Global Macro Research - Insight

19 March 2024

4.32 minute read | #Japan / #Inflation / #Monetary Policy

Beyond negative rate policy: What's next for Japan?

The Bank of Japan has finally exited negative interest rates and removed yield curve control. Short-term rates will be the primary policy tool from here, marking a return to more conventional policy. But further tightening is likely to be limited.

Key Takeaways

- The Bank of Japan (BoJ) finally exited the era of highly unconventional monetary policy, voting 7-2 to end negative interest rates and yield curve control. ETF and REIT purchases will also end. Commercial paper and corporate bond purchases will be scaled back.
- The move was broadly expected and priced by markets following a series of media leaks. The sell-off in the yen and small fall in bond yields is consistent with markets taking a "buy the rumour, sell the fact" approach to what is likely to be a very limited hiking cycle.
- The new policy framework appears aimed at engineering a smooth transition to conventional policy, with short-term rates the primary policy tool for the first time since 2007.
- In the press conference, Governor Ueda acknowledged both progress made in inflation and uncertainties ahead.
- Further rate hikes will depend on the scale of wage and price hikes that materialise at the start of the new fiscal year. While the early evidence from the Shunto negotiations is encouraging, this strength needs to filter into realised wage growth, especially for smaller firms. And it is not clear whether firms have pricing power to push through increases as part of a virtuous wage/price dynamic.
- We expect additional tightening to be limited, as domestic inflation pressures are likely to continue to ease over coming months.

Dismantling unconventional measures

The Bank of Japan (BoJ) voted 7-2 to end negative interest rate policy (NIRP) and axed the three-tier policy rate system. The unsecured overnight call rate was restored as the policy rate, anchored within a 0.0-0.1% range.

In addition, yield curve control (YCC) with a 0% target and a 1% upper bound for 10-year Japanese government bond (JGB) yields was abolished. YCC had been progressively watered down over the past year and, in any case, the current level of 10-year yields, at 0.73%, is well within the previous upper bound.

However, the BoJ will continue to purchase broadly the same amount of JGBs as before (JPY 6 trillion per month). And it said that it will increase purchases if it sees a rapid rise in long-term yields. While we don't know exactly what sort of moves the BoJ would respond to, this commitment is consistent with trying to make today's announcements a fairly dovish exit.

Exchange-traded fund (ETF) and real estate investment trust (REIT) purchases, which were originally adopted to encourage risk taking, will also end. These tools have not been used in a while – the BoJ last bought ETFs in October 2023, and REITs in June 2022. Commercial paper and corporate bond purchases will also be reduced, with a view to end completely in 12 months.

Moreover, the overshooting commitment – whereby the BoJ promised to expand the monetary base until core CPI (ex-fresh food) was stable and above 2% year over year – was removed from the monetary policy statement.

Finally, prior forward guidance referring to scope for "additional easing measures if necessary" was replaced with statements saying that "accommodative financial conditions will be maintained for the time being". The two dissenters to these historic shifts voiced concerns over the weakness of the economy and the sustainability of inflation pressures.

A neutral press conference

Governor Kazuo Ueda delivered a carefully worded press conference, and he refused to be drawn into signalling specific future changes to rates or balance sheet policy.

Ueda pointed to the recent strength of wage negotiations as providing a strong backdrop for the policy shift and evidence that NIRP had served its purpose.

Early announcements show that the Shunto wage round was the strongest in over 30 years, with wage increases averaging 5.3% and base pay deals at 3.7%. However, these figures may be revised lower as small firm tallies are included.

While Ueda expressed confidence that wage deals should continue to be strong, he also reiterated the importance of maintaining an accommodative policy stance.

Meanwhile, weak domestic activity data could not be ignored and were flagged as a key risk going forward.

Ueda acknowledged that there is still "some distance" to cover before inflation expectations become sustainably anchored at 2%. He also admitted that he was not 100% certain of hitting the price goal.

