15 September 2023

Research Japan

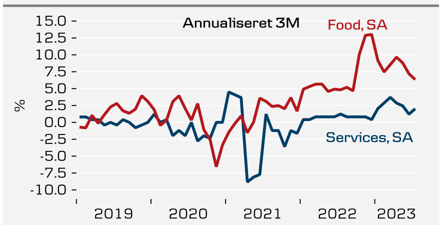
Data supports BoJ tweak, not bold moves

- **The inflation target has been met for 16 consecutive months but the reflation narrative has lost some steam recently.**
- **We think the data supports another tweak of the yield curve control (YCC) this year, most likely in October, as one last step ahead of completely dismantling YCC.**
- **We expect enough reflation traction for the BoJ to hike its policy rate to zero in Q2 2024. However, we think there is a long way to a situation where the BoJ can tighten much further than that.**
- **We forecast USD/JPY towards 130 on 6/12M horizon, primarily as we deem long US yields are at (or around) peak and that the global environment favours the JPY.**

The BoJ has met its inflation target for 16 consecutive months and the economy has been a relatively strong growth performer this year, only surpassed by the US among the G7. This comes after some rough years in the Japanese economy, though, where the rebound from the pandemic has choked in lockdowns and lower purchasing power and the primary growth driver remains foreign demand. The reflation narrative has suffered some blows recently. Below we go through the most important aspects of the inflation story as we see it.

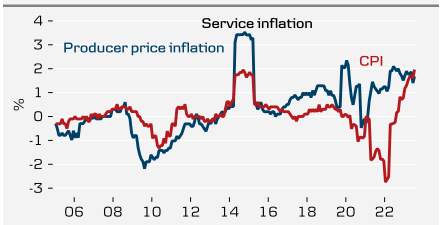
Inflation data: The BoJ's favourite inflation measure, CPI excl. fresh food, has been stable just above 3% this year. Energy prices have declined, so CPI excluding fresh food and energy was 4.3% in July. The majority of this is driven by food (excluding fresh food). The rest is spread out on other goods and services. Services are key here because they reflect the underlying demand in the economy more than goods prices, which are largely affected by global factors. Demand has been heavily supported by the return of tourists in Japan, which is closing in on pre-pandemic levels with 2.3 million visitors in July compared to the 3 million all-time high four years earlier. Thus, the BoJ will be looking closely at service inflation to measure the underlying price pressure in the economy.

Food prices have surged



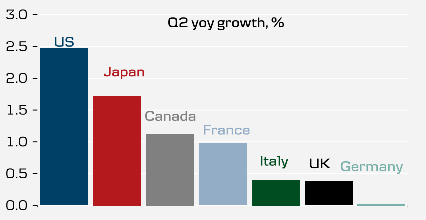
Source: Japanese Statistics Bureau, Macrobond Financial

Higher service inflation



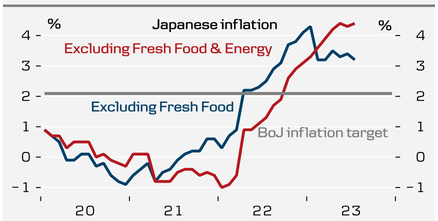
Source: Bank of Japan, Japanese Statistics Bureau, Macrobond Financial

The economy has rebounded but remains behind



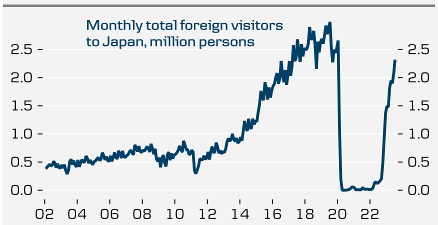
Source: Macrobond Financial

Inflation stable around 3%



Source: Japanese Statistics Bureau, Macrobond Financial

Tourism closing in on pre-pandemic highs has been a strong demand boost



Source: Japan National Tourism Organisation, Macrobond Financial

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Service inflation stood at a solid 2% in July, however, looking at momentum service prices have lost a little bit steam during recent months and service producer prices do not seem to warrant a further pickup.

