BoJ: battling inflation or investors?

Governor Kuroda may hope to hand the existing yield curve control (YCC) framework to the new governor. The macro backdrop supports unchanged policy settings, but miscommunication leaves the BOJ open to further market challenges.

Key Takeaways

- The BoJ's attempt to manage market distortions in December swiftly backfired. Dislocations were exacerbated.
- The current framework is likely to be handed to the new governor in April, however, intense market pressure raises the risk of further adjustments or abandoning yield curve control altogether.
- From a macro perspective the BoJ needs evidence of stronger wage growth to ensure inflation can sustainably achieve central bank target.
- Governor Kuroda's press statements opened the door to the possibility of further policy adjustments and will likely fuel further bouts of market volatility amid speculative attacks on the trading band in the coming weeks.
- Key triggers for market pressure include inflation prints, the announcement of a new governor, "Shunto" wage negotiations and global economic backdrop.
- Longer-term easing of global inflation drivers, and recession across advanced economies will likely reduce inflation pressures in Japan.

BoJ vs investors: Round 2 begins

In the face of intense market pressure, the Bank of Japan (BoJ) left policy settings unchanged at its January 18 meeting, with interest rates at -0.1%, the target for 10-year yields under the curve-control program around 0% and a trading band of around +/- 50bps.

The central bank said it would continue large-scale bond purchases, and committed to increasing them if necessary. The BoJ also enhanced its loan provision to commercial banks to encourage them to buy more debt and help defend yield curve control (YCC).

The updated forecasts in the BoJ's January Economic Outlook suggest that officials remain sceptical that inflation pressures will be sustained. Growth was downgraded for 2024, CPI excluding fresh food and energy was nudged higher for 2023 but left unchanged for 2024, consistent with the view that inflation is transitory.

The report maintained the view that risks to the inflation forecasts were skewed higher. The potential for wages accelerating was noted, along with the possibility of further adjustments in price setting behaviour and cost pass through.

Figure 1: Median forecasts by BoJ board members signal transitory inflation:

Current forecast (Oct 22 forecast)

	Real GDP	CPI ex fresh food	CPI ex fresh food and energy
Fiscal 2022	+1.9 (+2.0)	+3.0 (+2.9)	+2.1 (+1.8)
2023	+1.7 (+1.9)	+1.6 (+1.6)	+1.8 (+1.6)
2024	+1.1 (+1.5)	+1.8 (+1.6)	+1.6 (+1.6)

Source: BoJ (January 2023)

Indeed, recent BoJ publications have flagged early evidence that corporates are increasingly hiking prices and that pass-through effects have become broad-based**. However, there is still no evidence of a structural shift in behaviour that could lead to more sustainable inflation pressures.**

In fact the surprise decision at the December monetary policy meeting (MPM) to double the permissible trading band to “around zero +/- 50bps” came as inflation pressures were nearing the peak.

Communication failure

The move was aimed at tackling the deterioration in bond market functioning. The move was not intended as policy tightening or an exit from the current regime, nor was it intended to pave the way for the next governor.

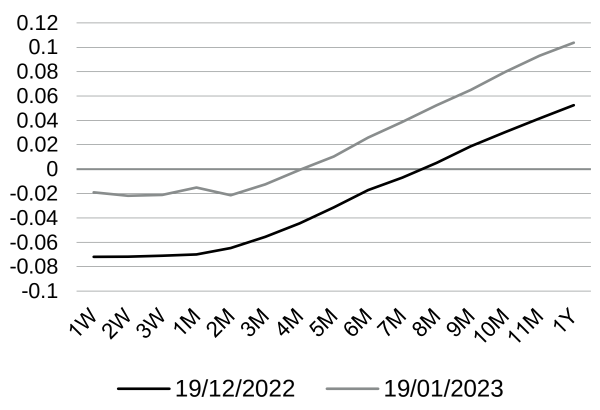
Yet, a month later bond market dysfunction has intensified with the BoJ engaged in aggressive market intervention following the December MPM announcement.

Prior to the December MPM, the BoJ hosted the semi-annual meeting of bond market participants. The minutes indicated serious deterioration in JGB functioning. Bid-ask spreads had widened, market depth had worsened, liquidity and price discovery had deteriorated so far that it became difficult to trade at the intended price. However, the policy targeted at these issues swiftly backfired.

In addition to the regular Rinban and 10-year JGB fixed-rate bond-buying operations, the BoJ was forced to ramp up the purchase of bonds through unscheduled Rinban operations and expand fixed-rate bond purchases across all tenors, not just the 10-year on the run JGBs.

However, the market remains sceptical of the bank’s communication and expectations of policy normalisation increased while distortions in the curve have not been resolved. Figure 2, shows the upward shift in the OIS curve as investors look beyond YCC tweaks and increasingly expect hikes in overnight policy rate in 2023.

