A brief history of unconventional monetary easing by the Bank of Japan and Japan’s inflation

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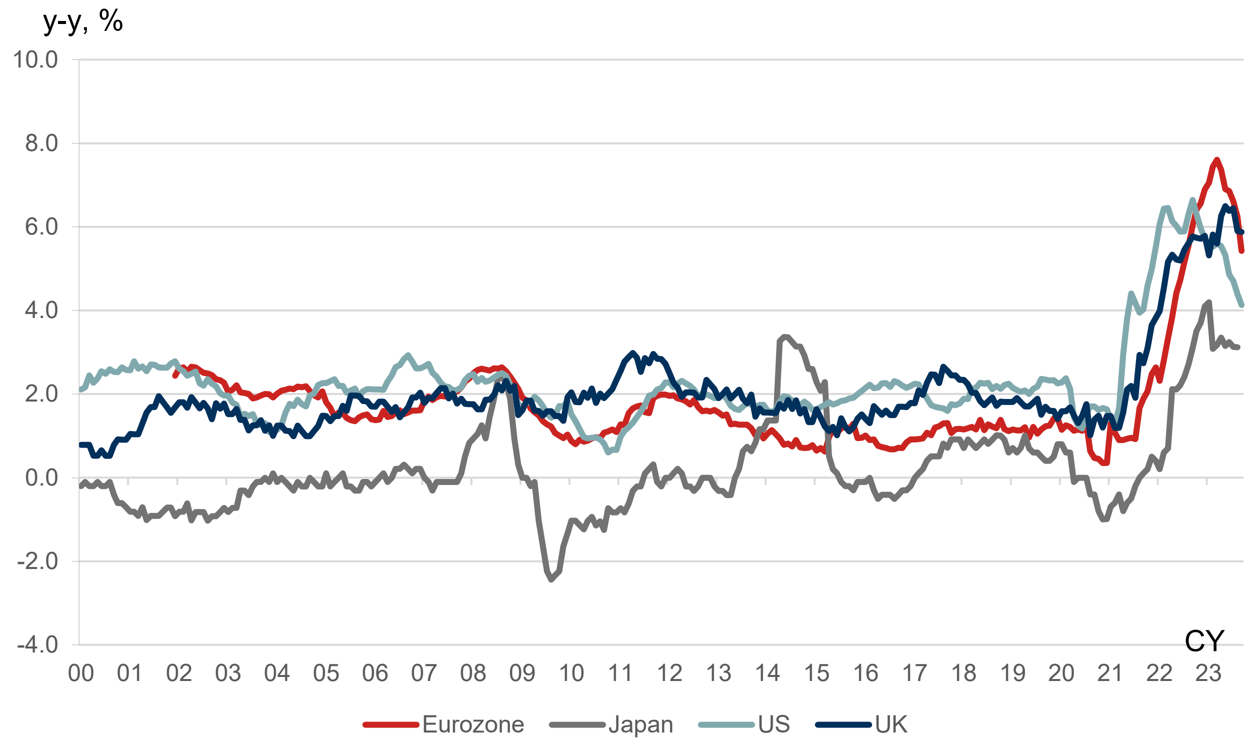
Abstract

In Japan, where both the waning of the pandemic impact and the acceleration in inflation came somewhat later than in Europe and US, we have yet to see a clear slowing in inflation. This has led many to begin to question the appropriateness of the BOJ's decisions to persist with monetary easing under its YCC policy despite the ongoing acceleration in inflation. Focus has begun to shift toward the possibility that the BOJ could end its longstanding large-scale monetary easing, and the potential impact on financial markets if it were to abandon its accommodative policies. In this report, we look back over how inflation and monetary policy have played out in Japan thus far, and discuss the outlook for inflation and monetary policy from now.

Introduction

Inflation began to gather pace around the globe from around spring 2021 as the impact of the COVID-19 pandemic gradually wound down. Just over two years have passed since then, and inflation rates are now slowing in more advanced economies in North America and Europe (Figure 1). The tightening of monetary policy intended to counter rising inflation looks to be having its desired effect. In Japan, however, where both the waning of the pandemic impact and the acceleration in inflation came somewhat later than in Europe and North America, we have yet to see a clear slowing in inflation. This has led many to begin to question the appropriateness of the BOJ's decisions to persist with monetary easing under its YCC (yield curve control) policy despite the ongoing acceleration in inflation. Focus has begun to shift toward the possibility that the BOJ could end its longstanding large-scale monetary easing, and the potential impact on financial markets if it were to abandon its accommodative policies.

