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Bank of Japan Pauses Along Its Policy Normalization Path

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Summary

- The Bank of Japan (BoJ) did not make any meaningful policy changes at its June 13-14 meeting, reiterating that it would encourage the uncollateralized overnight call rate to remain at around 0.0%-0.1% and would conduct bond purchases in accordance with the decision made at its March monetary policy meeting.
- The monetary policy statement did include a signal that the BoJ would reduce its pace of bond purchases following their July 31 meeting. In a post-meeting press conference, Governor Kazuo Ueda noted that officials would take a careful approach to this process, but that the size of the change could be "substantial".
- We believe further monetary policy normalization is ahead. However, given our outlook for only gradually improving economic growth, inflation and wage growth trends, we believe the BoJ will take a gradual approach to policy normalization.
- **We maintain our view for the BoJ to wait until October to deliver another policy rate increase, where we expect a 15 bps hike in the uncollateralized overnight call rate to 0.15%-0.25%. Beyond that, we forecast the BoJ will wait until its April 2025 announcement before delivering a 25 bps rate hike.**
- We also expect the BoJ to normalize policy through a gradual reduction in the pace of its bond purchases, a process which we believe the BoJ will enact independently of the timing of any policy rate increases. **In our view, the BoJ will reduce its pace of bond purchases by 1 trillion yen at a time, beginning in July with a confirmation of a slower ~5 trillion yen pace of bond purchases through the remainder of Q3-2024. We then see a slowing to ~4 trillion yen pace in Q4-2024, ~3 trillion yen pace in Q1-2025 and ~2 trillion yen pace from Q2-2025 forward.**

Bank of Japan Holds Policy Steady in June But Signal Further Changes Ahead

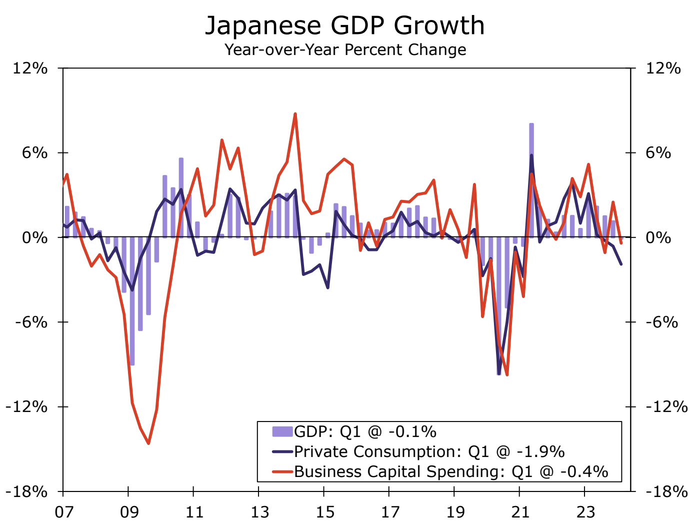
The Bank of Japan (BoJ) did not make any meaningful policy changes at its June 13-14 monetary policy meeting, reiterating that it would encourage the uncollateralized overnight call rate to remain at around 0.0%-0.1% and would conduct bond purchases in accordance with the decision made at its March monetary policy meeting.

This was arguably a relatively dovish outcome, given that in the lead-up to the meeting, market participants had increasingly begun to expect that the BoJ could announce an immediate change to its bond buying operations. The monetary policy statement included a nod in this direction, however, as it noted that BoJ officials had decided to reduce the pace of bond buying following their July 31 announcement. Leading up to that meeting, policymakers will survey various market participants, so that they are able to “decide on a detailed plan for the reduction of its purchase amount during the next one to two years or so.”

The monetary policy statement also included a somewhat encouraging view of the Japanese economy. Officials noted that the economy has “recovered moderately”, despite some softness, and that private consumption has been “resilient”. Looking ahead, officials expect Japan's economy to keep growing at a pace above its potential growth rate, in part based on their expectation that a virtuous cycle between income and spending “gradually intensifies”. Policymakers also expect CPI ex-fresh food inflation to “be pushed up through fiscal 2025”, and for underlying CPI inflation to increase gradually, reaching a level that is consistent with the 2% inflation target over the second half of their forecast horizon.

BoJ Governor Kazuo Ueda offered some slightly hawkish-leaning commentary in the post-meeting press conference. In regard to the central bank's bond buying operations, he noted that the BoJ will take a cautious approach, but that the size of the reduction in bond buying may be “substantial” or “considerable”. Market participants also took note of Ueda's remark that a July policy rate hike was “possible” depending on the data.

Overall, the Bank's outlook for economic growth and price pressures suggests, in our view, that further policy normalization is on the horizon. However, the fact that they have not made meaningful policy change since lifting the policy rate in March, and that they are taking a slow approach to the process of reducing bond purchases, suggests to us that forthcoming policy change will be rolled out in a gradual manner. We discuss our own assessment of Japan's economy and monetary policy implications below.



