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The Big Picture: BOJ moves towards normalization, what's next?

宏观视野：日本央行迈向货币政策正常化，将如何影响市场？

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Small but decisive steps to normalize policy; likely more ahead. The BOJ ended its negative interest rate and Yield Curve Control (YCC) policy this week, marking a clear shift to normalize its monetary policy. Despite the medium-term growth challenges, we expect Japanese cyclical growth to hold up on the back of modest improvement in domestic demand growth and a resilient global outlook. We expect further small hikes in the magnitude of 0.2-0.3ppt later this year from the still ultra-loose policy stance.

BOJ moves should lead to slightly higher JGB yield and a stronger JPY against the USD. The initial market reaction to the BOJ's decisions has so far been muted, especially in light of assurances by the BOJ. We expect the resilient economic outlook for Japan coupled with further BOJ hikes to push the 10Y JGB higher towards the 1% mark by year-end, and likely slightly higher next year. The BOJ is still likely to step in to dampen sharper moves. A weaker USD as the Fed embarks on rate cuts in 2H could see the USDJPY strengthen towards 140.

Unwinding of carry-trade could exacerbate the liquidity shortage in the global market although the direct impact on Asia would be small. We estimate that short yen positions are at a historical high, and that a large part of Japanese outward investment could be unhedged, adding to the risk of carry trade unwinding should the yen strengthen. As recent Japanese outward bond investment has been driven by the US, we expect the unwinding of carry trade to have a muted effect on the Asia market.

预计日本央行继续谨慎走向货币政策正常化。日本央行于本月结束负利率政策并取消国债收益率曲线控制（YCC），迈出货币政策正常化进程的关键一步。尽管日本中长期的经济增长仍面临挑战，但我们预计国内需求端的提振以及全球的复苏预期将支撑周期增长。我们预计日本央行下半年将进一步小幅加息 0.2-0.3 个百分点。

货币政策的转向预计推升日本国债收益率和日元汇率。考虑到日本央行偏鸽派的表态，市场初时反应较为平淡。尽管如此，我们预计经济韧性和日本央行的进一步加息将推动十年期国债收益率在年底前升至 1%，并有望在明年继续小幅上升。考虑到美联储可能在下半年降息推动美元走软，日元兑美元汇率有望升向 140。

日元走强和套息交易平仓可能冲击全球流动性，对亚洲市场的直接影响有限。我们估算，当前日元空头头寸处于历史高位，而日本相当一部分对外投资没有进行对冲，这增加了套息交易的平仓风险。由于近期日本的对外投资主要投向美国，我们预计平仓交易对亚洲市场的直接影响有限。

The Bank of Japan moves away from its ultra-loose monetary policy stance

On 19 March, the Bank of Japan (BoJ) announced steps to move further away from its ultra-loose monetary policy, including:

- Ending its negative interest rate policy by raising the interest rate for the first time in 17 years from -0.1-0.0% to 0.0-0.1%.
- Ending Yield Curve Control (YCC), after softening its upper bound last October.
- Maintaining JGB purchase plans at the same pace of around JPY 6t per month, despite abolishing the YCC. Actual JGB purchases have slowed to around JPY1.7t per month, below scheduled purchases over the past year (Fig 2).
- Suspend buying exchange-traded funds (ETF) and Japan real estate investment trusts (J-REIT). The BOJ will also slow its purchases of corporate paper and corporate bonds, with a goal of ending purchases in one year.

Table 1 lays out the latest policy changes of the BOJ while and Fig 1 provides a timeline of the BOJ's monetary policy operations in the last decade.