Figure 1: Core CPI inflation in four major more economically developed regions



Source: Nomura, based on data from Japan's Ministry of Internal Affairs and Communications (MIC), the European Central Bank (ECB), and UK Office for National Statistics (ONS)

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thus far, and discuss the outlook for inflation and monetary policy from npow.
First, it would be useful to look at why inflation has remained low for so long in Japan relative to in other countries and regions, and in advanced economies such as the US and Europe, in particular. Next, we turn to what sort of effects the BOJ was aiming for with the monetary easing policies it enacted to counter deflation and low inflation, and we briefly examine what the effects have actually been.

Finally, we look at how the BOJ has assessed the global acceleration in inflation seen since 2021 and its ripple effects on inflation in Japan, at what its policy response to this has been, and at the outlook for monetary policy from now.

1. Background to prolonged low inflation in Japan: Will it be overcome by a wave of global inflation?

(1) The special characteristics of inflation in Japan and the background to that

In line with the wave of rising inflation globally, the inflation rate in Japan is accelerating markedly compared to the trend in recent years. Among financial market participants, there are strongly held views that the BOJ may commit the same error as the US Fed, dismissing the acceleration in inflation as a transitory phenomenon in the initial stages, resulting in inflation growth subsequently becoming protracted, or that this global inflation shock might lead to the low inflation trend in Japan being completely overturned.In responding to these questions, we think it worthwhile to again consider why deflation and low inflation became entrenched in Japan over such a long period.

A commonly held view as to the main reason for Japan experiencing low inflation for a long period is that it is the result of the existence of a "norm" (in terms of scale and custom) related to inflation and price-setting. The first person to clearly state the possibility of a norm related to prices and inflation was economist Arthur Okun, but the person who has argued that the existence of a norm is the main reason for protracted low inflation in Japan was Professor Tsutomu Watanabe of the University of Tokyo. Professor Watanabe argued that the assumption of low inflation has taken root in various economic entities in Japan and that these entities' behavior is based on an assumption of low inflation, with this in itself preventing a rise in the inflation rate [1].

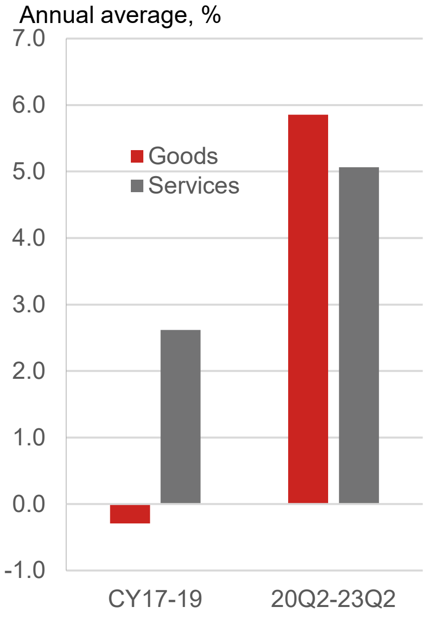
We think the mechanism by economic entity via which the existence of a norm leads to low inflation becoming entrenched is broadly as we set out below.The mechanism for corporations starts with pricing power declining because of the deflation shock accompanying a decline in actual inflation, and acts in this way: (1) a decline in pricing power itself makes it more likely that low inflation will take root; (2) amid sustained low inflation, there is increased psychological inhibition as moves to hike prices are seen as leading to deterioration in sales and lower market share; (3) lower pricing power leads to lower margins; and (4) pressure to curb wages increases in particular in Japan, where it is difficult to improve margins by cutting headcount.

In the case of households, the mechanism is that: (1) tolerance of price hikes declines in reaction to sluggish or lower purchasing power as a result of wage constraints; and (2) that leads to people cutting back their overall purchasing schedule and being increasingly selective in their purchases based on the price of the same kind of goods and services, and we also think that itself reinforces the low-inflation norm.

(2) Has the global inflation shock changed the low-inflation trend in Japan?