Inflation expectations ticking higher is another prerequisite for the BoJ to start normalising its policies. The data here largely supports BoJ having exited the deflationary mind set for good. There is however some way from that to a situation that rhymes with 2 percent inflation. The level of reflationary tendencies varies according to whom is asked. Businesses gives the clearest answers. They see inflation above 2 percent in both 1, 3 and 5 years and have done so for a year now. This has not been the case since the beginning of the survey in 2014. If you ask households, the replies are slightly less clear. 14% expects deflation over the coming year, which is not much in a historical perspective. However, a smaller share actually see prices increasing on a 5-year horizon compared to pre-pandemic levels. Looking at markets, 10-year break-even-inflation has climbed above 1%, which is still not much. The level might reflect risk-premia etc., though, and comparing with pre-pandemic levels somewhere between 0-½ percent, this does reflect a significant improvement.

The labour market: The Japanese labour market is notoriously tight, with more job openings than candidates. That said we have seen indications of a somewhat less tight labour market recently with the unemployment rate increasing 0.3 percentage points in July and the jobs-to-applicants ratio edging continuously lower through this year. Absolutely key to the sustainability of Japanese reflation are wage pressures. Several big Japanese companies reported solid wage growth significantly above the 3% mark in the spring. The question remains whether this feeds through to the SME segment and in particular sectors less exposed to foreign demand and tailwinds from the weak yen but still affected by higher import costs. May data was promising with annual total cash earnings at 2.9% close to the magical 3% aspired to by many Abe governments. However, data has been disappointing over the summer, and annual earnings growth was only 1.2% in July, leaving real earnings growth at -2.0%, which weighs heavy on the consumer.

Cautious approach

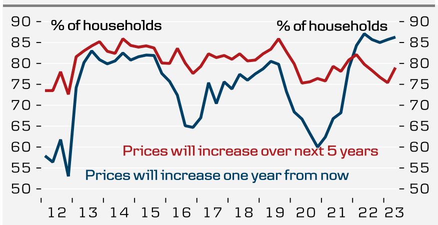
As we see it, the fear of moving too fast is deeply imbedded in the BoJ's thinking. No one wants to repeat the policy mistakes of the 2000s, when the BoJ tried to exit the zero-rate-policy without success. The risk is that tightening too soon will trigger a slowdown that drives Japan back in a deflationary mode. In the BoJ's July outlook, the inflation forecast for the fiscal year 2025 was unchanged at a modest 1.6% with an overweight of board members who think risk to that forecast is on the downside. As we see it, this reveals the BoJ's dovish bias and we will have to see higher wage growth and stronger inflation dynamics for the BoJ to consider a policy rate hike.

On Saturday 9 September in an interview, Governor Ueda said, "the BoJ could have enough data by year-end to determine whether it can end negative rates." This triggered quite a market reaction with 10-year JGBs trading above 70bps and a short-lived strengthening of the yen. It reflects that firms kick off wage negotiations in March but the BoJ could get information from corporate executives ahead of that. With the current wage dynamics in mind, where big corporates' wage hikes have far exceeded wage growth in the SME segment, we consider it unlikely that the BoJ will make any bold moves by the end of this year based on indications of big corporate predictions, though. This might have merely been an attempt to boost the continuously weaker yen.

Businesses convinced inflation will be higher

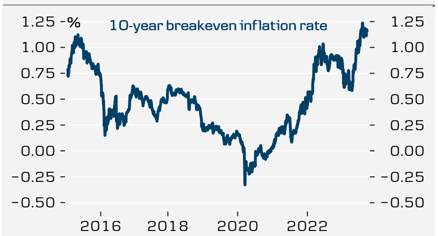
Source: Bank of Japan, Macrobond Financial

Less clear cut answers from households



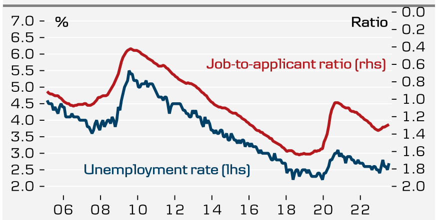
Source: Bank of Japan, Macrobond Financial

