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Arcus

How The Bank of Japan Can Turn A Problem Into a Triumph

Summary

- The Bank of Japan's huge treasure trove of domestic equities has soared in value
- It has a dilemma – keep receiving dividends or seek an innovative sale of some or all of its holdings
- Its options are not too dissimilar from those faced by the Hong Kong Monetary Authority after the Asian Financial Crisis
- A sale to NISA account holders with a "loyalty bonus" incentive structure would be suitably imaginative

If the Bank of Japan ("BoJ") were a hedge fund, it would be celebrating a fantastic performance as its huge treasure trove of Japanese equities has soared in value. Instead, there are concerns about how it can ever sell them. Fortunately, there is a solution that would cause minimal market disturbance while turbo-charging Japan's new equity culture.

Government bodies are rarely renowned for their investment skills. More typical are their blunders such as the decision of the UK Treasury to sell Britain's gold reserves in 2001. That might have been good idea in theory, but the timing was disastrous. The transaction was done near to the 20 year low of $270 per ounce, and by 2011 the yellow metal had rocketed to $1,800 per ounce, causing billions of pounds of opportunity loss.

All the more reason, then, to applaud the superb market timing of the Bank of Japan's foray into stock market investment. Some tiny positions in bank stocks were held on the BoJ's balance sheet as early as 2011, but the really massive purchases were made from 2015 to 2021, as part of the "unconventional monetary policy" initiated by then-BoJ Governor Haruhiko Kuroda.

The average level of the Nikkei Index during that period was 20,800. The largest monthly purchases occurred during the Covid crash, but as the market swiftly recovered, the BoJ decided in early 2021 that enough was enough. The guidelines were changed, and since then the policy has effectively been shelved.

With the Nikkei Index subsequently rocketing towards its all-time high of 39,000, the results have been extraordinary. As of the end of January 2024, the BoJ's stake in listed Japanese companies – mainly held in the form of Exchange Traded Funds – is worth 67 trillion yen against an acquisition cost of 37 trillion yen.

These are huge numbers, overshadowing the domestic equity holdings of Japan's Government Pension Investment Fund, often termed the world's largest pension and known in the Tokyo market as "the Whale". Now it seems more of a sleek orca, while the BoJ has taken on the appearance of a heavyweight and potentially dangerous Moby Dick.

In the early days, critics of the BoJ charged that holding equities would be disastrous in the event of a financial crisis, blowing up the bank's balance sheet and causing a run on the currency. Now the concern is the reverse; that the BoJ's investments have become too big to sell into the market without triggering a meltdown. With Japan's central bank owning some 7% of the Prime Market, any announcement of an intention to sell could well cast a pall on stocks for years.

Whereas bonds disappear when they reach maturity, equities are forever. The BoJ is under no pressure to act quickly – it can carry on collecting the roughly one trillion yen of dividends year by year – but the problem will only become more anomalous as stock prices rise over time, as has generally been the case historically.

Is there any precedent for the BoJ's dilemma? Yes, there is. During the Asian Financial Crisis of 1997/98, the Hong Kong dollar and stock market came under heavy speculative attack. In response, the Hong Kong Monetary Authority ("HKMA") made massive purchases of the major stocks in the benchmark Hang Seng Index.

The financial battle lasted ten days, and in the end, the HKMA proved victorious. However, it had used one fifth of its balance sheet in the process. Estimates at the time suggest that it had accumulated about a third of the equity of the 33 stocks in the index. As with the BoJ today, the investment turned out to be highly profitable in the end, generating a capital gain of 70%.

Proud of its reputation as a free market bastion, Hong Kong was keen to return the stocks to the private sector as soon as possible. For individual investors, incentives such as "loyalty bonuses" (effectively discounts that became valid after a certain amount of time elapsed) were offered to encourage them not to sell. There was also some showbusiness razzmatazz, with Canto-pop singer Danny Chan being chosen by the taskforce to provide the campaign song.

There are obvious differences between Hong Kong's position then and Japan's today but the big picture – the need to return a large amount of stocks to the private sector – is the same. Likewise, incentives are needed to attract investors, but ordinary discounts will encourage "flipping" – selling the stock (Exchange Traded Fund, in this case) at the prevailing market price and pocketing the difference.

The way to avoid that is to restrict eligibility to individual investors with NISA accounts and make the discount a Hong Kong-style retrospective "loyalty bonus" that gradually diminishes over a 5-year horizon.

Given the enormous scale of the BoJ's equity portfolio, it would also be advisable to stretch the process out over several years, perhaps using a lottery system, as was the case for the listing of Nippon Telegraph and Telephone Corporation ("NTT") in 1987.

If all this happens as described, it would be a win-win for everybody, politicians included, as the much discussed move from bank deposits to stock market investment became a reality, with all the action centred not on U.S. or Indian equities, but exclusively Japanese names.

Needless to say, the Bank of Japan, whose excellent market timing made the whole thing possible, would be basking in glory. At the very least, its board members should be allowed to choose the J-pop singer of the campaign song.