Bank of Japan policy update: A question of when, not if

New Governor expected to take cautious and measured approach to monetary policy

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Key points

- Inflation has risen considerably in Japan, with CPI reaching a 41-year high of 4.3% in January. Improving wage dynamics indicate price rises may be more sustained compared to previous episodes
- Shunto – Japan's spring wage negotiations – are pointing towards a 30-year record in terms of wage increases. Improving wages should prompt the Bank of Japan (BoJ) to start removing its accommodative monetary policy
- The Bank's yield curve control (YCC) was put in place in September 2016 to prevent long-term yields from falling too low, reducing pressure on the financial system. But higher inflation is putting pressure on this policy
- We expect the BoJ – and its new Governor – to cautiously and gradually adjust policy. We expect it to reduce the targeted tenor of its YCC and delay any interest rate hikes to 2024

The end of a decades-long battle with deflation?

Over the past 12 months, Japan's inflation rate has gone from 0.9% to 3.3% – a staggering rise for a country which has faced decades of deflation. Rises in global energy costs and other goods have been the key drivers, but the backdrop has been exacerbated by a weakening yen, which slumped to 32-year lows against the US dollar in the wake of the widening monetary policy gap between Japan and other developed markets. These combined shocks have been sustained – and unlike in previous episodes – have begun to feed through more broadly to domestic prices in other sectors of the economy.

However, price pressures remain tentative with services inflation reaching only 1.3% in February 2023. While improving wages indicate that inflationary pressures may potentially persist, given Japan's history of prolonged deflation, we remain cautious in assuming such a future development is certain.

Against this backdrop, the Bank of Japan (BoJ) will consider the super-accommodative monetary policy it has kept in place since 2014, to try to sustainably return inflation to its 2% target after years of battling with deflation.

The BoJ's policy of quantitative and qualitative easing (QQE), which targets a rapid expansion of the monetary base, began in April 2013, while its negative interest rate policy – a cut in the Call Rate to -0.1% – was introduced in January 2016. Under this policy the BoJ adopted a three-tier system and charges a negative interest rate of -0.1% on the lowest tier of excess reserves held by commercial banks at the central bank.

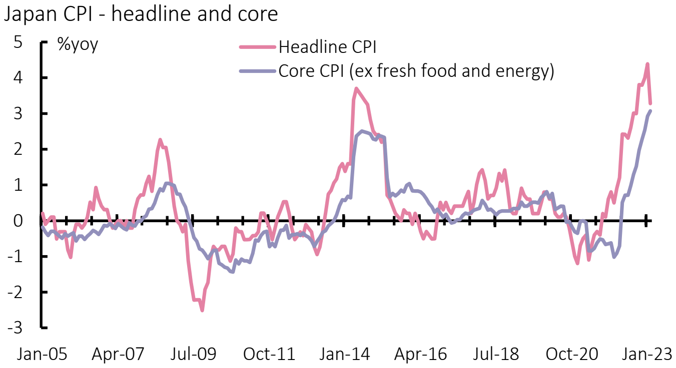
Following a pronounced flattening of the yield curve after the introduction of the negative interest rate policy, as investors feared years of potentially lower interest rates, the BoJ began targeting long-term yields under its Yield Curve Control (YCC) policy. YCC sees the BoJ commit to unlimited purchases aimed at maintaining 10-year Japan government bonds (JGBs) at 0% with a tolerance band that was initially set at +/-10 basis points (bp). This was intended to maintain an upward sloping yield curve to minimize pressures on the financial system, tighten credit conditions and ease the risk of exacerbating headwinds to the economy. The band around YCC has been widened since introduction, now standing at +/-50bp since the BoJ's adjustment in December 2022, following a sharp decline in market functioning. Although the policy initially intended to steepen the JGB yield curve, more recently it has been limiting yield increases, with the BoJ forced to purchase increasing amounts of JGBs.

