**FINANCIAL POST**

# Forget bonds, Bank of Japan buys stocks

Tim Shufelt Aug 10, 2011 – 6:48 PM ET

As the pioneer of quantitative easing, Japan has set the best precedent for the sustained use of the controversial tool. But central banks that have followed Japan's lead, including the U.S. Federal Reserve, should be wary of the perils of such intervention as emphasized by the Japanese experience.

Not only have years of bond purchasing failed to conquer deflation and spur the Japanese economy, the Bank of Japan has since turned to equity markets, scooping up record amounts of exchange-traded funds in recent days.

Additionally, it's quantitative easing program has swelled to include riskier assets such as corporate bonds, commercial paper and real-estate trust funds.

"It's almost anything under the sun," said Mark Calabria, director of financial regulation studies at the Washington, D.C.-based Cato Institute. "They have tried it, and they have tried it in a big way."

In recent days, the Bank of Japan has dramatically increased its ETF purchases, an indication of the extent to which the country's central bank now props up its capital markets.

According to those familiar with the Japanese monetary policy, the intention of the intervention was not to influence equity values, but rather to provide a psychological lift to rattled investors.

"The size of the purchase is too small to influence markets. But there is no harm in having markets believe that the BoJ would buy on dips," said one source familiar with the central bank's thinking.

Faced with renewed market panic of late, Japanese bankers raised the target for its ETF purchases by more than 50% to ¥15-trillion ($18.1-billion), part of an asset-purchasing program totalling ¥15-trillion ($194.0-billion).

Japan first resorted to quantitative easing in the aftermath of its Lost Decade, during which ultra-low interest rates failed to encourage economic growth. Ten years later, however, deflation persists in spite of the country's QE experiments.

Elsewhere in the world, having run out of room to cut interest rates any further, central bankers are resorting to quantitative easing as a tool of last resort to prod lagging economies. The Fed blew up its balance sheet with two separate rounds of asset purchases totalling US$2.3-trillion. And since Standard & Poor's downgraded the country's credit rating, pressure is rising on Fed chairman Ben Bernanke to announce round three.

But before concluding that the United States is on a fast track to Japan's fate, it's important to note some key differences, said Mark Chandler, head of Canadian fixed income and currency strategy at RBC Capital Markets.

The U.S. economy is considered to be more flexible than Japan's, while U.S. demographic trends are far more favourable.

Also, the corporate sector of the United States is much more robust than that of Japan after its bubble burst in the 1990s.

Still, one can see quantitative easing in the United States gaining momentum and the scale of asset buying by the Fed creeping higher, Mr. Chandler said. "You have very, very little tolerance for slow growth."

With unemployment refusing to sink below 9%, constituents demand remedies to economic retreat, prodding the Fed into the kind of action that was once considered extraordinary. "Abnormal policy becomes normal," Mr. Chandler said.

While the United States has orchestrated a different brand of quantitative easing than Japan, the gap is closing, Mr. Calabria explained.

QE1 included the purchase of a great volume of mortgage-backed securities. "So we've already dabbled in the non-government sector," he said.

QE2 then targeted long-dated Treasury securities rather than just short-term bills. It's not difficult to imagine the scope of additional easing expanding further under changing conditions.

"If they get to the point where we are concerned about liquidity in the economy, I have no doubt they will loosen what they will lend against and what they're willing to outright buy," he said.