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IB Economics – Commentary Cover Sheet

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BOJ starts policy meeting as weak inflation fuels easing expectations

KYODO, REUTERS OCT 30, 2019

The Bank of Japan began a two-day *policy* meeting Wednesday, with market participants expecting the central bank to cut its *inflation forecasts*, a move that would raise pressure for it to take additional steps to stimulate the economy.

The BOJ will study the possibility of further *monetary easing*. But some within the central bank believe it can hold its fire amid signs of *moderate growth* in the nation despite a *consumption tax hike* earlier this month and a slowdown in the world economy amid the fallout from the prolonged U.S.-China *trade conflict*.

The BOJ Policy Board will make a decision around noon Thursday, hours after the U.S. Federal Reserve announces its own on Wednesday. U.S. central bankers have so far kept the door open for a third *interest rate cut* this year.

A Fed *rate cut* could trigger a spike in the yen against the dollar, an undesirable development for the BOJ that could force it to follow suit in order to offset the potential impact on the *currency market*, where *interest rate gaps* between the U.S. and Japanese economies are one of the main focuses for traders.

The BOJ faced a similar situation in September but left its *policy* unchanged despite a rate cut by the Fed, pushing the yen slightly higher against the dollar. A stronger yen erodes overseas *profits* for Japanese firms when *repatriated*.

BOJ Gov. Haruhiko Kuroda has reiterated since the September meeting that he will not hesitate to employ further *stimulus measures* if momentum toward the central bank's **2 percent** *inflation goal* is lost. The BOJ will re-examine *economic and price developments* at this week's meeting. The BOJ is widely expected to lower its *inflation forecast* for fiscal 2019 ending March from **1.0 percent** projected in July. It has failed for years to hit the **2 percent** goal despite *aggressive monetary easing*, including *negative interest rates*.

The country's core consumer price index grew just **0.3 percent** in September, the weakest rise since April 2017, fueling the view that the BOJ is running short of *policy tools* to achieve its *inflation goal*.

"Companies aren't translating the *tax hike* impact onto consumers as much as expected," said Mari Iwashita, chief market economist at Daiwa Securities.

"The BOJ is likely to trim its *inflation forecast* at its quarterly report for October," she said, adding that the *nationwide core CPI* is likely to hit **0.5 percent** in October.

Japan's government proceeded with a twice-delayed increase in the *sales tax rate* to **10 percent** from **8 percent** in October as part of efforts to rein in the country's huge *public debt*.

Kuroda has denied such speculation, saying in recent interviews that *cutting interest rates* further into negative territory is among the *policy options* at the central bank's disposal. The BOJ currently keeps *short-term interest rates* at minus **0.1 percent** while guiding *long-term rates* around **zero percent**.

The *negative rate policy*, however, has already been criticized for squeezing the *profitability* of commercial banks. Many economists believe the BOJ would have to introduce some measures to alleviate the pressure on their *lending margins*.

"We expect the BOJ to cut *short-term interest rates* and express its strengthened commitment (to keep *rates* at ultralow levels)," analysts at Mitsubishi UFJ Morgan Stanley Securities Co. said in a recent report.

Legend		
Stake Holders	*Economic Concepts*	**Numbers/Data**

This article is about the monetary policies the Bank of Japan is implementing in order to stimulate growth in the Japanese economy. This task was made harder by the government's recent increase in the consumption tax, which negatively impacted the aggregate demand (AD) of Japan's economy. In order to stimulate economic output and maintain efforts to achieve 2% annual inflation, the BOJ is considering whether to ease monetary policy even further.

In early October the Japanese Government enacted a "consumption tax hike" in order to combat "rising public debt." The tax on all goods increased from 8% to 10%. By making goods more expensive to buy, this increase is expected to reduce both private consumption (C) and private Investment (I):

↑**Consumption Tax** → ↓**Consumption** (C) + ↓**Investment** (I)

Since consumption (C) and investment (I) are components of the aggregate demand (AD), in the absence of any changes in Government spending (G) or Net Exports (NX) we expect aggregate demand to decrease:

↓**Consumption** (C) + ↓**Investment** (I) + **G** + **NX** → ↓**Aggregate Demand** (AD)