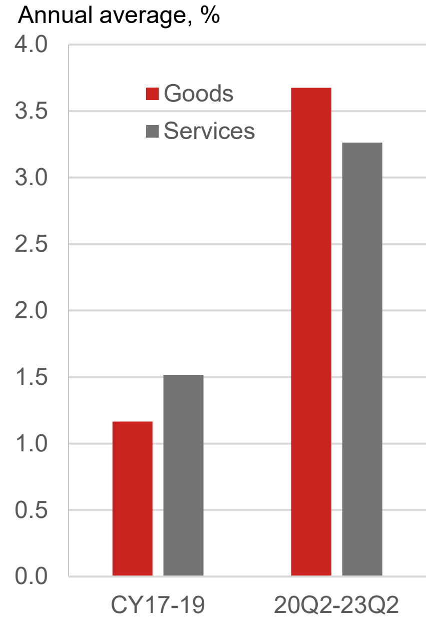
So, has the global inflation shock that occurred as the pandemic wound down resulted in the low-inflation trend in Japan being overturned? Or could it trigger the complete elimination of low inflation in Japan?We carried out a simple comparison by region as a way to assess this. Specifically, we divided the core CPI, which excludes food and energy in line with the definition in Western countries, into goods and services, and compared the average rise before and after the pandemic (**Figures 2-4**).

Figure 2: Comparison of change in CPI before and after pandemic—US



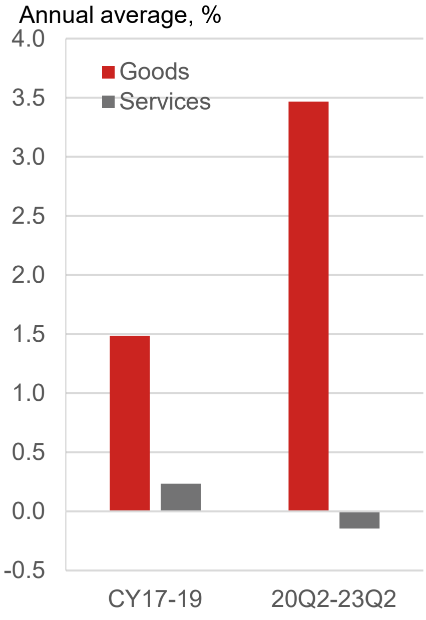
Note: Goods exclude food and energy.
Source: Nomura, based on US Department of Labor data.

Figure 3: Comparison of change in CPI before and after pandemic—eurozone



Note: Goods exclude food and energy.
Source: Nomura, based on European Central Bank data.

Figure 4: Comparison of change in CPI before and after pandemic—Japan



Note: Goods exclude food and energy.
Source: Nomura, based on Ministry of Internal Affairs and Communications data.

Common to Japan, the US, and the euro zone is that there has been a sharp rise in goods inflation. Assuming growth in the three years 2017 to 2019 as prior to the pandemic and growth in the three years from Apr–Jun 2020 through Apr–Jun 2023 as the post-pandemic figure, we can see that the annualized rate of goods inflation (CPI minus food and energy) was -0.3% for the former and +5.9% for the latter in the US, +1.2% and +3.7% in the euro zone, and +1.5% and +3.5% in Japan, a considerable acceleration in inflation in each case.

Looking at the same figures for services inflation shows +2.6 and +5.1% in the US and +1.5% and +3.3% in the euro zone, marking a considerable acceleration in both cases, albeit not as much as for goods. However, services inflation in Japan was +0.2% and -0.1%, pre- and post-pandemic respectively, thus remaining sluggish. Although we need to discount the impact of mobile phone charges being cut in March 2021, there has been a clear stagnation in services inflation in Japan.

We think the differences between Japan and the US/Europe seen in the above comparison hold the keys as to whether the current inflation shock will change Japan's low-inflation trend in future. One key is whether, by capitalizing on the acceleration in goods inflation that is also materializing in Japan, the global inflation shock can overturn the low-inflation norm that has become stronger and entrenched as a result of the protracted low-inflation trend in Japan. In particular, if we assume that the acceleration in goods inflation represents the cost-push inflation factor that started overseas also resulting in pass-through into goods prices in Japan to a degree, an important point will be whether that becomes established and leads to changes in the weak pricing power of companies and their reluctance to hike prices.

Second, we think wage growth acceleration is key when looking at weaker services than goods inflation and the overcoming of the norm in relation to that. We think acceleration in services inflation in Japan has been weaker than goods inflation because of the reining in of personnel costs, which account for a larger weighting in the service sector cost structure than in the manufacturing sector. We think there is evidence to support this view in wage growth acceleration in the US and the euro zone, where inflation, including for services, has risen markedly.

(3) Expectations for end of low inflation in Japan

We next consider whether the recent global inflation shock might lead to the end of the low inflation trend in Japan. The 2023 spring wage negotiations, which have a major bearing on macro wage trends, resulted in a marked rise in base pay growth. Final data compiled by the Japanese Trade Union Confederation (Rengo) showed the rate of increase in seniority-based pay calculatd on the average wage method (weighted average hike in per-capita wages of union members) was 3.58% in 2023, up sharply from 2.07% in 2022.