Expectations have risen for the BoJ to adjust monetary policy from here. These have been driven by economic fundamentals, both the rising short-term inflation outlook and the risk of increased inflation persistence, underpinned by improving wage dynamics. Considerations of the side effects of the current BoJ policy in terms of market functioning are also driving the debate. However, the BoJ's long history of combatting deflation and the prospect of the current uptick reversing as energy shocks fade and several developed economies see growth slowing over the coming quarters will make the BoJ cautious about any such change.

Prices on the rise

Headline Consumer Price Index (CPI) inflation in February 2023 stood at 3.3% having fallen from a 41-year high of 4.3% in January, driven lower by government subsidies to limit the increase in energy costs (Exhibit 1). The BoJ's preferred core CPI measure that excludes fresh food and energy (BoJ core) continues to rise and currently stands at 3.5%. Price increases are occurring in a range of items which have previously been immune to such pressures following years of stagnant inflation, including in Tokyo subway fares, which rose in March for the first time in 28 years. Notably credit research company Teikoku Databank estimated the prices of over 12,000 food items are set to rise over the course of this year.[1]

Exhibit 1: Inflation has risen considerably



Source: Statistics Bureau of Japan, Refinitiv and AXA IM Research, April 2023

We expect inflation to continue to decline over the coming months as 2022's steep increase in energy and food prices begin to drop out of the headline measure. However, wage increases passing through into domestic prices should see inflation remain above recent averages of around 0.5% (from 2015-2019). Overall, we forecast CPI inflation to average 2.7% in 2023 and 1.3% in 2024. This will depend on the evolution of wages and we continue to see the balance of risks skewed to the upside.

Other measures of underlying inflation are also improving in contrast with previous periods of inflation. Weighted median CPI and mode CPI[2] – which more closely measures prices ignoring the impact of outliers – have risen to their highest levels since these series began in 2000.

More broadly, the output gap, which can indicate the degree of slack in the domestic economy and is closely related to domestic inflationary pressures, measured by both the BoJ and the Cabinet Office have showed signs of closing (absorbing excess capacity). The BoJ's last estimate showed the output gap to be at just 0.1% below the economy's potential – a sign that domestic inflationary pressures should be rising. Finally, what we think separates this episode of rising prices from historic episodes is the rise in wages. Wages have begun to pick up, with spring wage negotiation settlements pointing to further future gains.

Wages – a key missing piece in the puzzle

Shunto refers to Japan's annual spring wage discussions between unions and employers and while only 16.5% of employees are covered by unions[3], these negotiations act as a key barometer for the pace of wage increases throughout the economy. The Japanese Trade Union Confederation (RENGO) released the first set of data from the 2023 negotiation on 17 March. As shown in Exhibit 2, the results revealed a 3.8% rise in wages, comprising

[1] Prices to rise in Japan on over 10,000 food items over higher costs, The Japan Times, 11 February 2023.

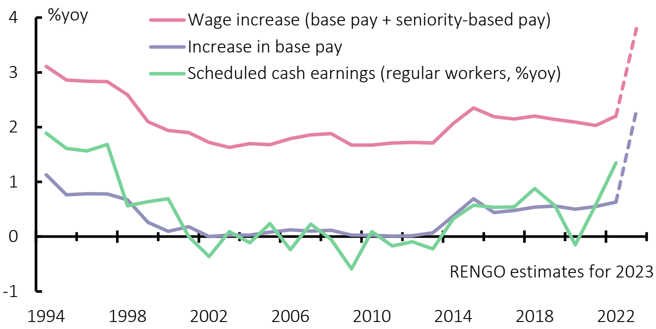
[2] Weighted median CPI is the inflation rate of the item at the middle of the price changes in the CPI basket (the 50th percentile by weight). Mode CPI is the most common inflation rate observed in the CPI basket.

[3] Basic Survey of Labour Unions, Ministry of Health, Labour and Welfare, 2022

of both seniority pay and base pay hikes. Isolating base pay hikes, which most closely correlate with headline wage growth, the figures point to a 2.3% increase. The difference is stark when compared with last year, which delivered a 2.2% increase in overall pay (0.5% base pay). This year's pace is the fastest outcome for spring wage negotiations in more than 30 years.

