JAPAN: BOJ approaches generational policy shift

- The latest consumer price index (CPI) data adds to the case for a near-term interest rate hike by the Bank of Japan (BOJ), following the record-breaking performance of the stock market.
- Though not every recent data point would justify monetary policy tightening, the key indicator—wage increases—looks to be moving in the direction of a 'virtuous cycle', in the view of both the BOJ and the IMF.
- While a 19 March shift remains possible, 26 April still looks to be the most likely date for a rate hike, though it seems that the Yield Curve Control policy will not be ended at the same time.

Case for

As the Bank of Japan (BOJ) mulls what would be a first interest rate hike in about 17 years, the consumer inflation data released on 27 February showed January's core CPI (excluding fresh food) at 2.0%. Although this represented a slow-down from December's 2.3% rise, the deceleration was less than market expectations. Moreover, stripping out a policy-induced reduction in prices of energy, the core-core CPI for the same period was 3.5%, suggesting that domestically-generated inflation remains robust.

Governor Kazuo Ueda told the Diet on 22 February that Japan was now in a "state of inflation"—a true milestone after a quarter-century of policy measures aimed at escaping chronic deflation. The BOJ's 23 January Outlook Report stated that longer-term inflation expectations had "risen moderately" and forecast core CPI at 2.4% in FY2024 and 1.8% in FY2025, while a recent International Monetary Fund (IMF) forecast sees Japan's CPI staying slightly above 2% in both years.

The stock market's record-breaking performance in recent days will likely be interpreted as evidence that large firms have sufficient business momentum to weather a modest rate hike. Psychologically, the fact that the Bubble Era peak has finally been surpassed after 34 years will surely strengthen the confidence of policymakers and business leaders alike that the economy has indeed entered a new phase. Moreover, the fact that the Nikkei 225 has been rising so rapidly—about 28% in calendar 2023 and already 17% so far in 2024—could be seen as a sign that stock market exuberance needs tempering.

Signposts

Not all recent data points are pointing in the 'right' direction to justify monetary tightening. Weak private consumption and business investment demand led to a slight dip in GDP in Q4 2023, putting the economy into technical recession—though the BOJ seems to think that private consumption will naturally rise assuming a robust round of wage hikes this spring. Similarly, the output gap (between supply and demand) has narrowed recently but remains negative. Even so, the BOJ has been less focused on this gap than before in its recent outlook reports.

The key statistic to watch now is the average wage hike level. The January Outlook Report cited positive changes in firms' wage-setting behavior, pointing towards a 'gradually rising' likelihood of realizing the long-sought virtuous cycle of wage and price increases. A 26 February BOJ report reviewing recent developments in the relationship between wages and prices also highlighted signs of changing corporate behavior, saying that moves by firms to reflect wage increases in their prices were gradually spreading. The IMF shares the BOJ's optimism that Japan will achieve its virtuous cycle.

Timing

The first tranche of outcomes of this spring's collective wage negotiations will be gathered and processed by labor union federation Rengo on 13 to 15 March. Further rounds of outcomes are due to be reported on 22 March and 4 April. Governor Ueda in January seemed to leave open the possibility of a policy change at the 18-19 March Monetary Policy Committee (MPC) meeting, saying that a shift could be decided without a new Outlook Report being issued. Even so, the BOJ would have only the preliminary annual wage hike data at that point, which would surely be seen as insufficient basis for a generational policy shift.

Our base case scenario remains that 26 April is the most likely date for the BOJ to raise short-term rates from -0.1%, likely to zero or +0.1%. Additional wage data will be available by then and a new Outlook Report will also be published. If the MPC were to postpone a hike until its subsequent meeting (30-31 July), it would face the risk that the preliminary Q1 2024 GDP data due in May could show a third successive quarter of shrinking GDP, undercutting the case for a rate rise.

The BOJ has also been laying out its likely policy path after the initial rate hike. Deputy governor Shinichi Uchida said on 8 February that Yield Curve Control would not be ended immediately, and that the current economic outlook warranted maintaining an accommodative monetary policy stance even after a rate rise. Governor Ueda has suggested it would be normal for subsequent rate hikes to follow, but at a slower pace than those seen in the US and EU. It seems that the BOJ is planning a pragmatic approach to those future policy tweaks, based on trends in inflation, wages, and the general economic environment.

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