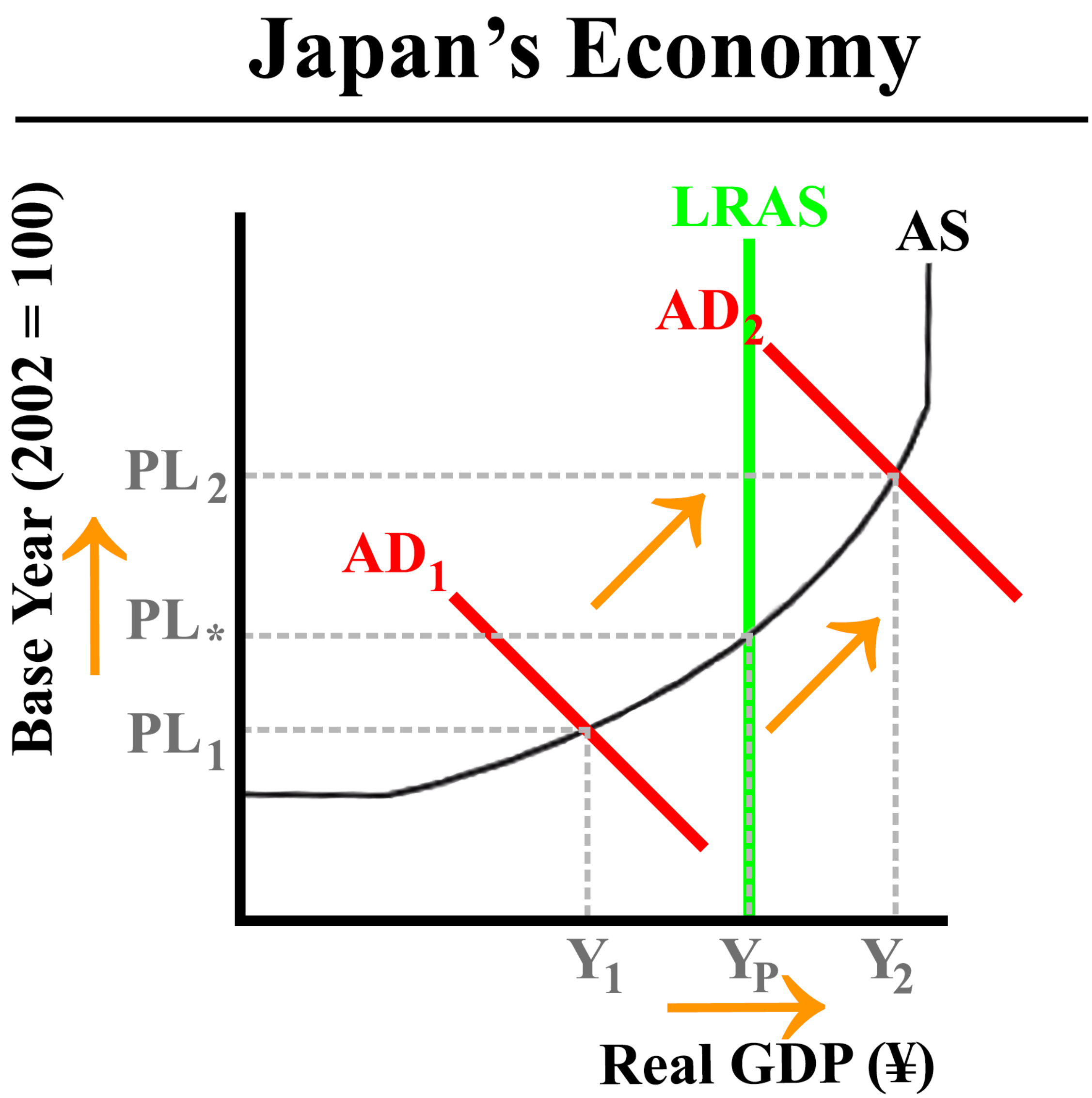
This can be seen on the graph on the next page, AD is lower than at potential (AD_1<LRAS) and this results in a lower price level (PL_1<PL_*) and a lower level of output (Y_1< Y_*). To offset this and reach its target of "2% annual inflation rate", the BOJ decides to "decrease interest rates" (i) which stimulates both private consumption (C) and investment (I):

↓**Interest Rates** (i) → ↑**Consumption** (C) + ↑**Investment** (I)

This will lead to an increase in aggregate demand (AD):

↑ **Consumption** (C) + ↑ **Investment** (I) + **G** + **NX** → ↑ **Aggregate Demand** (AD)

