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JAPAN

Is it possible to increase inflation just by changing the target?

Concerned about the negative effects that could be created by overly low long-term interest rates, on September 21, the Bank of Japan (BoJ) announced that it would set the rate for Japanese 10-year bonds at around 0%. Initially, this gives the impression that the BoJ is backtracking from its prior interventions but, at the same time, it kept its annual asset purchases at ¥80,000B (US$800B), in addition to raising its inflation target for the coming years.

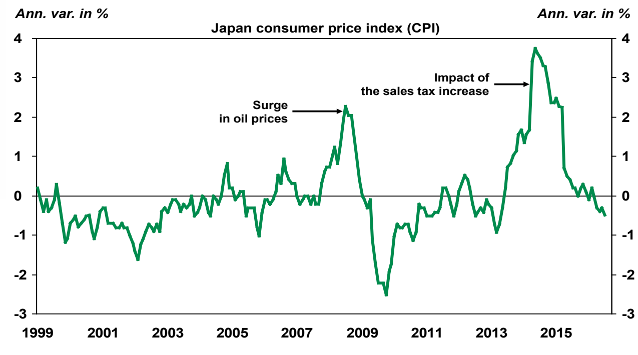
Previously, the BoJ aimed to get annual price growth back up to 2%. It is now aiming for average price growth of 2% over the entire economic cycle. This means that the longer inflation stays low, the more the BoJ will be prepared to tolerate high inflation later in order to achieve average price growth of 2% a year.

With this approach, the BoJ hopes to increase its leverage over inflation expectations. Faced with inflation's current weakness, Japanese expectations should adjust upward, which should eventually help drive price growth up in compliance with the central bank's target.

In theory, this seems wonderful but, in practice, the outcome will be highly dependent on the central bank's credibility, especially its actual capacity to increase inflation by stimulating the economy. In this area, however, the BoJ has not been not notoriously successful. Since 1999, inflation has gone well above zero only twice, in 2008, when oil prices were taking off, and in 2014, when the sales tax was increased.

A central bank's ability to increase inflation may also depend on the tools at its disposal and its leeway. Once again, there are serious doubts about the BoJ, which says it wants to expand its balance sheet until inflation is above 2% on a lasting basis. The problem is that its balance sheet becoming enormous and should exceed 100% of Japan's nominal GDP next year. In comparison, the Federal Reserve's balance sheet corresponds to just over 20% of U.S. GDP. Given these projections, there is room to wonder how many assets will be left for the BoJ to buy. This issue is magnified by the new target for the ten-year bond yield. To keep the yield from dropping too much, the BoJ will likely have to limit its purchases of long-term securities and maybe even sell some.

We can wonder about the Bank of Japan's ability to increase inflation



Sources: Datastream and Desjardins, Economic Studies

Implications: The BoJ's lack of credibility in stimulating the economy and bringing inflation up therefore suggest that the change to its inflation target will have little impact. The financial markets seem to agree, as shown by the yen's continued rise.

The BoJ will have to quickly show that it can still take action if it wants to increase its leverage over inflation expectations. Unless it tolerates a lower 10-year bond yield, an increase in the pace of government security purchases seems unlikely. The BoJ could turn to other types of assets, but the amounts at stake will remain marginal. All in all, the alternative of another cut to the deposit rate seems the most likely outcome. However, that might not be enough.

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