AT A GLANCE | Japan

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Outlook for the Bank of Japan's Exit Process

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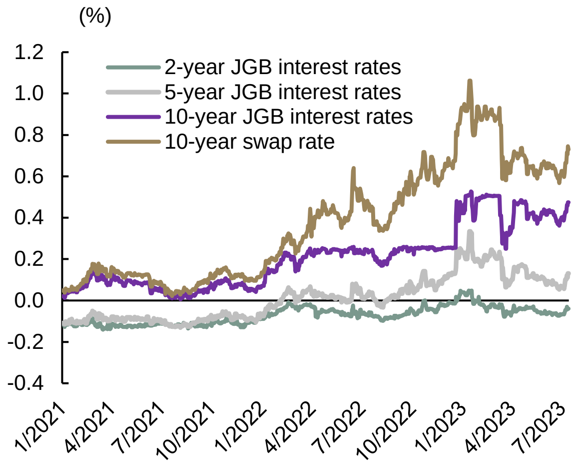
Domestic Interest Rates Rise

Domestic long-term interest rates have suddenly risen (Figure 1). This is partly due to a rise in long-term U.S. interest rates, but also because the Bank of Japan (BOJ) is expected to make policy adjustments soon. In an interview on July 27-28, Bank of Japan Deputy Governor Shinichi Uchida said, "[w]e will continue with the YCC," but added, "we want to make a balanced decision" (on the revision of the YCC). In terms of economic indicators, the June Tankan released on July 3 confirmed the resilience of the economy by improving business conditions in both manufacturing and non-manufacturing industries, and on July 7, another release showed that nominal wages increased by 2.5% from the previous year, confirming that wage increases due to the strong spring wage negotiations are being reflected. The environment is shaping up for the Bank of Japan to make policy adjustments, such as increasing its tolerance for yield curve control (YCC) fluctuations.

In this regard, our view (as per the policy rate forecast at the end of this report) is that the YCC will increase by ±25 basis points in July. Since the Bank of Japan's policy adjustment at the end of December 2022, we had expected the YCC readjustment to take place in June 2023, when the policy adjustment was justified in terms of economic fundamentals. As such, we believed that June was a time when policy revisions could actually be made, but the revision may have been postponed due to uncertainty surrounding the dissolution of the House of Representatives by the administration and the fact that the policy committee members' price forecasts were not released in the next month's outlook report. However, considering the economic environment, the core Consumer Price Index (excluding fresh food and energy) remains above 4% and underlying price movements remain strong (Figure 2). In addition, as the Bank of Japan has said, there have been recent changes in firms' pricing stance and wage increases. In light of this, it seems possible that not only the YCC readjustment, but also the achievement of the inflation target and the subsequent rate hike are in store for the near future, such as next year. It may be time for the BOJ to start thinking about the actual exit process from its quantitative easing policies, as well as preparations for the actual exit (rate hikes, balance-sheet compression).

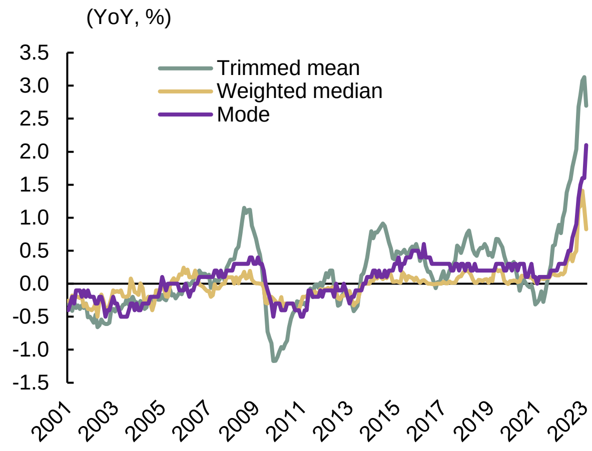
In light of this, we would like to discuss the main scenario we consider for the Bank of Japan's future policy path.

