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Japanese economy stepping towards normalisation

3 March 2023

- 2023 will be a year of normalisation for the Japanese economy which has lagged behind global peers.
- Above all, a change in the Bank of Japan's monetary policy under new governor and deputy governors has become the focus. We expect the central bank to modify its yield curve control of long-term interest rates, currently 10 year Japanese government bond yields, at an early stage. However, we believe the bank will make a more careful approach in making a decision on short-term interest rates, with a possible change of short-term policy target back to overnight unsecured call rate from the policy rate current account balance held at the bank.
- We expect the Bank of Japan's monetary policy to revert back to more predictable one based on the outlook of fundamentals such as economic growth and price inflation, just as in other countries.

We think 2023 will be a year of normalisation for the Japanese economy which has lagged behind global peers for three reasons.

Firstly economic activity will normalise out of the Covid pandemic. The Japanese government has refrained from imposing restrictions even with the spread of infection since the latter half of last year. This, together with the government promotion of domestic travel, led to a recovery in service consumption in October-December 2022. From May onwards, the government plans to relax Covid classification from Category II to V, the level applied to seasonal flu, marking an official shift to a living with Covid society. Border restrictions have been relaxed and the number of foreign visitors to Japan has reached one and a half million in January, recovering to half of the record high visitor level of three million achieved in July 2019.

Secondly, we expect Japan to enter a virtuous cycle of rising prices and wages. Consumer prices in Japan, excluding fresh food and energy, which are nearly equivalent to the U.S. CPI core definition, rose by 3.2 percent year-on-year in January 2023, the highest growth since the Japanese asset price bubble in 1990. The recent rise in prices has been due to cost push inflation caused by import prices and other costs, which we expect to slow in the future (Figure 1).

As price rises slow down, the possibility of ending decades of zero inflation and entering the positive cycle hinges on substantial wage growth. This time, we believe, the time is ripe for both labour and companies to agree on wage increases, in an effort to sustain living standards amid recent price rises on the labour side and to retain workforce amid labour shortages on the company side.

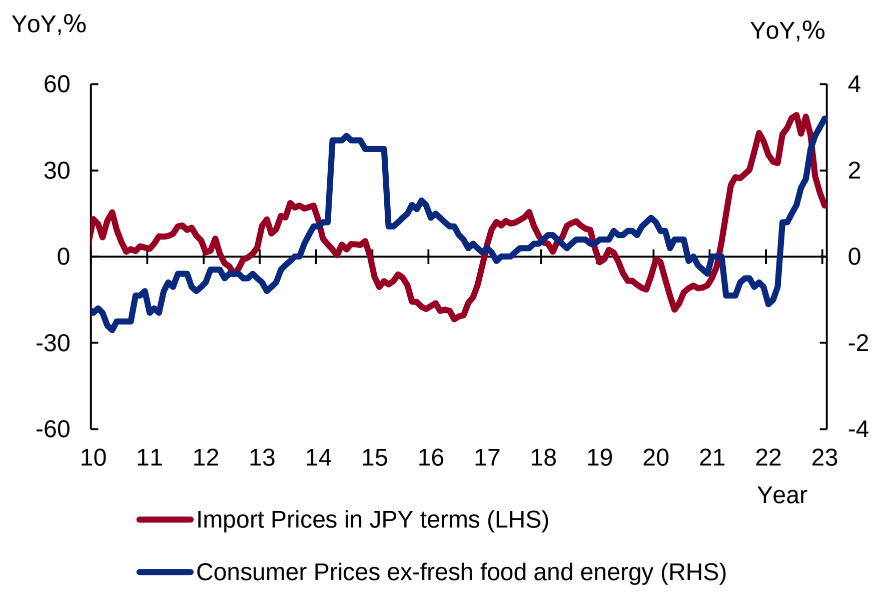
Yuko Iizuka, Economist

"Japanese economy stepping towards normalisation"

In this year's Shunto, literally meaning spring battle, annual wage negotiations between major labour unions and large corporations that take place in spring, we expect wage increases of around 3 percent, clearly exceeding the 2 percent level in 2022.

The third reason is the Bank of Japan's (BoJ) monetary policy under a new regime with the replacement of the governor and deputy governors in March and April. The governor nominee Kazuo Ueda, professor in economics, deputy governor nominees Shinichi Uchida, the bank's director in charge of monetary policy and planning, and Ryozo Himino, former director-general of the Financial Services Agency, are expected to take office. Despite the BoJ's measures to increase the sustainability of its easing measures since last December, such as the expansion of the allowable fluctuation range in long-term interest rates, Japanese interest rates have continued to come under upward pressure due to the prospect of a prolonged period of monetary tightening in the U.S. In 2023, we expect the central bank to end its extraordinary large-scale easing and normalise monetary policy under the new regime.