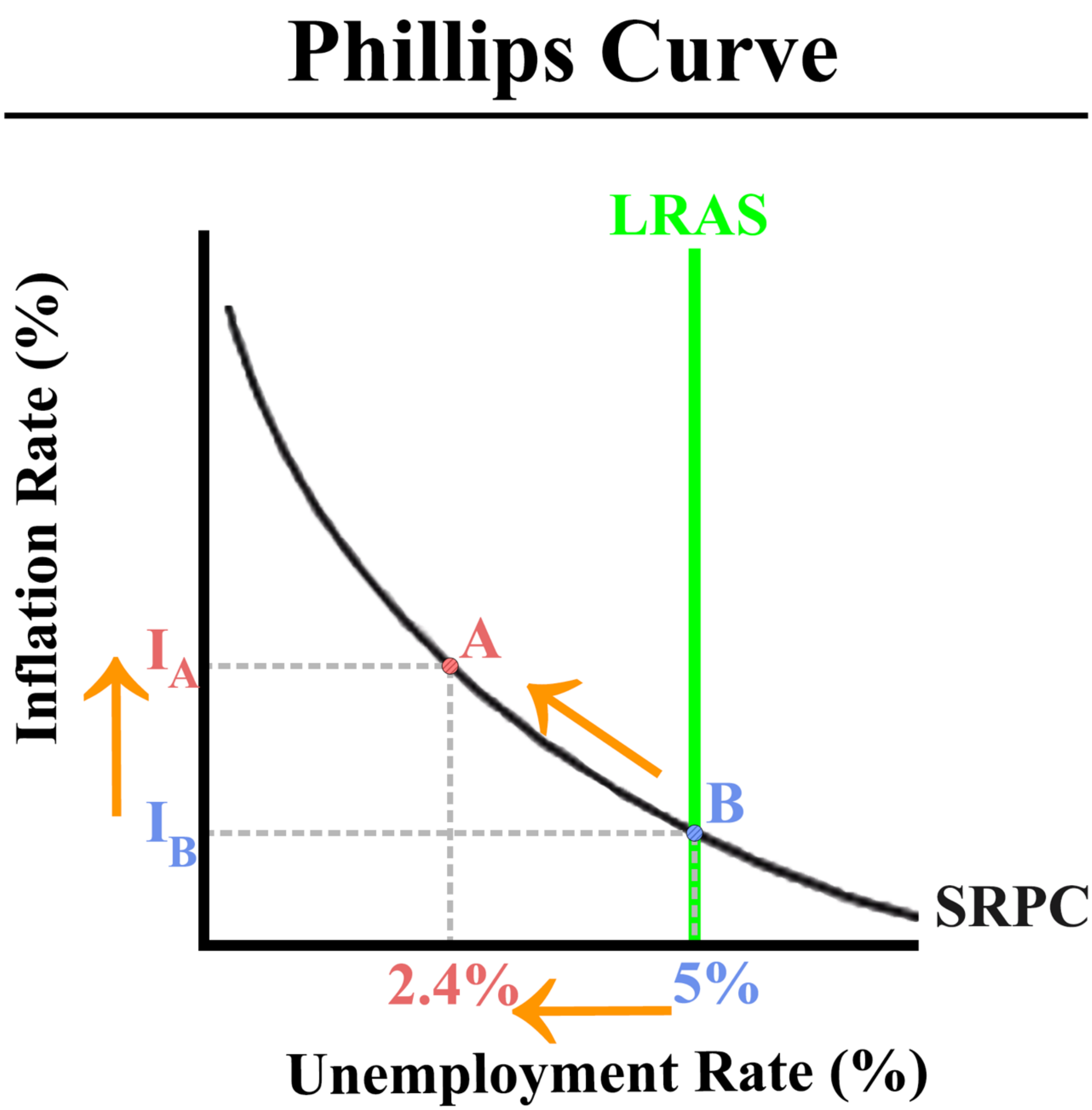
This rightward shift in AD (AD_1→AD_2) causes the price level and thus inflation rate to increase (PL_1→PL_2) and generates a higher level of output (Y_1→Y_2) that is also known as an inflationary gap. The orange arrows show this shift.



Thus, the expectation is that this policy response by the BOJ will counteract the impact of the consumption tax and preserve economic growth and the achievement of their "inflationary goals".

Japan has gradually been reducing interest rates since 2011 with the goal of encouraging the banks to lend out more. This GDP injection spurs consumption and investment for the consumer and supplier stake holders. This policy also has the added value of having a very low opportunity cost for the Japanese government as, unlike fiscal policy, the government would not need to increase its spending and cause a rise in public debt.

There are indicators that this policy is working as Japan's unemployment has decreased steadily from 5%[1] to its present-day value of 2.4%[2].



