

### **Strategy Bulletin Vol.124**

## Don't fight the BOJ! Believe in Kuroda's resolve!

"Don't fight the central bank" is an iron-clad rule among stock investors. By using different financial policies, central banks have the power to control liquidity (purchasing power for financial assets) and greatly influence market prices. In the United States, investors say "don't fight the Fed." Similarly, shifts in the stance of the BOJ can dramatically alter market prices.

Timing is what makes the actions of central banks decisive. During the 1980s, prices of Japanese stocks were inflated by an extended asset bubble that lasted until about 1990. Why did the bubble burst early in 1990? The reason is that BOJ Governor Yasushi Mieno began to cut back liquidity to break the bubble. Another question is why Japan experienced unusually low stock prices (a negative bubble) and an unusually strong yen until the fall of 2012. The answer is that BOJ Governor Masaaki Shirakawa decided to allow the yen to rise and stocks to fall. Furthermore, the big reversal of the yen and stock prices that began late in 2012 was caused by the confidence among investors that the BOJ would alter the policies of Governor Shirakawa (because of the election of Prime Minister Abe).

### Governor Kuroda does what he says

So what is the current goal of the BOJ? The bank is focused exclusively on "taking responsibility for achieving 2% inflation and sustained economic growth." If raising inflation to 2% becomes difficult, the BOJ has a clear commitment to do whatever is needed to reach this target. Mr. Kuroda's motto is the same as that of the Abe Cabinet: "Do what you say and achieve your goals." Mr. Kuroda has stated that "it is a mistake to think that a weaker yen is not something we want." In addition, he said that the 2% consumption tax rate hike is good for Japan. What he means is that there would be concerns about the commitment of the Japanese government to restore financial soundness without the planned October 2015 increase from 8% to 10%. He went on to say that there would be worries about a rapid increase in long-term interest rates (although this is unlikely to happen). This is why a consumption tax hike is desirable. People were justified in criticizing Mr. Kuroda because making statements about fiscal policies used to be forbidden for a BOJ governor. However, we should view Mr. Kuroda's statement as a sign of his commitment to use BOJ financial initiatives to respond to the risk of slower economic growth and a drop in prices following the next consumption tax hike.

# Another round of the first and second arrows would be vital to make the 2% tax hike possible

BOJ Governor Kuroda supports the 2% tax increase. Moreover, many economists and people in the academic sector support this tax hike in order to restore Japan's financial soundness. All this support means that Japan is very unlikely to postpone or suspend this tax increase. Furthermore, delaying or canceling the tax increase would be dangerous due to the large number of opponents to Abenomics who remain out of sight. If the tax increase cannot be implemented because of worries about an economic downturn, there is no doubt that the pessimistic view that Abenomics has failed will gain momentum. This would have a major negative impact on market sentiment. There is a saying that "all illnesses come from the mind." Similarly, we can say that Japan's deflation was a self-fulfilling event because capital accumulated as cash was retained precisely because people expected deflation to continue. This is why eliminating the deflationary mindset was a critical step.

Musha Research Co., Ltd. President Ryoji Musha Direct +81-3-5408-6821 <u>musha@musha.co.jp</u> http://www.musha.co.jp

901 Renai Partire Shiodome 2-18-3 Hiagshishinbashi, Minato-ku, 105-0021 Tokyo Destroying this mindset should prevent any further deterioration in sentiment among consumers and investors.

With respect to fundamentals, the April 2014 consumption tax increase has apparently ended the economic recovery that began in the second half of 2013. In the second quarter of 2014, after a revision, Japan's GDP contracted by an enormous annualized 7.1%. There was clearly a very weak recovery following the drop in demand after consumers rushed to make purchases prior to the April tax hike. Unfavorable summer weather probably held down the GDP somewhat. Japan's economy will most likely resume growing in the third quarter now that the temporary disruption caused by the consumption tax hike has ended. But the economy is still lackluster. Additionally, inflationary pressure is weakening because the yen has stopped declining and prices of imported goods are no longer climbing. Reaching the BOJ's 2% inflation target in 2015 will be very difficult under these circumstances. Furthermore, the decline in the Nikkei-UTokyo Daily Price Index, which the BOJ too is watching closely, has been gaining speed since June.

Now that Abenomics has come this far, the first and second arrows must be reconstructed so that Abenomics can regain its momentum and the next tax hike take place. There is no other course of action. To give the economy a big boost in the first half of 2015, Japan must implement the second round of quantitative easing (QQE2). Then the resulting growth in tax revenue should be used to fund a larger supplemental budget.

### Change in sentiment is now waited for

The points I have just discussed show that the BOJ must implement additional quantitative easing. In the United States, the cyclical economic recovery is gaining strength and the end of ultra-low interest rates is now in sight. In Japan, stocks are still extremely undervalued. In addition, the strong earnings that supported the valuation of Japanese stocks created a solid foundation for the weaker yen and higher stock prices. This is the environment in which BOJ Governor Kuroda is saying "leave everything up to me." So we can now believe him, can't we?

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