Figure 1: Consumer Prices and Import Prices



Source: Ministry of Internal Affairs and Communications, the BoJ
Period: Monthly data from Jan. 2010 to Jan. 2023
Note: The consumer tax increased by 3% in Apr. 2014 and by 2% in Oct. 2019

The BoJ has built a complex monetary policy structure. In 2013, Governor Kuroda took office and introduced (i) Quantitative and Qualitative Monetary Easing in April with an aim of achieving 2 percent price stability target within two years. With no prospect of achieving the target, the policy framework shifted to (ii) Quantitative and Qualitative Monetary Easing with Negative Interest Rates in January 2016 and to (iii) Quantitative and Qualitative Monetary Easing with Yield Curve Control (YCC) in September 2016 (Figure 2).

"The current complex structure of monetary policy"

Figure 2: Quantitative and Qualitative Monetary Easing with YCC

1. Yield Curve Control

Short-term policy interest rate:
Apply a negative interest rate of minus 0.1 percent to the Policy-Rate Balances in current account at the Bank.
⇒The current account at the Bank comprises a three-tier structure:
i) Positive interest rates, ii) Zero interest rates, iii) Negative interest rates
Adjust the amount of negative interest rates applied (currently around 5 trillion yen).

Long-term interest rate:
Purchase Japanese government bond (JGB) in order that 10-year JGB yields remains more or less around 0 percent.
⇒Expand the allowable fluctuation range in long-term interest rates(currently ±0.5 percent).
Conduct Fixed-Rate Purchase Operations for Consecutive Days and Funds-Supplying Operations against Pooled Collateral to curb the rise.

2. Guidelines for asset purchases

Purchase exchange-traded funds (ETFs), Japan real estate investment trusts (J-REITs), CP and corporate bonds.
⇒Currently purchase ETFs and J-REITs as required.

3. Overshooting commitment

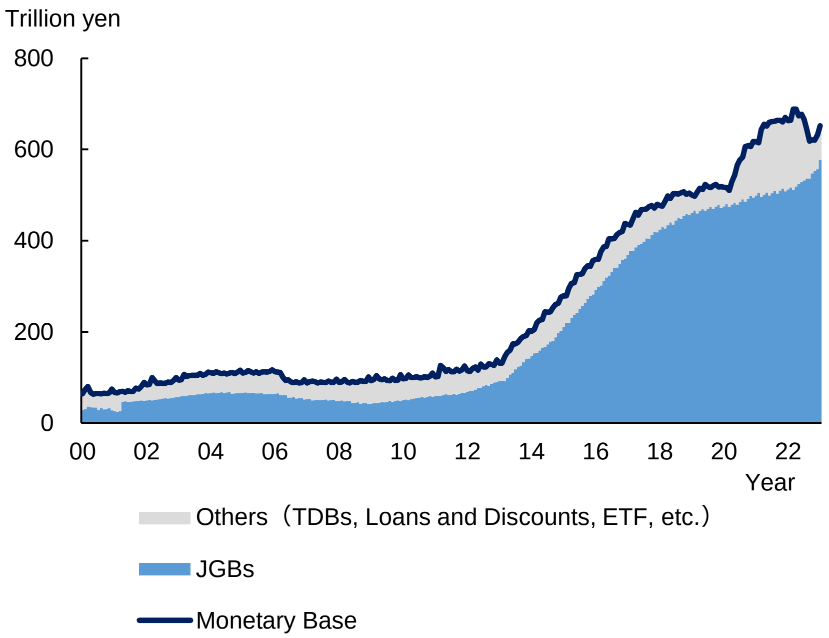
The monetary base balance may fluctuate in the short term, but the policy of expansion will continue until the actual year-on-year rate of increase in the CPI (excluding fresh food) exceeds 2 percent in a stable manner.

Source: The BoJ

The pace of monetary base growth was the target of market adjustment operations for (i) Quantitative and Qualitative Monetary Easing and (ii) Quantitative and Qualitative Monetary Easing with Negative Interest Rates, whereas (iii) Quantitative and Qualitative Monetary Easing with YCC targets long- and short-term interest rates, and the policy of monetary base expansion was positioned as an overshooting commitment, a so-called time-based policy. With this prolonged period of monetary easing, the structure of the monetary base has transformed into a complex interplay between quantity, quality and interest rates. In order to contain the upward pressure on interest rates, the bank has purchased large amounts of long-term government bonds, leading to an expansionary trend in the monetary base (Figure 3).

