Article

Monetary policy

Abenomics: the Bank of Japan is doing its job

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At the beginning of 2013, Prime Minister Shinzo Abe launched an ambitious programme of expansionary policies (popularly known as Abenomics) to reactivate Japan's sluggish economy. The strategy designed granted the Bank of Japan (BOJ) a leading role and gave it a twofold task: to combat the country's entrenched deflation and provide easy financial conditions for households, companies and government. Japan's monetary authority has implemented a wide range of measures to achieve these ends, two of which particularly stand out. On the one hand, the establishment of an explicit inflation target of 2% and, on the other, large-scale purchases of financial assets, mainly Japanese government bonds (JGB) but also securities issued by firms. Although it is still too soon to claim victory for the ultimate goal in growth terms, it can be said that the BOJ is making good headway with its intermediate goals, as shown by the bond market.

As expected, the dynamics of the JGB market have altered dramatically. In theory, the new inflation target, as it becomes accepted by private agents, should raise the nominal yield demanded while the direct bond purchases by the BOJ should push down real yields and therefore also nominal yields. The existence in Japan of both regular (nominal) JGBs and inflation-linked (real) JGBs helps to gauge the extent of both these effects as the gap between the nominal and real yield, which is usually called «inflation adjustment», is a reliable estimate of expectations regarding this variable among bond market operators (a more precise measurement would require adjustments due to the presence of various risk premia and other technical issues; inflation swaps also help to resolve certain gaps in information for JGBs).

Two broad features can be seen in the trend observed since the end of 2012 (when Abenomics was already expected) up to mid-2014. Firstly, «inflation adjustment» has increased appreciably. This reveals a change in agents long-term expectations who have effectively taken on board, at least partly, the goal of achieving and sustaining higher inflation. Secondly, the real yield has fallen dramatically and is now clearly in negative terrain, providing favourable financial conditions for economic agents (which can also be seen in the gains made by the Nikkei, 80% during this period, and in the yen's depreciation). Several studies have shown that the huge bond purchases made by the BOJ (the cumulative figure since April 2013 totals 20% of GDP and is proportionally greater than the Federal Reserve's own quantitative easing) are a key factor in this drop in the real yield (as well as other global factors, examined in the article «Real interest rates and growth prospects» in this Report). For example, Goldman Sachs economists put the impact of these bond purchases at around 60 basis points for the yield on ten-year bonds.

The downward pressure on yields will remain as long as the BOJ continues or increases its quantitative easing but, at some point, the BOJ will have to prepare and implement an appropriate exit strategy. Everything depends on the overall economic and financial situation which, in turn, depends critically on the other two branches of Abenomics: fiscal policy and structural reforms. If everything goes according to plan, yields are bound to rise, more or less rapidly, to levels in line with the economy's fundamentals.

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