A Change in the BOJ's Buying of ETFs?

Has the BOJ Changed Its Purchase Criteria?

The Bank of Japan (BOJ)'s policy on buying exchange-traded funds (ETFs) has become a topic of conversation for the first time in a while. This occurred because the Bank of Japan decided not to buy ETFs despite a major drop in share prices on November 13 and 14.

The BOJ has not disclosed its purchase criteria, but in the eyes of the market, "The BOJ buys ETFs when the Tokyo Stock Exchange Stock Price Index (TOPIX) in the morning falls about 0.5% from the previous day's closing price." However, even with rates of decline close to what the market expects as the buying standard of the BOJ on the 13th (-0.497%) and 14th (-0.491%), the BOJ made no purchase of ETFs. This has led to some market players asking, "Has the BOJ changed its purchase criteria?" and has become a topic of conversation.

This change is partly because the BOJ’s buying pace has been slowing. The BOJ aims to purchase 6 trillion yen each year, but the pace of its purchases has declined significantly in recent months.
No Wonder There Was a Stir Created in the Market

At the Monetary Policy Meeting held July 30-31, 2018, the BOJ announced a new policy on ETF purchasing, stating, "With a view to lowering risk premia of asset prices in an appropriate manner, the Bank may increase or decrease the amount of purchases depending on market conditions." With the addition of "may increase or decrease," the purchase amount for a single year is now likely to exceed or even fall below 6 trillion yen depending on the situation.

Market players are concerned about the "purchase criteria" under the new policy. Figure 2 shows the rate of decline of the TOPIX in the morning and the BOJ’s purchasing of ETFs. The blue bars indicate days when the BOJ bought ETFs, and the red bars indicate days when no purchase was made.

Until now, purchases have been made without exception on days when the decline in the TOPIX exceeded 0.5% in the morning. What is noteworthy is that although purchases have been made in the past when the rate of decline of the TOPIX in the morning was...
around 0.5% (there have even been days where it was less than 0.5% (orange frame)), no purchase was made for two consecutive business days on November 13 and 14 (yellow-green frame) despite the fact that the rate of decline was around 0.5% on both days. Based on these figures, it seems natural that it has become a topic of conversation among market players.

![Figure 2] No Wonder There Was a Stir Created in the Market
(Note) Blue = ETFs Purchased, Red = No ETFs Purchased
(Source) Bank of Japan, Bloomberg

Rate of Decline of TOPIX Is Not the Only Factor in Decision-Making

Has the BOJ really changed its ETF purchase criteria? The remark made by BOJ Deputy Governor Masayoshi Amamiya at a meeting of the House of Councillors’ Committee on Financial Affairs in May of this year provides a clue to this. He was asked a question from a lawmaker, "How do you grasp risk premiums?" He explained several viewpoints as seen in Figure 3, then he said, "It is necessary to make a judgment comprehensively."

In other words, the BOJ does not decide whether it will buy ETFs based solely on the rate of decline of the TOPIX.
**Strengthening the Sustainability of ETF Purchase Policies**

As an example, we analyzed the correlation between the price-earnings ratio (P/E ratio) and the BOJ’s buying of ETFs. P/E ratio is calculated as share price/earnings per share (EPS), and under a zero interest-rate policy, P/E ratio and risk premiums share an inverse relationship. When P/E ratio is low, risk premiums are high (investors are sensitive to risk), and when P/E ratio is high, risk premiums are low (investor's risk tolerance is high).

Figure 4 shows the rate of decline of the TOPIX in the morning against P/E ratio from August 2018 following the change in the BOJ’s ETF purchase policy. The rate of decline of TOPIX is displayed along the vertical axis and P/E ratio is displayed along on the horizontal axis. The blue dots indicate days when the BOJ bought ETFs, and the red dots indicate days when no purchase was made.

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(Source) the House of Councillors’ Committee on Financial Affairs (May 30, 2019)

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**The BOJ may have refrained from purchasing ETFs based on the judgment that the risk premium is within an acceptable range (not rising).**
A comparison of the rate of change of the TOPIX in the morning and P/E ratio and whether ETF purchases were made shows that at low P/E ratio (higher risk premium), the BOJ bought ETFs even when the rate of decline did not exceed 0.5% (the days in the orange frames in Figure 2 had a P/E ratio of roughly 11 to 12 times).

On the other hand, it can be seen that on November 13 and 14 (yellow-green frame) when no purchase was made, the P/E ratio was high (lower risk premium) at around 14 times. This level is higher than the other days when the rate of decline of the TOPIX in the morning was around the same. It is only speculation, but the BOJ may have decided not to buy ETFs because it judged that the risk premium was within an acceptable low range at least (not increasing).

As Deputy Governor Amamiya explained to the Diet, the BOJ observes risk premiums from multiple viewpoints, so it would be a mistake to predict whether an ETF will be purchased based solely on the rate of decline of the TOPIX. Moreover, as the blue line in Figure 4 is my subjective viewpoint, and because the BOJ observes “holistically” not only P/E ratio but other factors, it fails to distinguish completely how the BOJ determines its buying of ETFs.
Strengthening the Sustainability of Policy

Considering the above, the decision by the BOJ not to buy ETFs on November 13 and 14 was the result of continuing easing policy rather than to scale back easing.

Figure 5 shows the actual state of purchases before the policy change (From January 2017 to July 2018). Regardless of the level of P/E ratio, purchases were made without exception on days when the TOPIX fell more than 0.3% in the morning. By setting a rule of "No purchase if risk premium is not high (P/E ratio is not low)" the BOJ may be trying to avoid buying more ETFs than necessary.

Needless to say, the change is made for "exit" and "cost." An unnecessary increase in ETF balance not only increases the difficulty of exit strategies but also increases the cost of holding ETFs (management fees).

Nevertheless, if worry concerning a U.S.-China confrontation and economic slowdown rises and the P/E ratio falls again (higher risk premium), I believe the Bank of Japan will continue to buy ETFs even if the TOPIX falls by less than 0.5% in the morning.

It should be noted, however, that the BOJ does not buy ETFs to boost share prices. It is important for the economy and corporate performance to recover, and we should not expect too much in terms of share prices from the BOJ’s buying of ETFs.
[Figure 5] From Mechanical Purchases to More Sustainable Purchases

(Note) January 1, 2017 – July 31, 2018
(Source) Bank of Japan, Bloomberg
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Shingo Ide heads the Japanese equity research team at NLI Research Institute. A financial researcher with more than 20 years Japanese equity research experience. NLI Research Institute is a think tank of Nippon Life Insurance Group and it was established in July 1988.

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