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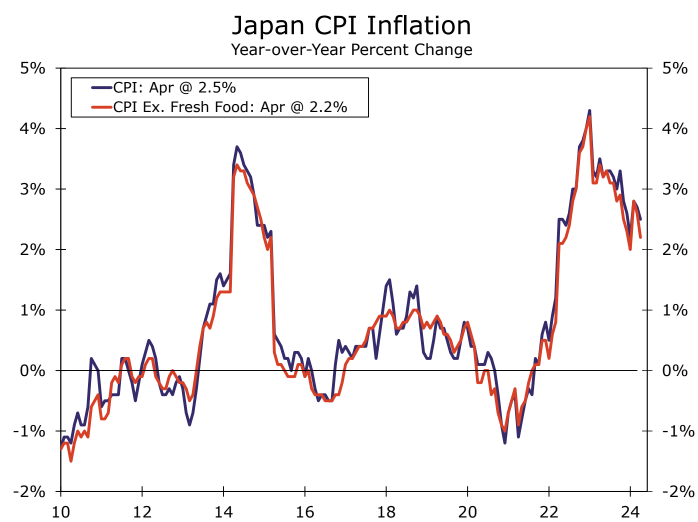

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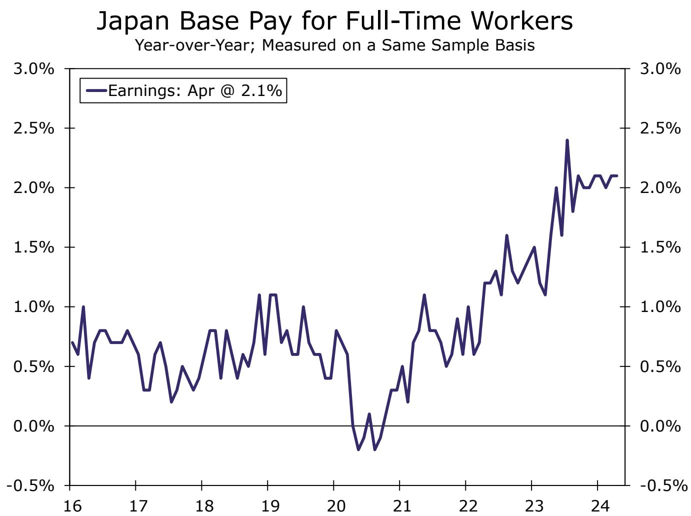
Gradual Economic Recovery Should Mean Gradual Policy Normalization

Although the Bank of Japan did not make meaningful monetary policy changes at last week's meeting, market participants remain attuned to the possibility of further monetary policy normalization to come in 2024 and 2025. Policymakers' comments in recent months suggest that they are motivated to take advantage of a period of moderately elevated wage and price growth to at least partially normalize monetary policy. However, given that current economic trends are soft and that an economic recovery will likely strengthen more noticeably only later in 2024 and into 2025, we still expect policymakers will take a cautious approach to policy normalization.

While the BoJ displayed some tentative optimism toward Japanese economic conditions in last week's monetary policy announcement, our own assessment is not quite as constructive. Economic growth and underlying domestic demand have remained generally soft; after contracting in Q3-2023 and barely growing in the final quarter of last year, the Japanese economy shrank at a 1.8% quarterly annualized pace in Q1-2024. The underlying details of domestic demand that accompany each quarterly GDP release have also been somewhat disappointing. Consumers have continued to tighten their purse strings with consumer spending contracting for the past four quarters, and business investment has been similarly soft, shrinking for three out of the past four quarters. With that being said, we do expect some of this economic sluggishness to dissipate as 2024 progresses and into 2025, which should eventually contribute to an economic backdrop that may make BoJ policymakers feel comfortable normalizing policy over time.

Turning to price developments, we would argue that inflation trends over the past several quarters overall are consistent with the BoJ proceeding cautiously with policy normalization. On the one hand, inflation has been historically elevated in recent quarters, reaching a peak in January 2023 of 4.3% year-over-year for headline inflation, and 4.2% for CPI inflation excluding fresh food. Moreover, both of those inflation measures have been above the Bank of Japan's 2% inflation target for 25 months in a row. While elevated inflation perhaps provides justification for proceeding with policy normalization, the more recent ebbing of inflationary pressures arguably provides justification for proceeding gradually. The latest inflation figures for April saw headline CPI inflation of 2.5% and CPI excluding fresh food inflation of 2.2%, though inflation could tick slightly higher in the months ahead as government subsidies that had been intended to tame inflationary pressures have come to an end. While elevated inflation provides a rationale for Bank of Japan policymakers to adjust policy, the more recent easing in price pressures—as well as Japan's history of low inflation and bouts of deflation—means we do not see the current inflationary episode in Japan is one that warrants hasty monetary policy normalization efforts.

