Japan: a change of course for monetary policy

Spurred by an economy that has lived through a long period of low growth and insufficient inflation, since the 2000s the Bank of Japan (BoJ) has been a pioneer in the implementation of unconventional monetary policies, such as asset purchase programmes (QE), negative interest rates and the yield curve control policy (YCC). The inflation rebound that Japan has experienced over the past two years – initially triggered by supply chain bottlenecks, the rise in global energy and food prices and the devaluation of the yen, but which more recently appears to be generating self-sustaining dynamics –[1] has led to a rethinking of monetary policy in the country.

How can the yield curve be kept under control without maintaining yield curve control?

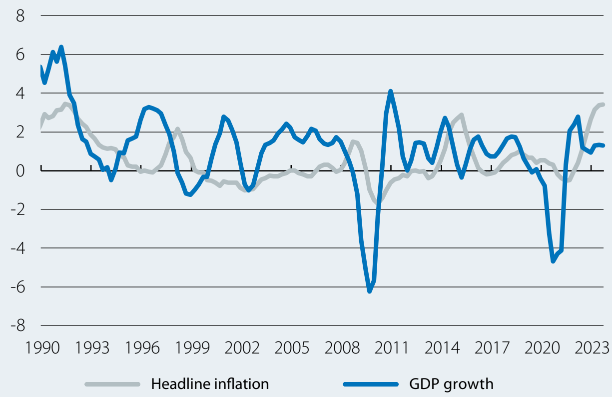
In recent years, a core element of the BoJ's monetary policy has been YCC. This tool consists of setting target interest rates for specific maturities of the sovereign yield curve, which implies an implicit commitment to acquire (or sell) those assets in the amount necessary to keep rates in line with the target. Specifically, in 2016, after lowering its official rate and bottoming out at –0.1%, the BoJ decided to bolster its monetary policy by controlling the yield curve and set a target for the 10-year sovereign interest rate at 0%.[2] Thus, while Japanese rates at shorter maturities were tied to the official BoJ interest rate, YCC served to influence longer maturities along the curve and to keep those rates close to target.

Since the BoJ announced YCC, it has managed to keep the 10-year sovereign rate close to 0% with more gradual balance sheet increases than in the past (see second chart). This does not alter the fact that, in times of stress such as the pandemic, the BoJ has still had to increase its degree of intervention. However, beginning in 2022 – at a time when inflation was beginning to leave its mark, the interest rate spread with the US was widening and the yen was losing value (see third chart) – expectations began to emerge that the BoJ could abandon YCC and the institution began to take small steps in that direction. Since then, 10-year interest rates

1. Headline inflation stood at 3.3% in October, while core inflation stood at 4.0%. The Bank of Japan expects core inflation of 3.8% for the 2023 fiscal year and of 1.9% for 2024.
2. One of the benefits of this type of tool is that it allows for clear communication of monetary policy, thus helping to convey a greater sense of certainty to investors. YCC can therefore be understood as a more transparent alternative to QE programmes, which do little to clarify «how low» the central bank wants these rates to be. YCC may also be more efficient than QE programmes insofar as the same target rate can be achieved with a lower level of asset purchases, provided investors believe the central bank. See the Focus «Yield curve control: a new tool for the Fed?», in the MR09/2020.

Japan: headline inflation and GDP growth

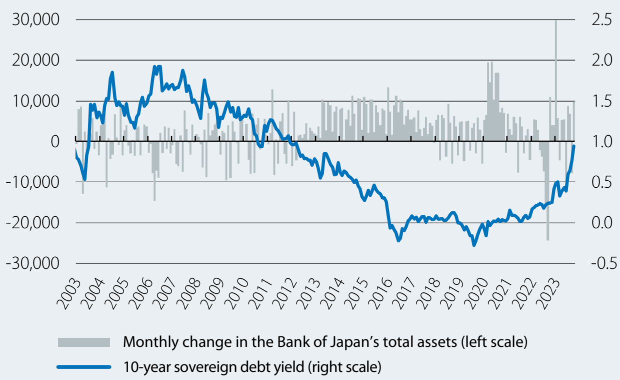
Year-on-year change (%)



Note: *The chart shows four-quarter moving averages.*
Source: *CaixaBank Research, based on data from Bloomberg.*

Japan: 10-year sovereign rate and central bank assets

(JPY millions) *(%)*



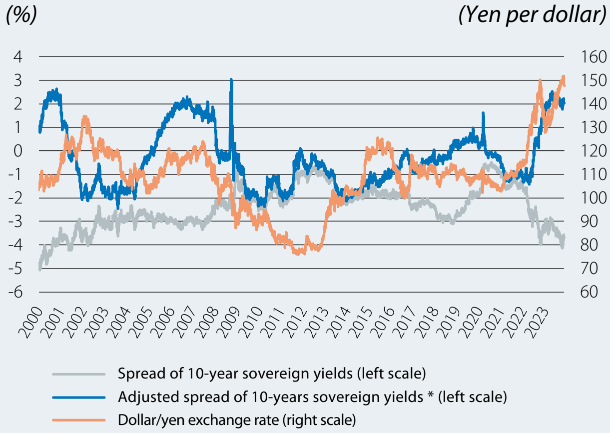
Source: *CaixaBank Research, based on data from Bloomberg.*

have «de-anchored» from 0% and have recently been trading at around 1%.