Figure 2: OIS curve has shifted higher following YCC widening



Source: Bloomberg, abrdn, January 2023

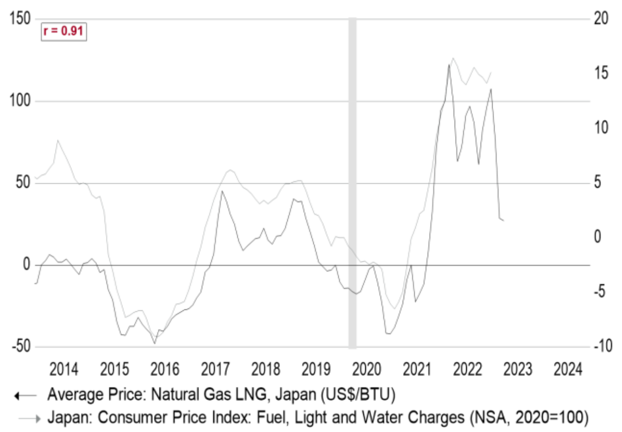
Macro environment calls for policy on hold

Inflation has trended higher over the past year. Nationwide CPI stands at 4% and even “western core” excluding food and energy nudged up 0.1 ppt to 1.6%. This is low by global standards but is the fastest pace in four decades for Japan.

Yet it is difficult to see how the recent increase in pricing power can be sustained while demand remains lacklustre and household incomes stagnate.

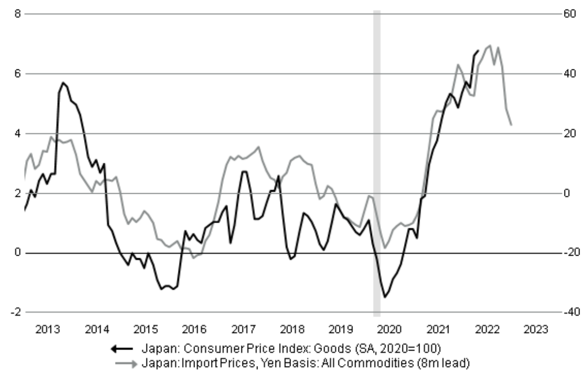
Base effects from commodities look set to pull headline CPI sharply lower in the coming months (Figure 3) while goods inflation looks set to decelerate as global supply chain pressures ease and declining imported input costs will feed through with a 7-8 month lag (Figure 4).

Figure 3: Energy base effects on the verge of rolling over



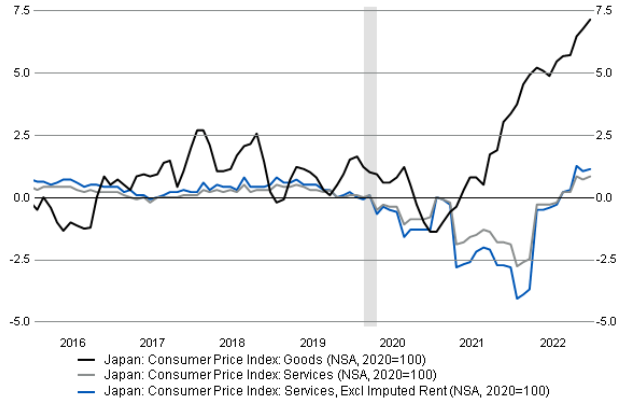
Source: Haver, abrdn, December 2022

Figure 4: Goods inflation also peaking



Source: Haver, abrdn, December 2022

Figure 5: Services inflation back in positive territory but still no sign of sustainable trend



Source: Haver, abrdn, December 2022.

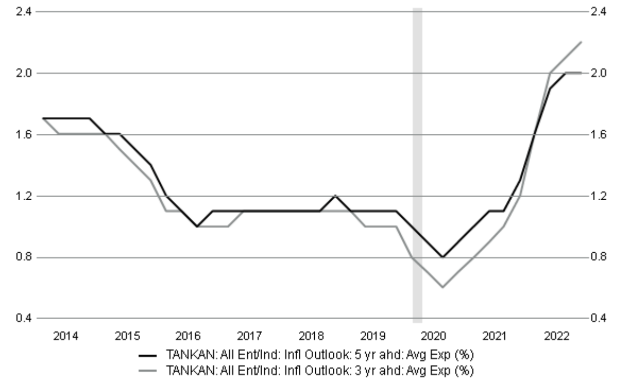
Service inflation has picked up and is now in positive territory (Figure 5). However, at a pace of 1% y/y growth, is showing little sign of sustained pressure.

Spring "Shunto" wage negotiations will be keenly watched, but November wage data show few signs of acceleration. Scheduled earnings growth remained in the region of just 2% y/y while real total wages contracted.