Exhibit 2: Spring wage settlement points to historic rises

Japan - Annual wage negotiation increase and scheduled cash earnings



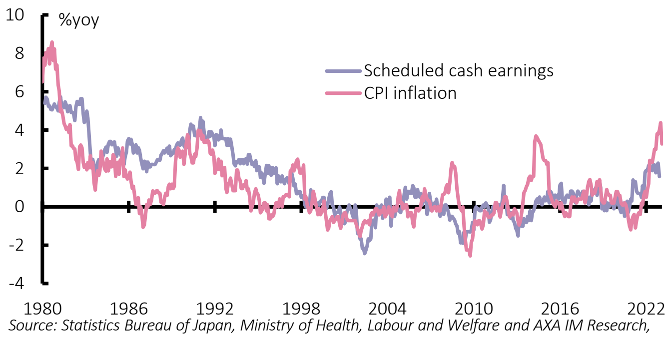
Source: RENGO, Ministry of Health, Labour and Welfare and AXA IM Research, April 2023

This resonates with reports of other large wage increases from some of Japan's largest firms, including Fast Retailing (the parent company of Uniqlo), Toyota and Nintendo[4]. However, these companies' figures are at the upper end of wage hikes and we expect these headline numbers to mask considerable dispersion across Japanese businesses. Many large multinational exporters have posted higher-than-expected profits having benefited from a weak yen. In contrast, most small and medium-sized enterprises and companies, which are more oriented towards the domestic market, are less likely to have the capacity to match these sort of wage hikes. This divergence is significant given the relative importance of small and medium enterprises in Japan's economy; they account for 69% of the private sector labour force.[5]

Alongside the risk of divergence of wage increases across firms, there continues to be a risk of revision to the figures initially reported as more unions report over the coming months. The final increase is expected in July, but historically this has been little changed following the second update. Higher wage growth is seen as a prerequisite for returning inflation to the BoJ's 2% target on a sustained basis because of the close relationship between nominal wage growth and prices over longer periods of time (Exhibit 3). Faster nominal wage growth supports faster nominal consumption growth which in turn helps lift domestic inflationary pressures in the economy. In the years leading up to the pandemic (2015-2019), wage growth has averaged just 0.5% and real consumption growth has been flat, which has contributed to low domestic inflationary pressures.

Exhibit 3: Wage inflation feeds through to broader CPI inflation

Japan - Inflation and wages



Source: Statistics Bureau of Japan, Ministry of Health, Labour and Welfare and AXA IM Research, April 2023

New leadership, new directions

Amid the evolving inflation backdrop, a new BoJ Governor has taken the reins. Kazuo Ueda, an economist and expert on Japanese monetary policy, replaced Haruhiko Kuroda on 8 April. Ueda's first meeting at the helm of the BoJ will be the upcoming April Monetary Policy Meeting on 27-28 April. The government also nominated former Financial Services Agency chief Ryozo Himino and current BoJ Executive Director Shinichi Uchida as deputy governors.

In his decade at the helm of the Bank of Japan, Kuroda shaped the direction of the organisation, taking dramatic steps to expand the monetary base in an attempt to prevent Japan from slipping further into deflation. We think the fresh slate provided by the change of personnel, alongside improved pricing dynamics, is likely to trigger a change in approach, although we think any deviation is likely to be cautious and gradual.

Little is known about Ueda's contemporary policy views. He previously served as a BoJ Policy Board member between 1998 and 2005 and during this time he was seen as a dovish member of the policy board, but we are cautious in assuming his present-day views will echo those of 20 years' ago. More recently, comments made at his confirmation hearing in front of the Diet on 24 February gave us an indication of his present views. These suggested broad continuity with no obvious break from current polices, albeit acknowledging that alterations may be required to address the side effects of current policies irrespective of the path of inflation. He remarked that even if pricing dynamics do not improve notably "the bank must continue its ultra-easy policy, while paying attention to deterioration in the market." Comments on the direction of policy were careful to emphasize that Japan remains some way away from sustainably achieving its 2% target with Ueda arguing "there is still some distance" to achieving this, suggesting the path to normalisation is unlikely to be rushed.

