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# Bank of Japan's Monetary Policy Shift and Its Future Implications

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- The Bank of Japan (BoJ) announced in its March 2024 monetary policy meeting that it would end policies such as negative interest rates and yield curve control, signaling a shift in its monetary policy. However, we expect that the impact of this decision on the economy and financial markets will be limited.
- What is important is the pace of future interest rate hikes and where the policy rate will peak. The next rate hike could occur as early as this year. However, we anticipate that the pace of rate hikes will be moderate and the policy rate will not reach a high level.
- Looking ahead over the next 1 to 3 years, there is a possibility that interest rates will rise to some extent, the yen will strengthen against the dollar, the economic stimulus effect will diminish, and the flow of investment funds will change. There is also a risk that fiscal conditions and other economic aspects will be affected.


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**"The BoJ lifted the negative interest rate policy"**

During the March 18 - 19 policy meeting, the Bank of Japan (BoJ) decided to make changes to its monetary policy framework. These changes include discontinuing yield curve control and the negative interest rate policy (Figure 1). The operational target for monetary policy has now shifted to the unsecured call rate (overnight rate), with a guided range of 0.0 - 0.1%. Prior to this decision, the short-term financial market mainly functioned within the range of - 0.0 - 0.1%, so there will be an increase of approximately 0.1 percentage points. However, the resulting increase in the unsecured call rate is relatively small, and the level remains extremely low.

**Figure 1: Summary of BoJ's March 2024 Meeting Announcement**

| | |
|---|---|
| Prices | ・Confirmation of a positive cycle between wages and prices.<br>・Determination that the sustained and stable achievement of the 2% "price stability target" is foreseeable.<br>・The conditions for Inflation-overshooting commitment are fulfilled. |
| Framework of Monetary Policy | ・Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control and the negative interest rate policy has ended.<br>・Encouragement to keep the uncollateralized overnight call rate around 0.0 - 0.1%.<br>・An interest rate of 0.1% is applied to the portion of current account balances that exceeds the required reserve amount. |
| Outlook | ・We expect an accommodative financial environment to continue in the near term. |
| Asset Purchases | ・Long-term government bonds will be purchased at approximately the same amount as before (around 6 trillion yen per month). In the event of a sharp increase in long-term interest rates, the amount of purchases may be increased, and operations such as limit orders and common collateral fund supply operations may be implemented.<br>・Purchases of ETFs and J-REITs have been discontinued.<br>・Purchases of commercial paper (CP) and corporate bonds will be phased out over the course of one year. |

Source: BoJ

On the other hand, major financial institutions have opted to keep the short-term prime rate unchanged. This rate directly affects variable interest rates on housing loans, and as a result, existing variable interest rates on most housing loans are not expected to rise.

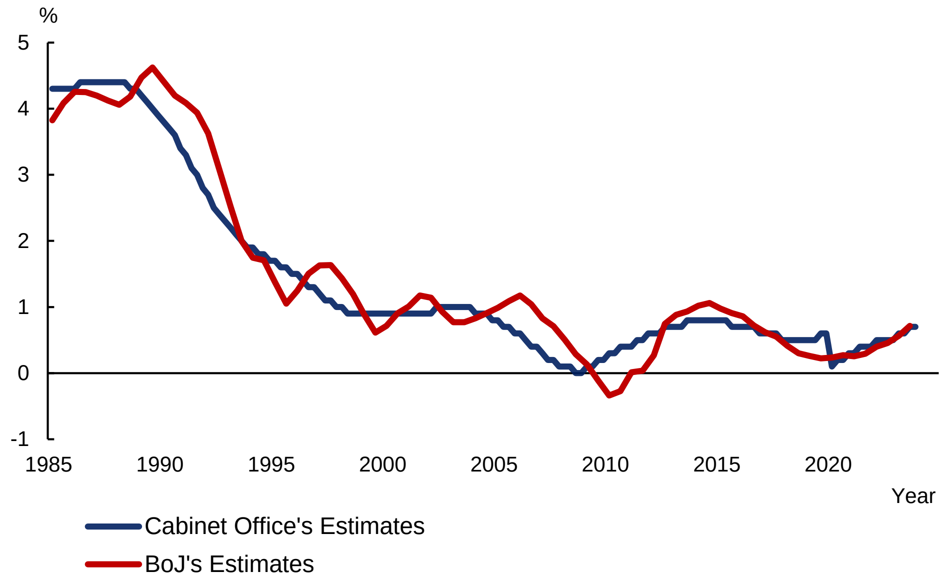
Based on the above, the impact of this monetary policy change is anticipated to be limited, at least for the time being. Nevertheless, since this move represents a symbolic shift from negative to positive interest rates, it is advisable to exercise caution regarding any unforeseen consequences that may arise across different areas of the economy.

