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#Japan / #Monetary policy / #Inflation

Monitoring the Japanese wage-price cycle

The market seems geared up for the Bank of Japan (BoJ) to scrap yield curve control (YCC) and negative rates (NIRP) this year. But communication over timing remains unclear. And there are even doubts about the sustainability of Japan's exit from disinflation over the medium term. We break down the waymarks to watch for any policy shift.

Key Takeaways

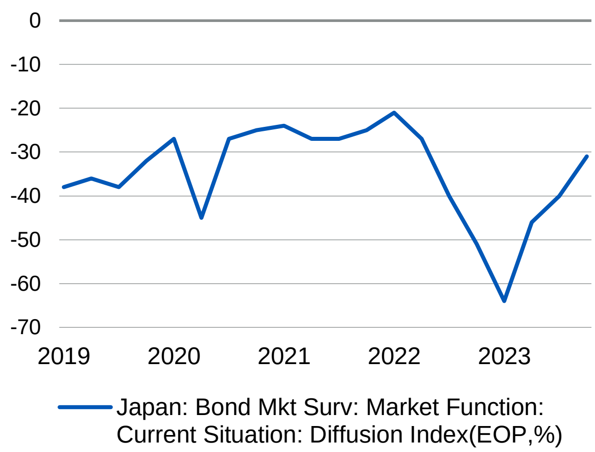
- The impending exit from yield curve control (YCC) and negative interest rate policy (NIRP) in Japan is now a consensus view. But there is a lively debate over the timing and extent of the adjustments.
- Minutes from the January BoJ meeting revealed a distinct hawkish shift among members, showing greater confidence around achieving the inflation target.
- The BoJ thinks it has a "golden opportunity" to adjust policy before other central banks get into rate cutting mode, pinning its hopes on a "virtuous cycle between wages and prices".
- Policymakers have stated that a wide range of signals, both quantitative and qualitative, must be monitored to assess developments in wage growth.
- We think inflation, wage growth and expenditure data provide a mixed picture and have yet to fully confirm that price pressures are sustainable. While the Shunto wage round should be strong, headline inflation is falling back and the economy is in recession.
- While there are risks around the timing of a policy shift, the BoJ is focusing on spring wage negotiations, the April regional bank report, and its own monetary policy review. We expect a shift by July, although the extent of subsequent policy tightening may be limited.

Approaching a major policy pivot

Following intense market speculation over the past year, the BoJ has steadily adjusted YCC settings, loosening its grip over Japanese government bond (JGB) yields.

Market functioning has improved over that period (Figure 1). In Q4 2022, bond market liquidity and price discovery across JGBs and swaps collapsed as the BoJ surprised markets and widened the trading band around 10-year JGBs. Rapid depreciation in the yen ensued and led to numerous bouts of verbal intervention by the Ministry of Finance (MoF), while BoJ board members noted the importance of stability across bonds and FX.

Figure 1: BoJ survey of bond market participants



Source: abrdn, Haver, February 2024

Investors are now anticipating an end to both YCC and NIRP, but the timing remains unclear.

Communication from the BoJ has often been misinterpreted and contributed to further volatility across Japanese assets.

In this note, we assess the key indicators and events to watch that can help signal the timing and extent of an exit from YCC and NIRP, and the sustainability of higher inflation.

January BoJ communication distinctly more hawkish

The latest Summary of Opinions – the minutes from the January monetary policy meeting (MPM) – marks a distinct shift toward board members becoming more confident that the 2% inflation target will be achieved.

It states the BoJ has "entered a phase where it needs to determine the likelihood of achieving the price stability target" and that "the Bank is highly likely to reach a point where it can normalise monetary policy".

However, there was no clarity over timing or sequencing of policy, with reference to unwinding large-scale monetary easing as a whole rather than specific measures such as NIRP.

The BoJ also referenced the impact of forthcoming policy easing from other major central banks, such as the Fed, which could reduce BoJ flexibility, meaning that "now is a golden opportunity". These comments were clearly more hawkish than recent comments from Governor Ueda and signal that all upcoming meetings are live.

