

## Lost in Translation

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When the Bank of Japan (BOJ) announced negative interest rates on January 29th, it certainly caught the market by surprise. What does a negative interest rate policy mean? And what are the implications for Japan and the rest of Asia?

First, the BOJ's negative interest rate applies only to a portion of excess reserves in the banking system, similar to the negative tiered system of Swedish and Danish central banks. What we know from the Danish and the Swedish experience is that the banks have not passed the negative interest rates to their depositors. Given that the central bank gets a negative rate on reserves but has to still pay at least zero interest on deposits, this incentivizes the bank to lend its excess cash. However, since corporate balance sheets in general are flush with cash, we know the binding constraint for increasing loan demand was not the lack of supply, but rather the lack of demand. As such, we do not believe this policy will materially increase loans. So if we don't think that negative interest rates will move the needle on loans, and thus induce corporations to increase capital expenditures, what then does the BOJ hope to achieve?

We believe that BOJ Governor Haruhiko Kuroda's primary intention was to send a strong signal to the market that he is determined to continue to do whatever it takes to re-ignite inflation in the Japanese economy. Skeptics of easy monetary policy have pointed to diminishing returns to continued rounds from quantitative easing (QE). Given the scale of QE in Japan and its continued use to ease monetary policy, some economists have argued that the BOJ has exhausted its bullets in its battle against deflation. By introducing negative interest rates, Kuroda is, in effect, saying that Japan still has plenty of ammunition. Signaling is critical because, ultimately, defeating deflation is about changing expectations. If the consumers and markets expect inflation to come back, then it becomes a selffulfilling prophecy.

Another important transmission channel to higher inflation expectations is a weaker currency. In a negative rate environment, domestic investors are prompted to look for higher yield elsewhere, inducing investors to invest overseas, exerting a depreciation effect on the currency. Similarly, global investors who are seeking yield are less likely to invest in Japan now given that the interest rates are even lower compared to yields offered by other countries' interest rates. The combined effect of these two forces lowers demand for the yen.

Another important effect of negative interest rates is to induce greater demand for risky assets onshore. Instead of putting money in the bank for zero return, the depositor might be induced to seek yield through riskier investments, from higheryielding fixed income to equities.

A determined central bank, a depreciating currency, and increasing demand for riskier assets are all factors that should help Japan bring inflation back to its economy.

For the rest of the region, the move by Japan's central bank might get lost in translation and be interpreted as a shot across the bow in what appears to be a global competition to depreciate currencies. Whether or not negative rates indeed lead to a cheaper yen might matter less than market expectations. The expectation, in and of itself, might be sufficient to lead to a competitive devaluation. We believe that a more depreciated yen is just a means to an end. While Japan's current account surplus picked up nicely in 2014, it had fallen in recent years due to the higher fuel bill that resulted from the shutdown of all nuclear power plants in Japan after the 2011 tsunami. Since then, only three nuclear power plants have been restarted. When oil prices start rising again, the net benefit from a cheaper currency falls. In summary, we believe this bold move by Japan's central bank is necessary to maintain the current momentum in driving inflation expectations higher. Too much focus on this move as another step in a competitive devaluation would be missing the point.

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