



Global Macro Research

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#Japan

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What does Bank of Japan tapering mean for markets?

The rapid depreciation of the Japanese yen has moderated, but policymakers still face difficult choices. The BoJ will publish its plan for tapering bond purchases at the end of July. Tapering may lead to higher bond yields and some support for the currency. But we think large international spillovers will be minimised by tightening cautiously.

Key Takeaways

- Japanese policymakers have sought to limit the speed and extent of the yen's recent depreciation. But, with the interest rate differential between the US and Japan so wide, the impact of currency market interventions has typically been swamped by economic fundamentals, notably in the US.
- Most recently, softer nominal growth in the US, a safe-haven bid and expectations of further Bank of Japan (BoJ) monetary tightening – including tapering its asset purchases – have helped support the currency.
- The BoJ owns around 50% of outstanding Japanese government bonds (JGBs), so the path back to investor-driven price discovery may be bumpy. Indeed, tapering the BoJ's asset purchases could have international spillovers, with other overseas bond yields moving higher and Japanese investors selling out of various overseas assets to purchase JGBs.
- But the BoJ is aware of the risks and is consulting with market participants on the path for asset purchases. It will try to ensure the pace of tapering is gradual.
- Moreover, with Japan's exit from deflation only half convincing and activity and inflation data mixed, domestic economic conditions also argue for only a gradual tightening in financial conditions.
- We expect the BoJ to announce that the monthly pace of JGB purchases will initially fall from Y6 trillion to Y4-5 trillion. We also think a July rate hike is possible and expect policy rates to be at 0.2%-0.3% by year-end.

Rapid yen depreciation poses challenges, and intervention attempts have been shrugged off

The USD/JPY cross seems to have stabilised recently following a period of exceptionally rapid depreciation. Extended positioning and political developments fuelled a brief rally over the past week. But the currency broke through a 38-year low of 161 at its weakest point, and ongoing volatility and weakness present several challenges to policymakers.

First, the weaker currency has led to imported inflation via fuel and food costs rising sharply. While Japan has battled for decades to generate sustained inflation pressure, exchange rate depreciation is better seen as a negative shock to the level of living standards rather than a source of more benign domestically generated price pressures. Indeed, this imported inflation has been politically painful for Prime Minister Fumio Kishida ahead of his party's leadership contest in September and the general election next year.

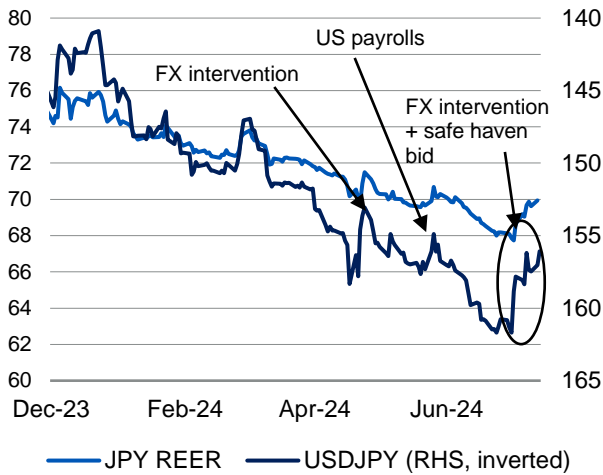
Second, currency volatility has made corporate planning more difficult, and firms report little ability to pass on rising input costs to reticent consumers. According to a survey by the Japan Chamber of Commerce, only 2.3% of surveyed small- and medium-sized businesses state that the weaker yen is good for business, while 55% point to adverse effects.

Partly in response to these concerns, policymakers have sought to stem the speed and extent of currency depreciation, including via direct currency market interventions.



However, these interventions have tended to have little lasting effect on the yen, with the USD/JPY instead proving to be much more responsive to US macroeconomic developments in general and the outlook for Fed policy in particular (see Figure 1).

Figure 1: The USD/JPY cross has been very sensitive to US economic developments



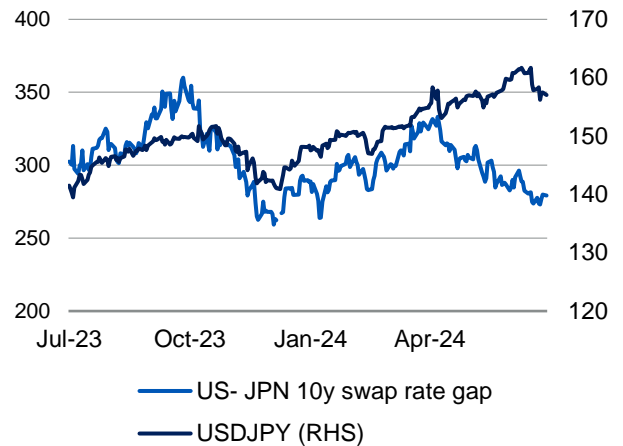
Source: Bloomberg, abrdrn, July 2024

The recent softening in US activity and inflation data, and the consequent repricing of Fed expectations, has therefore provided some relief for the yen and led to a more stable trading range.