Generally steady wage growth as of late could, in our view, represent another reason for the BoJ to maintain a cautious approach to monetary policy normalization. Governor Ueda referred to an already-underway virtuous price-wage cycle in last week's monetary policy announcement, and the idea of such cycle has been highlighted by the central bank many times since last year. However, in our view, recent wage data have not yet shown the meaningful acceleration in the pace of wage growth that the central bank is perhaps looking for. Although this year's spring wage negotiations resulted in agreements for a historically high wage gain of over 5% for members of Japan's largest labor unions, this result is not yet clearly evident in the monthly earnings figures. Headline nominal labor cash earnings grew 2.1% year-over-year in April, a somewhat elevated pace but still broadly in line with the pace seen over the past year. In addition, we believe BoJ officials are especially focused on regular earnings for full time employees using a measure that focuses on the same sample base. This measure held steady at 2.1% growth in April. BoJ policymakers have at times cited wage growth of around 3% as consistent with sustainably achieving its inflation target over time. While stronger Japanese wage growth is not clearly evident yet, we believe the monthly wage figures will become more encouraging as 2024 progresses.



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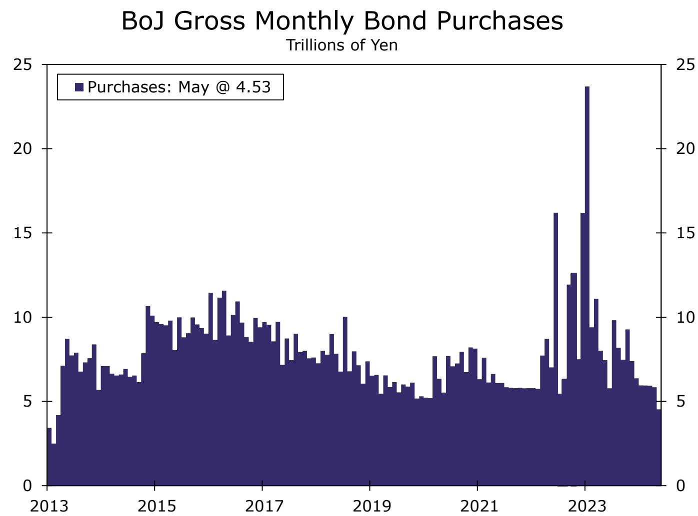

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To reiterate, we believe BoJ policymakers are motivated to take advantage of a period of moderately elevated wage and price growth to at least partially normalize monetary policy. And while recent economic figures offer some reasons for caution, we believe the economic backdrop will evolve in such a way that will make BoJ monetary policy normalization more appropriate later on in 2024. As mentioned, we expect to see a meaningful acceleration in wage growth in the coming months as the wage hikes agreed to in the spring wage negotiations take hold. Firmer earnings growth should also help Japanese households' purchasing power, which in turn should be supportive of stronger consumer spending as well as overall economic growth. Throughout the second half of 2024 and into 2025, more balanced economic growth paired with faster wage growth should help to sustain inflation that is consistent with the BoJ's 2% target. As BoJ policymakers over time gain greater assurance that inflation can sustainably remain on-target, we believe they will feel comfortable proceeding with policy normalization.

Overall, when we consider a gradually improving economic backdrop, we believe the BoJ will take an accordingly measured approach to monetary policy normalization. To that point, **we maintain our view for the Bank of Japan to wait until October to deliver another policy rate increase, where we expect a 15 bps hike in the uncollateralized overnight call rate to 0.15%-0.25%. Beyond that, we forecast the BoJ will wait until its April 2025 announcement before delivering a 25 bps rate hike.**

In addition, we also expect the BoJ will normalize policy through a gradual reduction in the pace of its bond purchases. That said, we expect such changes in the pace of its bond purchases to conducted somewhat independently of the timing of any interest rate increases. We also noted Governor Ueda saying in last week's press conference that the BoJ wanted to be careful in this process, but that the size of the reduction to bond purchases could be “substantial”. **In our view, the BoJ will reduce its pace of bond purchases by 1 trillion yen at a time, beginning in July with a confirmation of a slower ~5 trillion yen pace of bond purchases through the remainder of Q3-2024. We then see a slowing to ~4 trillion yen pace in Q4-2024, ~3 trillion yen pace in Q1-2025 and ~2 trillion yen pace from Q2-2025 forward.** This outlook involves a relatively gradual pace of reductions, yet still results in a “substantial” change to the pace of the BoJ's bond buying. The full details of the Bank of Japan's bond buying plans should become much clearer at the upcoming July monetary policy announcement.

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