PICTET 1805

Flash Note

Japan: BoJ - last man standing

BoJ keeps monetary easing as inflation remains below target

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The BoJ announced to keep its current monetary easing program intact. The Bank will continue with its "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control (YCC)", aiming to achieve and overshoot the core inflation target of 2%.

The reason for the BoJ to stay put is the stubbornly low inflation in Japan. After five years of unprecedented monetary easing, core inflation in Japan (all CPI items excluding fresh food) remains below 1%, less than half of the BoJ's target of 2%.

In the short term, we don't expect BoJ to make any significant changes to its policies.

In the longer term, BoJ probably will have to adjust its policies even if it fails to achieve the inflation target, due to either practical constraints or changing global economic environment.

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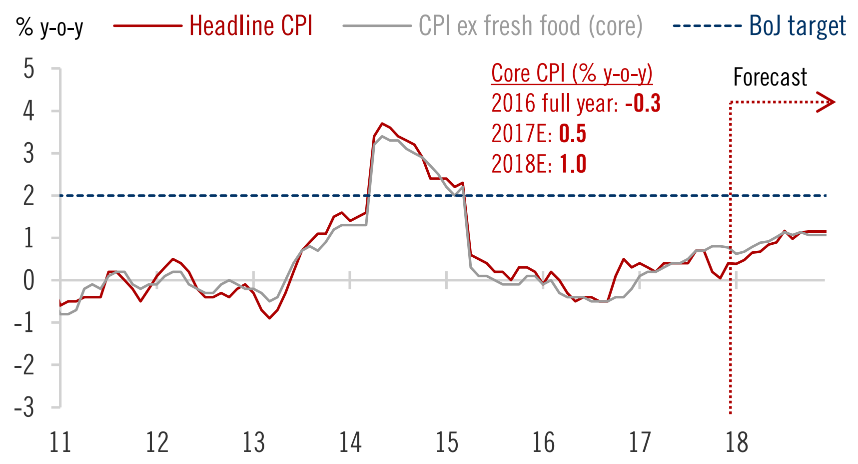
After its Monetary Policy Meeting of December, the Bank of Japan (BoJ, or the Bank) announced to keep its current monetary easing program intact. The Bank will continue with its "Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control (YCC)", aiming to achieve and overshoot the core inflation target of 2%.

Under the YCC policy, the BoJ applies a negative interest rate of -0.1% to the Policy-Rate Balances in the current accounts held by financial institutions at the Bank, and the BoJ will continue to purchase Japanese government bonds (JGBs) so that 10-year JGB yields will remain at around 0%.

Regarding asset purchases, the BoJ's guideline of increasing its holding of about JPY80 trillion per year remains unchanged, although the actual amount of purchases by the Bank had decreased to around JPY60 trillion annualised in recent months. In addition, the Bank will continue to purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) at the pace of about JPY6 trillion and JPY90 billion per year, respectively.

These decisions by BoJ are in line with the market consensus as well as our own expectations. With no change to its monetary policies, the BoJ now becomes the only major central bank in the world that is still firmly committed to monetary easing of almost the same magnitude as in the most aggressive days without even hinting at an exit.

Chart 1: Y-o-y changes in headline and core CPI in Japan



Source: Pictet WM - AA&MR, Statistics Japan

Stubbornly low inflation in Japan

The reason for the BoJ to stay put, of course, is the stubbornly low inflation in Japan. After five years of unprecedented monetary easing, core inflation in Japan (all CPI items excluding fresh food) remains below 1%, less than half of the BoJ's target of 2% (*Chart 1*). In October 2017, core CPI rose by 0.8% year-over-year (y-o-y), but three quarters of that increase was due to the rise in energy prices, largely driven by the global crude oil, while the measure of the underlying inflation momentum (all CPI items excluding fresh food and energy) increased by only 0.2%.

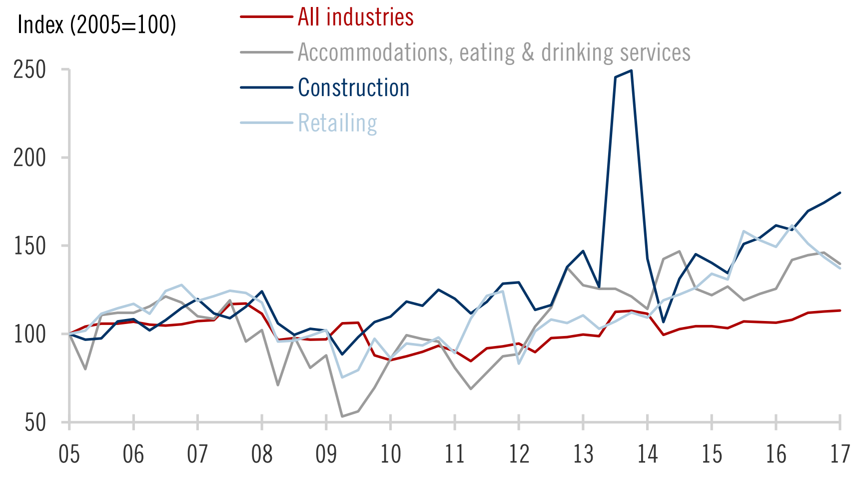
As Japan's labour market gets increasingly tight – the unemployment rate reached 2.8% in October 2017, the lowest since mid-1994 -- the lack of inflation appears especially puzzling.

In one of his recent speeches, Haruhiko Kuroda, Governor of the BoJ, offered two explanations, referring to the wage- and price-setting behaviours of Japanese companies.

First, both labour and management in Japanese firms place priority on the long-term stability of employment over wage increases. As a result, during economic downturns there is minimal employment adjustment or wage reduction for full-time employees. But this also means that when the economy recovers, wages will remain largely stable even if the labour market conditions tighten.