The favorable results of the latest wage negotiations are being reflected in macro-level wage data too, with total cash earnings in the Ministry of Health Labor and Welfare's Monthly Labour Survey and growth in scheduled cash earnings showing faster growth since May, when the results of the spring wage negotiations likely started being reflected in actual wage payments. The acceleration in base pay growth in the 2023 spring wage negotiations owed in part to both employees and employers taking account of the recent rise in inflation in their negotiating stances, which suggests that the global inflation shock may present an opportunity for Japan to break out from its sluggish wage growth.

We also identify Japan's increasingly severe labor shortage as a factor that could help sustain this stronger wage growth in Japan's labor market. The shortage of labor caused by Japan's aging society and declining population started deepening alongside the economic recovery triggered by the Abe administration's economic policies from around 2013 ("Abenomics"). However, prior to the pandemic, an increase in the labor participation rate among women and seniors (mainly via employers raising their mandatory retirement age or rehiring existing employees) resulted in growth in the number of employed people, which likely allowed companies to secure sufficient personnel without having to raise wages all that much.

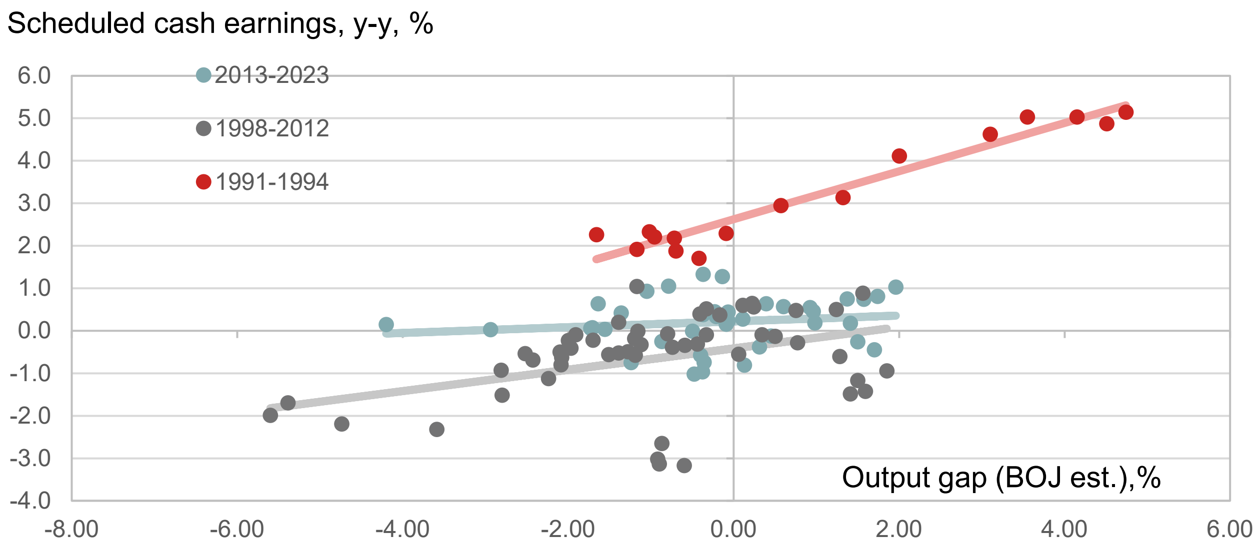
During the period of economic reopening after the pandemic, however, growth in the labor force participation rate among seniors in particular and growth in the overall labor force appear to be peaking out. The shortage of labor could well prove more severe than during the Abenomics-fueled economic recovery, which would make it more likely that the current strong wage growth will be maintained.

We now look at sustainable wage growth, key to arguing that Japan has overcome low inflation, and what sort of conditions it refers to. We think it useful here to consider the thinking of BOJ Governor Ueda, who seemed to favorably reference the Phillips curve in a speech given not long after his appointment in April, 2023. In this 19 May address, Mr. Ueda explained that the mechanism by which deflation and low inflation took hold for a prolonged period was the Phillips curve shifting downward as a result of a decline in people's inflation expectations, meaning that the inflation rate that could be achieved with the same output was lower [2]. Conversely, this would suggest that the Wage Phillips curve needs to shift upwards to reflect changes in wages sufficient to overcome Japan's low inflation.

