PICTET 1805

Flash Note

Japan: BoJ keeps policies unchanged

Sluggish inflation will keep BoJ on easing for a long time

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In July's monetary policy meeting, the Bank of Japan (BoJ) decided to keep its monetary easing program unchanged, maintaining its qualitative and quantitative easing (QQE) with yield-curve control (YCC). In addition, the BoJ cut its inflation estimates for the current and next fiscal years, and revised its expectation for hitting its 2% target to one year later than the previous projection.

The reason for the BoJ to stay put despite other central banks' tightening is that inflation in Japan is showing very little momentum so far, way below what the BoJ hopes to achieve.

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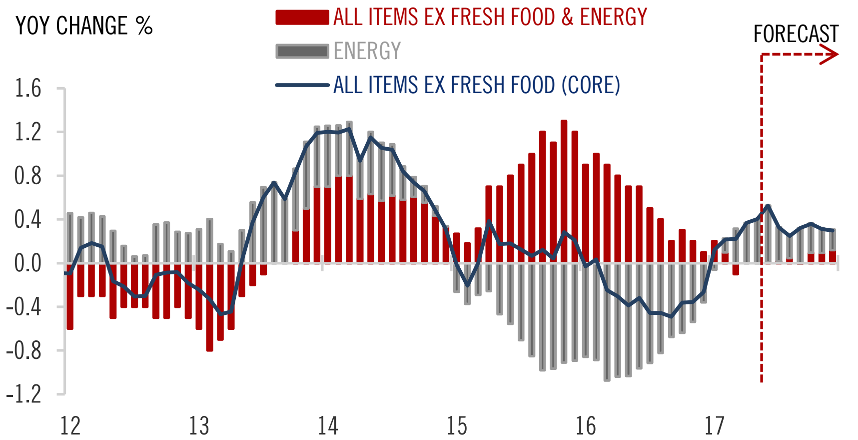
The BoJ's decision to keep its monetary policies unchanged was widely expected, including by us. But this decision is in sharp contrast to what the other major central banks are currently doing. The Fed has already started to normalise its monetary policy, hiking interest rates three times since last December. Although the ECB has not made any material changes to its policies so far, it has signaled that it will move to start winding down its QE programme later this year. Finally, the People's Bank of China (PBoC) has been pushing up inter-bank interest rates through open market operations since late 2016 in an effort to deleverage the financial system.

The reason for the BoJ to stay put despite other central banks' tightening is that inflation in Japan is showing very little momentum so far, way below what the BoJ hopes to achieve, despite more than four years of unprecedented monetary easing.

Chart 1: Japanese core inflation and components, including forecast



Source: Pictet WM - AA&MR, Statistics Japan

In May 2017, Japan's core CPI (all items excluding fresh food) rose by 0.4% year-on-year (y-o-y), far below the BoJ's 2% target. And all of this increase

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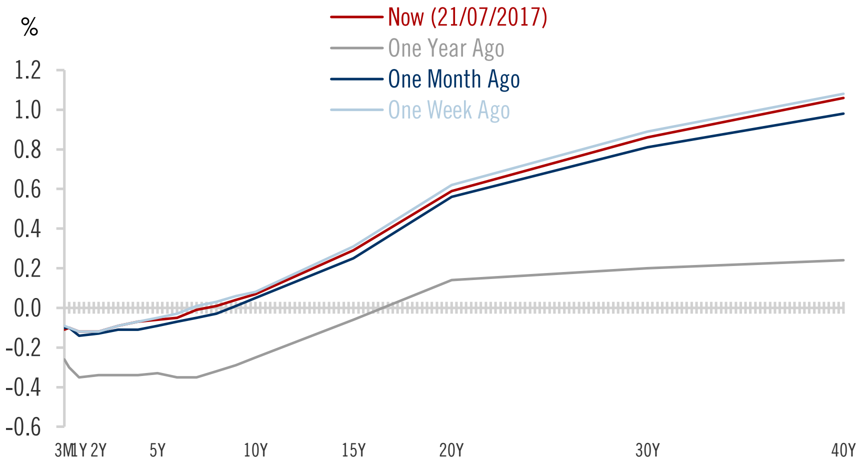
was due to rising energy prices, which, in turn, were largely driven by the y-o-y increase in global oil prices. But underlying inflation pressure, as measured by CPI items excluding fresh food and energy, showed no growth at all (*Chart 1*). Our forecast is that underlying inflation will likely gradually pick up, but only at a very modest pace. However, the boost from energy prices will start to wane as global oil prices do not seem to have much further upside ahead. As a result, Japan is very unlikely to hit its 2% inflation target remains in the foreseeable future, at least until the end of 2018.

To the BoJ's credit, its massive monetary easing is not all futile. Economic growth has picked up since BoJ started its QQE program in 2013, although the recovery in global demand was also a major contributor to Japan's economic revival. Regarding price levels, underlying inflation actually did show some notable increases in 2014 and 2015, but the positive effect was wiped out by the slump in oil prices in 2015, which was out of the BoJ's control (*Chart 1*).

Unfortunately, though, what matters for Japan is the *observed* inflation rate. This has been extremely low, which definitely did not help change Japanese consumers' and corporations' deflationary mindset. The following excerpt from the BoJ's *Outlook for Economic Activity and Prices* for July 2017 explains this point well.

"[…] *the mindset and behavior based on the assumption that wages and prices will not increase easily have been deeply entrenched among firms and households* […] *Firms have been making efforts to absorb a rise in labor costs by increasing labor-saving investment and streamlining their business process, while limiting wage increases […] mainly to wages of part-time employees. As suggested by these developments, firms' wage- and price-setting stance has remained cautious despite the steady tightening of labor market conditions and the high levels of corporate profits. A rise in medium- to long-term inflation expectations has been lagging behind somewhat, as such expectations are largely affected by the observed inflation rate*."

Chart 2: JGB yield curves



Source: Pictet WM - AA&MR, Factset

In September 2016, the BoJ reinforced its monetary easing stance by committing to overshooting the 2% inflation target. In our view, the further delay to achieving the inflation target, combined with the inflation overshoot commitment, implies that policy normalisation by the BoJ is still very far away.

This means the BoJ will keep nailing the 10-year Japanese government bond (JGB) yield at about 0% and keep the short-term policy rate at -0.1%. So far BoJ has been quite successful in controlling the yield curve (*Chart 2*), and there has not been any sign that the BoJ will deviate from this strategy any time soon.

In conclusion, no surprise from BoJ's July policy meeting, and no change in our scenario regarding the BoJ's future policy moves.