

JAPAN UPDATE

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QUANTITATIVE EASING MAY BE OUT OF FASHION IN THE UNITED STATES, BUT IT IS STILL BIG IN JAPAN – AND GETTING BIGGER

The Bank of Japan added to stimulus in July by doubling its purchases of stocks

The BoJ is likely to increase stimulus again in September after the government announces its fiscal stimulus plan

Quantitative easing is still in fashion in Japan. The Bank of Japan (BoJ) intensified its monetary stimulus program at the conclusion of its July 28-29 Policy Board meeting, nearly doubling purchases of stock funds to a ¥6 trillion yen annual rate from ¥3.3 trillion prior to the meeting (of which ¥3 trillion had been net new purchases and ¥0.3 trillion were operations to roll over the BoJ’s legacy holdings of stocks). The BoJ also increased the size of a US dollar loan support program to \$24 billion US dollars from \$12 billion dollars previously, a mostly symbolic change to a relatively small program. Other components of the BoJ’s unconventional monetary easing program were unchanged in July. They held their negative policy rate unchanged at -0.10 percent, where it has stood since they introduced the negative rate in January 2016, and continue to buy Japanese government bonds (JGBs) at an ¥80 trillion yen annual rate and Japanese real estate investment trusts at a ¥90 billion (¥0.09 trillion) annual rate. July’s expansion of monetary stimulus fell short of expectations for both an increase in asset purchases and a reduction in the policy rate, but the BoJ’s monetary stance is still expansionary to an extent that would have been unthinkable a decade ago. The BoJ has purchased more than a third of all outstanding central government debt, and 2 percent of all Japanese stocks (See Chart 1)! In addition, the BoJ in July opened a door to further increases in stimulus at their September 20-21 meeting, when they will conduct a “comprehensive assessment” of the outlook for economic activity, inflation, and their mix of unconventional monetary policy tools. This delay until September provides the BoJ time to coordinate with the Japanese government’s impending fiscal stimulus announcement. Prime Minister Shinzo Abe informally stated in late July that the government would soon formally announce a ¥28 trillion yen (\$270 billion US) stimulus package, but the details were not final when the BoJ met in July. PM Abe already announced in June that the government would delay a value-added tax hike to October 2019 rather than raise the VAT from 8 percent to 10 percent in April 2017 as

CHART 1: THE BANK OF JAPAN'S MONETARY STANCE WOULD HAVE SEEMED UNTHINKABLY AGGRESSIVE A DECADE AGO

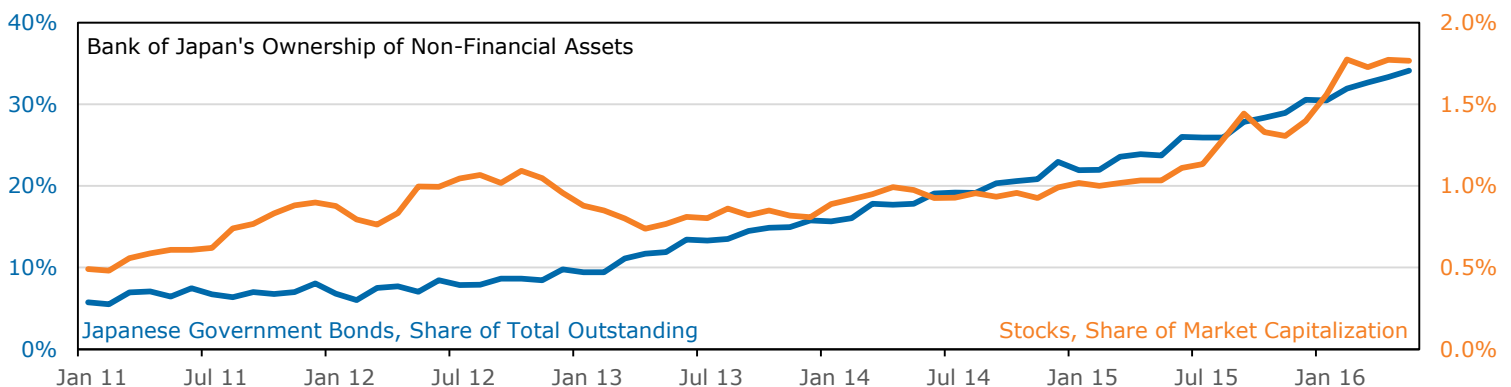


Chart sources: Bank of Japan, Japan Exchange Group, CEIC, The PNC Financial Services Group