In part, this de-anchoring reflects the lower stringency of the BoJ: despite having a YCC policy with a target of 0%, in 2018 it introduced a fluctuation range of ±0.1 pp around this target rate, in 2021 it extended that range to ±0.25 pps, in December 2022 it raised it to ±0.5 pps, and in July 2023 it stated that beyond this range it considered 1% to be the maximum level the 10-year sovereign rate could reach. In late October we saw another sign indicating that the end of YCC was looming: without touching interest rates, the BoJ declared that the 1% limit is now considered a «benchmark». This suggests a greater tolerance for the sovereign rate to fluctuate around that threshold, while also reflecting concerns that defending that limit too strictly could impact the ordinary functioning of the market. This shift in communications is just part of a sequence of a number of small steps.[3]

Although YCC can be considered a success to date, from the point of view of anchoring expectations and managing the central bank's balance sheet,[4] at a time of monetary policy change in Japan there is uncertainty about what the «day after» will bring. For instance, while the process of abandoning YCC is expected to be prudent and gradual, there is a risk that when the central bank ceases to ensure a particular interest rate in the market, asset prices could become more volatile as investors «test» the new equilibrium. This, in turn, would have ramifications for large holders of sovereign debt (in particular, financial institutions such as pension funds and insurance companies), potentially forcing the authorities to act in order to support the financial system.

Japan: dollar-yen exchange rate and sovereign spreads



Notes: ** The adjusted spread of sovereign yields takes into account the cost of hedging against exchange rate fluctuations when investing in assets denominated in foreign currencies (in this case, against fluctuations in the dollar-yen exchange rate). The chart shows daily data.*
Source: *CaixaBank Research, based on data from Bloomberg.*

«Ueda strategy»: one eye on financial stability... two on deflation

For now, the market response to these monetary policy adjustments has been limited, and market stability and control of the yield curve have been maintained. Nevertheless, the withdrawal of YCC comes with significant challenges. Domestically, the insurance sector is the most exposed to rate hikes, as the second-largest holder of sovereign bonds (after the BoJ), accounting for 40% of the sector's total assets. On the other hand, pension funds could be more affected by a rapid appreciation of the yen, as a significant portion of their assets are denominated in foreign currencies. Externally, the risk is that the narrowing of the interest rate spread between Japan and the other major global economies could trigger greater capital repatriation flows. Indeed, the ECB has itself pointed out that a more sudden withdrawal of Japanese investors from the euro area's bond market could have a significant impact on prices, amplifying the effects of the ECB's own quantitative tightening.[5]

Looking ahead to 2024, the end of YCC is expected to lead to a gradual rise in interest rates. In addition, according to market expectations, in the first half of the year the BoJ could announce the first official interest rate rise, putting an end to negative rates.

One risk that worries the BoJ in the medium term is that Japan could fall back into a prolonged period of deflation. Governor Kazuo Ueda has repeatedly pointed out that his primary focus is on preventing a return of the deflationary nightmare, stressing that in order to meet this goal, sustained wage increases above 2% are needed. In other words, the BoJ wants a «good» price-wage spiral, in the sense that this would help it to maintain its inflation target. Every March, Japan's biggest corporations meet with the unions to negotiate wage rises for the following fiscal year (which begins in April). This process, which also influences wages offered in smaller companies, is known as *shuntō*, or the spring wage offensive. Will the 2024 *shuntō* also lay the foundations for a monetary policy offensive in Japan?

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3. For further details, see P. Kowalewski and S. Shirai (2023). «History of Bank of Japan's more than two decades of unconventional monetary easing with special emphasis on the frameworks pursued in the last 10 years». ADBI Working Paper nº 1.380, Asian Development Bank Institute.
4. As of 2023, the BoJ holds over 50% of the total sovereign bonds in circulation on its balance sheet, compared to 30% in 2016.
5. Around 4% of euro area bonds in circulation are held by Japanese investors, and this figure rises to 6% in the case of France (3% in Spain and Germany), while in the case of US bonds they hold 3%.