Household and corporate inflation expectations have climbed in recent months. In December, the Consumer Confidence Survey showed a rapid increase in medium-term expectations to near 8%. A signal that either wage negotiations could be more aggressive this year, or households turn cautious and reign in spending, a pattern of behaviour repeated in recent decades during periods of elevated inflation.

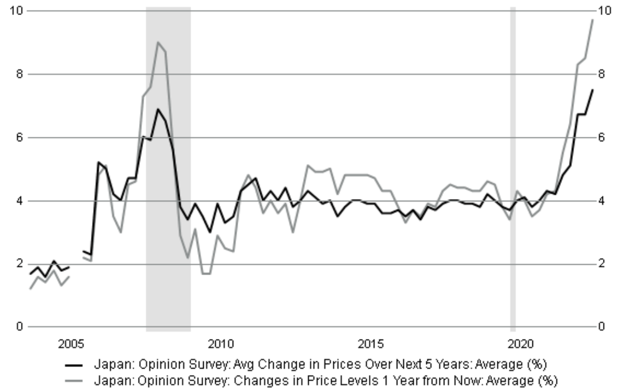
Meanwhile, corporate sentiment has merely shifted from expecting persistent weak inflation to expecting the BoJ to finally achieve target inflation. This casts doubt over the intention or ability for businesses to grant large wage increases. Furthermore, the bulk of employment sits within SMEs which are less able to endure existing input cost increases.

Figure 6: Corporates now looking for inflation to meet BoJ target over the medium term…



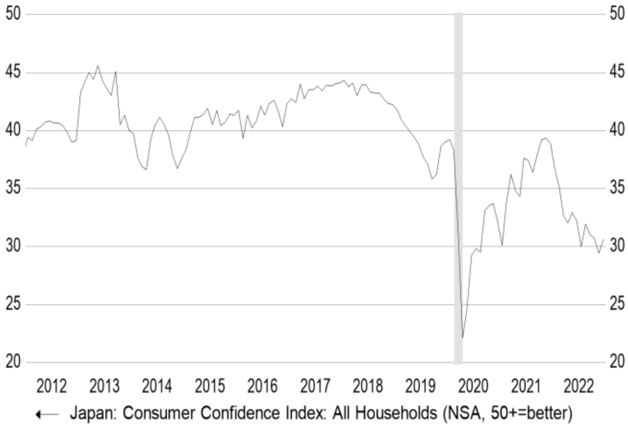
Source: Haver, abrdn, December 2022.

Figure 7: … while consumer surveys show households are more concerned of runaway inflation



Source: Haver, abrdn, December 2022.

Figure 8: Higher household inflation expectations could just lead to cautious spending



Source: Haver, abrdn, December 2022.

A new governor… a new era?

At the press briefing Governor Kuroda reiterated that policy easing would be maintained in order to meet the inflation target.

However, he also highlighted that financial conditions had eased considerably as real rates have fallen, and flagged the possibility of future policy changes. He also said that more time was needed to assess the impact of December YCC adjustments.

This flexibility in wording will likely lead to many more weeks of speculation. Will there be a significant move away from Abenomics? The stance of the new governor will be heavily scrutinised.

Bloomberg recently reported that a close aide to PM Kishida revealed that the government may present a new joint statement with the BoJ, revising the milestone Abe/Kuroda agreement presented a decade ago.

A section committing the central bank to achieve the 2% inflation target "at the earliest time possible" may be ditched. But any change in wording could fuel speculation of a significant change in negative interest rate policy (NIRP) and YCC, triggering a further volatile rise in yields at a critical time in Japan's inflation battle.

A tense few weeks ahead

There are many triggers ahead for speculators over the coming weeks: Japan's CPI could accelerate further in January before easing from February onwards. The new governor will likely be announced by mid-February.

Spring "Shunto" wage negotiations will be closely watched for signs of sustainable wage and price pressures. Meanwhile the global economic backdrop remains shaky.

The lagged impact of monetary tightening is expected to push many developed economies into recession. Japan is also expected to suffer through trade channels, reducing the macro need for further policy adjustment from the BoJ.

Implications for investors

- Intense market pressure raises the risk the BoJ may be forced to adjust or even abandon YCC.
- As the next policy announcement will not be until March 10^{th}, there are many triggers ahead for speculators.
- Japan's CPI is expected to accelerate in January before easing from February onwards.
- The new governor will likely be announced by mid-February.
- Most important for near term policy decision, spring wage negotiations will be closely watched for signs of sustainable wage and price pressures.
- Recession across developed economies in H2 would drag Japan's external trade and further reduce the need to adjust policy settings.
- Without sustained wage inflation Japan should return to the low inflation backdrop seen pre-pandemic.

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