Plotting a Wage Phillips curve with the output gap on the horizontal axis against the year-on-year change in scheduled cash wages on the vertical axis shows that compared to the Phillips curve during the first half of the 1990s, when there was relatively steady inflation, the current Phillips curve has shifted further downwards, and it remains to be seen whether there has been a clear upward shift after just one year of strong growth in base pay following the 2023 spring wage negotiations (**Figure 5**).

Have there been any signs of change to the "norm" in terms of corporate pricing power and pricing behavior? Cost pass-through rates have clearly risen, chiefly for goods such as in the food and energy sectors, in the face of an inflation shock spawned overseas that was accompanied by a sharp rise in import price inflation. We would like to ascertain if this will lead to sustained changes in pricing behavior or lead other sectors to start passing through rises in costs.

Figure 5: Wage Phillips curve



Note: Straight lines are trend lines based on simple regression for each period

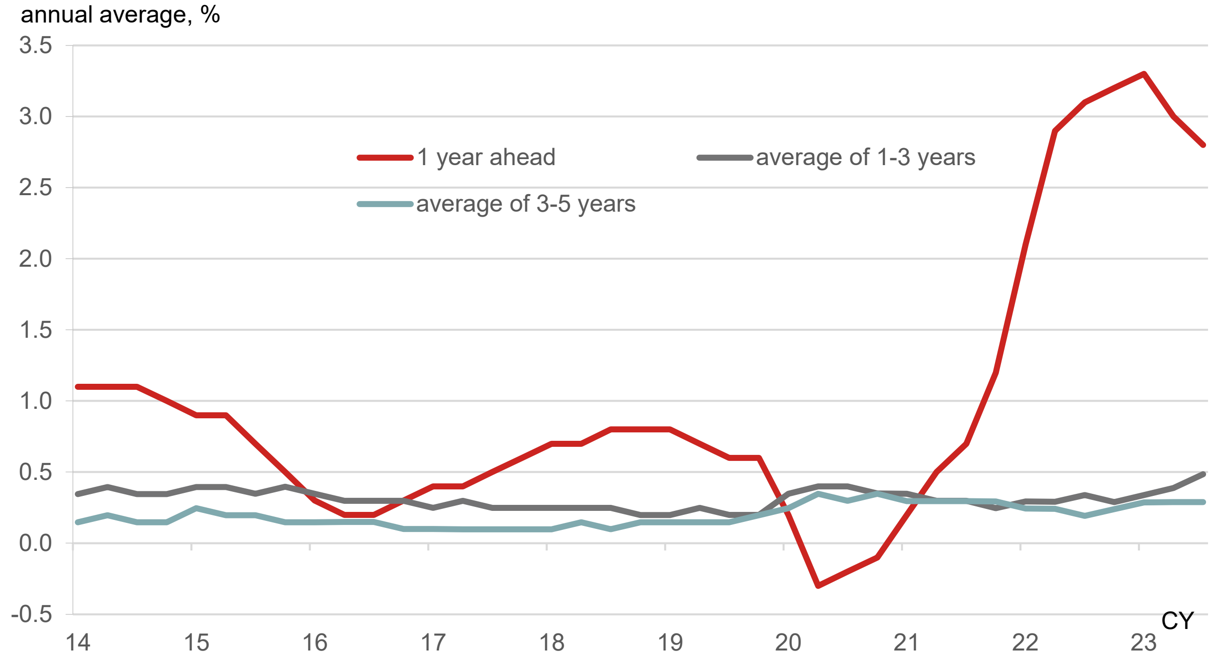
Source: Nomura, based on Ministry of Health, Labour and Welfare and BOJ data

One way to ascertain this would be to focus on projections of output prices included in the BOJ Tankan corporate inflation outlook. The survey asks respondents about their outlook for output prices one year, three years, and five years ahead, and we think this is an effective way of confirming whether companies have started to form plans to continue cost pass-throughs or price increases more than one year ahead. As the questions in the survey also compare output price outlooks for three and five years ahead to current prices, we note that the data needs to be adjusted to confirm whether companies have any intentions beyond the first year to raise prices versus the prior year and if they do, the extent to which they plan to raise prices.

Figure 6 shows our estimate of annual average output price changes for 1-3 years ahead and 3-5 years ahead, derived from our prorating of output price outlooks for one year, three years, and five years ahead. The chart indicates to us that the latest global inflation shock has started to urge companies to plan to raise output prices over the one-year period from the time of the survey, and that price increases and cost pass-throughs are becoming more broad-based, in the sense that the scope of price increases in the chart grows over time. The average annual change in output price for 1-3 years ahead and 3-5 years ahead stays flat at around zero this whole time. It does not look like pricing behavior is changing as it has in the past in terms of plans for prices to be raised every year because price increases and cost pass-throughs become "sustained". With respect to the outlook for one year ahead, the rise in the output price outlook showed signs of leveling off in the June 2023 survey, which could mean that the broadening of price increases and cost pass-throughs has run its course.