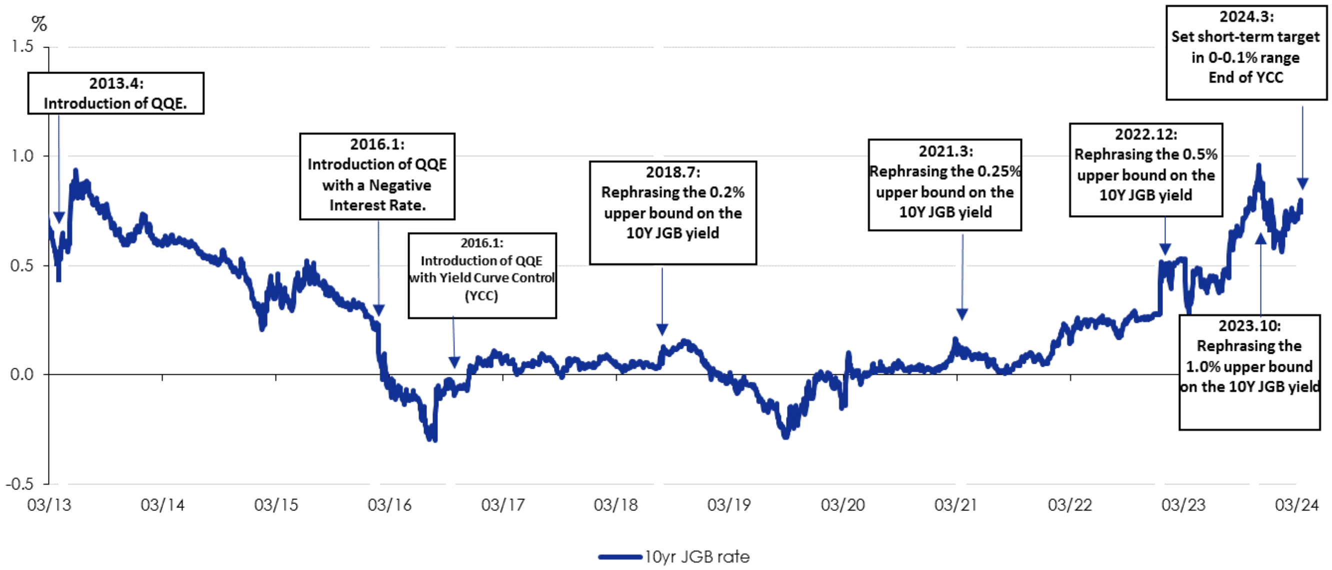
For now, the BoJ has maintained a dovish stance, emphasizing that "accomodating financial conditions will be maintained for the time being", as there is "some distance" for inflation expectations to reach 2%. While leaving the door open for additional tightening, Mr. Kazuo Ueda, Governor of the BOJ, stated that the BOJ can avoid a rapid series of rate increases given the current outlook. The continuation of JGB purchase suggests the BOJ could step in to tame the market if necessary.

Table 1: Summary of policy changes

	Before announcement	BoJ's updated monetary policy
Policy rates	The BoJ established a three-tier system for banks' current account with the central bank, and applied a negative interest rate of -0.1 percent to the policy rate balance in current accounts.	The BoJ restored the uncollateralized overnight call rate as a primary policy tool, and set the rate in a range between 0% to 0.1%.
YCC	BOJ conducted bond purchases so that 10-year JGB yields would remain at around zero percent. Since Oct-2023 the BOJ has loosened the upper bound for 10-year JGB yields, using 1% as a reference in its market operations.	End of YCC
QE/QQE	The BOJ conducted large-scale JGB purchases and made nimble responses for each maturity.	A continuation of its JGB purchases of around JPY6t yen per month.
Risky assets	The BOJ purchased ETFs/J-REITs as necessary with upper limits of JPY12t and about JPY180b, respectively. The BOJ kept outstanding commercial paper at about JPY2t.	The central bank will discontinue the purchase of ETFs/J-REITs while gradually reducing the amount of its purchases of CP and corporate bonds. It will discontinue the latter purchases in about a year.

Source: BoJ, CCBIS

Fig 1: BOJ policy timeline



Source: BOJ, Wind, CCBIS

Additional rate hikes expected this year on the back of improving economic outlook

Recent wage negotiation has lifted the hope of sustained domestic demand growth. The strong preliminary wage negotiation outcome has played a pivotal role in this monetary policy shift. Japan's largest labor confederation said last Friday that its member unions won an average 5.28% increase in wages this year, the biggest raise in more than 30 years, far exceeding market expectations. The outcome was positive for achieving the virtuous cycle of rising wages and sustained inflation, long considered by the BOJ as a crucial criteria for tightening policies.

