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The Bank of Japan's ETF endgame: how it could gratify small investors

Summary

- The Bank of Japan has been buying public equities for a decade
- Its portfolio of equities has reached JPY 45 trillion
- How will it offload such an enormous holding and how will doing so impact the market?

Disclaimer

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If the Bank of Japan ("BoJ") were a hedge fund, it would be congratulating itself on a blow-out year, and getting ready to pay out generous bonuses. In March and April, when stocks plunged across the world as fears spread of a global COVID-19 depression, the BoJ waded into the Japanese market and bought Exchange Traded Funds ("ETFs") worth JPY 2.7 trillion (USD 26 billion). That proved to be a highly successful contrarian call. By the end of November, the Nikkei 225 index had rallied 60% from its spring lows.

Central banks are not usually noted for their market savvy. One unhappy example is the Bank of England, which – on government orders - sold a large part of the UK's gold reserves at a price below USD 300 an ounce in 1999-2002. That was pretty much the bottom, and the yellow metal has subsequently risen more than sixfold

The BoJ developed a different approach, mirroring Warren Buffett's famous dictum: "Be greedy when others are fearful and be fearful when others are greedy." Its purchase program requires it to accumulate ETFs every year, but the amount and timing are flexible. This year, it invested three times as much in March as it had in January and, as the Tokyo market recovered in the autumn, its purchases tailed off to negligible proportions.

Japan's central bank ownership of public equities started in small way ten years ago, under the austere regime of Governor Masaaki Shirakawa. The idea was to allow distressed banks to unload shareholdings of related companies without crushing their stock prices. Purchases of equities became an explicit instrument of "non-conventional monetary policy" when the current BoJ governor, Haruhiko Kuroda, took over the reins in 2013.

This was intended to be a temporary measure but, like many of the policy innovations spawned by the global financial crisis of 2008, it has endured much longer than expected. Initially, Kuroda set the annual purchase limit at JPY 1 trillion, but subsequently lifted it step-by-step. To cope with the coronavirus crisis, he has raised the ceiling to JPY 12 trillion. That is roughly enough to buy a company the size of Sony, Japan's second largest, every year – though by using ETF's, the BoJ buys the market index, not particular stocks.

The BoJ is under no compulsion to use all of its potential fire-power and rarely does so, but the existence of this huge unconstrained buyer has a significant effect on market psychology – as intended.

Altogether, the BoJ now owns some JPY 45 trillion of equities, equivalent to 7% of the Tokyo market. That makes it the largest single investor, overshadowing the Government Investment Pension Fund, once known as the whale of Tokyo. Thanks to its "buy on weakness" approach, the BoJ is currently sitting on an unrealised profit of JPY 10 trillion – enough to finance Japan's defense budget for 20 months.

Clearly, this is a strange state of affairs, but perhaps no stranger than a central bank owning half the outstanding stock of government bonds, which is the case in Japan, the UK and some other countries. Traditionally, government bonds have been considered the ultimate safe asset because buyers always get their money back at maturity. But in today's world of negative rates, they offer not a risk-free return but a return-free risk.

Indeed, if central banks succeed in their avowed goal of generating inflation, then their massive bond holdings are likely to incur significant real losses. Investors would get their money back, but its purchasing power would be less. In such circumstances, the BoJ's equity holdings could provide a useful buffer, since equities have done well, historically, in times of sub-5% inflation.

The BoJ's explicit rationale for its ETF purchase program is to reduce the perceived riskiness of equities and thus push the equilibrium level of the stock market higher than it would otherwise be. None of the other major central banks have launched similar programs, but higher asset prices have long been a policy goal in many countries.

In the UK, a number of government initiatives have subsidised home buyers, with the inevitable effect of jacking up house prices and enriching existing owners. In the US, the Federal Reserve has a history of slashing interest rates whenever the stock market runs into trouble, a phenomenon once known as the "Greenspan put," meaning that former Fed Chairman Alan Greenspan would effectively protect investors from downside risk.

More recently, the Fed has been buying packages of corporate bonds, including debt issued by Apple, to finance the purchase of its own shares. The BoJ has simply been more honest about its intentions. By taking equities onto its own balance sheet, it has cut out the middlemen.

If the BoJ carries on with its current approach, it will eventually end up owning enough of the Japanese economy to gladden the heart of Karl Marx. So there has to be an exit strategy – especially as the goal of reducing the perceived riskiness of the stock market has surely now been met.

Bonds will eventually run off central bank balance sheets as they mature, but equities, having no fixed term, last forever. What to do? The BoJ could sell its holdings, but ETFs have limited liquidity. Winding down such an enormous portfolio might cast a pall on investor sentiment for years. Alternatively, it could hold on to them and remain the Moby Dick of the Tokyo market, sending the uncomfortable signal that emergency financial measures can never be removed.

A neater and potentially highly popular solution would be to put the assets directly into the hands of the public at a significant discount to their market value on condition that they must be held for several years. That would probably necessitate a recapitalisation of the BoJ, but such technical matters could be easily handled, given the political will.

If done well, this could be a major financial event, to rank with the privatizations of the 1980s. In line with the government's promotion of a shift from bank savings to securities investment, it would give a major boost to the development of an individual investor-oriented equity culture. And it would get the BoJ out of a trap of its own devising.