Markets' inflation expectations have climbed higher



Source: Bloomberg, Macrobond Financial

Slightly less tight labour market



Source: Japanese Ministry of Labour, Japanese Statistics Bureau, Macrobond Financial

After the July policy tweak effectively removed the binding constraint on the yield curve, a potential next step for the BoJ could be to dismantle YCC completely. With 10-year yields still trading with a significant buffer to the BoJ's 1% tolerance level, now could be a good time to skip the YCC completely if the aim is to normalise policies and set markets free.

The signalling effect in such a move would be significant, though, and what speaks against this is the risk that yields increase more than expected, adding too much to the 220% of GDP public debt burden. We think the BoJ's very cautious approach so far warrants an increase in the yield target from the current 0% to say 0.5% with the yield cap being raised from to 1.50% or some other tweak as a final small step ahead of completely abolishing YCC. The October meeting where we also get a new outlook report looks like the most likely one for such a move.

Abolishing NIRP

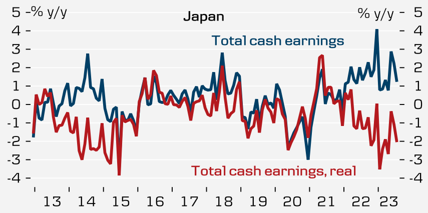
A policy rate hike is only feasible if Japan's most important trading partners model through without entering recession. With promising signs of a soft landing in the US and our expectations that Chinese authorities will do what it takes to keep the Chinese economy afloat, the foreign prerequisites for actual BoJ tightening are in place. However, we will have to see a pickup in wage growth before the BoJ will be able to move away from its negative interest rate policy (NIRP). We think the BoJ is motivated to move away from NIRP and also recognises that the window for tightening might close next year when other major central banks embark on a cutting cycle. We expect the BoJ will find enough reflation signs in wage and inflation data to hike the policy rate to zero in Q2 next year and to dismantle YCC completely. However, we also think there remains a long way to a situation where the BoJ can tighten much further than that.

What does it mean for the JPY?

For the rest of this year, the biggest driver of the JPY is likely the developments in global yields, especially US yields, and energy prices, to a lesser extent. We deem that US yields are at (or close to their peak), which is the main argument for our bearish USD/JPY stance. From a fundamental perspective, our valuation models suggest that the cross is overvalued. Furthermore, in the current global economic environment where both growth and inflation are declining, history suggests that it is favourable conditions for the JPY. Hence, we forecast USD/JPY to be around 130 in a 6/12-month horizon.

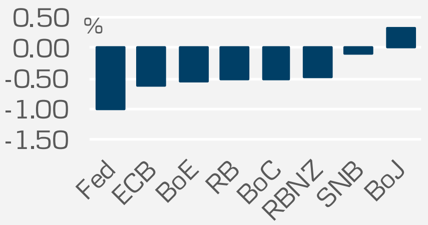
If the US enters a recession within the next couple of quarters, prompting the Fed to start a rate-cutting cycle, we find it unlikely that the BoJ will start normalizing monetary policy as long as the Fed is cutting rates. In such a scenario, the BoJ will keep policy unchanged until at least H2 2024 when the Fed is done cutting rates. That scenario will likely add support to the JPY on the back of narrowing rate differentials. Looking at market pricing for 2024, the BoJ is the only central bank among G10 economies where there are net rate hikes priced in, currently around 33bp worth of rate hikes. Especially after Ueda's comments on 9 September, we have seen a notable repricing of expectations for the BoJ's rate path next year. Either way, relative rates should be a tailwind for the JPY in 2024.

Real earnings continue to decline



Source: Japanese Ministry of Labour, Japanese Statistics Bureau, Macrobond Financial

Central bank pricing in 2024



Source: Bloomberg, Danske Bank

Disclosures

This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Bjørn Tangaa Sillemann, Director, and Mohamad Hashem Hasan Al-Saraf, Associate.

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