Global Macro Research - Insight

10 November 2023

8:20 minute read

#Japan / #Monetary Policy / #Inflation

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Following three lost decades, is Japan at a turning point?

Japan is closer to achieving its inflation target over the medium term than it has been in decades. But higher wage agreements and inflation expectations are only weakly embedded, so the BoJ's exit strategy will be very cautious. We expect yield curve control and negative rates to end next year, but little tightening thereafter.

Key Takeaways

- There has been persistent speculation about the end of yield curve control (YCC) and negative interest rate policy (NIRP) in Japan.
- The Bank of Japan's (BoJ's) changes to the YCC framework in June and October, which raised the trading range for 10-year yields, helped fuel this.
- More fundamentally, the policy path depends on whether the country has exited three decades of low or negative inflation. Certainly, the recent global inflationary environment has raised Japan's headline and core measures to more than double the 2% target.
- But pandemic- and Ukraine-related pressures are now unwinding. The true tests of a new inflation regime are wage growth and inflation expectations.
- The 2023 Shunto spring wage negotiations were the strongest since the early 1990s, resulting in a 3.6% wage hike. The current elevated rate of inflation and corporate earnings growth could see another 3%+ Shunto agreement in 2024.
- But this has yet to be reflected in realised earnings growth. Meanwhile, inflation expectations have picked up, but may be weakly entrenched given the historical experience.
- The BoJ's exit path will be very cautious. We don't expect any changes before mid-2024 but think another decent Shunto wage round could prompt the BoJ to drop YCC and raise the policy rate to 0%. But we don't envisage further hikes over our forecast horizon, so Japan may only be replacing negative with zero rates.

The Bank of Japan versus the markets

Over the past year, Japanese assets have come under pressure as markets test the Bank of Japan's (BoJ) resolve to maintain ultra-loose monetary policy. There has been persistent speculation among market participants about the end of yield curve control (YCC) and negative interest rate policy (NIRP).

This speculation is being driven by a variety of factors, including distortions in bond market functioning, the sharp deprecation in the yen as the yield differential with the rest of the world widens, the BoJ's own unclear communication on the topic and surprise changes to the YCC framework, and a perception that Japan may have finally exited three decades of low or negative inflation. In this note, we assess whether the latter is the case.

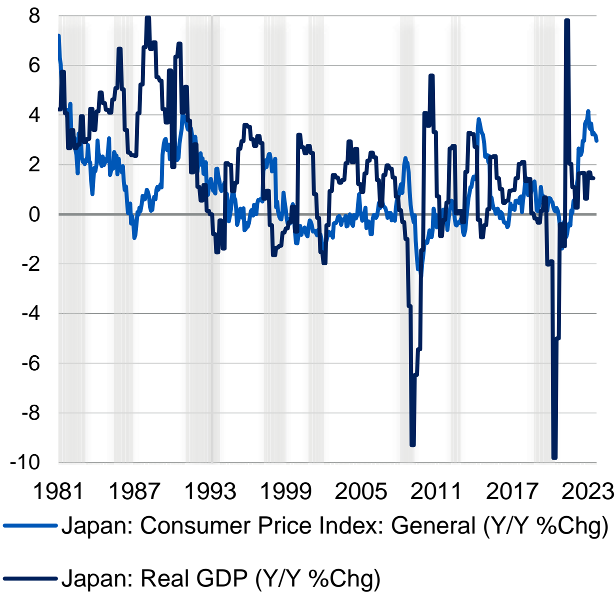
A difficult legacy to leave behind

Japan's "lost decades", lasting from 1991 to arguably as late as 2021, were the result of the bursting of the asset bubble of the late 1980s, natural disasters, inappropriate monetary and fiscal policy, and demographic challenges. GDP growth averaged 0.7% and inflation averaged 0.4% over this period, despite several short-lived occasions in which activity and inflation temporarily accelerated (see Figure 1).

The (second) election of Shinzo Abe in 2012 brought political stability – after a period which saw six prime ministers in six years – and hopes that the lost decades would be left behind.

However, despite the growth-focused approach of "Abenomics", the supply side of the economy did not improve markedly. Potential growth and productivity remained weak while inflation did not return to target.

