Research Institute - Insight

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The Bank of Japan is still on hold for now

The BoJ left all policy settings unchanged today, as widely expected. We think the tolerance band around the 10-year JGB yields will be widened to at least +/- 75bps in July. However, the window of opportunity to adjust policy is narrow.

Key Takeaways

- The BoJ voted unanimously to maintain all of its monetary policy settings unchanged, including yield curve control (YCC).
- The assessment of the economy and related risks were also left unchanged from April, when the last quarterly Outlook Report was released.
- On inflation, the BoJ continues to expect CPI excluding fresh food to decelerate toward the middle of fiscal year 2023. During the press conference Governor Ueda continued to express uncertainties over the outlook for wage and price pressures.
- Recent wage data were weaker than expected. It will take another few months to confirm how much of the 3.7% wage rise resulting from the Shunto negotiations will filter into actual core earnings.
- Ueda has repeatedly stressed that *next* year's Shunto negotiations will confirm whether wage and inflation pressures are sustainable.
- The window of opportunity to adjust YCC may be quite narrow. Waiting until the September or October meetings may provide greater clarity over the pass-through of Shunto negotiations. However, spillovers from the US recession at the turn of the year will challenge the macro rationale for a policy shift.
- The fate of YCC is therefore finely balanced. We expect the most likely change will be a widening of the tolerance band around the 10-year JGB trading range to +/-75bps, perhaps at the July meeting. But the opportunity to make changes could yet be missed.

BoJ holds firm as the outlier

The Bank of Japan (BoJ) maintained all major policy settings unchanged, leaving interest rates at -0.1% and the target for 10-year yields under yield curve control (YCC) was left at 0% +/-50bps. The assessment of the economy and related risks was left largely unchanged from April when the last quarterly Outlook Report was released.

On inflation, the BoJ continued to state that CPI excluding fresh food would "decelerate toward the middle of fiscal 2023 with a waning of the effects of a pass-through to consumer prices of cost increases led by a rise in import prices".

Inflation is then projected to accelerate again moderately as the output gap improves and firms' price- and wage-setting behaviour changes. The statement noted recent economic strength despite the impact of past high commodity prices and expects continued support from pent-up consumer demand.

During the press conference, Governor Ueda maintained a very neutral stance and gave no signal over the timing of any policy adjustments. Ueda continued to express uncertainties over the outlook for wage and price pressures, but stated that a big change in the "price view may lead to a policy change". This suggests forecast adjustments in the July Quarterly Outlook are key to determining tweaks to YCC policy.

Some of the recent wage data have been weaker than expected, despite strong spring Shunto wage negotiations earlier this year. It will likely take another few months to confirm how much of the 3.7% negotiated wage increases will filter into actual core earnings.

Ueda has repeatedly stated that *next* year's Shunto round will be more important in determining whether wage and inflation pressures are sustainable.

Overall, the content of the April and June monetary policy statements and press conferences lean dovish, signalling that a tweak in policy settings this summer is more likely than a major rehaul, and raising some risk of no change at all.

Bond market functioning has improved. But the yen is under pressure as yield differentials widen

Through 2022 and H1 2023, the BoJ had been a monetary policy outlier. Significant monetary tightening by other major central banks around the world opened up wide yield differentials between Japanese government bonds (JGBs) and those elsewhere.

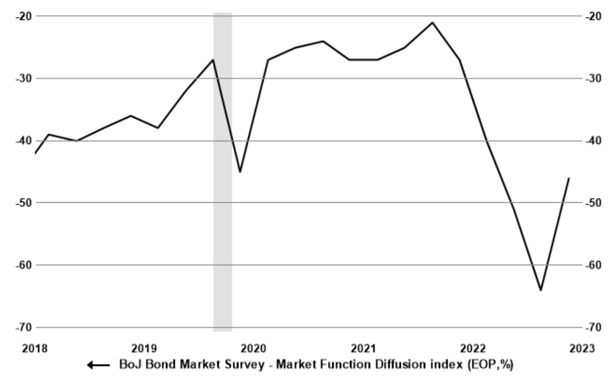
Serious deterioration in market functioning, as reflected in poor liquidity and price discovery, made for a very difficult trading environment for JGBs.

The BoJ attempted to resolve these issues through a surprise decision at the December 2022 monetary policy meeting to double the permissible trading band to "around zero +/-50bps". The official communication stated the move was not intended as policy tightening or an exit from the current regime. Bond market dysfunction merely intensified in response.

However, speculative attacks on YCC have subsided in recent months. We think this provides a good window of opportunity for the BoJ to surprise investors with a policy tweak.

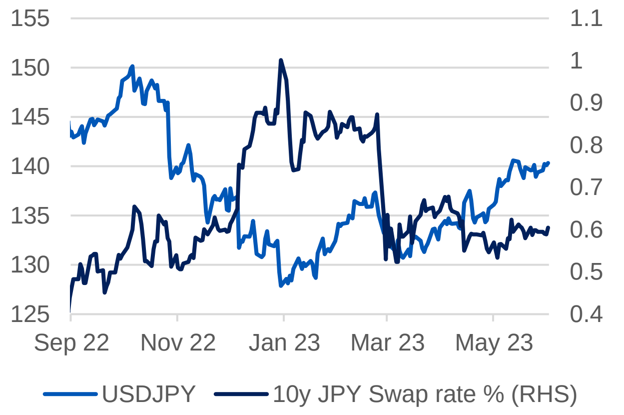
Figure 1 highlights the deterioration in bond market conditions in Q1, following the BoJ's December surprise, when 10y Japanese swap rates breached 1% in response (Figure 2). Yields stabilised and survey responses on market functioning improved after Kazuo Ueda took the helm.

