Can the Bank of Japan afford to wait and see?

London – December 16, 2022

Since October 21st, the Japanese currency experienced a major appreciation against the greenback: +10% as of December 2nd. Chief among the drivers behind this turnaround were the general shift in market expectations towards less aggressive Fed hikes combined to recent indications of Covid restrictions easing from China. However, these events could hardly be seen as sufficient to support a true yen pivot of their own, as least not without concrete signs that the Japanese central bank ought to change its trajectory and align with other countries in the global tightening cycle.

But are there reasons to believe that the Bank of Japan's unwavering resolve to maintain negative rates and to preserve loose monetary mechanisms will soon prove unsustainable given Japan's current macro-economic framework?

Japan's monetary policy objective[1]

According to the Boj, Japan is growing below its long-run potential. As such, although output is expanding and unemployment is decreasing, the economy is currently operating under its state of full capacity, a condition which can hardly generate demand-pull inflation through the wage-price spiral. Labour market indicators have yet to reach their pre-pandemic levels. Available labour force may have surpassed 2019 highs thanks to increased women participation, but the unemployment rate, which currently stands at 2.6%, is still due for a complete recovery, in particular for non-regular employees. Besides, nominal wages have only moderately improved this year. This has resulted in negative real income growth for the Japanese given the steady rise in headline inflation, now hovering around 3.8% year-on-year.

Under these circumstances, the central bank's governor, Haruhiko Kuroda, asserts there is room to implement loose monetary directives in an economy which has been plagued with prolonged deflation and low growth for decades. Most conspicuous, the bank would like the population to react to the recent rise in inflation by increasing expectations for higher price levels in the long-run. This should encourage workers to eventually demand higher wages and companies to eventually pass-down higher input costs to prices. The Boj not only wants to foster the country's post-Covid recovery; it also seeks to reach the price stability target of 2% inflation trough price-wage loops. As such, next year's spring salary negotiations, known as Shunto, during which the Japanese Trade Union Confederation is set to request the highest wage adjustment from companies in decades, will be closely monitored by the central bank.

[1]Source: The *Outlook for Economic Activity and Prices* (October 2022)
https://www.boj.or.jp/en/mopo/mpmsche_minu/index.htm/

The Bank of Japan's mechanisms

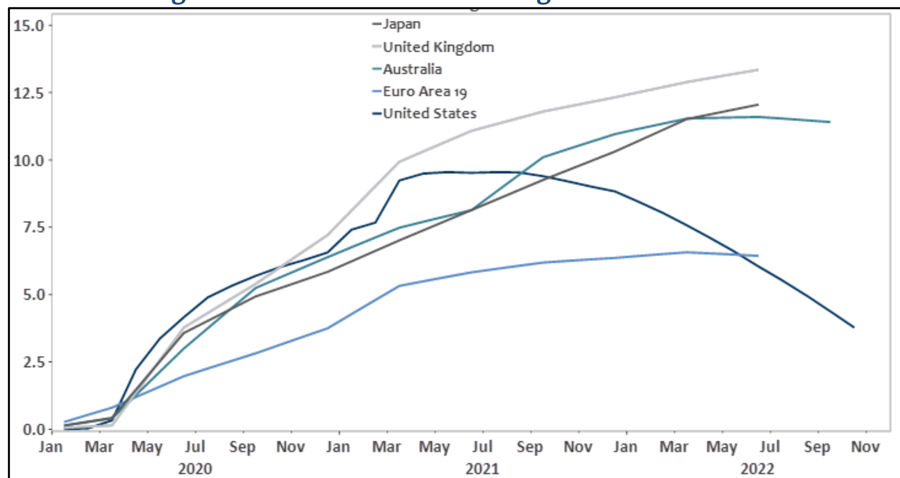
The stringent management of short-term & long-term bond yields is a key segment of Japan's monetary policy, known as the Yield Curve Control (YCC). How does it work? First, the bank applies a -0.1% policy rate on balances held by commercial banks in accounts under its management. This way, it influences short-term rates at which funds are borrowed and lent on the interbank market. The bank also stands ready to buy as many Japanese government bonds (JGBs) as necessary in order to cap 10-year, sovereign bond yields at a level close to zero, and thus, to restrict longer term yields from increasing too much. To do so, the Boj offers to purchase specific, 10-year maturity issues at a 0.25% yield every business day. Quantitative as well as qualitative easing programmes, aimed at increasing the Boj's holdings and diversifying the type of securities purchased, are also implemented to add downward pressure on long term rates and further ease financial conditions. The lack of flexibility with which these mechanisms are applied could be at play with the end of Kuroda's decade-long term in April 2023.

