New Bank of Japan governor has to tread a fine line

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16 February 2023

The Japanese government's appointment of Kazua Ueda as governor of the Bank of Japan (BOJ) to replace retiring governor Haruhiko Kuroda at the end of next month comes at a crucial turning point for the world's third largest economy and one of its chief sources of finance.

Ueda, aged 71, a professor emeritus of economics at the University of Tokyo and a BOJ board member from 1998 to 2005, was not the first pick to fill the post. In fact, he was not on anyone's list of possible appointees.

According to press reports, the deputy governor Masayoshi Amamiya was approached to take the job but turned it down.

Ueda's appointment, assuming it is approved by the parliament, will be the first time in post-war history that someone outside the Bank of Japan or the Ministry of Finance has been given the top job at the central bank.

The key task facing the new governor will be the reorientation of the central bank's policy away from yield curve control (YCC), instituted in 2016, under which the BOJ has purchased massive amounts of government bonds to keep interest rates at near zero levels.

This program, which was broadly in line with the policy of other central banks, has now come under pressure because of the interest rate increases initiated by the US Federal Reserve and other major central banks around the world.

In December, Kuroda made a surprise move when he lifted the ceiling on bond yields, effectively marginally raising interest rates. This was interpreted by financial markets as a step towards the ending of YCC. But Kuroda, the architect of the policy, said it was intended to improve its functioning.

However, speculation the policy was on the skids increased and the BOJ had to spend $179 billion in bond markets last month to keep yields within its designated range.

When news of his appointment became known last week, Ueda maintained that the current monetary policy was "appropriate and monetary easing needs to be continued at this point."

These remarks were largely directed at dampening immediate movements in the financial markets rather than the expression of longer-term objectives.

While he has not offered public criticism of the YCC policy since its implementation, the *Wall Street Journal* (WSJ) reprised a comment piece Ueda wrote for it in 2000, while he was on the BPJ's policy board. In it he cast doubt on all the various methods by which the central bank could spark economic expansion through monetary policy.

Setting an inflation target of 2 percent was not a bad idea, he wrote, but it would "require reasons other than monetary policy for the economy to recover" and that "no country has ever used inflation targeting to reflate the economy."

He noted in the article that in order to hold down long-term rates "the Bank of Japan would be forced to purchase a huge amount of government bonds."

More recently he has commented on the need for devising a means for ending the present monetary policy. Last July he wrote in the *Nikkei* that it was "necessary for the Bank of Japan to establish an exit policy" but did not indicate what that could be.

Ueda's prediction that the present policy would require massive purchases by the BOJ has been borne out. It now holds the equivalent of more than $4 trillion on its books, just over half all the bonds outstanding. In addition, the BOJ is a major force in the Japanese stock market.

The policy of YCC, championed by former prime minister Shinzo Abe, has failed to stimulate the economy or to produce a reflation which would open the way for a more "normal" monetary policy. While the Japanese inflation rate has now risen above the target level of 2 percent this is not the result of any stimulation of the domestic economy but is largely the product of the rise in international commodity prices.

The Japanese economy grew by 1.1 percent last year, but it still remains below where it was before the pandemic because of sluggish consumer spending and corporate investment.

The obvious failure of YCC, the core of so-called Abenomics, to provide a stimulus, appears to have set off a conflict in ruling circles about the direction of economic policy.

A report in the WSJ this week said that the "reflationist camp" that had supported Kuroda was pushing for more government spending, including on the military, to try to fire up the economy.

However, Prime Minister Kishida has said Japan's debt is a burden on future generations and has called for increased taxes.

The article noted this had been denounced by Etsuro Honda, a former Ministry of Finance official who advised Abe, who said tax increases were "a policy of incomparable stupidity" and called for increased fiscal stimulus, saying it would be extraordinarily effective in promoting economic growth.

It remains to be seen how the differences over how to deal with the ongoing stagnation of the Japanese economy will develop but they could well play into the drive for increased military spending now underway.

But what is certain is that whatever moves are made under Ueda to pull back the present policy, however gradual they may be to begin with, will have significant consequences for the global financial system.

With central banks tightening their policies, Japan is a major source of international liquidity. It is the world's largest creditor nation with more than $3 trillion of international investments and even a relaxation of the YCC policy will see a rise in interest rates and the move of finance back to the domestic market.

There are concerns this could have major implications for the stability of global financial markets.

Writing in the *Sydney Morning Herald* in an article entitled "If Japan's surprise pick gets it wrong global chaos awaits," financial commentator Stephen Bartholomeusz noted that the December decision to lift the cap on the yields on Japanese bonds "triggered volatility in bond, equity and currency markets that was a foretaste of much greater turbulence and destabilisation if and when Japan abandons its unconventional policies."

If the BOJ failed to establish a smooth pathway to a more conventional monetary policy and deflation and recession-like conditions re-emerged, he wrote, the result could be "turmoil and trauma in global financial markets."

Such sentiments were also voiced by Bloomberg financial commentator John Authers. He said reversing a policy that has been in place since 2016 would "raise the risk of a financial accident of the kind that has been preoccupying many since the UK gilts crisis debacle" of September-October last year.

That crisis, which saw the interest rates on government bonds rise at a historically unprecedented rate and threatened the viability of £1.5 trillion worth of investments by pension funds, was only halted by a major intervention by the Bank of England.

Any number of "accidents" resulting from a shift in Japanese monetary policy could have similar or even larger consequences.