2:55 minute read

#Japan / #Monetary Policy / #Inflation

Bank of Japan delivers a "flexible" YCC tweak

The BoJ voted to maintain the official yield curve control (YCC) settings, but with a greater degree of flexibility that essentially widens the trading band to +/-1%. We expect underlying inflation pressures to ease by the end of the year and diminish the macro need for further YCC adjustments. However, clear communication is needed to prevent renewed bond market volatility.

Key Takeaways

- The BoJ voted eight to one to maintain the official yield curve control (YCC) settings, but introduced a greater degree of flexibility that essentially widens the trading band by 50bps to +/- 1%.
- Policy rate was maintained at -0.10% and the target for 10-year JGB yields was maintained at 0% with an official +/-0.5% trading band as a guide rather than the previous rigid limits.
- Markets whipsawed in response to an initial media leak and then to the BoJ statement announcing it would keep the 0.5% band but apply a 1% cap which led to some confusion.
- During the press conference, Governor Ueda focused on the JGB market functioning and continued to express uncertainties over the outlook for wage and price pressure, emphasizing that this was not a step towards policy normalisation.
- We expect inflation pressures to ease over the course of H2 2023. Weakening activity in the US and other trading partners will likely weigh on Japanese growth and inflation, diminishing the need for further YCC adjustments.
- However, without clear and effective communication, there is a risk that the BoJ may face further bouts of market speculation.

An effective widening of the trading band

The Bank of Japan (BoJ) notionally maintained all major policy settings, leaving interest rates at -0.1% and the target for 10-year yields under yield curve control (YCC) at +/-50bps. However, YCC will now be conducted with a greater degree of flexibility with regards to the upper and lower bounds of the range, effectively tightening monetary policy.

The statement now considers the trading band as "references" as opposed to "rigid limits" in market operations, with the BoJ only offering to purchase 10-year JGBs at 1% every business day. This change effectively widens the trading band by 50bps at a time when market consensus had completely priced out any policy change.

From the series of documents published alongside the statement, this seems to be an attempt to signal that this is not meant to be a step towards policy normalisation. Indeed, the BoJ has tried to frame this as a response to market distortions. Strictly capping long-term interest rates was seen as affecting "the functioning of bond markets, and the volatility in other financial markets".

During the press conference Governor Ueda continued to express uncertainties over the outlook for wage and price pressures and reiterated the transitory inflation view as there was not enough evidence that 2% inflation target could be sustained.

In the quarterly Outlook Report, the BoJ revised up the inflation outlook for FY2023 to +2.5% from +1.8% in April, while FY2024 was nudged lower and FY2025 left unchanged.

The policy tweak was described as a technical change aimed at preventing market dysfunction.

However, Ueda also described it as a pre-emptive shift given the upside risks for inflation. This contradiction is worrying as clear communication is essential to prevent renewed asset price volatility and distortions in bond markets.

Figure 1: BoJ Median Economic outlook

	July	April
Real GDP % y/y		
FY 23	1.3	1.4
FY 24	1.2	1.2
FY 25	1.0	1.0
Core CPI % y/y (Core-core CPI)		
FY 23	+2.5 (+3.2)	+1.8 (+2.5)
FY 24	+1.9 (+1.7)	+2.0 (+1.7)
FY 25	+1.6 (+1.8)	+1.6 (+1.8)

Source: abrdn, BoJ, April 2023

The BoJ continues to face the challenges of being a monetary policy outlier

In 2022, the BoJ was a monetary policy outlier. Significant tightening by major central banks around the world caused wide yield differentials between Japanese government bonds and those elsewhere.

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

Core inflation measures, in particular labour-intensive service sector inflation, stand at 30-year highs.

Domestic wage trends are key to determining the inflation outlook as pandemic- and war-related pressures unwind. And Shunto spring wage negotiations were strong compared to previous years: 3.7% based on the June release compared to just 2.1% in FY2022.

Much of this increase has come from a very strong push from the government. But the corporate earnings recovery has also helped, and firms are more confident in passing on some input costs to consumers.

That said, it may take time for the Shunto wage hikes to be reflected in the earnings and wage data, implying that the BoJ will be watching these closely over the coming months.

Our longstanding view has been that the BoJ had a narrow window of opportunity to tweak YCC and that July was the opportune moment to widen the band to at least 75bps.

This policy change means that, even as the official band remains unchanged, the effective trading band has been widened by 50bps, 25bps more than what we had thought was the most likely outcome.

At the time of writing the market reaction has been relatively stable compared to the surprise policy change delivered in December. But the lack of clarity in messaging reopens the risk of speculative attacks despite the flexibility that this policy change brings.

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.

These estimates at least suggest that the BoJ's new flexible trading range of up to 1% for 10-year JGBs may keep market pressures in check if inflation pressures subside as we expect.

However, clear communication is key for preventing speculative attacks on what is effectively a new ceiling at 1%.

Authors

Sree Kochugovindan

Important Information

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

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

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 02 July 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, Gibraltar, 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-210823-167188-4