

Central Bank Watch: Tokyo Calling

Monetary policy decisions from the US Federal Reserve and the Bank of Japan are expected to drive investor sentiment this week. For both, the decisions will be revealed tomorrow and an intense shift in outlook or policy could lead to nervousness in the global financial markets.

Given the recent data - that's been softer, markets are not expecting any major change in stance from the US Federal Reserve. It is believed that the Fed will hold off on an interest rate hike until December and could use the September communiqué to just 'prep' the markets - reiterating the gradual yet sustainable improvement in labour market that's underway.

De facto, the real action is likely to be coming out of Tokyo, where speculation is rife for a possible rate cut (deeper into negative territory), an extension of the ongoing asset purchase program and above all, a possible tapering in overall purchases of long-dated bonds (JGBs) to encourage steepening of the yield curve in Japan matched by lower yields at the short-end.

- Of the three the last one is important. BOJ governor Kuroda had asked for a comprehensive review of the efficacy of monetary measures and some analysts have interpreted this as a rethink on the quantitative easing. Indeed Kuroda has expressed concerns about the adverse impact of a flat yield curve on the profitability of financial institutions, leading to speculation that there could be an active effort to 'retwist' the yield curve (the mirror image of the Fed's operation twist in 2011 when it set out to lower long term yields and push short yields down) by selling long and buying short.

Whatever the BOJ ends up doing has its risks. Non-intervention or mere tweaks to the policy could be interpreted as a verdict that the central bank has serious doubts about what money pumping can achieve and whether the era of QE is nearing an end and the ammunition available to central banks is fast depleting. On the other hand, any explicit move to retwist the yield curve could spook the markets by pushing up long term yields.

Options before the BOJ:

- **Cut in the policy rate along with 'operation retwist':** Although negative interest rate policy is the most debated element of the BOJ's current monetary policy framework, recent speeches from Governor Kuroda suggest that the benefits of NIRP (negative interest rate policy) could outweigh the cost that it entails. Therefore, a further cut in deposit rate (by around 10-20 bps) is possible. In the worst-case

scenario this could at least hypothetically be accompanied by tapering in purchase of long dated bonds in favor of more buying at the short-end of the yield curve.

If implemented, such a policy would be mirror image of Fed's Operation Twist, which was used in 2011 to flatten the US yield curve by buying long-term debt and selling short term debt. It should result in steepening of the bond yield curve in Japan, and could benefit banks or other financial institutions to borrow cheap and lend at a higher rate of interest but spook markets with the risk of an across-the-board rise in long yields amidst weak global growth.

- **Expanding the range of instruments:** The BoJ might decide to add FILP (Fiscal Investment and Loan Programme) and local government bonds to the list of assets it can purchase. This should settle down the sustainability issue related with bond purchases (supply of JGBs could run out in two years) and as such prevent further flattening of the yield curve without tampering with the quantum of bond buying.
- **A switch to purchase-range of JGBs instead of an annual target:** By introducing a range for its monetary target, with a higher mid-point (say JPY 95 trillion compared to current annual target of JPY 80 trillion), the BOJ could gain flexibility to intervene as per market conditions. Such a policy shift could also help in controlling the tapering expectations and help in strategic alignment of the yield curve. Although intricate break-up of asset purchases would be important in this regard to control flattening of the yield curve on a sustainable basis.
- **Expand the scope of the lending program:** to further reduce the impact of NIRP on the banks, the BOJ might consider reduction in interest rate for the Loan support program to -0.2% (or consider it matching to the revised marginal deposit rate). This could offset the impact of flattening yield curve on banks and the BOJ could continue its NIRP for a longer duration.

The most likely outcome in our view is the expansion of pool of assets (including local government bonds etc.) and a cut in interest rate for the loan support program. Moreover, to impart longevity to the asset purchase program, there could be change in the inflation forecast, that is expected timing for the achievement of 2% inflation could be changed from "during fiscal 2017" to "over medium term".

In our view, explicit announcement to reduce the JGB book for steepening of the yield curve seems unlikely. Such a policy could work in the reverse direction and yet again spark fears about unsustainability of the ongoing program. Instead, we believe that shifting to a range instead of an annual target should give the BOJ much needed flexibility to taper or expand the JGB purchases as per market conditions. Thus, if in case the BOJ decides to make a move towards steepening, we expect a shift towards ranged-annual-target as the first step in this direction.

The Fed's recap:

Admittedly, a lot of excitement (and nervousness at the same time) was initially built up about the policy meet on the back of a series of hawkish speeches by some of the central bank members and after a slew of economic data releases surprised on the upside. **However the barrage of short-term data that has recently come out has not been able to establish a comprehensive cyclical recovery yet. And this, in our opinion, will lead to the Fed's decision to stay on hold tomorrow.** For instance,

- While the US labor market added a healthy 151,000 jobs in August (though lower than market's expectation of 180,000 addition), annual growth rate of average hourly earnings did not keep up with the pace and slipped to a six-month low of 2.4%.
- This has mapped into soft real income and retail spending growth - retail sales declined 0.3% MoM in August after edging up 0.1% percent in July. Core-retail sales slipped as well by 0.1% MoM after a similar drop in July.
- Inflation broadly remains subdued in the US. Even though consumer prices rose by a 1.1% YoY in August, up from 0.8% in July, much of the uptick was on account of a big jump in health costs and housing rents, while food and consumer goods prices remained flat.
- Additionally, though investment in home-building, home sales both of new and existing stock have improved along with house prices, Business activity has remained weak. Industrial output for instance fell 0.4% MoM in August after a downwardly revised 0.6% increase in July. With lower output, capacity utilization in the industrial sector also fell 0.4 ppts in August to 75.5% from 75.9% in July. (The Fed sees capacity utilization as a leading indicator in gauging the inflationary pressures for the economy).

In our view, while the Fed will remain focused on the short-term data flow between now and the December policy, it does seem prepped to hike rates once this year. Fed Chair Janet Yellen's speech at the recent Jackson Hole symposium (25-27 August 2016) claimed that the case for a rate hike had strengthened but did not provide a hard signal on the timing. **The more compelling case for a rate hike, in our opinion, would stem from the Fed's need to regain credibility and ensure that its communication does move the markets. We continue to stand by our case for a rate hike of 25 bps in the Fed Funds rate in December.**

The Upshot:

For the yen, a minor change in the asset purchase program (cut in interest rate for the loan support program or expansion of pool of assets) is unlikely to please the markets and could at best lead to marginal depreciation in the near-term, if not a knee-jerk appreciation. In fact,

short-term appreciation bias could be reinforced if the BOJ disappoints. However, if there is a comprehensive change in monetary policy stance, with utilization of most of the options (we mentioned above), there could be a change in trend towards depreciation.

For the US dollar, given USD's current valuation (the Trade weighted index is at a fairly high level of 96.11 as of 16 September 2016), we expect some ease-off after the policy announcement (assuming a status quo on policy rates). While, anticipation of a rate hike in December and upbeat economic data releases may fetch some gains for the dollar in the coming months, we do not foresee a runaway rally in the USD (for detailed forecasts please refer to our report: *FX and the world economy – Focusing on fundamentals, 14th September 2016*).

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