Figure 6: Outlook for Output Prices in the BOJ Tankan

All-enterprise basis



Source: Nomura, based on BOJ data.

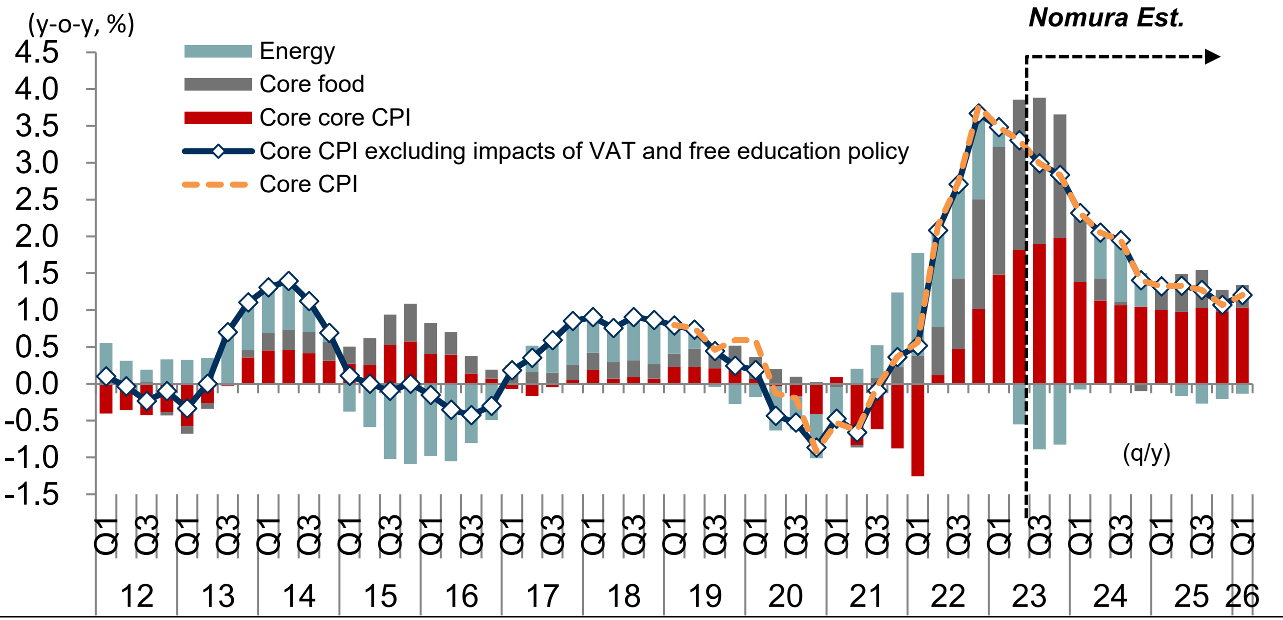
(4) Outlook for inflation in Japan

In section (3) we saw how, against the backdrop of the global inflation shock, inflation in Japan may have become stickier than it has been in the past owing to the acceleration in wage growth which has moreover moved onto a more stable footing. At the same time we saw that it is too soon to conclude that the low-inflation norm has disappeared completely in Japan, in terms of companies' pricing behaviors and their ability to control prices.

Our current inflation forecasts (**Figure 7**) are broadly consistent with this view.

In other words, if rises in inflation for energy and core food (food ex fresh food)—which have been strongly affected by higher overseas supply costs and accelerating import inflation—drop out of the picture, then Japan's underlying inflation rate, which is relatively unaffected by such external supply shocks, will still not reach the annual 2% target set by the BOJ. Our forecasts call for the contribution of the core core component (excludes energy and food; corresponding to the core component in the US/Europe) of overall CPI to contract to around +1.00 to 1.50% from the second half of 2024. If we assume that at this point the contribution of the import inflation shock will have tapered off broadly in the core food component, we think that Japan's underlying core CPI inflation (i.e., Japanese core CPI, excluding fresh food only) will similarly be at around the 1.00 to 1.50% level.

Figure 7: Nomura's Core CPI inflation forecasts



Note: The core CPI is the consumer price index less fresh food. Core core CPI = Core CPI - energy - core food (excluding fresh food and alcohol).

Source: Nomura, based on Ministry of Internal Affairs and Communications data.