Japanese policymakers are no doubt aware of the significance of US data, with the large rally in the yen following the softer June US CPI suggesting that the Ministry of Finance (MoF) has started strategically timing its currency interventions around US data releases to maximise the market impact.

Investor positioning became quite extended, with the yen far weaker than the steady narrowing of the US and Japan yield differentials (see Figure 2). Admittedly, the 350bps gap in 10-year swaps and the 545bps gap for three-month swaps suggest the carry trade could remain strong and the scope for a meaningful yen rally limited until the Fed embarks on a clear easing cycle.

Figure 2: The US-Japan rate differential has narrowed recently



Source: Bloomberg, abrdrn, July 2024

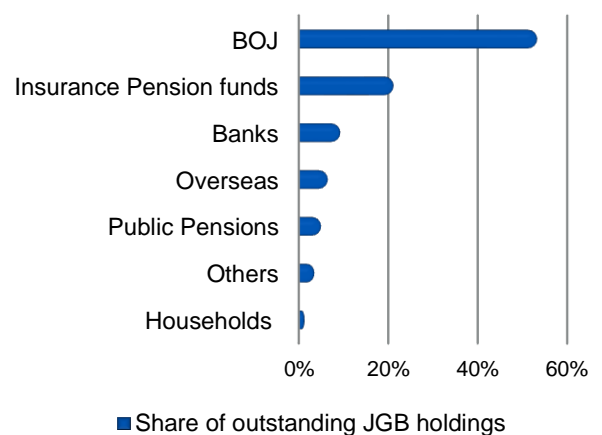
But US yields are already falling on the back of softer nominal growth data. And Japanese government bond (JGB) yields are moving higher as markets move to price the prospect of further rate hikes from the BoJ and, perhaps more importantly, the start of asset purchase tapering.

The BoJ will start tapering its asset purchases soon

The BoJ is set to announce its tapering plans at its July 30-31 policy meeting. At his June press conference, BoJ Governor Kazuo Ueda seemed to signal the BoJ is serious about materially reducing its role in the JGB market as part of the process of exiting its ultra easy policy stance.

The BoJ's JGB holdings far outweigh other market participants, with the central bank's Y585-trillion stock of bonds representing around half the outstanding supply (see Figure 3). So, shifting back towards investor driven price discovery may be a bumpy process.

Figure 3: The BoJ currently dominates the JGB market



Source: Bloomberg, abrdrn, July 2024



As such, the BoJ has been gathering views from commercial banks, securities firms and the buy side via its Bond Market Group to help decide, and guide expectations around, the path of tapering.

According to surveys conducted by Reuters, market consensus is for the BoJ to decrease JGB purchases from Y6 trillion per month at the moment to Y3-5 trillion per month a year from now, and Y2-3 trillion two years from now.

Over time this tapering should see JGB yields rise higher as investors demand a higher term premium to finance Japan's large borrowing requirements with less support from the central bank. This is in line with the BoJ's broader strategy of gradual monetary tightening and should also help support the yen through reducing the yield differential between Japan and the rest of the world.

Indeed, one way to more aggressively support the yen in the near term might be to deliver a more rapid pace of tapering than currently expected by the market.

This would push up the term premium on JGBs even more and shift expectations about the likely path of short-term interest rates by signalling a more hawkish reaction function.

However, such a strategy is not without risks. A faster-than-expected pace of tapering risks disrupting bond market functioning. An undesirably large spike in yields could derail the nascent recovery in growth and inflation and make it more difficult for the government to service the interest payments on government debt.

JGB repricing could impact global asset prices

More generally, a steeper JGB yield curve could have several important implications for the economy and markets.

Domestically, it should help improve Japanese banks' profitability over time, somewhat blunting the tightening in financial conditions normally associated with higher bond yields. However, there may also be a near-term hit to profitability through mark-to-market losses on fixed income securities.

Higher JGB yields could also incentivise Japanese investors to hold more JGBs in their portfolios. Given Japan's large net foreign asset position, any portfolio re-allocation by Japanese investors towards JGBs could push down on the price of overseas assets as these are sold to finance JGB purchases.

In particular, the portfolio allocation of Japan's Government Pension Investment Fund (GPIF) will be watched very closely by investors. GPIF is one of the world's largest institutional investors, with Y245 trillion in assets under management, while many of Japan's other pension funds and insurers also follow shifts in its asset allocation.

GPIF has recently emerged as a strong source of demand for JGBs, with a 25% increase in holding in the fiscal year ending on 31 March. This was financed by reducing

allocations to domestic T-bills, domestic corporate debt and FX-hedged foreign debt. Moreover, it has historically bought JGBs on dips, and may look to buy more on any market weakness as the BoJ tapers.

Significantly, though, it is due to announce its five-year portfolio review in coming weeks, and any major shifts that involve selling overseas assets could become a catalyst for a wider repatriation of Japanese investment. Expected return calculations in the portfolio review will determine the scale of any shift, but a higher return target would imply maintaining a strong allocation to foreign assets.

