Crisis of confidence

In a week that was dominated by the disappointment of the Bank of Japan (BOJ) no-show, there were a few crumbs of comfort in the economic data. The labour market continued to improve with the unemployment rate unexpectedly falling 0.1ppts to 3.2% in March, while the job to application ratio rose from 1.28 to 1.3. Elsewhere, industrial production rebounded by 3.6% m/m, while retail sales staged a recovery up 1.4% on February. Unfortunately, this was simply the equivalent to a dead cat bounce after what has been a dismal start to 2016. Taking the most recent three months together, industrial output averaged a decline of 1.1% on a q/q basis. It was a similar story for partial indicators of consumption, with retail sales flat on a q/q basis. Furthermore, according to the Family and Income Expenditure Survey, real consumer spending fell 5.3% y/y in March, resulting in a quarterly decline of 1.8%. Indeed, partial indicators are now pointing towards another contraction in output in Q1. Given the limp data, there was little surprise that the BOJ revised down its growth forecast when it published its Outlook Report last week. GDP is now expected to expand 1.2%, rather than the previous estimate of 1.5% in FY2016, with estimates of growth pushed down to just 0.1% for the FY2017 – reflecting the government's plans to raise the consumption tax. This is just the latest in a series of major growth disappointments for the Bank (see Chart 8). So what has gone wrong?

Judging by governor Kuroda's post policy meeting comments, it is simply a matter of time before negative interest rates drives a capex-led acceleration in growth. **We are seriously concerned that the Bank is not acknowledging a much larger problem**. There are two possible causes of the listless economic performance: either real interest rates have not fallen enough – possibly due to the constraint of a liquidity trap - or structural constraints have reduced potential growth to such a level that the response of investment and consumption to a lower interest rate is almost negligible. The latter view would suggest that other factors such as demographics, regulatory requirements and productivity prospects are a more powerful determinant of saving and investment decisions than the interest rate. Understandably, the BOJ has placed great emphasis on the former interpretation. However, if real interest rates have been below the natural rate since early 2013 (see Chart 9) then why has there not been a more aggressive pick-up in growth and inflation? Using the demand-side framework, the weight of evidence suggests that real interest rates have not fallen enough – and may actually be rising. Alternatively, if one interprets the recent economic performance through the supply-side prism, it would suggest investment and savings are indeed immune to the interest rate. The BOJ's response to this has been muddled. In a recent speech, Deputy Governor Nakaso confessed the difficulty he was having distinguishing between supply and demand-side factors, hinting at a "shake up of conventional ways of thinking" on the issue due to Japan's experiences – without giving details. Governor Kuroda appeared equally woolly, insisting that the QQE framework was effective without having the conviction to ease further. We suspect that last week's decision reflects political considerations both domestically – ahead of the summer elections – and international – ahead of the G7 meeting later this month. **That monetary policy has been subordinated to political priorities suggests the BOJ is less independent than we had assumed**.