Figure 1: The lost decades saw persistently low growth and inflation, and repeated recessions, in Japan

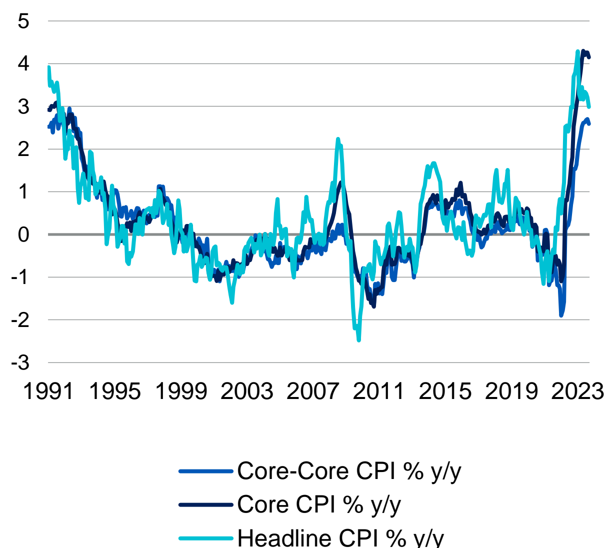


Source: abrdn, Haver, November 2023

What has changed after the pandemic?

The post-pandemic global inflationary environment has helped fuel inflation pressures in Japan. Headline and core measures of inflation reached a 40-year high in 2022 and early-2023, peaking at more than double the 2% inflation target (see Figure 2).

Figure 2: Inflation peaked at a 40-year high earlier this year, but has declined somewhat since



Source: abrdn, Haver, November 2023

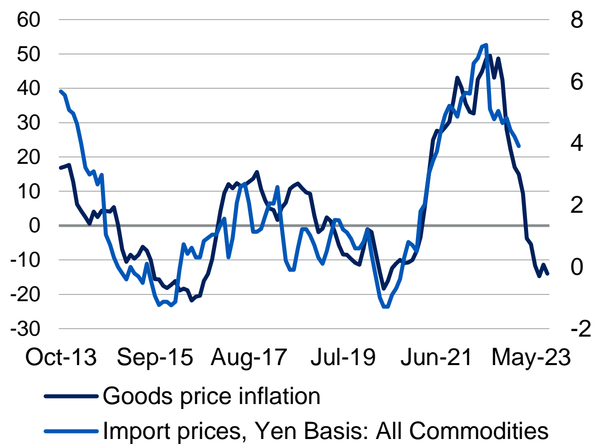
Global factors such as commodity price increases and supply chain bottlenecks have driven much of the increases in Japanese inflation.

The pass-through of higher global energy prices has been somewhat attenuated as the government implemented subsidies for gasoline prices that helped constrain energy prices. But, when these subsidies eventually expire in April 2024 as is currently planned, 1ppt could be added to CPI inflation.

Meanwhile, Japanese goods price inflation peaked in June 2022 and should decline considerably further (Figure 3). Imported raw material inflation leads goods prices by eight months and signals lower inflation ahead.

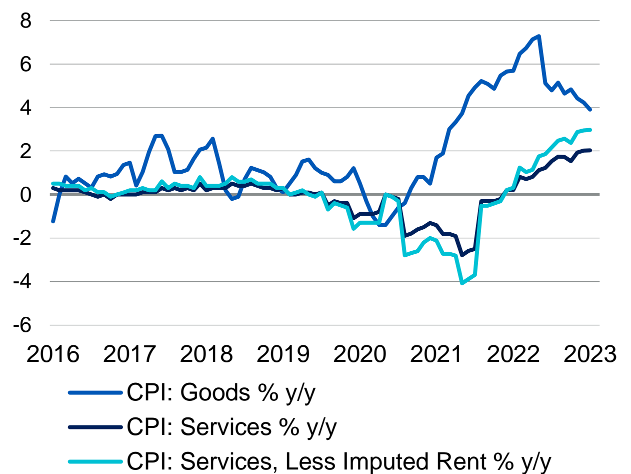
Domestically generated and service sector inflation have lagged that of the goods sector (Figure 4). However, the post-pandemic move higher in core services inflation is continuing for now. This has been the first summer without Covid warnings in Japan and the breakdown of inflation shows pockets of price pressures in recreational services, food, and hotel charges, driven by the return of inbound tourism.

Figure 3: Japanese goods inflation peaked in mid 2022



Source: abrdn, Haver, September 2023

Figure 4: Services inflation exceeds 2% after years of flat or negative growth



Source: abrdn, BoJ, September 2023

However, these price pressures may eventually ease as pent-up demand for services normalises.