**"Pace and Reach of Future Interest Rate Hikes"**

BoJ determined during its March meeting that the target inflation could be achieved. As a result, it is believed that the BoJ has entered a phase of raising interest rates, and the focus will now be on the pace of rate hikes and the level at which policy rates will peak. In the press conference following the March meeting, Governor Ueda mentioned topics such as the Taylor rule and neutral interest rates, which suggests that market participants have a strong interest in the level at which policy rates will peak. The pace at which the BoJ reduces its asset purchases, including government bonds and ETFs, will also be closely monitored.

We believe that the level at which policy rates will peak due to rate hikes will be influenced by the potential growth rate. If the potential growth rate is low, the number of investment opportunities with high returns is reduced, and the demand for funds decreases with high interest rates. Therefore, it is expected that the level at which policy rates will peak will be low. Currently, Japan's potential growth rate is estimated to be around 0 - 1% by the Cabinet Office and BoJ (Figure 2). Considering the potential growth rate, inflation, interest rates, and trends in monetary policy in Japan and other countries, we anticipate that both the BoJ and market participants will consider the level at which policy rates will peak to be around 0.5 - 1.0%. Depending on the economic and price developments, the BoJ may raise interest rates again within this year. However, the pace of rate hikes is expected to be gradual, taking into consideration the state of the economy, and the reduction in asset purchases will also be implemented with consideration for the market. Therefore, it is assumed that there will not be a significant increase in policy rates or market interest rates. In the following analysis, we will examine the potential impact on the economy, financial markets, and fiscal conditions over the next 1 - 3 years under this scenario.

## Figure 2: Trend of Japan's Potential Growth Rate




Source: BoJ, Cabinet Office

Note: 1. Cabinet Office's Estimates: Quarterly data from 1Q 1985 to 4Q 2023

BoJ's Estimates: Semi-Annual data from the 2nd half of FY1984 to the 1st half of FY 2023

2. Cabinet Office's Estimates are annualized quarter-on-quarter rates.

BoJ's Estimates are year-on-year rates.

**"Impact of the BoJ's Interest Rate Hikes on the Economy"**

First, in terms of the impact on the economy, an increase in interest rates is expected to curb economic growth. As interest rate hikes progress, the stimulative effects of monetary easing on the economy are likely to diminish to a certain extent. However, the expected magnitude of future interest rate hikes is relatively small, so the overall impact of curbing economic growth would be limited.

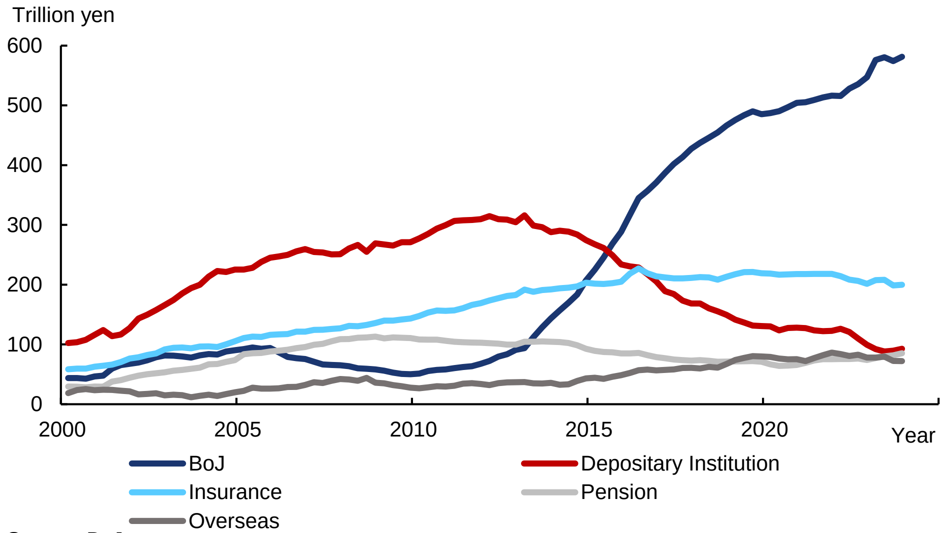
However, the individual impacts may vary among companies and households depending on their asset and liability positions, as well as their income and expenditure situations. Some companies and households may face more challenging circumstances than others.

During the next round of interest rate hikes by the BoJ, we expect short-term prime rates will also rise. In such a case, households with variable-rate mortgage loans will experience increased interest burdens, influencing their financial positions. This could lead to some changes in household consumption behavior.

Furthermore, future interest rate hikes may prompt struggling companies to exit the market. In such cases, it is important to closely monitor whether these exits result in positive transformations in the industrial structure, such as increased market efficiency, or if they simply contribute to economic shrinkage.

