Daiwa Securities

Daiwa's View

Will BOJ also conduct additional easing?

- Will central bank be able to formulate effective measures to lower reversal rate in order to address side effects?"

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Daiwa Securities Co. Ltd.

Will BOJ also conduct additional easing?

Will central bank be able to formulate effective measures to lower reversal rate in order to address side effects?

Speculation on additional easing by the BOJ is growing. Much of the current market data signals the need for additional easing[1]. If the insufficiency can be eliminated via additional easing combined with measures to address the side effects, we would welcome such a move.

The essence of monetary easing is to stimulate economic activity by inducing the real interest rate to a level lower than the equilibrium interest rate, and eventually raise inflation expectations by widening the output gap.

However, a cut to the policy interest rate gradually increases the side effects of monetary easing. In particular, when the equilibrium rate approaches the reversal rate level (in which intermediate functions at financial institutions are impaired and effects of monetary easing on economy reverse), the benefits from easing are outweighed by the side effects. As Japan is now considered to be close to this condition, additional easing needs to be combined with measures to address the side effects.

In short, key for discussions regarding additional easing in Japan is whether the BOJ will be able to implement effective measures to lower the reversal rate below the equilibrium interest rate in order to cope with the side effects. If the BOJ is able to lower the reversal rate as a step to address the side effects, all the central bank has to do is to lower the real interest rate below the equilibrium rate via regular operations.

Here are the major factors that determine the current reversal rate in Japan: (1) excessive competition due to overbanking and (2) structurally low profitability at depository institutions caused by the fundraising structure and the zero lower bound of deposit rates. The root of the side effect measures can be summarized in the "overbanking" and "deposit" issues.

Regarding the overbanking issue, what the BOJ can do is limited as the issue is under the jurisdiction of the Financial Services Agency. For example, some media reports yesterday stated that a preferential scheme was under consideration for deposit insurance cost at regional financial institutions that implement integration/mergers with peers. This is a prescription for the issue by the Financial Services Agency. Of course, these schemes are likely to exhibit the effects over the long term, but they are unlikely to play a main role among the upcoming measures to address the side effects, given the speed of global yield declines and pressing need for additional easing.

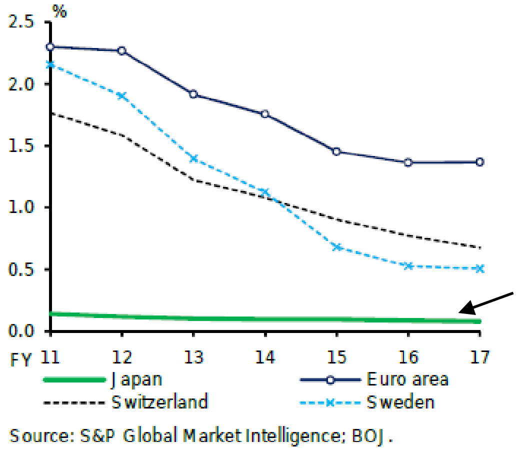
[1] Refer to our reports of 23 Aug *Daiwa's View: Non-JGBs also entered era of issuance at negative yields*, 21 Aug *Daiwa's View: Excessive cheapness will not continue*, 19 Aug *Daiwa's View: BOJ succeeded in controlling yield curve, but facing rocky road ahead*.

If so, a key point of the measures to cope with the side effects would be the "deposit." One major problem regarding the profitability and deposits at financial institutions lies in the structure of negative margins, in which financial institutions pay positive deposit rates (zero lower bound of deposit rates), while investment return is on a downtrend (to negative territory) due to the negative interest rate environment. Given the global yield declines, we think that the primary measure to deal with this issue is for financial institutions to charge negative rates to clients' deposits. This would enable them to lower the fundraising cost by deepening negative deposit rates in line with a further reduction in the negative interest rate.

However, these measures have not been taken thus far for good reasons (social, political restrictions). If so, the next best option would be to compensate for the adverse effects via other measures, while paying attention to the aforementioned restrictions. As a major direction, the central bank would take measures to expand de facto subsidies to financial institutions, including a hike in the IOER in current accounts at the BOJ.

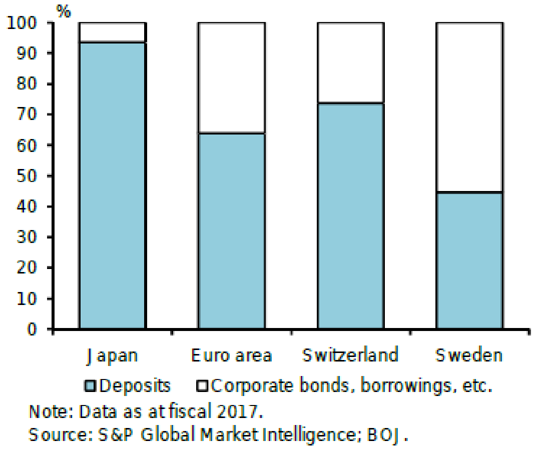
The BOJ has limited room for additional easing, which has been the consensus in Japan thus far. Elimination of this consensus would enable the Japanese market (which had been fragile) to more easily ride the risk-on waves. We would like to point this out and believe such a move would be desirable for Japan.

Chart: Yields on Financial Liabilities



Source: BOJ's Financial System Report*; compiled by Daiwa Securities*

Chart: Breakdown of Financial Liabilities



Source: Extract from BOJ's Financial System Report.

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2) Establishment of control systems (fairness of the rating process, and prevention of conflicts of interest, etc.).
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■ Credit Rating Agencies

[Standard & Poor's]

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The name and registration number of the Registered Credit Rating Agency in the group: S&P Global Ratings Japan Inc. (FSA commissioner (Rating) No.5)

How to acquire information related to an outline of the rating policies and methods adopted by the person who determines Credit Ratings

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Credit ratings assigned by Standard & Poor's are statements of opinion on the future credit quality of specific issuers or issues as of the date they are expressed and they are not indexes which show the probability of the occurrence of the failure to pay by the issuer or a specific debt and do not guarantee creditworthiness. Credit ratings are not a recommendation to purchase, sell or hold any securities, or a statement of market liquidity or prices in the secondary market of any issues.

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[Moody's]

The Name of the Credit Rating Agencies Group, etc

The name of the Credit Rating Agencies group: Moody's Investors Service ("MIS")
The name and registration number of the Registered Credit Rating Agency in the group: Moody's Japan K.K. (FSA commissioner (Rating) No.2)

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The information is posted under "Unregistered Rating explanation" in the section on "The use of Ratings of Unregistered Agencies" on the website of Moody's Japan K.K. (The website can be viewed after clicking on "Credit Rating Business" on the Japanese version of Moody's website (https://www.moodys.com/pages/default_ja.aspx)

Assumptions, Significance and Limitations of Credit Ratings

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[Fitch]

The Name of the Credit Rating Agencies group, etc

The name of the Credit Rating Agencies group: Fitch Ratings ("Fitch")
The name and registration number of the Registered Credit Rating Agency in the group: Fitch Ratings Japan Limited (FSA commissioner (Rating) No.7)

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The information is posted under "Outline of Rating Policies" in the section of "Regulatory Affairs" on the website of Fitch Ratings Japan Limited (https://www.fitchratings.co.jp/web/)

Assumptions, Significance and Limitations of Credit Ratings

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May 2018

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator
Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association
The Financial Futures Association of Japan
Japan Investment Advisers Association
Type II Financial Instruments Firms Association