

Snap | 19 December 2023

JAPAN

## Bank of Japan moves closer to normalisation but not there yet

The Bank of Japan kept its major policy settings unchanged and made no changes to its forward guidance, pushing the yen down against the dollar. But we think the shift in tone is clear and major policy changes will be made early next year



Bank of Japan governor Kazuo Ueda

# -0.1%

## Policy Balance Rate

0.0% 10-year yield target

As expected

### No surprise from the Bank of Japan

The news that economic policy minister Yoshitaka Shindo would be in attendance at the Bank of Japan's policy meeting had sparked market speculation about a shift in policy sooner than expected. It is rare for a minister to sit in a BoJ meeting and, in the past, when the Bank delivered major policy decisions, senior government officials attended the meeting, thus

the market had expected a somewhat hawkish move by the BoJ.

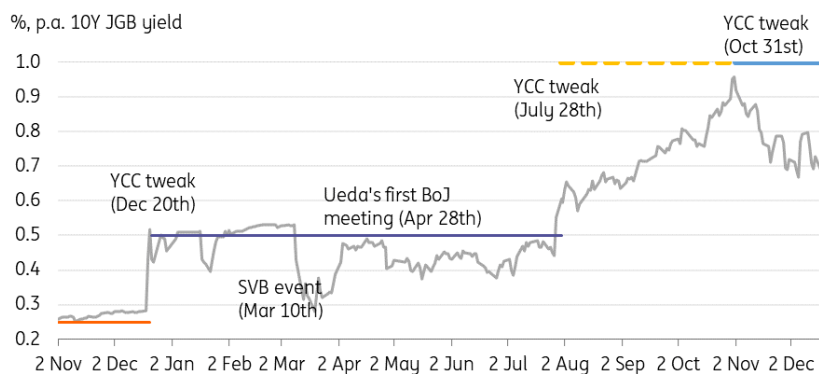
But it turned out that this was just the market's wishful thinking. In line with our view, the Bank of Japan unanimously decided to maintain its policy rate at -0.1% and its 10-year yield target at 0.0% while keeping its dovish forward guidance "take additional monetary easing steps without hesitation if needed", which may have disappointed some market players the most. But it is too early to be disappointed. It should be noted that the BoJ's assessment of the economy, especially its assessment of prices and private consumption, has changed and it is more important to read between the lines. The BoJ's wording, in our view, paves the way for normalisation next year. For example, the Bank said private consumption has continued to increase moderately, year-on-year CPI is likely to rise above 2% through fiscal 2024, underlying CPI inflation is likely to gradually increase, and inflation expectations have risen moderately.

### **Governor Ueda sounded positive about sustainable inflation and rising wages but not strong enough to please the market**

As the BoJ stood still and kept its dovish forward guidance unchanged, the market's focus rapidly shifted to what Governor Kazuo Ueda would say about future policy direction at his press conference.

Governor Ueda's comments on inflation and wage growth sounded quite positive, most notably, the "chances for hitting the 2% target are rising" and "steadily moving toward achieving stable 2% inflation". We believe that his remarks have opened the door for policy normalisation. However, although the exit plan and the timing of such action are still quite ambiguous, he was clearly communicating with the market about the policy direction.

### **Bank of Japan's policy adjustments over the past 12 months**



Source: Bank of Japan, CEIC

### What's next?

We still believe that January is the likely time for the BoJ to begin its policy adjustment - scrapping the yield curve control. Governor Ueda mentioned that there is not much new data before the January meeting, thus the option of a rate hike won't be on the table. But in January, the Bank of Japan will release its latest macro outlook report and we assume the CPI inflation outlook will be revised up for 2024 and 2025 above 2%. Also, thanks to the US Treasury rally, the 10-year JGB yield should stay below the current reference rate of 1%. These conditions will likely justify the change in the yield curve control policy. In March, the Bank of Japan won't like to deliver any policy changes as it coincides with the end of the fiscal year.

The first rate hike will come sometime after in the second quarter. By then, the BoJ's policy review will be complete and the BoJ will have more evidence of sustainable inflation and solid wage growth after the spring wage negotiation season. But the market will likely anticipate any such a move ahead of time, thus the volatility of the yen and rates markets is expected to be high early next year.

### FX: Cautious BoJ puts rates back in the driver's seat

The reaction in the FX market reflected investors' disappointment with the unchanged guidance by the Bank of Japan: the yen is pushing the 144 level as we write, around 0.80% weaker on the day. As noted above, a reiteration of the dovish guidance does not mean that there has been no movement towards normalising policy, as Ueda's words on the inflation outlook pave the way for a two-step normalisation in our view: scrapping the YCC in January, and hiking in April. Market expectations appear broadly in line with this timeline, and today's negative reaction in the yen seems mostly an unwinding of bets of a surprise move (in communication, more than rates) today and on a January hike. There has not been a major dovish repricing across the JGB curve.

Our perception is that external factors – US interest rate dynamics in particular – will be back in the front seat for the yen now. The BoJ communication seemed aimed at reiterating that the Bank won't be rushed into normalisation by the market and that the transition to the end of negative rates will likely be gradual. This can work as a disincentive for markets to enter into new hawkish bets in the new year, and FX/rates action may be more concentrated around when effective changes are made rather than in the run-up to the meetings.

Our view remains bearish on USD/JPY in 2024, as the oversold JPY can still benefit from the BoJ path to normalising policy and above all we expect the Federal Reserve to 'out-dove' the market with 150bp of cuts. However, a decisive break below 140 may only be a story for the second quarter if next year.

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