Next, let's discuss the impact of interest rate hikes on the financial markets. In the bond market, an interest rate hike leads to a rise in bond yields and a decrease in bond prices. However, it also increases the attractiveness of domestic bonds. With the BoJ being the last major central bank to maintain negative interest rates, its policy shift could potentially raise global interest rates higher than before. The expected reduction in the BoJ's bond purchases could also be a factor in pushing interest rates higher (Figure 3). Nevertheless, it is anticipated that the BoJ will proceed with the reduction at a pace that doesn't cause excessive interest rate increases.

**Figure 3: Trend of Japan's Government Bond Holdings**




Source: BoJ
Note: 1. Quarterly data from 1Q 2000 to 4Q 2023
2. This data includes government bonds and FILP bonds.

In the foreign exchange market, the BoJ's interest rate hike could narrow the interest rate differential between domestic and foreign currencies, potentially leading to a shift from yen weakness to yen strength. If the unwinding of carry trades, where funds were borrowed in low-interest rate currencies and invested in high-interest rate currencies, accelerates due to the narrowing interest rate differential, it could have an impact on the prices of the assets.

As a result, the relative attractiveness of domestic assets may increase, causing a potential flow of investment funds back into Japanese domestic bonds from global bonds, among others, thus potentially altering the flow of investment capital to some extent.

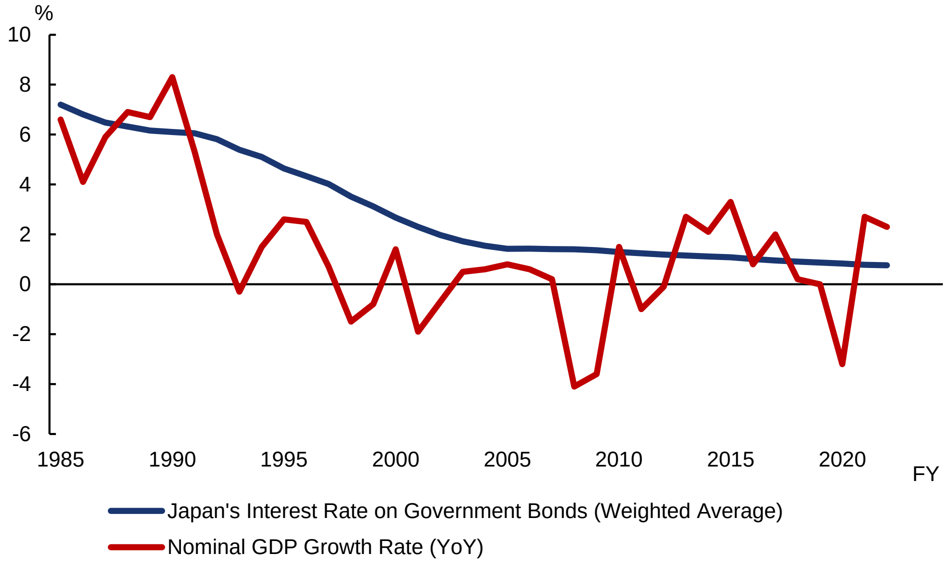
In the stock market, the fading effect of economic stimulus from interest rate hikes, a change in yen trend from weakness to strength, and speculation surrounding the disposal of ETFs by the BoJ could potentially weigh on share prices.

“Implications of BoJ's Interest Rate Hike on Fiscal Conditions”

Lastly, let's consider the implications for fiscal conditions. The rise in interest rates leads to increased interest payments on government bonds, putting pressure on fiscal balances and potentially increasing the need for expenditure cuts or tax hikes. Furthermore, if the interest rate on government bonds exceeds the nominal GDP growth rate, it becomes a factor in the rise of the government debt-to-nominal GDP ratio. The relationship between government bond rates and nominal GDP growth rates can vary depending on the circumstances, but if nominal GDP growth stagnates, concerns about fiscal sustainability may rise (Figure 4).

A related point of consideration is the financial soundness of the BoJ. If the BoJ proceeds with interest rate hikes while still holding a large amount of purchased assets, it is expected that it would also raise the interest rate paid on current accounts to ensure smooth interest rate control in the short-term money market. In this case, there is a possibility that the BoJ's payments to private financial institutions would increase, potentially leading to a deterioration in the BoJ's balance sheet. Although there might be temporary concerns, as long as the interest rate hikes are not rapid, the BoJ can rely on interest income from its asset holdings, and it is not expected to lead to a situation that fundamentally undermines its credibility. Furthermore, these issues regarding Japan's fiscal situation and the financial soundness of the BoJ could also serve as constraining factors on the upper limit of the policy interest rate.

**Figure 4: Trend of Japan’s Interest Rate on Government Bonds (Weighted Average) and Nominal GDP Growth Rate**




Source: Cabinet Office, Ministry of Finance Japan
Note: 1. Annual data from FY1985 to FY2022
2. For nominal GDP growth rate prior to 1994, the figures of simple retroactive calculation are used.

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