Apart from the limited rise in wages, the pass-through of the moderate rise in labour costs to sales prices has been minimal. This might reflected businesses' efforts to absorb increased labour costs through labour-saving investment such as in information technologies. Software investment has been rising strongly in some industries where labour shortage is especially acute, such as restaurants, retail and construction (*Chart 2*). The productivity increase brought by this kind of investment may have helped firms to avoid hiking prices for their products or services for now.

Chart 2: Software investment by Japanese companies by industry



Pictet WM - AA&MR, Bank of Japan, Bloomberg

The outlook for BoJ

In its latest policy statement, the BoJ re-affirmed its strong commitment to its inflation target through monetary easing.

"The Bank will continue with 'Quantitative and Qualitative Monetary Easing (QQE) with Yield Curve Control', aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner. It will continue expanding the monetary base until the year-on-year rate of increase in the observed CPI (all items less fresh food) exceeds 2 percent and stays above the target in a stable manner."

If taken at its face value, this means that, as long as Japan's core inflation is still below 2%, then there is no end to monetary easing.

But some questions remain.

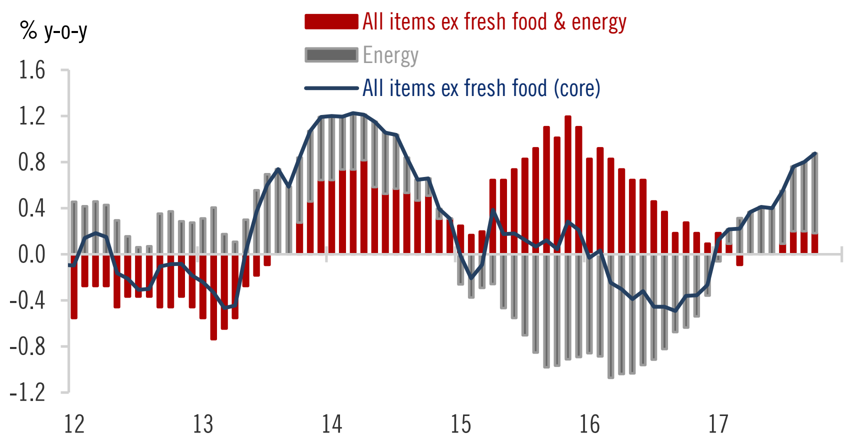
1. *Is Japan ever going to see core inflation stay above 2% in a stable manner?*

It is possible, but not very likely for the foreseeable future. In our base-case scenario, Japan's core inflation may reach 1.0% in 2018 and may rise to 1.1% in 2019.

Yes, inflation pressure is building up as the labour market gets tighter every day, and business owners probably will eventually start to increase wages for their full-time workers in a meaningful way. But it's quite uncertain when that may happen. If this process unfolds too slowly, it may not be able to drive inflation above 2% before the next global economic downturn hits and interrupts the inflation momentum.

In addition, the BoJ's target hinges on core inflation, which in Japan includes energy prices (but excludes the price for fresh food). Energy prices are largely determined by global crude oil (with a lag), which are out of the BoJ's control. Another slump in crude oil prices in the future, which is not impossible, can wipe out the gains of domestic inflation momentum in Japan, just like what happened back in 2015-2016 (*Chart 3*).

Chart 3: Y-o-y change in Japanese core CPI and its components



Source: Pictet WM - AA&MR, Statistics Japan

2. *If Japan really cannot reach the 2% inflation target, what will the BoJ do?*

In the short term (meaning the next one year or so), we don't expect BoJ to make any significant changes to its policies. The only thing that may vary is the quantity of JGBs that the BoJ will buy, because it's getting apparent that to control the yield curve, the BoJ no longer has to buy as much JGBs as it did before.

Many people are concerned how BoJ can continue its QQE operations with increasingly less JGBs available on the market. As of October 2017, the JGBs held by the BoJ accounted for 43.2% of the total JGBs outstanding, they keep growing.

Governor Kuroda is not as worried. In one of his recent speeches, he made the case for the sustainability of QQE with YCC. According to Kuroda, the effectiveness of yield curve control hinges more on the stock of JGBs that the central bank holds than on the amount of JGBs that the central banks buys on monthly basis (flow). This implies that, by holding more than 40% of the total JGBs outstanding, the BoJ has a strong power in controlling the yield curve. Second, as the supply-demand conditions in the JGB market tighten in the future, the Bank can have the same degree of effect in lowering interest rates with a smaller amount of JGB purchases, which is exactly what we observed over the past year. In conclusion, Governor Kuroda believes the yield curve control policy is highly sustainable.

In the longer term, however, we believe BoJ will have to adjust its policies even if it fails to achieve the inflation target, due to either practical constraints (e.g., the depletion of JGBs on the market) or changing global economic environment (e.g. significantly increased interest differentials with other major economies). There could be several possibilities.

First, with inflation showing more evidence of firming up (not necessarily reaching 2%), the Bank may discard the negative short-term interest rate, and/or raise the 10-year yield target to make Japan's interest rates more in line with other major economies.

Or, the Bank may change the yield curve control by re-anchoring the longer end of the curve to a shorter maturity such as 5-years from the current 10-years.

Last, the BoJ may lower its inflation target by admitting 2% is too ambitious for Japan given its economic and demographic structure, and then dial down monetary easing accordingly.

However, none of these scenarios will likely happen in the near term, given the sluggish inflation right now and possibly in the near future. In addition, there is a fairly high probability that Mr. Kuroda will serve a second term as the BoJ Governor after Shinzo Abe obtained a fresh mandate. With Kuroda's firm belief in the current policy framework and in the absence of any immediate pressure for the Bank to change those policies, we expect the BoJ to stay the course of monetary easing for quite a while longer.