The breakdown of real household spending shows services declined 1.8% month over month in September. A meaningful acceleration in wages will be required to drive sustainable services inflation.

Domestically generated inflation is key to establishing a new regime

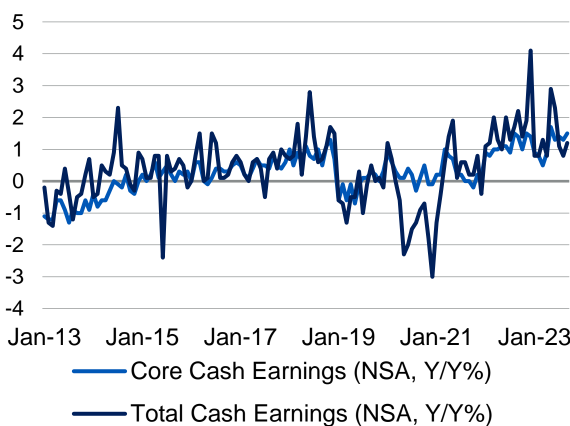
As these global factors unwind, the evolution of wage growth and the ability of corporates to pass higher input costs onto consumers are key to whether a new inflation regime will be established in Japan.

The 2023 "Shunto" spring wage negotiations were the strongest since the early 1990s, resulting in a 3.6% wage hike, compared to just 2.1% in FY2022. Strong corporate earnings, a sustained government-led drive for higher wage growth and global inflation drivers all helped to spur wage growth in those negotiations.

Heading into the 2024 Shunto round, more firms have announced plans to raise wages in the spring negotiations to secure talented workers. The elevated rate of inflation and decent corporate earnings growth could see another 3%+ Shunto wage agreement.

However, the impact of stronger reported wage settlements is yet to be reflected in *realised* earnings. That's because the headline Shunto number included automatic annual pay rises following the seniority-based wage scale in the life-time employment system. What matters most for aggregate household income is the base wage increase, i.e. a shift-up of the seniority-based wage scale itself. While headline earnings growth has experienced bonus-driven spikes, core earnings growth remains below 2% year over year and within the long-run trend (Figure 5).

Figure 5: Strong Shunto wage negotiations have yet to feed through to realised earnings growth

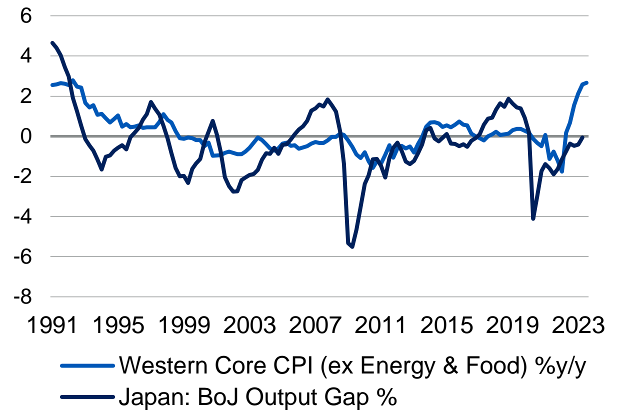


Source: abrdn, BoJ, September 2023

For a virtuous circle of strong wage and price growth to take place, base wage growth in the region of 3% per year and a marked shift in firms' price-setting behaviour is needed.

That will be difficult when the BoJ's measure of the output gap has barely closed (see Figure 6). And even if the output gap does turn positive in coming quarters, core inflation has not been very responsive to the business cycle as the Japanese Phillips curve has steadily flattened. In part that's because inflation expectations have been structurally low following decades of low inflation.

Figure 6: Output gap around zero



Source: abrdn, Haver, September 2023

Has the deflationary mindset been left behind?

So a change in inflation expectations is essential for a meaningful shift in domestically generated inflation.

Historically, Japanese firms have battled with a "deflationary" mindset. Corporates absorbed the bulk of input cost increases rather than passing these through to price sensitive consumers. Households accustomed to the low inflation environment have often pulled back spending in the face of price hikes.

