Agitating for change

A visit by 'Helicopter Ben' and increasingly vocal protestations that the QQE with negative interest rate policy (NIRP) has reached its limit have resulted in feverish speculation about the Bank of Japan's (BoJ) next policy move. Is such conjecture justified? The negative NIRP was only introduced in February and, typically, central bankers are loathed to change track so soon after rolling out a new policy framework. However, the market reaction indicates a policy failure, while Governor Kuroda's paymasters also appear restless. Etsuro Honda, an adviser to Japan Prime Minister Shinzo Abe, has reiterated his view against cutting the policy rate deeper into negative territory. The Bank's wait-and-see approach looks increasingly untenable, but is the evidence damning enough to merit a climb down? Here, we look at how the financial sector has been affected by NIRP and consider the wider implications.

A key reason behind the deployment of NIRP was the need to accelerate both portfolio rebalancing and loan provision. **So far, the evidence that this has occurred is mixed**. According to the BOJ's most recent Flow of Funds Report, the pace of decline in the domestic banks' JGB holdings slowed in Q1, while insurance and pension funds saw a rise in their holdings. At the same time, domestic banks reduced their equity exposure, although overseas equity holdings did rise significantly. As for lending activity, the Bank's Senior Loan Officer Report suggests lending behaviour among either large or small companies remains broadly unchanged (see Chart 8). More encouragingly, household loan conditions rebounded noticeably, as has housing activity. All eyes will be on whether this trend continues when the July report is published later this week.

Opponents of NIRP argue that these rewards are scant given the disruption that NIRP can have on the traditional banking business model. Ever lower interest rates squeeze net interest margins if banks refuse to pass on negative rates, weighing on profitability in the sector. The risks are particularly prescient among regional banks. Indeed, based on the FSA's own calculations nearly 20% of regional banks are expected to see a decline in profit of over 50% through fiscal-year 2018 (see Chart 9). If these projections were to be updated post-NIRP one would presume the results to be even worse. The issue of bank profitability was tackled directly in the Bank's most recent Financial Stability Report. It pointed out that, although there was no obvious end to the downward pressure on profitability, capital bases were sufficient to ensure their credit intermediation role was not affected. Furthermore, it argued that, "if financial institutions portfolio rebalancing activities lead to an improvement in economic and price developments, this is in turn likely to bring about a recovery in core profitability". There is little sympathy for the banks' plight here. **Indeed, we see no evidence the Bank considers itself close to the limits of its current policy**. Negative interest rates have been slow to impact financial institutions' behaviour. However, a combination of asset purchases and NIRP should continue to push portfolio rebalancing and, even if private sector loan demand remains weak, the public sector is positioned to exploit materially lower lending rates. The issue of bank profitability should not distract from the greater cause.