2. A brief history of the BOJ's easing: Aims and effects of QQE

Under Governor Kazuo Ueda, the BOJ has launched a "Review of Monetary Policy from a Broad Perspective" [3], a process by which it plans to assess the effects of the long-running monetary policy it has implemented since the end of the 1990s with the aim of breaking free of persistent deflation and low inflation. Here, we will attempt a similar retrospective, but will limit our scope to the period of quantitative and qualitative monetary easing (QQE) implemented under Governor Haruhiko Kuroda since 2013, the roots of the current policy regime. This is in order to focus less on how the BOJ responded to various periods of deflation and low inflation and the impact of these responses, and more on how it is likely to respond (or refrain from responding) to movements in the Japanese economy and prices in the face of the global inflationary shock. For convenience, we divide the changes in the BOJ's monetary policy under Governor Kuroda over the 10 years from April 2013 into two stages. We discuss the intent behind this division in the respective sections.

(1) Stage 1: "All-out attack"—major shifts in monetary policy under Governor Kuroda

The most appropriate starting point, in our view, is the implementation of QQE at the first monetary policy meeting of Mr Kuroda's tenure as governor in March 2013. This policy was also described as "easing from another dimension" and "the Kuroda bazooka" and was quite a bold shift in monetary policy. Here, we will look at why the BOJ made such a bold and rapid policy shift by examining the background behind the decision, the actual content of the policy, and the BOJ's goals in implementing it.

The decision-making process leading up to this change is revealed in the discussions in the monetary policy meeting transcripts for the first half of 2013, released on 31 July, 2023. (Transcripts are released a decade after the meeting in question). These transcripts show that the drastic shift in monetary policy toward QQE was proposed by Mr Kuroda himself. At the start of the discussions about near-term monetary policy operations, Mr Kuroda lit the fuse with the following remarks (translation by Nomura).

> The BOJ decided at its January 2013 meeting to set a price stability target of 2% y-y consumer price inflation, and pledged to achieve this as soon as possible. Today I would like to discuss how to implement the monetary policy necessary to achieve this target. I believe we need to deploy both quantitatively and qualitatively unprecedented monetary easing measures. And I think we will need to communicate this in a simple way in order to overhaul expectations in the market and in the overall economy. We must do all that we are able to do and avoid a sequential deployment of our resources so that we can achieve the target as soon as possible. I have in mind the next roughly two years as a specific time

frame for this.

QQE was then formulated as below, based on the policy Mr Kuroda proposed for qualitatively and quantitatively unprecedented easing to overhaul market and economic expectations as soon as possible within a time frame of around two years.

Deputy Governor Hiroshi Nakaso added comments in support, saying that given the limited downward scope for interest rates, there was no choice but to increase the BOJ's balance sheet; that a substantial scale that would not be seen as an extension of prevailing policy would be necessary to shift expectations; and that feasibility in terms of actual market operations was a crucial issue when looking at the extent of purchases (of assets such as JGBs) that would be possible. Current Deputy Governor Shinichi Uchida, who was head of the Monetary Affairs Department at the time, followed up by saying that it would be feasible to make asset purchases up to around 70% of the roughly ¥10trn in monthly JGB issuance value. This explanation appears to have led to the long-term bond purchasing target during the initial phases of QQE of a ¥50trn annual increase in the BOJ's bondholdings (subtracting bond redemption value from ¥7trn in gross monthly purchases). In the end, roughly ¥1trn in annual ETF purchases and roughly ¥30bn in annual J-REIT purchases were added to this, and the target for financial market operations was set at an annual monetary base increase of ¥60–70trn per year.