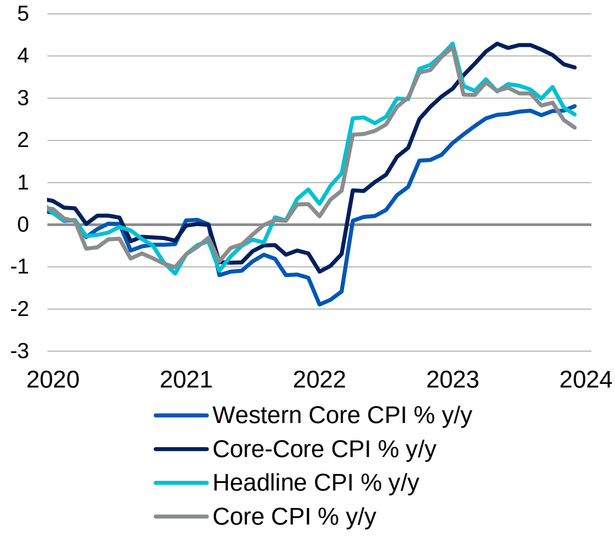
Waymarks to watch: classic quantitative indicators

Historically, the BoJ has shifted its focus across different measures of inflation and wage growth to send signals about the outlook.

Most developed economies monitor core inflation by excluding volatile items such as food and energy – a measure the BoJ refers to as "Western Core".

The Japanese central bank's "core" inflation is different and refers to headline excluding fresh foods but leaves in energy. "Core-core", on the other hand, excludes energy and fresh food prices (Figure 2).

Figure 2: BoJ key metrics for inflation



Source: abrdn, Haver, February 2024

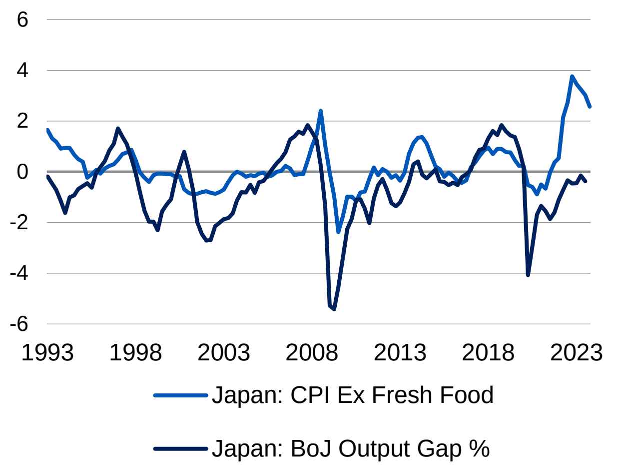
Fresh food prices can be highly volatile due to seasonal fluctuations in agricultural cycles. Japan is also prone to natural disasters that can disrupt production and transportation of perishable crops. Dependence on imports introduces further volatility from currency and shipping costs, and consumer preferences can also influence demand for specific fresh foods. Preserved or non-perishable food items exhibit more stable pricing in comparison.

Japanese inflation measures, both headline and core, accelerated as global pandemic drivers dominated. This in turn triggered speculation that **Japan had finally exited the "lost decades"** of deflation and disinflation. But headline inflation has been declining again since late 2022, in common with most other economies, and could dip back below 2% later this year.

In April 2022, for the first time, the BoJ introduced core-core CPI forecasts in the economic outlook that accompanies BoJ statements on a quarterly basis. This was a clear indication that the BoJ wanted to follow underlying price pressures more closely.

The forward-looking signals here are somewhat unclear. On the one hand, the still-negative output gap throws doubt on the sustainability of domestic wage and price pressures (Figure 3). But labour-intensive core services inflation stands at 30-year highs and is still increasing (Figure 4).

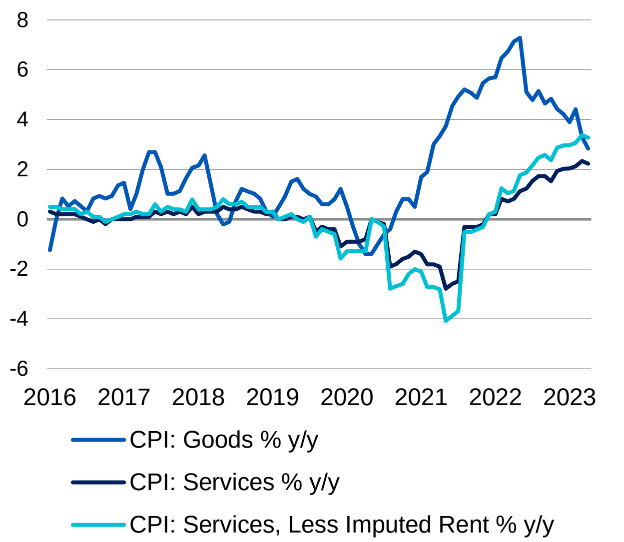
Figure 3: Output gap remains disinflationary…



Source: abrdn, Haver, February 2024

As we've written before, domestic wage trends and the evolution of inflation expectations are key to determine the inflation outlook as pandemic- and war-related pressures unwind.