Figure 1: Domestic Interest Rates



Source: Bloomberg

Figure 2: Underlying Inflation Rates



Source: Bank of Japan

BOJ's Central Issues Are the Timing to Achieve 2% Target and the Exit Transition

First, it should be clear that for the BOJ, there is a complete distinction between allowing long-term interest rates to rise (lift of negative interest rates and YCC) and raising interest rates. While Mr. Uchida hinted at the YCC adjustment, he said (of the negative rate) that "if it were to be lifted, the government would have judged it appropriate to prevent inflation by suppressing demand in the real economy," which struck him as a completely different step.

Among these different stages of policy change, the most important for the BOJ is the timing of achieving the inflation target and the timing of the exit transition (that is, the timing of the "lifting of negative interest rates and YCCs"). This is because, while hastening the timing of rate hikes could lead to a return to deflation, the impact on the economy could be greater if rates fall behind. If they rush to raise rates, a recession could follow a rate hike, as in 2000 or 2006, again dampening inflation expectations that had risen to 2%. On the other hand, if policy changes take a backseat and cause prices to rise faster, it may be necessary to tighten monetary policy as rapidly as in the United States and Europe, but the Japanese economy, which has had low interest rates for decades, risks not being able to withstand sudden fluctuations in interest rates. It is also plausible that a reasonable number of companies may go bankrupt or that the number of needy households may increase. In fact, in the minutes of the BOJ's April policy meeting, a policy committee member commented as follows, indicating similar concerns within the BOJ.

- *With signs of a virtuous cycle in wages and prices beginning to emerge, it is necessary to make appropriate judgments on the underlying trends so that policy responses do not fall behind.*
- *In a situation where ultra-low interest rates are embedded in the behavior of economic agents, it is necessary to avoid sudden fluctuations in interest rates. It is necessary to take a humble look at the trends in prices and wages and respond neither too early nor too late.*
- *Households, firms and financial institutions have conducted fund management and procurement activities based on low interest rates. It is necessary to confirm whether each economic entity is sufficiently prepared for future interest-rate fluctuations.*

We believe that the timing of "lifting negative interest rates and the YCC" will come as early as next year's spring wage negotiation cycle. Japan's inflation rate is currently very high at 4.3% in the core Consumer Price Index, and even if it peaks out in the future, it is quite possible that it will exceed 2% on average in fiscal year 2023. In this case, if inflation is 2% for the second consecutive year in 2022 and 2023, and if the wage hike resulting from the spring wage negotiations in 2024 is at a level (2% or more) that matches the inflation rate, the probability that inflation in fiscal year 2024 will be around 2% will increase. At this time, the Bank of Japan may need to seek a transition to the exit.

YCC Adjustments Should Be Considered Backwards From the Exit Transition Schedule

Then, if the timing of this exit transition is given, by when should the YCC be readjusted? The issues to be taken into consideration are “communication with the market” and “consideration of the political schedule”. In order to avoid market turmoil and the resulting negative impact on the economy, it is essential to have appropriate communication in advance, such as pricing in policy revisions, before monetary policy exits. However, since the current long-term interest rate is just below the allowable fluctuation range, it is difficult to achieve suitable communication regarding the exit under the current allowable fluctuation range. For this reason, it is necessary to realign the YCC before around April 2024. However, if policy revisions are to be made at a decision meeting at which the Outlook Report is published, the implementation period will be limited to three times: July 2023, October 2023, and January 2024. On the political side, however, there is talk of a dissolution and general election this fall, so the BOJ will have difficulty moving in October 2023. Also, January 2024 seems a bit late to communicate well with the market. We suspect that this is because before the exit transition (and perhaps several months before), a roadmap for the normalization process will be provided to share market perceptions, and that sufficient communication will be time-limited by the January 2024 YCC realignment. In light of these points, the YCC readjustment scenario in July 2023 seems highly probable.