PM Abe has announced a ¥28 trillion yen “sticker price” for the stimulus plan, but the devil is in the details

scheduled. The prior increase in the value-added tax from 5 percent to 8 percent in April 2014 triggered a recession. Because Japanese fiscal stimulus announcements routinely double-count previously scheduled spending, include spending spread out over many years, and include spending financed by new taxes (which does not add to aggregate demand), the BoJ will need to see the details of the government’s plan before deciding how much additional monetary stimulus is appropriate. ¥28 trillion yen in new deficit-financed spending during calendar-year 2017 would boost final demand much more than a more typical Japanese stimulus program with a ¥28 trillion yen “sticker price,” but only ¥7 trillion in new spending, funded 50-50 by tax hikes and borrowing. Expansionary policies should help real GDP growth pick up to a 0.5 percent annualized rate in the second half of 2016 and in 2017 after a year of stagnation. Real GDP alternated between growth and contraction for four straight quarters through the first quarter in 2016, leaving real GDP a scant 0.1 percent above its year-ago level. Export-oriented manufacturers have seen headwinds from slow growth in China and other emerging markets, and smaller spring base pay increases for salaried employees in 2016 than in 2015 are holding back domestic demand. Finances of retirees (a quarter of the population is over 65) are under pressure from extremely low yields on retirement assets, falling stock prices, and rising consumer prices which erode their real spending power. These headwinds explain why Japanese income growth is not accelerating, despite a historically tight labor market (See Chart 2). The unemployment rate is at its lowest since 1997, and the number of job openings relative to the number of active job seekers is the highest since 1991.

The BoJ’s “bazooka in a knife fight” monetary stance will likely cause the yen to depreciate in the second half of 2016 and in 2017

Weak wage growth, the 17 percent appreciation of the yen against the dollar in the first half of 2016 (Which lowers yen-denominated prices of foreign food and other imports), and low oil prices are holding Japanese headline inflation near zero and core inflation near 1 percent, well below the BoJ’s 2 percent target. Given the persistent headwinds to achieving its inflation target, the BoJ is likely to further intensify monetary stimulus in September, either by lowering the negative policy rate 0.1 percentage points to -0.2 percent, further increasing asset purchases, or by explicitly funding fiscal spending at negative interest rates. This incredibly aggressive stimulus program is likely to keep Japanese short-term and long-term interest rates negative, restraining increases in long-term US interest rates. While the yen appreciated a large 3 percent to ¥102 per dollar in the day after the underwhelming July BoJ decision, markets may be underestimating the BoJ’s resolve to buy every asset in Japan, if necessary, to achieve its inflation target. Their “bazooka in a knife fight” strategy will likely cause the yen to eventually trend weaker: PNC Economics forecasts for it to reach ¥105 per dollar by year-end 2016 and ¥110 by year-end 2017.

CHART 2: JAPAN'S LABOR MARKET IS ITS STRONGEST IN TWO DECADES, BUT HAS YET TO FUEL STRONGER INFLATION

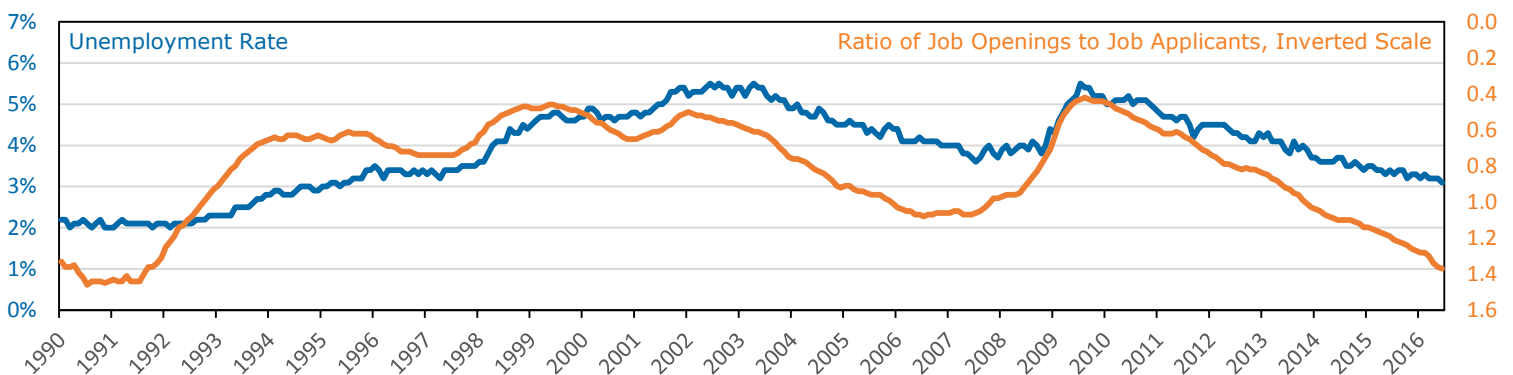


Chart sources: Japan Statistical Bureau, Ministry of Health, Labor and Welfare, CEIC, The PNC Financial Services Group

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