To be sure, the actual economic wide wage growth will likely be smaller than the 5.3% headline figure. Labor union workers participating in Shunto wage negotiations only account for 5% of the labor force, mostly in large manufacturing corporates, and small businesses are unlikely to match the pay rise agreed to by large Japanese corporates. Wage growth in the services sectors and SMEs, accounting for 80% of the economy, tends to be slower. However, the tightness of the labor market suggests that overall wage growth will still be solid, and real household income is set to further improve.

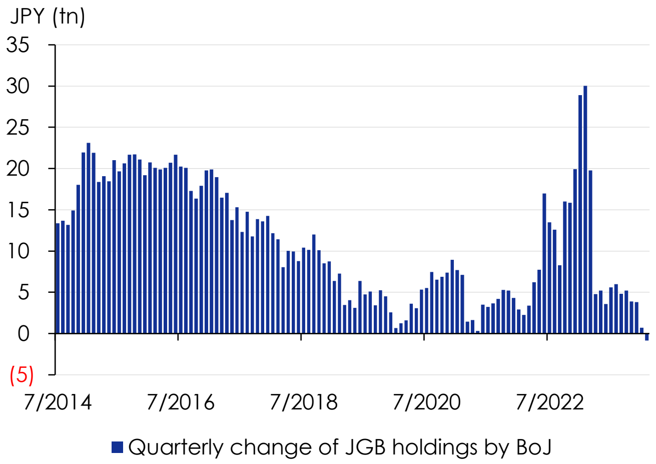
Further incremental steps of policy normalization expected. While neither the BoJ policy statement nor the Governor's press conference offered any clear guidance on the future policy rate path, as a whole the latest policy moves have laid the groundwork to further achieve incremental normalization of the ultra-loose monetary policy stance, as macroeconomic conditions improve.

- High frequency indicators point to an improving cyclical picture. Although domestic demand improved (Fig 5), 4Q2023 data was soft, as the economy narrowly avoided a technical recession. In particular, consumers have slowed spending since 2Q2023 as pent-up demand post-Covid faded and faster inflation than wage growth has dented consumers' purchasing power. Improved real household income on the back of the latest wage increase will be positive for consumption growth in the coming quarters (Fig 6). Business investment will likely strengthen this year, as the recent BoJ survey signaled improving investment sentiment (Fig 7). The improving global manufacturing cycle is also positive for the trade sector, with the latest data showing a growth rebound. On balance, we expect Japan to achieve solid growth of around 1% in 2024, only slightly below what the BOJ currently expects.
- Inflation is expected to fall from last year but domestic demand remains robust. Goods inflation will likely decelerate further as indicated by moderating import inflation (Fig 4), although the latest rebound in global commodity prices suggest that goods price disinflation could start to fade in the next six months. More importantly, the strong wage increase should help support domestic demand and sticky services inflation, keeping the overall inflation over 2%. The BoJ expects core inflation, excluding food and energy, will slow from 3.8% YoY for FY2023 to 1.9% YoY in FY2024 and FY2025, in line with the 2% inflation target.

The very accommodative stance also points substantial room for tightening. Adjusted for inflation, real interest rate remains at a historical low and is well below that of potential growth, estimated at around 0.5% by the BOJ (Fig 9), and an estimated neutral rate of around 0%, leaving room for further tightening.

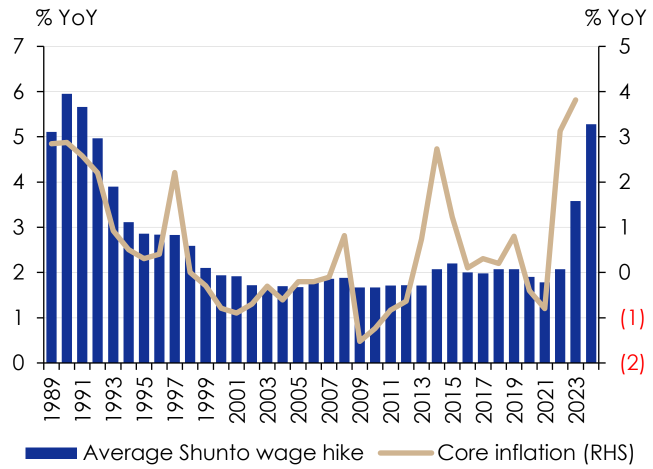
Our baseline expects further hikes by the BoJ to about 0.3-0.4% by year-end. The next BoJ hike may be in Jun or Jul as the BoJ needs additional data to gauge the outlook for growth and prices. The macro global backdrop also needs to be taken into consideration. We continue to hold the view that the Fed will cut interest rates only modestly in 2H 2024 in a soft-landing scenario, leaving room for the BOJ to continue with further hikes. More global inflation ahead on the back of geopolitical tension, or a stronger than expected global outlook driven by stronger China data or US growth, could lend support for additional hikes by the BOJ.