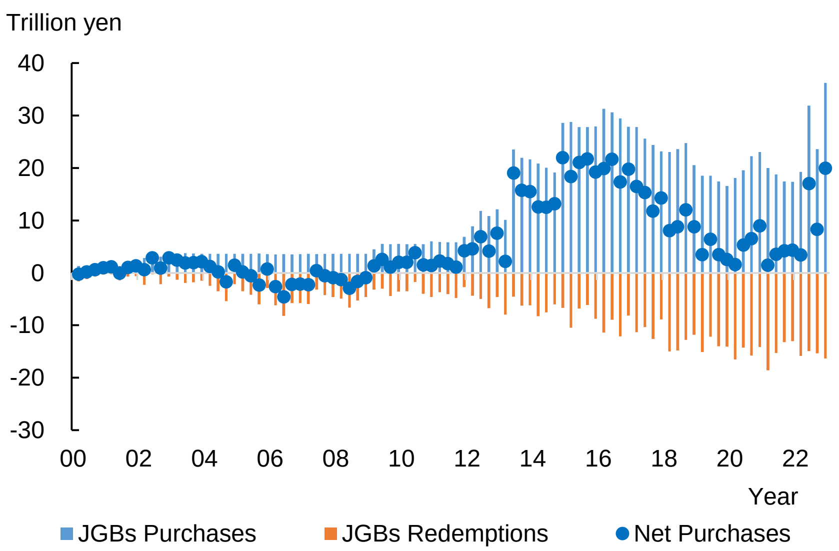
All else equal, maintaining the monetary base balance is closely linked to (i) the bank continuing to purchase long-term JGBs in excess of redemption amounts from the perspective of assets, (Figure 4), and (ii) maintaining the current account balance held at the bank from the perspective of liabilities.

Figure 3: BoJ's Monetary Base Balance



Period: Monthly data from Jan. 2000 to Jan. 2023
Source: The BoJ

Figure 4: BoJ's JGBs Net Purchases



Period: Quarterly data from Q1 2000 to Q4 2022
Source: The BoJ

A survey of firms on their assessment of monetary policy since Governor Kuroda took office shows that the initial easing measures, such as correcting the strong yen, raising stock prices and supporting business activity in a low interest rate environment, have been well received. On the other hand, there has been some criticism of the protracted large-scale easing.

“Assessment of the protracted Yield Curve Control”

The Reserve Bank of Australia (RBA) introduced a yield target (YT) on policy rates and three-year government bond yields during the Covid pandemic, similar to the BoJ’s YCC, but ended it by the force of the market pricing in rate hikes. The RBA has conducted a policy review and concluded that YT should only be implemented for a short period of time while confidence on maintaining it can be sustained, and that it is not suitable to be used for long periods of time. It also stated that YT had stopped working as the economy on the road to recovery.

“Focus on the normalisation of monetary policy”

At the confirmation hearing at the House of Representatives held to check the suitability of governor nominee Ueda for the position, Ueda responded with an assuring tone, affirming the current accommodative monetary policy and policy continuity. However, he also stated that "we are seeing very favourable developments in underlying prices. If this is expected to improve further and move closer to 2 percent, we will have to consider normalisation. If the opposite is the case, we will maintain the easing while mitigating side effects". In either case, we expect the bank to revise its 10-year interest rate target at an early stage after he takes office. We think that investors should pay attention to both the method of modification, which could include measures such as the expansion of the fluctuation margin, shortening or abolition of the 10-year target, and whether measures will be put forward to deal with a sharp rise in interest rates and to show that an accommodative stance will be maintained. In this context, the handling of the monetary base expansion policy in relation to the purchase amount of long-term government bonds and other securities is an interesting area of focus.

Dr. Ueda used the phrase 'returning monetary policy to a normal state' at one point in the hearing. We believe that this means returning the monetary policy operation target to the short-term market interest rate, which is the overnight unsecured call rate in Japan, as in other countries. Ueda states that "for now, there is still some way to go to achieve the 2 percent price inflation target", based on the assumption that price inflation rate is expected to slow down in FY2023. Considering the uncertainties in the economic situation overseas and other factors, we believe that the bank will not rush to lift negative interest rates and is likely to maintain it this year. If, at the same time as lifting the negative interest rate, the Bank is considering returning the short-term interest rate control target to the overnight unsecured call rate for the first time in about 10 years, it is likely to take a cautious decision, including on restoring the function of the short-term money market.

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