If we assume that the Phillip's curve relationship is correct, this reduction in unemployment (5%→2.4%) is indicative of "moderate growth in the economy". As well, the increase in inflation rate ($I_a \rightarrow I_B$) that we should expect from this relationship might not be occurring yet due to time lags.

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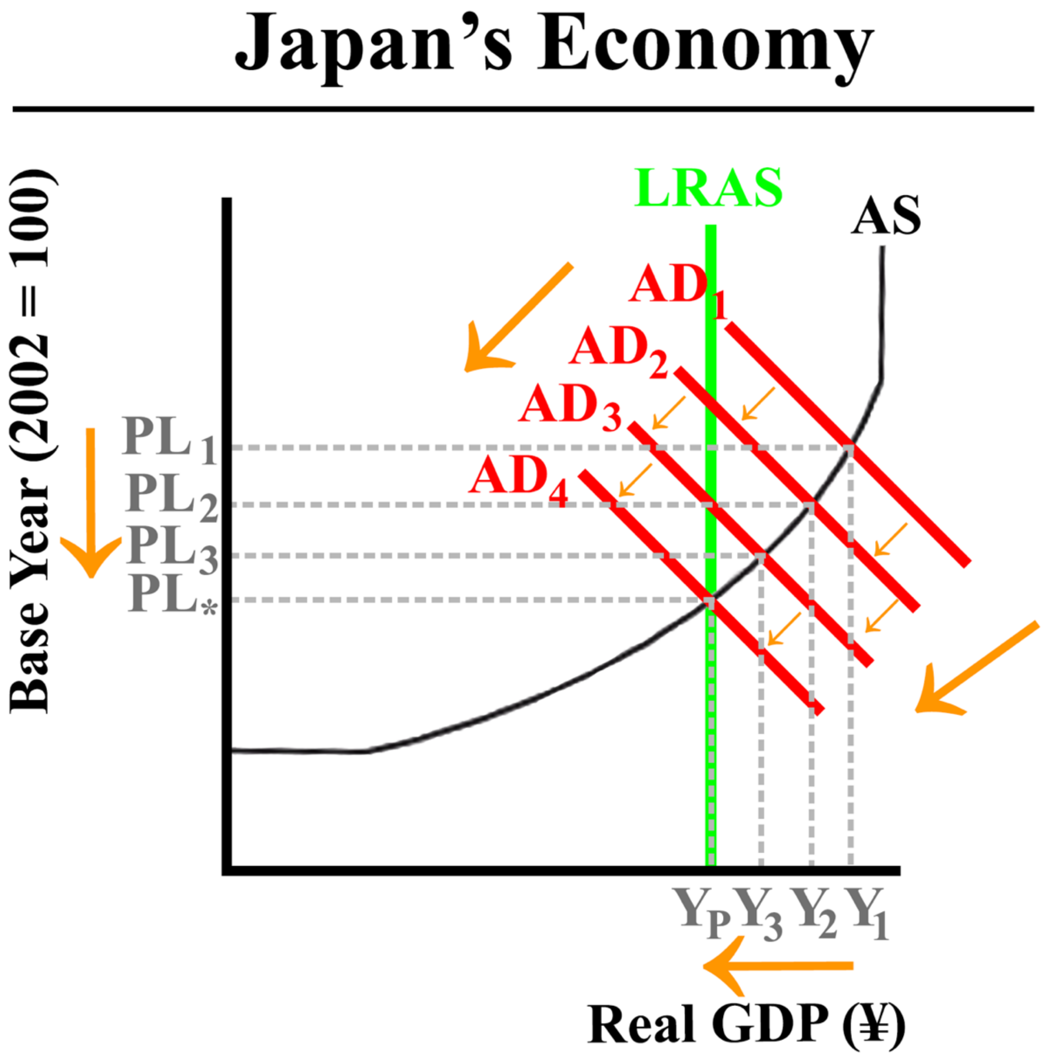
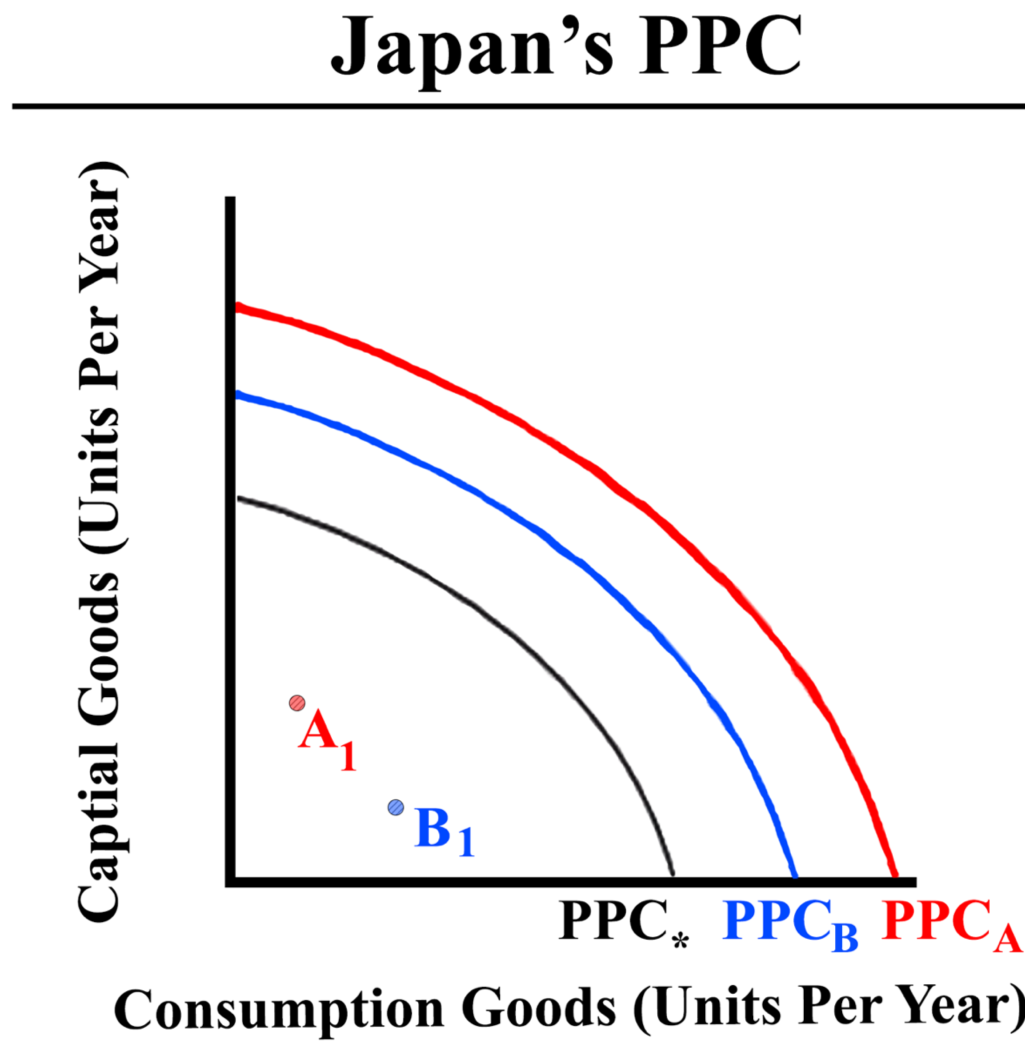
[1] https://tradingeconomics.com/japan/unemployment-rate
[2] https://tradingeconomics.com/japan/unemployment-rate