Fig 2: BoJ's JGB buying has slowed recently



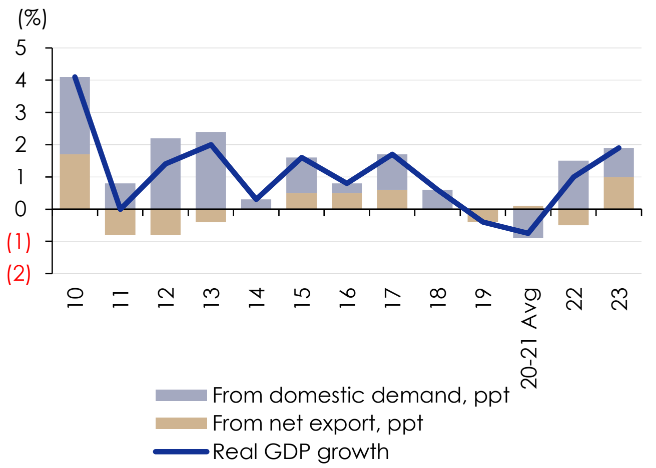
Source: CEIC, CCBIS

Fig 3: The largest pay rise since 1991



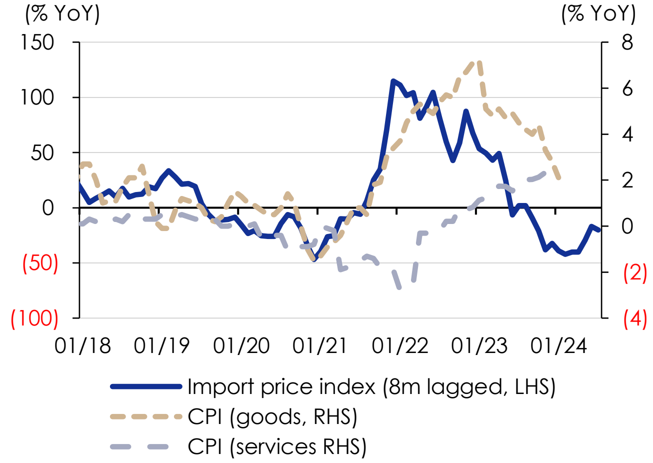
Source: Rengo, CEIC, CCBIS

Fig 4: Domestic demand has supported growth



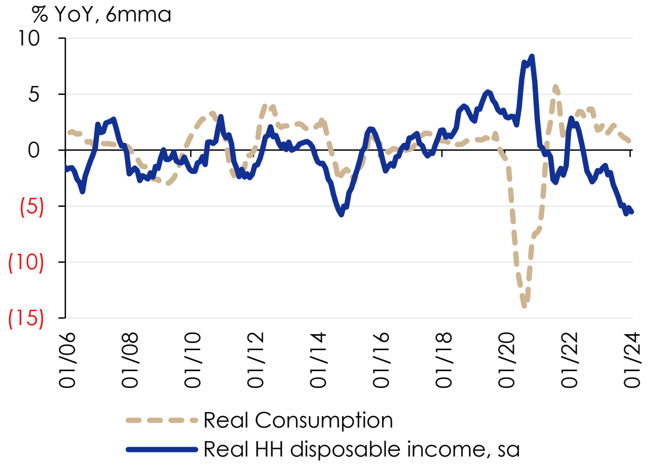
Source: Wind, CCBIS

Fig 5: Rising service inflation while goods disinflation slowing



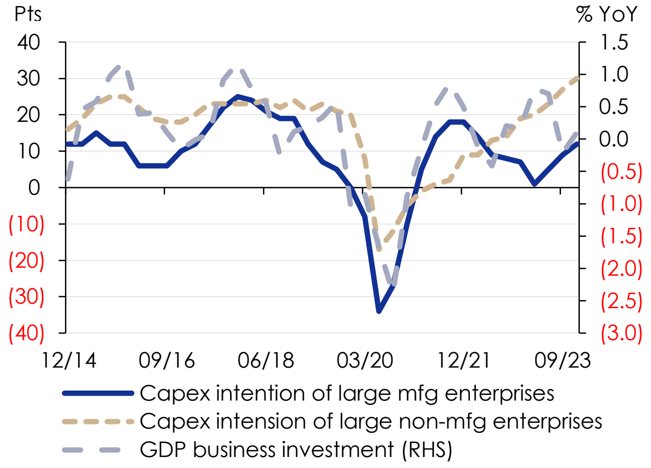
Source: CEIC, CCBIS

Fig 6: Expected pick-up in real income growth should support consumption



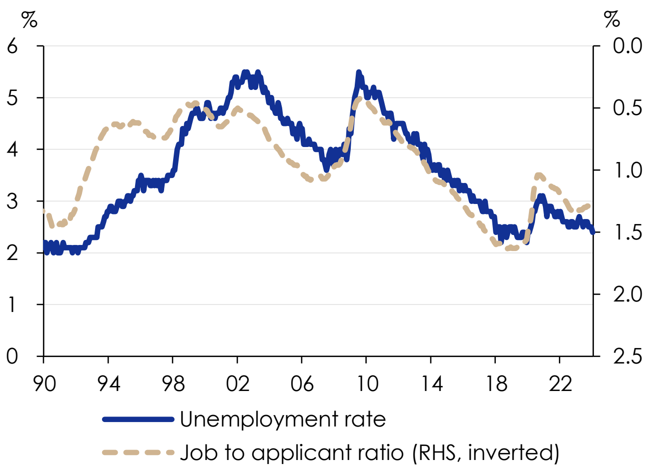
Source: CEIC, CCBIS

Fig 7: Tankan survey points to improving capex intention



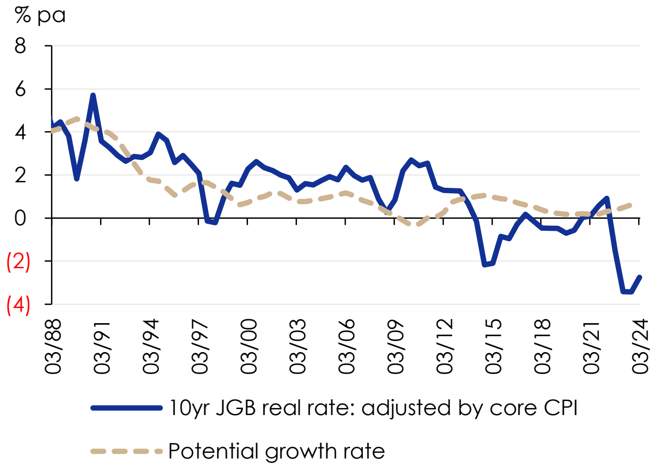
Source: CEIC, CCBIS

Fig 8: Labor market condition remains tight



Source: CEIC, CCBIS

Fig 9: Real interest rate remains very accommodative



Source: Bloomberg, CEIC, CCBIS

Higher JGB yield and stronger yen likely in 2H

In the near-term, the BoJ's muted tone towards additional tightening and continued commitment to JGB purchases will also dampen the sharp rise of JGB yield and JPY exchange rate. If the virtuous cycle between wages and prices are indeed confirmed in the next few months, JGB yields could lift modestly as markets will likely increase expectations of additional rate hikes. We expect the 10yr JGB yield will likely move towards 1% by the end of 2024F. Despite the abolishment of YCC, we think the BoJ is unlikely to tolerate a substantial yield move above 1% this year given financial stability concerns, but the further rise of JGB yields are still likely in future years.