Figure 1: BoJ survey shows a recovery in bond market function since the knee-jerk reaction to the December YCC surprise move



Source: abrdn, Haver, June 2023

Figure 2: Speculative attacks on YCC faded as Governor Kuroda stepped down



Source: abrdn, BoJ, June 2023

Widening yield differentials continue to place pressure on the yen. But dovish communication from the new BoJ governor Ueda, combined with the announcement of a 12-18-month monetary policy review, helped calm bond investors.

Is Japan entering a new inflation regime?

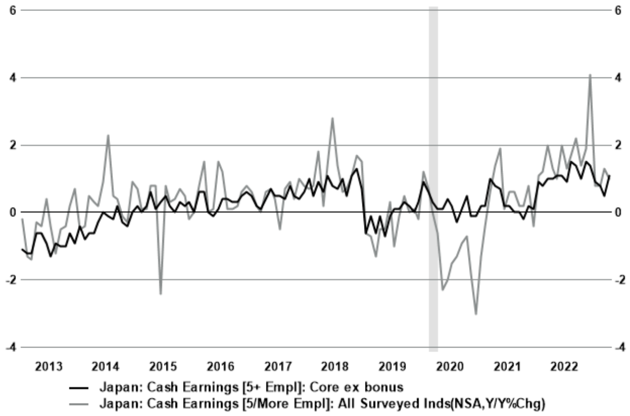
Despite the inflation overshoot and strong wage negotiations, the BoJ continues to hold the view that current inflation is mainly due to transitory cost-push factors rather than domestically generated inflation. Nonetheless, Ueda has acknowledged the need to address the adverse side effects of YCC policy.

Annual headline inflation pressures are now beginning to roll over, but core inflation measures, in particular labour intensive services inflation, stand at 30-year highs. Domestic wage trends are key to determine the inflation outlook as pandemic and war related pressures unwind.

Shunto spring wage negotiations were strong compared to previous years. The latest negotiated pay rise averages out at 3.7% based on the June release. FY2022 increases were just 2.1%, with much of this coming from a very strong push from the government. The corporate earnings recovery has also helped and firms are growing more confident in passing on some input costs to consumers.

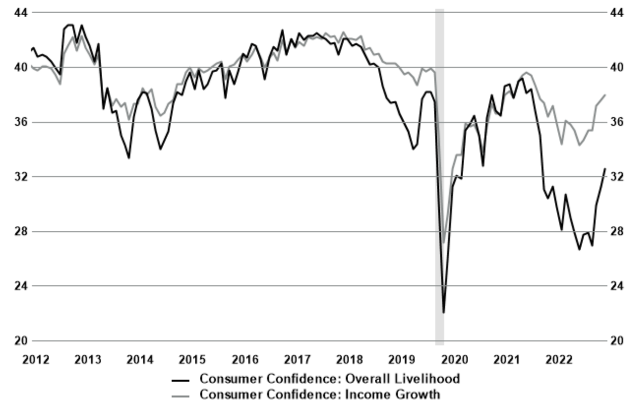
Yet the latest earnings data were weaker than expected, with core earnings growth slowing (see Figure 3). Shunto wage hikes may take time to be reflected in the earnings and wage data, which the BoJ will be watching closely over the coming months.

Figure 3: Core earnings ex-bonus need to accelerate further for sustained wage and price growth



Source: abrdn, Haver, June 2023

Figure 4: Households are becoming more confident of income growth



Source: abrdn, Haver, June 2023

Authors

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The BoJ has a narrow window of opportunity

The window of opportunity to adjust YCC may be very narrow. Waiting until the September or October meetings may provide greater clarity over the pass-through of Shunto negotiations. However, the spillovers from a likely US recession at the turn of the year, as well as the mechanical fading in Japanese headline inflation pressures as energy base effects drop out, will challenge the macro rationale for a policy shift.

The fate of YCC is therefore finely balanced**.** We believe the most likely change is a widening of the tolerance band for the 10-year JGB trading range to +/-75bps, most likely in July.

Were the band to be widened, yields will likely settle at the top end of the band immediately. Swap rates may overshoot this level temporarily as they price in the risk of a possible future removal of YCC policy.

Longer-term fair value estimates for 10-year JGB yields range between 80-120bps. Estimation methods vary from models based on neutral rates plus term premia, to models that incorporate inflation expectations and US Treasury yields.

However, the risk scenario is that the BoJ simply misses the window of opportunity to adjust YCC in the near term. In that case, removing some of the easing measures would occur much later in the BoJ's 12-18-month review of monetary policy. Either way, we don't envisage any end to negative interest rate policy.

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