However, a key disadvantage of this policy is that it is short term. While decreasing interest rates offer a temporary increase in consumption and investment, consumer confidence reduces over time as consumers get used to the new level of interest rate. Will thus, AD will also return to equilibrium (AD_1→…→AD_4). Inflation (PL_1→… →PL) and Real GDP (Y_1→Y_P) would follow.



Monetary policy has no impact on the quality and quantity of FOPs which means no shift in the LRAS in the long term. Investing in capital can be seen as choosing to produce at point A_1 rather than point B_1. In the long run this would result in more growth that would allow them to reach their economic output and "inflation" goals.



A big danger of low interest rates is that it might cause banks to go insolvent. The article brings this up and explains how bankers are urging the BOJ “to alleviate pressure on the their (banks’) lending margins”. If the banks make risky loans, it could lead to a negative spiral of loan defaults that might require government bail-outs, which would further increase the public debt.

In conclusion, expansionary monetary policy is not a long-term solution in and of itself. I believe that expansionary monetary in the short term can be used to offset the impact of the recent consumption tax. The proceeds of this consumption tax should be used for government subsidies in the field of technology. These investments in technology would shift LRAS in the long term, while having a very low opportunity cost and keeping all the stake holders happy.

Bibliography:

1. Economics, Trading. “Japan Unemployment Rate.” *Japan Unemployment Rate | 2019 | Data | Chart | Calendar | Forecast | News*, 2019, tradingeconomics.com/japan/unemployment-rate.