alpha commentary

28 March 2016

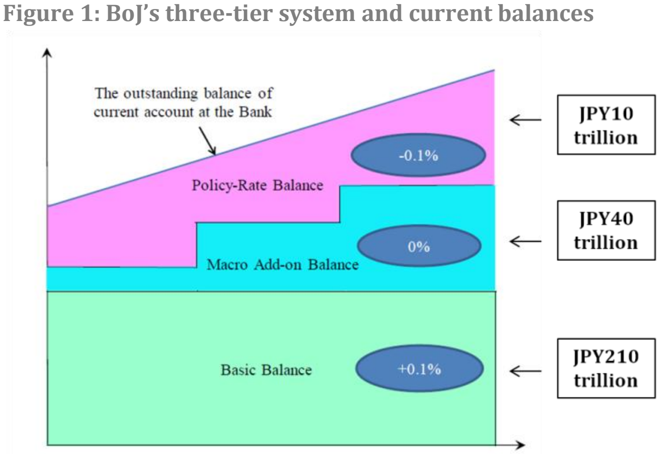
Japan negative interest rate: Limited impact

What happened

On 29 January, the Bank of Japan (BoJ) announced a negative interest rate to its quantitative and qualitative easing (QQE) programme. With effect from 16 February, the outstanding balances of financial institutions' current account deposits at the BoJ will be divided into three tiers, each of which will earn different interest rates of 0.1%, 0% and -0.1% respectively (Figure 1).

The interest rate of -0.1% will only be applied to the policy-rate balance (currently about JPY10 trillion) in excess of the basic and macro add-on balances. This balance will increase in line with the expansion of the monetary base at JPY80 trillion a year. To mitigate the impact on banks' earnings, the BoJ has the discretion to adjust the macro add-on balance so as to keep the policy-rate balance small at about JPY10-30 trillion. The BoJ will still be able to lower the short end of the yield curve because transaction prices in financial markets are determined by marginal gains or losses in a new transaction.

Figure 1: BoJ's three-tier system and current balances



Source: BoJ

The objective is to exert downward pressure on interest rates and encourage banks to lend and businesses and consumers to invest and spend. All things equal, the negative interest rate should also lead to JPY weakening, lift import prices and inflationary expectations so as to reach the BoJ's inflation target of 2%.

Implications

Bank lending

Commercial bank lending is not likely to increase significantly although home loan rates have been reduced. As banks have already been more accommodative in their lending since Abenomics, some banks may choose to tolerate the small loss from the negative interest rate rather than take on additional lending risk. The impact on major banks' earnings is estimated to be only around 1-2%[1]. Banks could also shift their money towards higher-yielding assets including equities, JREITs and real estate, or increase their lending overseas.

Consumption

Banks are unlikely to pass on the negative interest rate to savers for fear of customer backlash and triggering withdrawals. Some banks have lowered their deposit rates but with interest rates already so low, the cut in interest rate will not have a huge impact on depositors and cause them to suddenly shift funds towards risk assets or increase spending significantly.

Real estate sector

Notwithstanding the muted impact on the macro-economy, the negative interest rate policy is positive for the real estate sector in the short term:

- The real estate yield spread has increased as Japanese 10-year government bond yields have fallen 21 bps to -0.11% as at 23 March from 0.1% on 29 January. More funds are expected to flow into the higher-yielding JREITs. Coupled with the lower financing cost, this could incentivise JREITs to make more acquisitions.

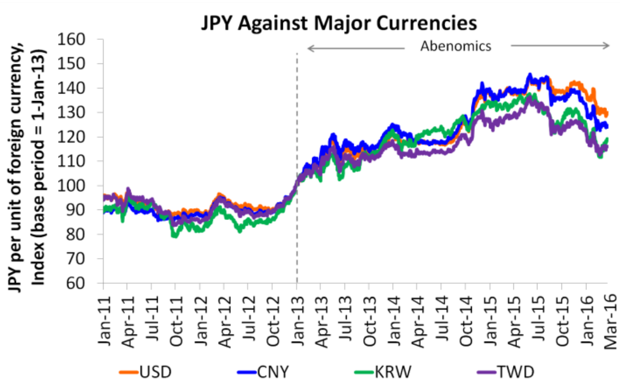
[1] Morgan Stanley, Nomura

- Investor interest in Japanese real estate is expected to remain strong. Further cap rate compression is expected although the extent could be limited as cap rates for prime commercial properties in Tokyo have already fallen to recent lows.

- The JPY initially weakened 2% to 121 against the USD on 29 January, but has strengthened 7% since the announcement of the negative interest rate policy to around 113 as at 23 March due to the JPY's status as a safe-haven currency. Nevertheless, the JPY is still much lower than the levels before Abenomics (Figure 2). This will continue to support corporate expenditure, office demand and rental growth.

- The JPY is also still lower against the currencies of the major tourist source markets (China, South Korea, Taiwan and Hong Kong). Inbound tourism growth is thus expected to continue, supporting growth of the hospitality and prime retail sectors.

Figure 2: Exchange rates



Source: Bloomberg, AIP Research

- Residential demand will be positively impacted through the lowering of home loan rates. Bank of Tokyo-Mitsubishi UFJ cut the interest rate on 10-year fixed-rate mortgages from 1.05% to 0.8% with effect from 1 March, following similar cuts to 0.9% by Sumitomo Mitsui Banking Corporation and Mizuho Bank[2]. Regional banks such as Shizuoka Bank and Musashino Bank have also lowered their rates on 10-year fixed-rate mortgages.

Conclusion

The full impact of the negative interest rate policy is not clear yet. Nevertheless, in the near term, as bank lending and consumption are not expected to increase significantly, the economic impact is likely to be limited, similar to the experience in Europe. The European Central Bank (ECB) had first cut the deposit facility rate to -0.1% in June 2014, and followed up with another three cuts, with the most recent cut to -0.4% in March 2016.

It is therefore likely that the BoJ will ease its monetary policy again later in the year, which will thus continue to be supportive of real estate asset flows.

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[2] The Asian Banker, 20 Feb 2016