Finally, higher JGB yields could push up on other government bond yields around the world, with the BoJ's purchases having plausibly helped to anchor other government bond curves lower over recent years.

A [2023 IMF study](#) suggested this effect is likely to be relatively small, finding that a 100bps rise in JGB yields would push US and European government bond yields up by just 5-10bps. In fact, the spillovers from the Treasury market to the JGB market appeared higher and more persistent, perhaps reflecting the dominance of the US market and Fed in driving global interest rates.

However, it is worth noting that the study was conducted during a relatively stable period for Japanese assets, so may not be fully representative of the impact of any global spillovers should there be a more disorderly repricing of the Japanese curve.

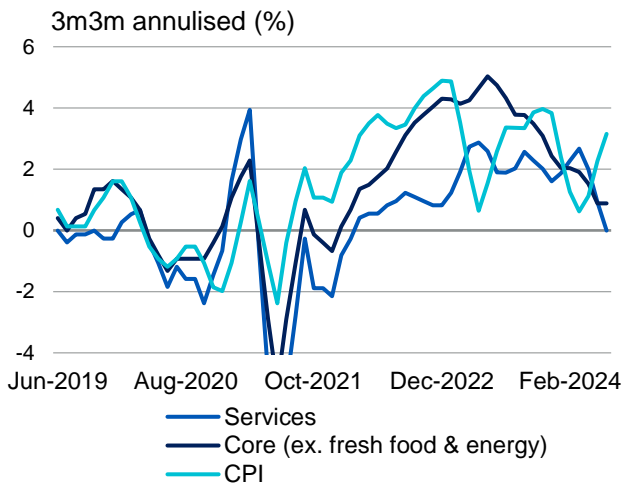
On balance, then, the risks of significant international spillovers from JGB tapering seem relatively limited. However, the BoJ will be cognizant of these risks, and, partly to ensure that they remain contained, will likely taper at a steady and well communicated pace. This may involve working with the MoF to ensure a stable JGB and yen environment.

Domestic conditions also point to gradual tightening

Japan's domestic economy provides further reasons for a gradual pace of tapering. The slowing pace of sequential core, especially core services, inflation makes a material tightening of financial conditions undesirable (see Figure 4).



Figure 4: Momentum has eased across Japanese core and services inflation



Source: Haver, abrdrn, July 2024

Firms are still struggling to pass on price increases to consumers. And revisions to Q1 GDP suggest activity growth is weak, and consumer spending growth has been negative for four consecutive quarters.

Admittedly, leading indicators point to some pick-up in activity, with the June Tankan survey showing that large corporates are resilient and have solid capex plans. We expect GDP to gradually recover over the coming quarters, but annual 2024 growth is set to remain lacklustre.

Meanwhile, the 2024 Spring “Shunto” wage negotiations resulted in the strongest negotiated wage increase in over three decades. Realised earnings data showed an acceleration in base pay growth in May, with sample adjusted earnings growth jumping 0.7ppt to 2.7% year over year.

This could rise to perhaps 3.6% if Shunto wage agreements fully feed into realised earnings – a contrast to the 2023

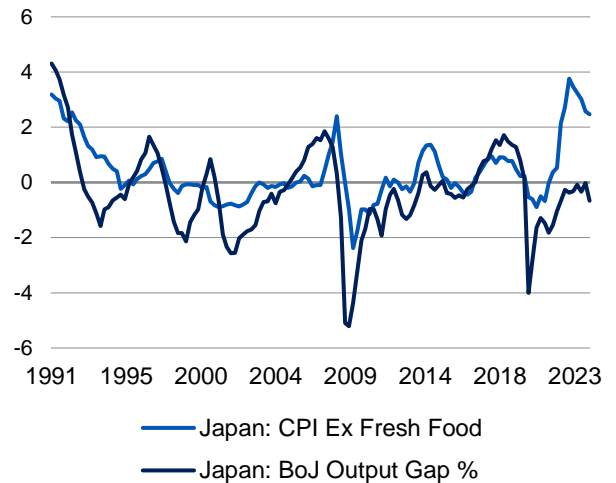
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Shunto outcome, when there was little pass-through to realised pay growth.

But fundamentally, there is still a persistent negative output gap in Japan, which limits domestically generated core inflation pressures (Figure 5). So, Japan’s exit from deflation is still only half convincing.

Figure 5: Output gap remains disinflationary



Source: Haver, abrdrn, July 2024

We expect JGB purchases to be reduced at a gradual pace to limit market distortions

Overall, we expect the BoJ will announce a reduction to Y4-5-trillion purchases per month a year from now, with further reductions over the coming years.

More imminently, we think the July policy meeting is live for a rate decision and could see a 10bps hike to 0.1%-0.2%. Either way, we expect rates to end the year at 0.2%-0.3%. But the persistent weakness in growth will limit the potential for significant further tightening next year.



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