that JGB holdings cannot exceed currency outstanding. As long as Prime Minister Abe continues to support these policies in the face of diplomatic pressure, the BOJ will succeed in reversing 15 years of deflation and currency strengthening. We continue to expect a turnaround in Japanese growth, continued strong performance by Japanese stocks, and continued yen weakness.

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the power of changing course in the direction of goodness.

- While central banks throughout the developed world rapidly and massively expanded their balance sheets by various means in the aftermath of the Great Recession, the BOJ's government bond holdings grew only glacially. Today their quantity is actually smaller than at the peak of the prior business cycle expansion (please see the chart on the previous page).
- The plan announced today to double these holdings will cause them to exceed the value of currency outstanding (again, please see the chart on the previous page).
- Until the aftermath of the Great Recession, central banks throughout the developed world have constrained their bond holdings to that limit, formally or informally. That rule been seen as an important symbol of central bank independence -- that they would not "monetize debt" by buying government bonds in excess of the natural demand for money.
- The BOJ explicitly set aside that rule today -- following the specific advice given a decade ago by Ben Bernanke. Given that there is a great deal of room between the current level of BOJ bond holdings and the level of currency outstanding -- which is itself rising over time -- we take it as an important token of the BOJ's serious and durable commitment to its new policies that it would make the seemingly unnecessary gesture of waiving this rule.
- Having freed itself from such self-imposed institutional shackles, there is no reason why the BOJ can't succeed at reversing Japan's deflation. Inflation -- and deflation -- is "everywhere and always a monetary phenomenon." If the BOJ perseveres in policies such as those announced today, it will prevail.

We think the BOJ's commitment to reflation is real and durable. For the near term -- until it can become embedded in the institutional identity of the BOJ itself -- it will depend on continued nurturing by Abe. Because it is part of Abe's mission to weaken the yen -- or, more in context, to reverse a decade of strengthening -- it fits into a larger political strategy for restoring Japan's regional competitiveness. Abe will come under intense diplomatic pressure to back off -- but we don't think this militant and nationalist prime minister will do so.

Bottom line

The Bank of Japan under new Governor Kuroda announced aggressive "quantitative and qualitative monetary easing," overturning intense skepticism that it could act quickly or at all. The BOJ commits to reach its 2% inflation target in two years, and will double the amount and maturity of its government bond holdings. In a significant symbolic gesture of setting aside its independence, it waived its longstanding rule that JGB holdings cannot exceed currency outstanding. As long as Prime Minister Abe continues to support these policies in the face of diplomatic pressure, the BOJ will succeed in reversing 15 years of deflation and currency strengthening. We continue to expect a turnaround in Japanese growth, continued strong performance by Japanese stocks, and continued yen weakness.

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