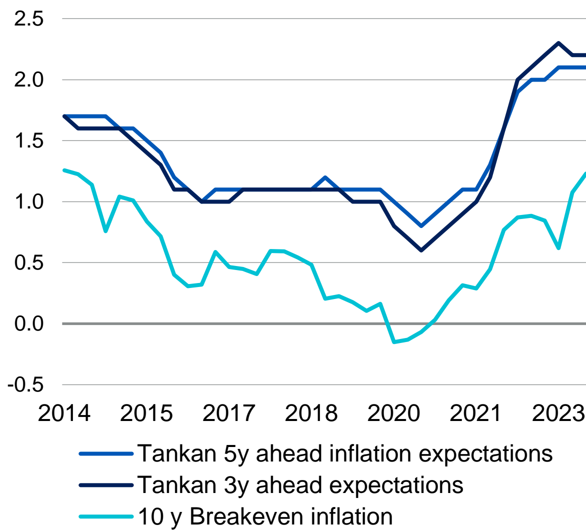
The combination of post pandemic inflationary pressures and a few years of relatively high wage rounds could lay the foundations for a shift in price- and wage-setting behaviour, potentially pushing Japan toward a higher inflation regime.

Figure 7 shows that there has indeed been an increase in inflation expectations among corporates. Medium-term (five year) inflation expectations have finally reached 2%. That said, markets remain sceptical as breakeven inflation has only just exceeded 1%.

The pick-up in inflation expectations and more aggressive wage demands from unions suggest it may be possible for Japan to move to target-consistent inflation rates over the coming years.

This would be a big achievement considering the inflation target has been out of reach for the past three decades. But we think that the burden of proof is on the data showing strong wage negotiations before meaningful BoJ action is taken.

Figure 7: Mixed picture from inflation expectations



Source: abrdn, BoJ, September 2023

The Bank of Japan's exit strategy

BoJ communication in recent months has been quite consistent in affirming that the bulk of Japanese inflation pressures are global and transitory. Policy makers consider domestic wage trends as key to determining the inflation outlook as "transitory" global factors unwind.

Ueda's speeches following the October meeting highlighted that there was no rush to normalise policy as lower-than desired inflation is harder to tackle than too-high inflation. Constraints such as the effective lower bound on interest rates create this asymmetry.

At the same time, recent changes to the BoJ's YCC framework reveal a desire to very gradually alter existing policy settings. The permitted trading band around 10-year Japanese government bond (JGB) yields has been slowly increased, in both July and October, with the current 1% upper bound watered down to be a "reference" rather than a genuine upper bound.

Still, the BoJ appears to need greater confidence in forecasting inflation around 2% six months, one year and 18 months ahead before additional action is taken.

While the economic rationale for policy adjustment remains tentative, the central bank is also sensitive to market pressures. In particular, the BoJ is carefully monitoring yen depreciation, widening rate differentials with the rest of the world, and impaired JGB market functioning.

We therefore expect no changes to YCC and negative interest rates between now and April next year. This forecast is not without risks, as a further rise in global bond yields and additional yen depreciation could push the BoJ into earlier action. But our best read of the central bank's sometimes unclear communication is that policymakers will wait for evidence from the next Shunto wage negotiation.

Indeed, we now think the BoJ will drop YCC after being able to confirm a decent Shunto round next year, possibly at the policy meeting on 30-31 July.

This would move the central bank back to a more orthodox policy framework centred on control of the short-term policy rate (the overnight rate for policy-rate balances in current accounts held by financial institutions at the BoJ).

Again, in the absence of clear BoJ communication around an exit strategy, this forecast is not without its risks. Rather than dropping YCC, the BoJ could continue to make the 10-year government bond yield cap an effective "crawling peg", progressively raising the upper end of the reference rate in 25bps increments.

But in the baseline, we also now expect negative interest rate policy to be dropped in July as well, with the BoJ raising the short-term policy rate from -0.1% to 0%. The government may use this moment to officially declare the end of the deflationary era.

However, our expectation of a mild US recession beginning in mid-2024, and our forecasts for interest rate cuts from the likes of the Federal Reserve, European Central Bank and Bank of England from around that point, mean that we see little scope for substantial BoJ rate rises. Having exited NIRP, the BoJ may remain in ZIRP (zero interest rate policy) for an extended period.

Overall, a new inflation regime may be within sight. But after many lost decades, this transition will be tentative and the BoJ will want to tread carefully to ensure target-consistent inflation becomes embedded. Japan's exit from yield curve control and negative interest rates will be symbolically important, but interest rates across the curve will likely remain very low.

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AA-221123-171171-11