This supports our view that even with YCC and NIRP now removed, the BoJ will maintain accommodative policy to ensure inflation is supported. Legacy JGB and ETF holdings are expected to remain on the balance sheet for some time.

Monitoring wage data to determine the path of policy

While global factors such as commodity prices and supply chain bottlenecks drove the first leg of the acceleration in Japanese inflation, the focus for the BoJ from here will be the sustainability of domestic wage and price pressures. These are key to determining the inflation outlook once external pressures unwind.

Encouragingly, core inflation measures, in particular labour-intensive service inflation, stand at 30-year highs (see Figure 1). Domestic wage trends are also strong, but the robust headline Shunto wage numbers need to filter through to realised wage growth (see Figure 2).

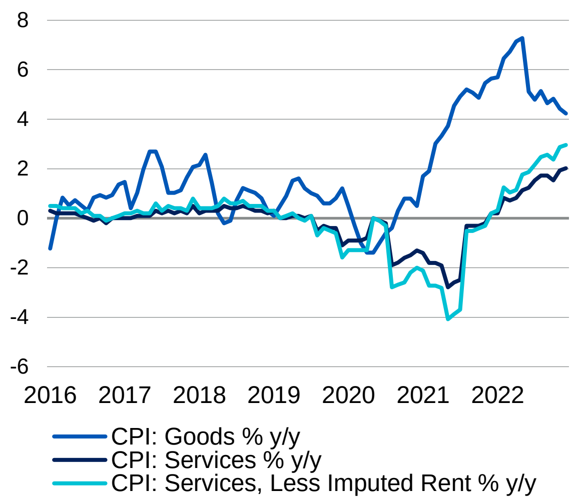
The start of the new fiscal year provides an opportunity for firms to implement price hikes. So far, consumers have been reluctant to tolerate increases, which may limit the extent of a virtuous price/wage spiral developing. Weak consumer and retail spending figures are consistent with a still low inflation mindset. As such, the April and May inflation data will be critical in assessing how confident corporates are about their ability to pass through costs to consumers.

An historically important but likely limited hiking cycle

Overall, the meeting delivered a symbolic end to the last remaining negative interest rate policy in the world. In the short term, focus will turn to the Sakura regional bank report on 20 April and the forecasts in the BoJ's Economic Outlook following the April policy meeting (April 26th) for further clues about the policy path.

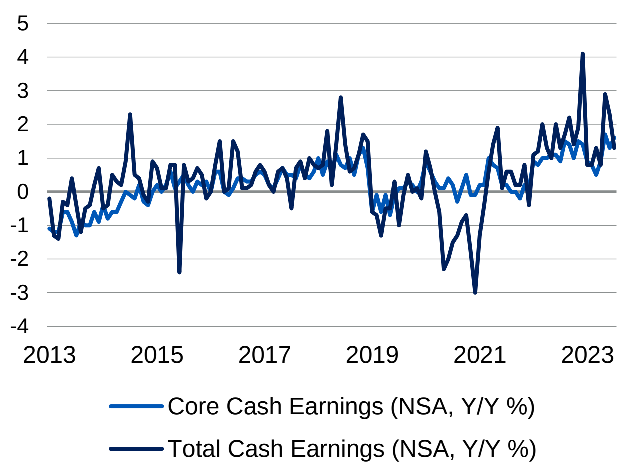
On balance, we think that further tightening will be limited and dependent on wage hikes from smaller firms and firmer evidence of pass-through to wages and prices.

Figure 1: Services inflation exceeds 2%



Source: abrdn, Haver, March 2024

Figure 2: Realised wages are key to monitor



Source: abrdn, Haver, March 2024

Author:

Sree Kochugovindan

Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 04 December 2023)

United Kingdom (UK)
abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1], Middle East and Africa
[1] In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM")**: abrdn Investments Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa**: abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 10 Queen's Terrace, Aberdeen AB10 1XL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.

AA-250324-175912-47