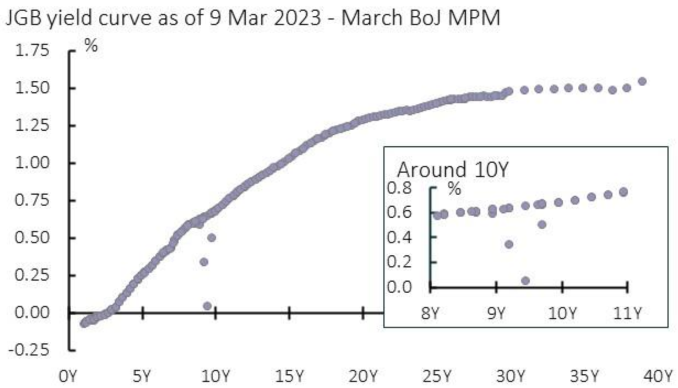
[4] Fast retailing said it will increase pay for the lowest earners by up to 40% and overall personnel costs are forecast to rise by 15%. Toyota agreed to hike base pay by 5% while Nintendo agreed to a 10% increase.

[5] 2020 White Paper on Small and Medium Enterprises in Japan, METI, SME Agency. Data are based on a 2016 government survey.

Deterioration in JGB market likely to also play a role

Since 2022, the BoJ has been attempting to deal with the upward strain on interest rates. Rising global pressures have created upward stress on JGB yields and expectations of YCC revisions. However, since the YCC targets only the current 10-year JGB rate, the yield curve has become increasingly distorted in shape, where the 10-year tenor dips sharply downward amid persistent upward pressure on interest rates (Exhibit 4). The BoJ tried to improve the curve by expanding the target range for the 10-year JGB yield from +/-0.25% to +/-0.5% last December. However, rather than alleviating pressure, the unexpected policy change raised the prospect of additional YCC revision and added to the upward yield pressure burden amid ongoing pressure from overseas.

Exhibit 4: Yield curve distortions around 10-year bonds



Source: Japan Security Dealers Association and AXA IM Research, April 2023

The BoJ was forced to step up operations, including purchases of 10-year JGBs in an amount equivalent to more than 100% of the three most recent JGB issues,[6] which resulted in a significant deterioration in the bond market's functioning. Market trading volumes declined further, interest rate volatility increased, and bid-ask spreads widened. Moreover, the artificial suppression of the yield curve has raised concerns about the appropriateness of JGBs as a reference rate, leading to widening credit spreads and a decrease in new issuance of corporate bonds.

Currently, the distortion of the yield curve is moderating as global yields have retreated, particularly given US banking sector and recession concerns. However, domestic policy changes have also helped reduce the demand-supply imbalance for long-term JGBs with the BoJ supplying a portion of its JGB purchases to the market by relaxing the conditions to access repurchase agreements (repo) via the Securities Lending Facility (SLF). Additionally, the increase in the repo rate from 0.25% to 1% for borrowing JGBs from the BoJ, announced at the end of February, is also expected to curb JGB short selling and prevent yields from coming under such pressure.

However, these are only stopgap measures, and smaller interventions by the BoJ will be necessary to deliver a fundamental improvement in the JGB market's functioning. In light of the fact that Ueda clearly pointed to the side effects of YCC policy at the Diet hearing, we believe the deterioration of JGB market functioning will be an important consideration for the BoJ's policy revisions.

BoJ policy outlook – steady, as she goes

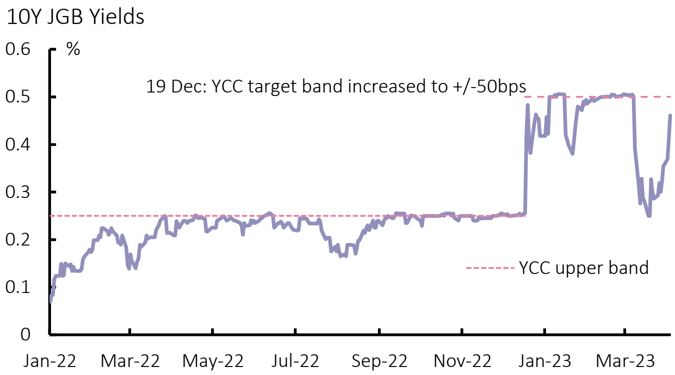
Given the improving wage and price dynamics and a consideration of the side effects associated with its current policy, we think the BoJ will begin to exit its ultra-easy policy in three gradual steps.