Figure 4: … but services inflation exceeds 2% after years of flat or negative growth



Source: abrdn, Haver, February 2024

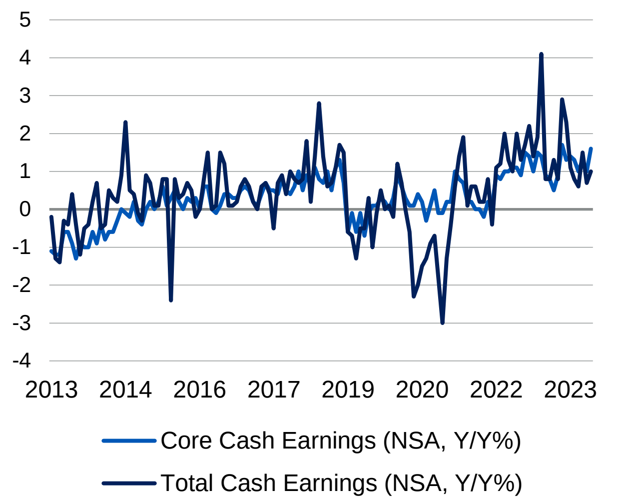
A broad range of wage details to be monitored

The spring "Shunto" wage negotiations in 2023 resulted in the strongest negotiated wage increase in three decades. However, these have yet to filter through to realised wage growth.

Going forward, the BoJ will monitor a broader range of indicators including qualitative measures, to monitor improvements in the wage outlook.

While headline earnings can be volatile, core, which excludes overtime and bonus payments, has been relatively stable at around 2% year over year (Figure 5).

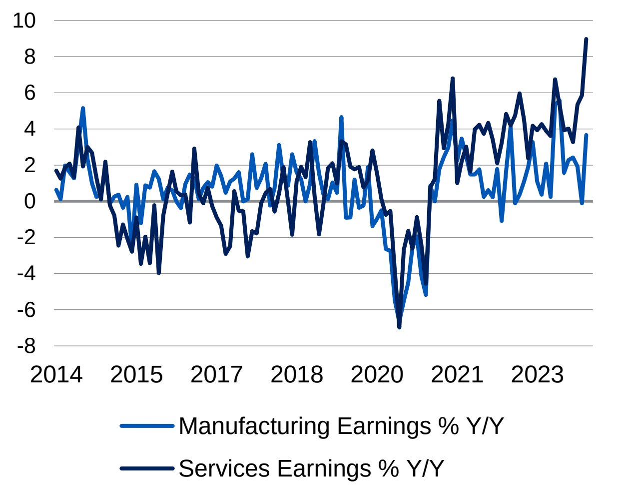
Figure 5: Wages fail to break out of historic trend



Source: abrdn, Haver, February 2024

The breakdown shows workers in the services sector, where labour shortages were more acute, have seen stronger earnings (Figure 6). There has also been some broad-based resilience in wage growth across large and small establishments.

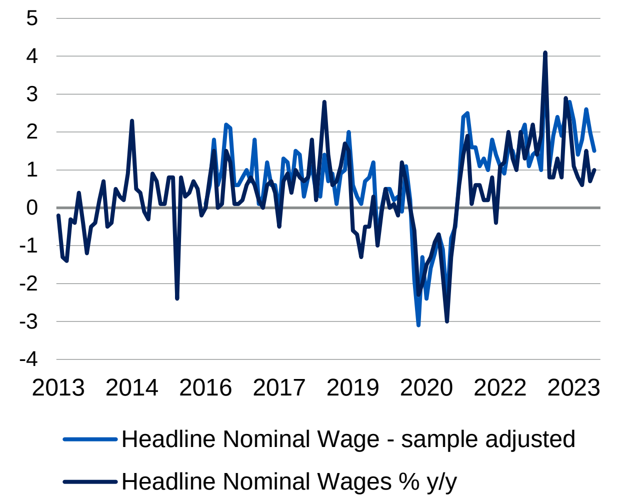
Figure 6: Signs of stronger wage growth to entice workers into services sector jobs



Source: abrdn, Haver, February 2024

However, these data are subject to measurement and sampling issues. The BoJ preferred sample-adjusted measure of headline earnings had proved more stable and elevated relative to the unadjusted measure. Disappointingly, this measure deteriorated in Q4 2023 (Figure 7).