What Is the Scenario for the Exit Strategy After That?

If there is no significant slowdown in overseas economies and domestic prices show a sufficient rise in the second half of this fiscal year, we believe that the BOJ will present a roadmap for the normalization process to avoid disrupting the market, as mentioned above. Consider the scenario presented here. We would like to add the following hypothetical conditions: (i) inflation has not risen to the level of a rush to tighten, and (ii) the economy is not in a state of rapid overheating as symbolized by the weak recovery of the output gap. The reference in this case is the Federal Reserve’s exit strategy from 2014 (because the situation in the United States at the time was such that inflation was not well above 2% and the unemployment rate was improving slowly).

In this case, the following scenarios are possible:

(a) Elimination of negative interest rates and YCC

(b) Reducing asset purchases and ultimately reinvesting only

(c) The Bank of Japan raises interest on current accounts

(d) Balance-sheet reduction due to reduced reinvestment

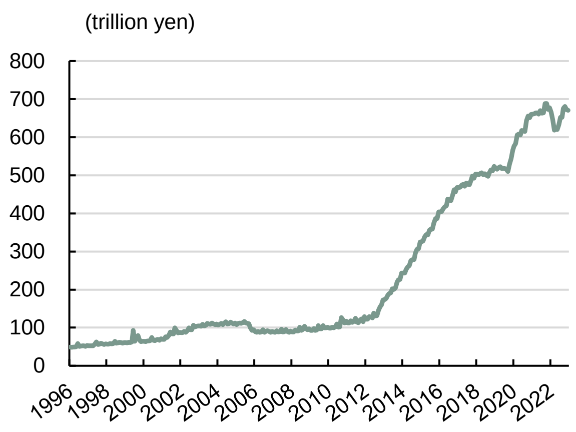
Here, (a) and (b) would be able to proceed without major adverse effects if the economic and price conditions allow the Bank of Japan to exit. (a) In the case where the expected inflation rate is close to 2%, the policy rate derived from the Taylor rule is well above 0.1%, as discussed in the previous section. In this case, the rate hike is not a “tightening” but a “normalization”. In other words, it does not cause a deterioration in the economy and prices. As for (b), long-term interest rates will rise somewhat, but the expansion of the monetary base stopped substantially before the COVID-19 pandemic, so it is unlikely that the supply and demand of Japanese government bonds (JGBs) will deteriorate significantly (Figure 3). For this reason, it is expected that the process up to (b) will be completed by the end of fiscal year 2024.

On the other hand, (c) and (d) require the BOJ to proceed with caution. (c) When short-term interest rates are raised, even if the real interest rate is much lower than the natural interest rate, there is a possibility that the Japanese economy, in which ultra-low interest rates are incorporated into economic entities, will have a significant impact. In addition, an increase in interest rates could mean an increase in the BOJ's interest payment burden, which could limit the BOJ's ability to match profits from government bonds it holds. (d) In the case of a sudden reduction in reinvestment, the government will have to absorb a large amount of refinancing bonds in the market, which could lead to a deterioration in the supply and demand of government bonds. Also, from the financial perspective of the BOJ, by maintaining a certain level of reinvestment, yields on JGBs held can be raised gradually, and the impact of the rate hike in (c) on earnings deterioration can be somewhat mitigated.

As for the timing of implementation of these scenarios, (a) and (b) will be implemented in the first half of fiscal year 2024, while (c) and (d) will be delayed until 2025. Depending on economic conditions, if foreign central banks were to cut interest rates in 2024, the BOJ would be unlikely to adopt a policy of economic tightening, as it is likely to cause the yen to rise rapidly and the economy to decline. This means that foreign central banks' interest-rate cuts will run their course before normalizing. And we should be prepared for the completion date of the balance-sheet reduction in (d) to be quite long. Even without reinvestment, it would take about 10 years for most of the balance sheet to shrink, given the current balance of government bonds held (Figure 4). Of course, the BOJ may consider selling its JGBs if the yield on its JGBs rises to a certain extent due to reinvestment after a rate hike or if the economy is experiencing a strong sense of overheating, but at least in the immediate post-exit scenario, the BOJ must be cautious about selling its JGBs, which could worsen the BOJ's finances and the supply and demand of JGBs.