The market expectation of continued ultra-loose monetary policy, dollar strength, and large yen carry trade have all contributed to the weak dollar-yen exchange rate. After the 25% depreciation since 2022, JPY is now one of the most undervalued currencies (Fig 10). The narrowing interest rate differentials between USD and JPY, a weaker dollar as the Fed embarks on rate cuts in 2H as we expected, and some unwinding of yen carry trade (further below) could all contribute to yen strengthening towards 140 this year, in our view.

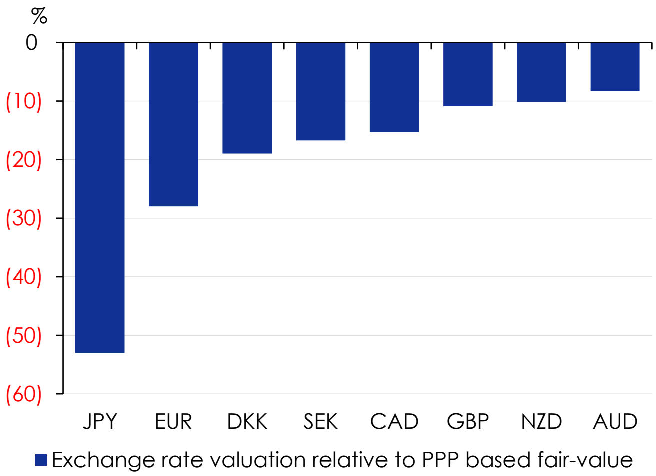
Risk of carry trade unwinding and implications

Markets generally expect the BoJ's pace of policy normalization will be very gradual, keeping JPY as a popular funding currency in a "higher for longer" world. While this is likely, the ultra-weak yen and large accumulated short-yen position that has been left unhedged has also increased the risk of sharp repatriation flows should carry trades unwind.

There are indications that the FX-unhedged outward investment by Japanese investors has been on the rise. Prior to 2022, the Japanese outward purchase of foreign bonds was consistent with positive FX-adjusted interest rate differentials. The rapid yen depreciation against the dollar since 2022 has been accompanied by a higher yen forward premium, pushing the FX hedged 10yr US Treasury yield into negative territory, significantly lower than 10yr JGB yields (Fig 12). Japanese investors responded by cutting their US Treasury holdings initially. However, once the Fed's tightening cycle came to an end in Q3 2023, Japanese investors started to increase their US Treasury holdings, suggesting that yield pick-up on an unhedged basis has been the key motivation for Japanese investment during the year. The short yen position is also near historical high (Fig 13).

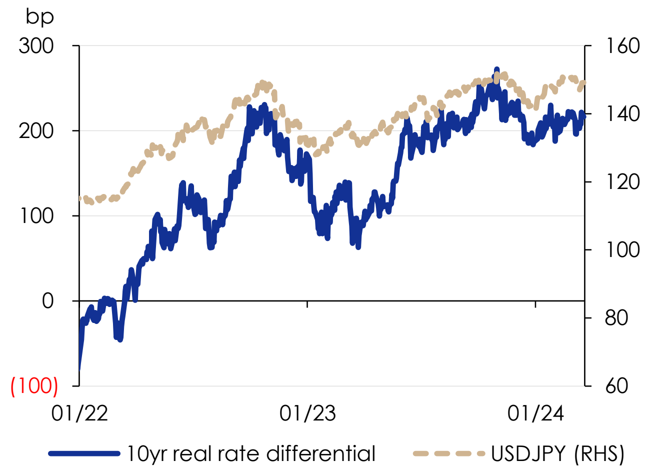
As such, an unwinding of short yen positions, should upside surprises of domestic growth and inflation materialize or if the BoJ indicates a more hawkish stance than markets currently expect, could be associated with significant portfolio repatriation. Japan MOF data suggests that the overseas bond investment by Japanese investors is concentrated in the US, EU and Asia (Fig 14). Japan is the largest foreign debt holder of the US, accounting for about 14% of foreign investment in US treasuries and about 4% of outstanding US treasury bonds. We estimate that long-term overseas debt purchases by Japanese investors ex-BOJ exceeded US$160b since 2023, an amount equivalent to about a quarter of foreign investment into US Treasuries and about a 9% increase in US Treasuries during the period. Unwinding part of the flows could add to liquidity pressure. In contrast, Japanese investment accounts for less than 2% of the Asian bond market, and investment into Asian countries last year was more muted (Fig 14 & 15). We expect the unwinding of carry trades to have low direct impact on the Asia markets.