Figure 7: Sample adjusted earnings measure deteriorated in Q4



Source: abrdn, Haver, February 2024

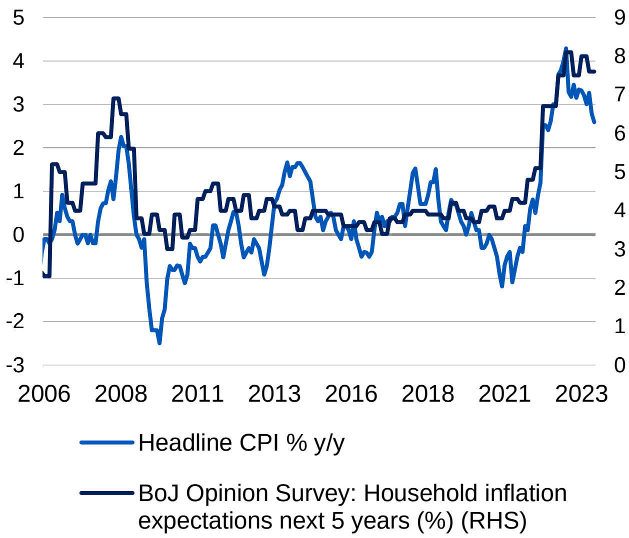
The detailed breakdown of earnings data will remain important for the BoJ's overall assessment. However, these continue to provide a mixed picture and limited evidence of pass-through from the 2023 wage negotiations.

Deflationary mindset needs to shift

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.

Figure 8: Japanese inflation expectations tend to follow headline inflation



Source: abrdn, Haver, February 2024

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 8 shows that there has indeed been an increase in medium-term inflation expectations among households. However, this is very closely correlated with the recent trend in headline inflation and may decelerate as pandemic drivers continue to unwind.

The Family Income and Expenditure Survey showed that consumers cut spending in November by 2.9% year over year, signalling that price increases had prompted shoppers to become more selective in purchases. The breakdown shows a mixed picture, with a decrease in services spending where prices and wage growth have been strong.

Qualitative waymarks: surveys, union demands, consumer preferences

Given the mixed outlook from inflation, wage and expectations data, the BoJ is now turning to more "qualitative" signals to help assess whether inflation pressures can be sustained.

The BoJ has started to place greater weight on the "Sakura" Regional Economic Report. This quarterly branch managers' meeting assesses household behaviour and the ability for corporates to pass on input costs. Importantly, the focus is on SMEs, which are essential for the outlook for pass-through of negotiated pay to actual realised earnings.

In the January report, companies hinted at more widespread wage growth and price hikes. The next report is due on 20 April.

Corporates have an opportunity to increase prices in March. The end of fiscal year in Japan could see a more meaningful price hike this time around, especially heading into the start of spring wage negotiations.

The Shunto initial indications will be announced in mid-March. Large unions announce early on, with smaller companies and unions following several weeks behind. So it can be as late as May before the economy-wide negotiations become clear.

Prior to official Shunto announcements, the BoJ will closely follow any signal from union leaders. In 2024, Rengo, Japan's largest labour union, is targeting wage increases of "more than 5%" compared to "around 5%" last year. While this is a marginal increase, it is an important signal nonetheless.

President of UA Zenson – a large union covering 1.8mn members from retail and restaurants – also plans to raise last year's pay demand of "around 6%" to "in excess of 6%".

Beyond the anecdotal evidence, there are also fundamental reasons to expect a strong Shunto wage round.

The labour market is tight, corporate profit margins have expanded, and the recent experience of higher inflation will put upward pressure on wage demands.

A policy shift by July, but little tightening thereafter

The 18-month policy review is still underway. The next policy review meeting is scheduled for May and could provide a useful platform to communicate a bigger overhaul of medium-term policy.

Consensus forecasts point to the April meeting for a policy adjustment, and the market is now pricing a 55% probability for an April hike and has shifted to 100% by June.

Risks around timing remain high, with March and April MPMs both live. But, considering the deceleration across price and wage trends, the timing of wage negotiations, data and reports, we think that the BoJ will drop YCC and raise interest rates to 0% by July.

We are less confident than the market of a continued hiking cycle thereafter though, given mixed evidence on whether Japan can really establish a new inflation regime at the 2% target.

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