After the Fed and the ECB, is the BOJ next in line to change its inflation diagnosis?

It could be argued that the vigorous scepticism surrounding the possibility for the Bank of Japan to depart from its expansionary monetary stance is justified given the slow pace of inflation compared with other economies, and most importantly, the pre-eminence of deflation in the list of macroeconomic pitfalls that have long kept the central bank preoccupied. Nonetheless, it is increasingly clear that the country will follow a path similar to the rest of the world. And this becomes apparent when the resemblance between the initial conditions that have underscored the inflation trajectory in other economies and Japan's current macro framework are taken into consideration.

Private consumption in Japan continues to strengthen as marginal propensity to save normalises to pre-pandemic trend levels while individuals draw upon significant pent-up savings built during the lockdowns (Figure 1). And much like other nations, Japan has also endorsed this "Whatever it takes" stance to protect its citizens from the hardships of inflation and maintain their purchasing power through outsized fiscal measures, as reflected in Kishida's USD 197bn spending package. Income, in real terms, stands to improve on the back of Japan's tight labour and from an expected decline in headline inflation as this year's rise in energy and food prices lose steam. Besides, the country's growing Service sector will constitute a major driver for activity, both domestically and through exports (Tourism), due to the recent restrictions relief in Asia.

Figure 1 – Cumulated Excess Savings in Percent of GDP

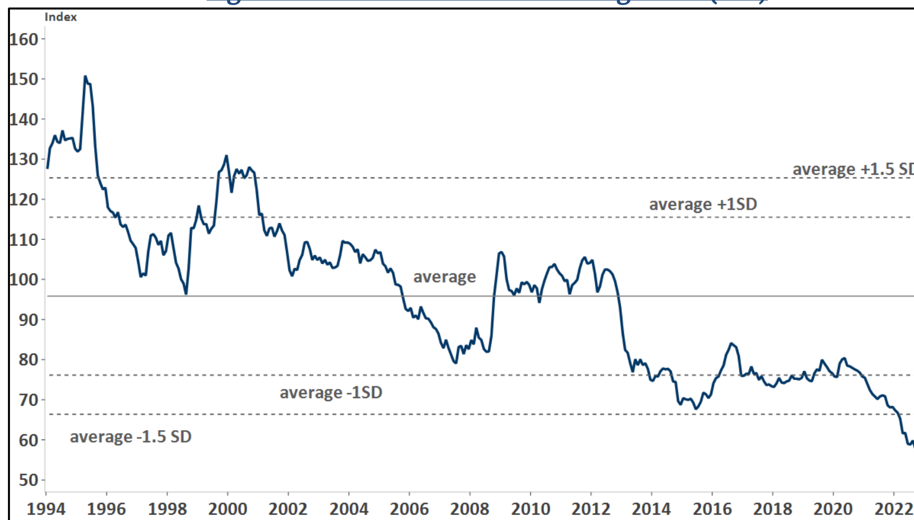


Source: H2O AM & Macrobond, data as of November 2022

Just like the Bank of Japan today, the ECB, as well as the Fed beforehand, have expressed strong doubts about the persistence of inflation and adopted a wait-and-see approach to monetary policy at first. But eventually, underlying conditions, similar to those described above, have supported growth and generated cyclical inflation despite known risks to activity (e.g., the slowdown in China, war in Ukraine, potential Covid resurgence). This prompted the Fed and the ECB to amend their discourse and change their course of action. The Boj, which has taken the same initial stance, will soon face similar concerns. But the longer the central bank decides to wait, the tougher will become its mandate to keep inflation under control.

The currency, which has reached a 22-year low against the dollar, has also reached a historic low against the currencies of its major trading partners in real terms (Figure 2) despite recent market interventions from the central bank. This year's intensified short yen positioning was undertaken by hedge funds as a proxy for rising rates globally, but also by real money participants (e.g., pension funds & corporates) underlying the country's major capital outflows. The yen now appears extremely depreciated against other major currencies in real terms. Any news that validates the strengthening of underlying inflation in Japan could thus inspire a major trend correction. Besides, investors should become increasingly inclined to hold the depreciated, safe-heaven currency to hedge against an uncertain global outlook, especially as the Fed confirms the impact of its monetary policy on inflation and moves away from 75 bps rate hikes.

Figure 2 – The Real Effective Exchange Rate (JPY)



Source: H2O AM & Macrobond, data as of October 2022

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