Fig 10: JPY is the most undervalued among DM currencies



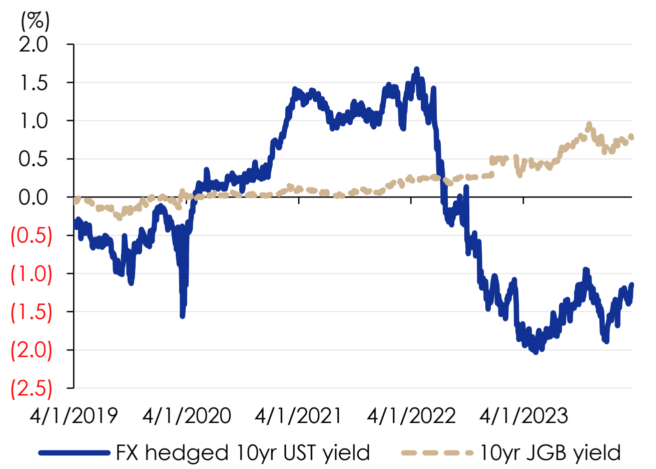
Source: OECD, CEIC, CCBIS

Fig 11: Elevated interest rate differential has supported the USDJPY, but this could start to narrow



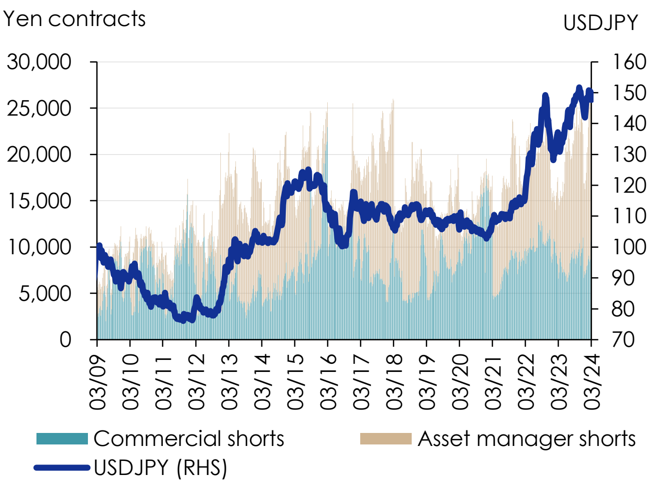
Source: Bloomberg, CEIC, CCBIS

Fig 12: 10-year JGB yield is more attractive compared with the 10-year UST yield on an FX-hedged basis