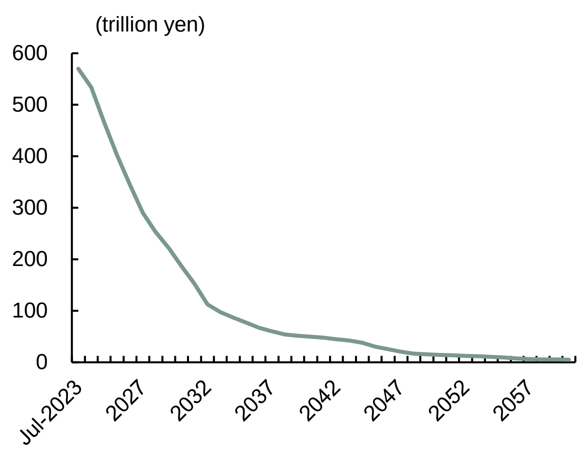
Taken together, the economic environment suggests that the BOJ may move to an exit process in the relatively near future. However, this process takes a very long time, and we think the BOJ will present such a scenario in advance of the exit transition and communicate closely with the market.

Figure 3: Monetary Base (month-end balance)



Source: Bank of Japan

Figure 4: Balance of Government Bonds Held by the Bank of Japan Without Reinvestment



Source: Bank of Japan

Economic Outlook: 2023-2024 Forecast

Figure 1: Forecasts for Economic Growth, Inflation, and Unemployment Rates

		2022			2023				2024				2021	2022	2023	2024
		Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4				
US	Real GDP	−0.6	3.2	2.6	2.0	1.5	−0.8	0.6	0.9	1.4	1.8	2.2	5.9	2.2	1.4	1.0
	Inflation	5.0	4.9	4.8	4.8	4.6	4.2	3.9	3.2	2.8	2.5	2.2	3.3	5.0	4.4	2.7
	Unemployment	3.6	3.6	3.6	3.5	3.5	3.7	4.3	4.6	4.7	4.7	4.6	5.4	3.7	3.7	4.7
Euro Area	Real GDP	0.8	0.4	−0.1	−0.1	0.3	0.2	0.1	0.2	0.3	0.3	0.2	5.3	3.5	0.6	0.9
	Inflation	8.0	9.3	10.0	8.0	6.2	4.8	3.2	3.1	2.9	2.7	2.5	2.6	8.4	5.6	2.8
	Unemployment	6.7	6.7	6.7	6.6	6.6	6.6	6.7	6.8	6.8	6.9	6.9	7.7	6.7	6.6	6.9
Japan	Real GDP	5.6	−1.5	0.4	2.7	1.7	1.0	0.9	0.9	0.8	0.8	0.7	2.3	1.1	1.0	0.9
	Inflation	2.1	2.7	3.8	3.5	3.3	2.8	2.3	2.9	2.7	2.6	2.2	−0.2	2.3	3.0	2.6
	Unemployment	2.6	2.5	2.5	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.8	2.6	2.4	2.3
China	Real GDP	0.4	3.9	2.9	4.5	7.8	5.0	5.7	4.7	5.0	5.0	5.0	8.4	3.0	5.8	4.9
	Inflation	2.2	2.8	1.8	1.3	0.2	1.4	1.5	1.6	1.9	2.0	2.0	0.8	1.7	1.1	1.9
	Unemployment	5.8	5.4	5.6	5.5	5.2	5.3	5.2	5.1	5.0	5.0	5.0	5.1	5.1	5.3	5.0

Real GDP growth is in QoQ annualized for U.S. and Japan, QoQ for euro area and YoY for China and India. Inflation rate is in YoY%. Inflation rate is YoY, % of core index (ex. fresh food) for Japan, YoY % of PCE deflator for U.S., and total YoY% for the rest.