Firstly, we expect the BoJ to announce a comprehensive monetary policy review looking at the effects of its current monetary policy regime.

Secondly, we think the BoJ will begin by making its YCC policy more flexible, most likely by July. Currently the BoJ targets 10-year yields. Policy options include targeting a different tenor, increasing the band around 10-year JGBs or abandoning yield curve controls all together. On balance, we expect the BoJ will reduce the tenor of its target to five years from 10 years as an interim step before fully removing yield curve control. This would allow the BoJ continue to exert some pressure on long-term yields while alleviating specific pressure in the 10-year tenor. We think it is likely to make this adjustment in July, although a move as early as June is possible.

Finally, we anticipate the removal of the negative interest rate policy to be delayed until 2024. The BoJ will want to see the impact of its policy adjustment – with potentially material consequence for 10-year yields, which in turn could feed back to impact the real economy. Further evidence will also be required of improvement in price dynamics, including from the next spring wage negotiations, before taking further steps.

Exhibit 5: Acute pressure on yields has eased



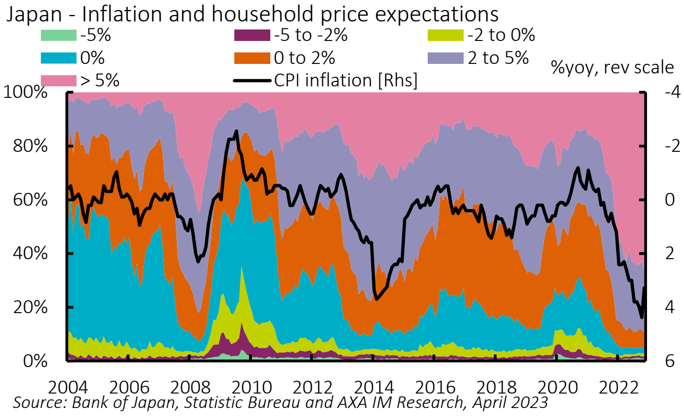
Source: Refinitiv, Bank of Japan and AXA IM Research, April 2023

6 The catch-22 for the BoJ as it wrestles with yields, Oxford Economics, 28 February 2023

Admittedly significant uncertainty clouds the BoJ outlook. Many now expect it to make some policy change over the coming months, but we expect it to be wary of rapid tightening. A rising yen is likely to be one outcome from this suggested adjustment. Rapid yen appreciation could slow Japan's fragile recovery and would reintroduce disinflationary pressures at a time when prices are just beginning to rise. Furthermore, we forecast weak global growth and the prospect of slowing external demand should add to hesitancy around any rapid policy change. Recent market moves have also decreased the acute pressure on the BoJ (Exhibit 5) and lingering downside tail risks from developments in the banking sector could see the BoJ delay action further.

Domestically we see risks around historic downward price rigidities. Household price expectations have shifted higher as spot inflation has increased – the proportion of households that currently expect inflation to be below 2% has declined to 10% from 53% at the start of 2021 (Exhibit 6). However, these expectations have closely followed realised inflation in previous episodes, quickly unwinding after inflation begins to fall back. This historic experience and risk of inflation expectations declining will add to the BoJ's step-by-step approach, pausing to see the impact of changes and the evolution of price dynamics before making further steps.

Exhibit 6: Expectations shifting – but historic shifts have not lasted



Source: Bank of Japan, Statistic Bureau and AXA IM Research, April 2023

Rising wages and signs of improving price dynamics mean that the BoJ may soon be in a position to adjust its super-accommodative policy, but history is littered with examples of improvements in pricing which in the end turned out to be short-lived. The considerable rises we have seen in wages and prices must be viewed in this context – risks to price improvement remain and therefore while some markets expect sudden changes, we think the BoJ will be measured and gradual – and we believe there is good reason for it to be so.

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