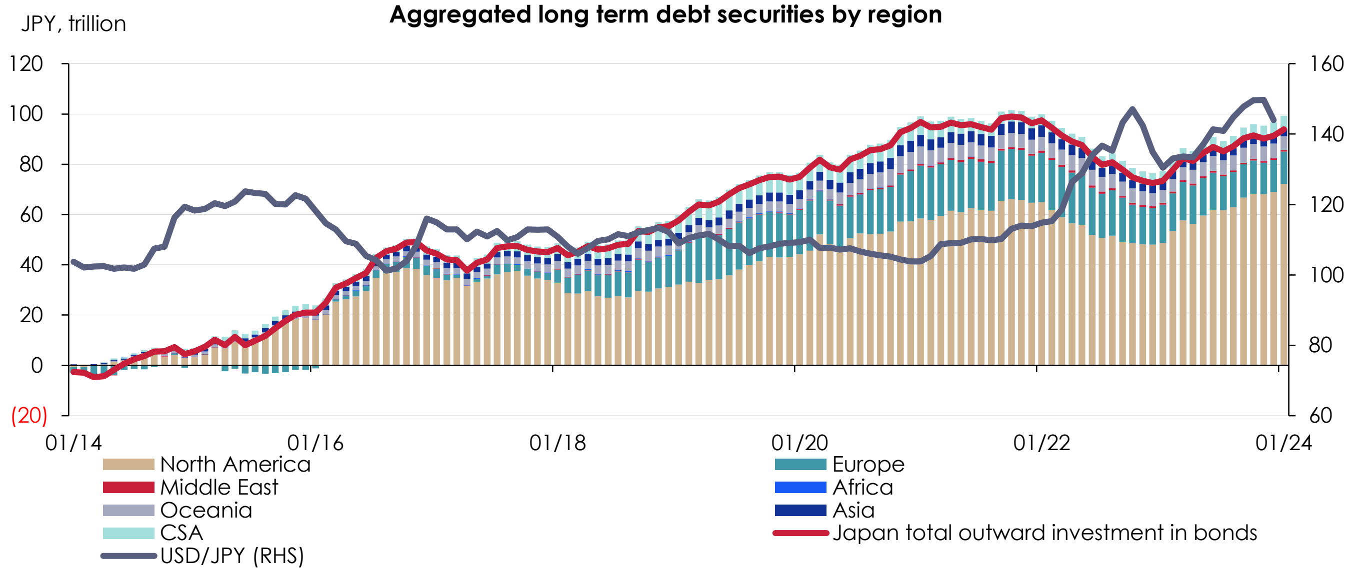
Source: Wind, CEIC, CCBIS

Fig 13: Yen short positions have built up



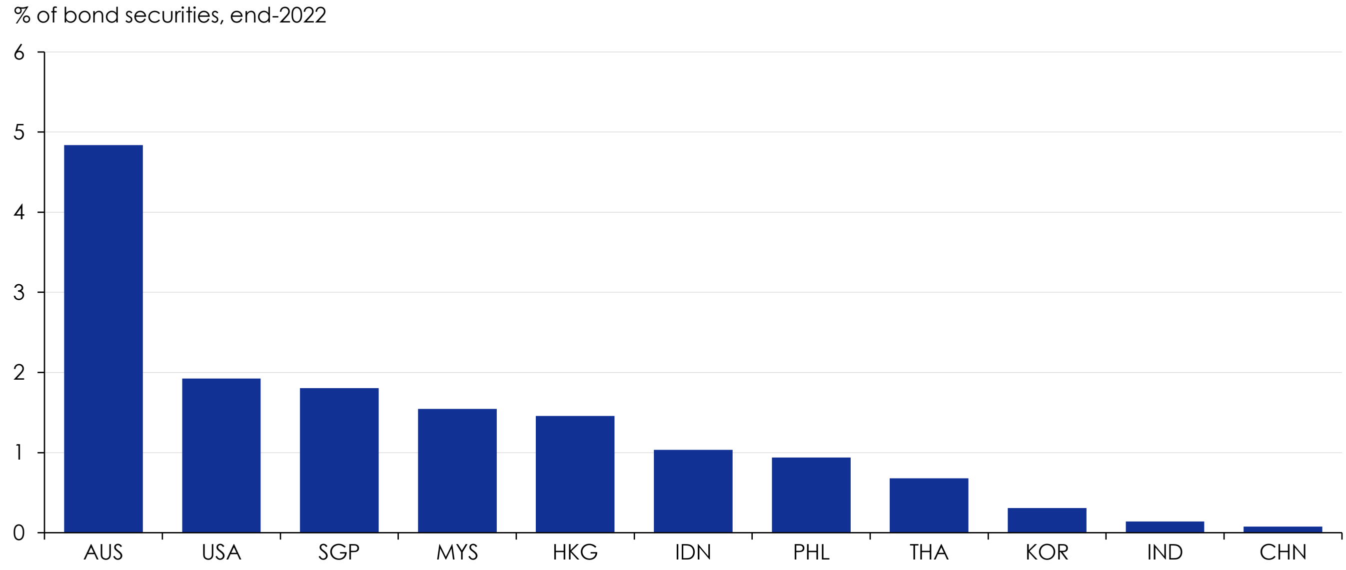
Source: Wind, CEIC, CCBIS

Fig 14: Japanese investors increased foreign bond holdings since mid-2023 amid a weakening Yen



Source: Wind, CEIC, CCBIS

Fig 15: Japanese LT bond investment as a share of local debt securities



Source: MOF, BIS, CEIC, CCBIS

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