Figure 2: Forecast for Rates

Interest rate		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
US	Policy rate	4.25~4.50	4.75~5.00	5.00~5.25	5.25~5.50	5.25~5.50	5.00~5.25	4.75~5.00	4.50~4.75	4.25~4.50	4.25~4.50	5.25~5.50	4.25~4.50
	2yr	3.43	4.03	4.90	4.20	4.00	3.80	3.60	3.40	3.20	3.43	4.00	3.20
	10yr	3.87	3.47	3.84	3.60	3.60	3.60	3.60	3.50	3.50	3.87	3.60	3.50
Germany	Policy rate	2.50	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	2.50	4.25	3.75
	Deposit rate	2.00	3.00	3.50	3.75	3.75	3.75	3.75	3.50	3.25	2.00	3.75	3.25
	2yr	2.50	2.68	3.20	3.20	3.00	2.80	2.60	2.40	2.30	2.50	3.00	2.30
	10yr	2.20	2.29	2.39	2.30	2.30	2.30	2.20	2.10	2.10	2.20	2.30	2.10
Japan	Policy rate	−0.10	−0.10	−0.10	−0.10	−0.10	−0.10	0.10	0.10	0.10	−0.10	−0.10	0.10
	2yr	0.04	−0.06	−0.07	0.10	0.15	0.20	0.30	0.30	0.30	0.04	0.15	0.30
	10yr	0.42	0.35	0.40	0.75	0.75	0.75	0.90	0.90	0.90	0.42	0.75	0.90
China	Policy rate	2.75	2.75	2.65	2.55	2.55	2.55	2.55	2.55	2.55	2.75	2.55	2.55
	2yr	2.39	2.41	2.11	2.16	2.24	2.32	2.39	2.49	2.59	2.39	2.24	2.59
	10yr	2.83	2.85	2.64	2.64	2.69	2.74	2.79	2.84	2.89	2.83	2.69	2.89

Figure 3: Forecast for FX and Oil Price

		2022	2023				2024				2022	2023	2024
		Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
USD/JPY	Range	130.58~151.95	127.23~137.91	130.64~145.07	128.00~147.00	125.00~138.00	121.00~135.00	119.00~133.00	116.00~130.00	116.00~130.00	113.47~151.95	125.00~147.00	116.00~135.00
	End of quarter	131.12	132.86	144.31	137.00	133.00	130.00	128.00	126.00	123.00	131.12	133.00	123.00
EUR/USD	Range	0.9633~1.0735	1.0806~1.1033	1.0635~1.1095	1.0300~1.1300	1.0200~1.1200	1.0100~1.1100	1.0000~1.1000	1.0100~1.1100	1.0100~1.1100	0.9536~1.1495	1.0200~1.1300	1.0000~1.1100
	End of quarter	1.0705	1.0839	1.0909	1.0700	1.0600	1.0500	1.0500	1.0600	1.0600	1.0705	1.0600	1.0600
EUR/JPY	Range	138.81~148.40	124.40~145.67	142.55~158.00	145.00~159.00	136.00~150.00	131.00~145.00	128.00~142.00	127.00~141.00	123.00~137.00	124.40~150.00	136.00~159.00	123.00~145.00
	End of quarter	140.41	144.01	157.43	146.59	140.98	136.50	134.40	133.56	130.38	140.41	140.98	130.38
Crude Oil Prices (WTI)		82.64	75.99	73.67	75.00	80.00	80.00	75.00	77.00	78.00	98.74	76.17	77.50

※ Crude oil prices are averages for each period. Source: SMBC.

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