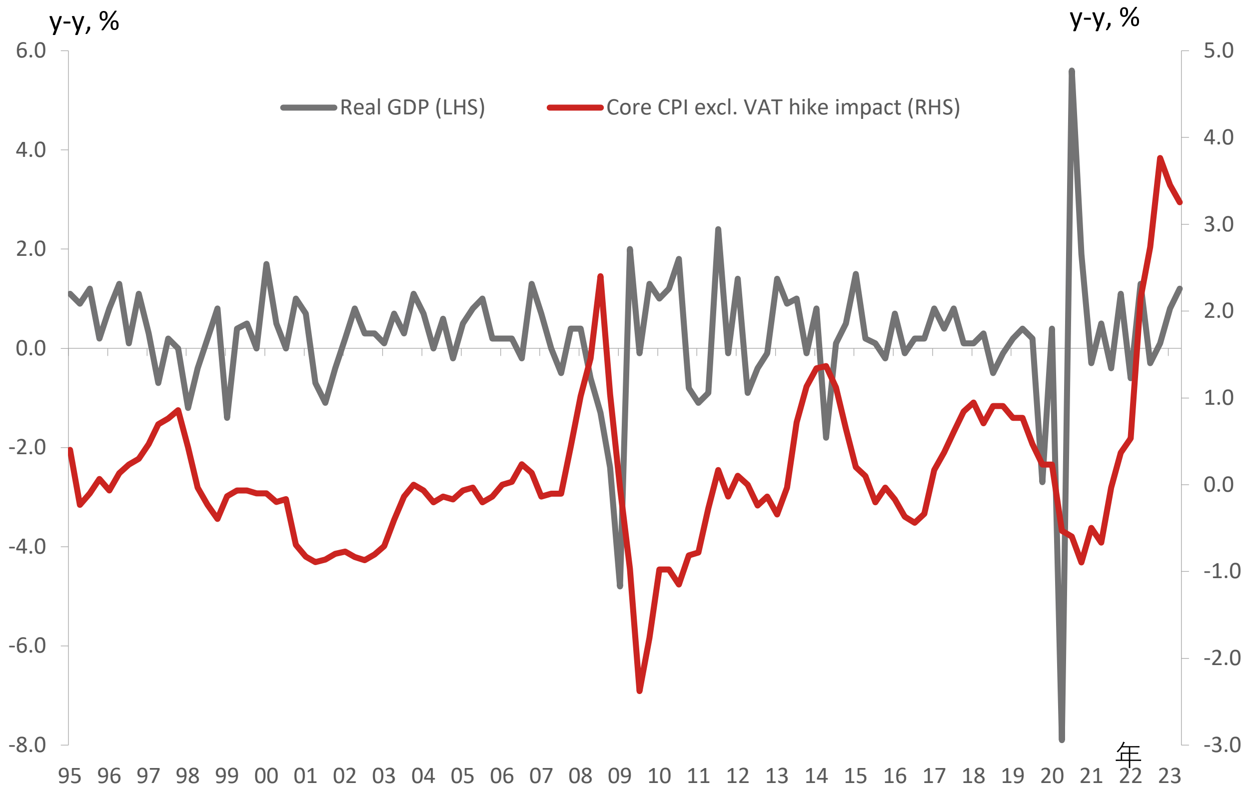
One point of contention was Governor Kuroda's execution time frame of two years. Board member Takahide Kiuchi advocated setting time limits in light of concerns over smooth operational execution, declines in financial market function, and possible speculation about fiscal financing. The opposing view won out, however, as a result of countervailing concern that time limits could hinder smooth expectation formation or cause issues with implementation of operations. This resulted in a policy without a specified time frame, with the BOJ "aiming to achieve the price stability target of 2 percent, as long as it is necessary for maintaining that target in a stable manner."

Subsequently, the BOJ described the effects of the bold monetary easing that came out of this process in its comprehensive assessment ("Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE)") [4]. We also think the additional measures the BOJ took afterward in response to the dropping out of the policies effects were likely based on the same thinking as this bold and decisive policy set in April 2013. In the comprehensive assessment, the BOJ described the changes in economic activity and prices following the introduction of QQE in three phases based on changes in inflation expectations (see Figure 8 for actual price increases and real GDP growth in each of these phases).

The first phase runs from the introduction of QQE through summer of 2014, when the BOJ identifies clear increases in all the major inflation expectation indicators. During the second phase, from summer 2014 though summer 2015, the BOJ says that many indicators of inflation expectations held flat. It concluded that "the fall in crude oil prices since summer 2014 and weak demand after the consumption tax hike in April 2014 seem to have pushed down inflation expectations." It expanded QQE in October 2014 in response to these economic and price conditions. The main changes to QQE here were expansions to the scale of JGB purchases, raising the annual pace of expansion in the BOJ's holdings from around ¥50trn to around ¥80trn, and a tripling of the targets for purchases of ETFs (to roughly ¥3trn) and J-REITs (to roughly ¥90bn).

During the third phase, from summer 2015 through summer 2016, the BOJ judges many inflation expectation indicators as weak, as a result of slower growth in the global economy stemming from a slowdown in emerging economies, unstable moves in international financial markets on concerns related to Brexit, and a further decline in crude oil prices. The BOJ's response to this was the introduction of the negative interest rate policy (NIRP; three tiers of interest rates for current accounts at the BOJ, with one of the tiers subject to negative rates) in January 2016.

Figure 8: Real growth and CPI inflation under the long-lasting monetary easing

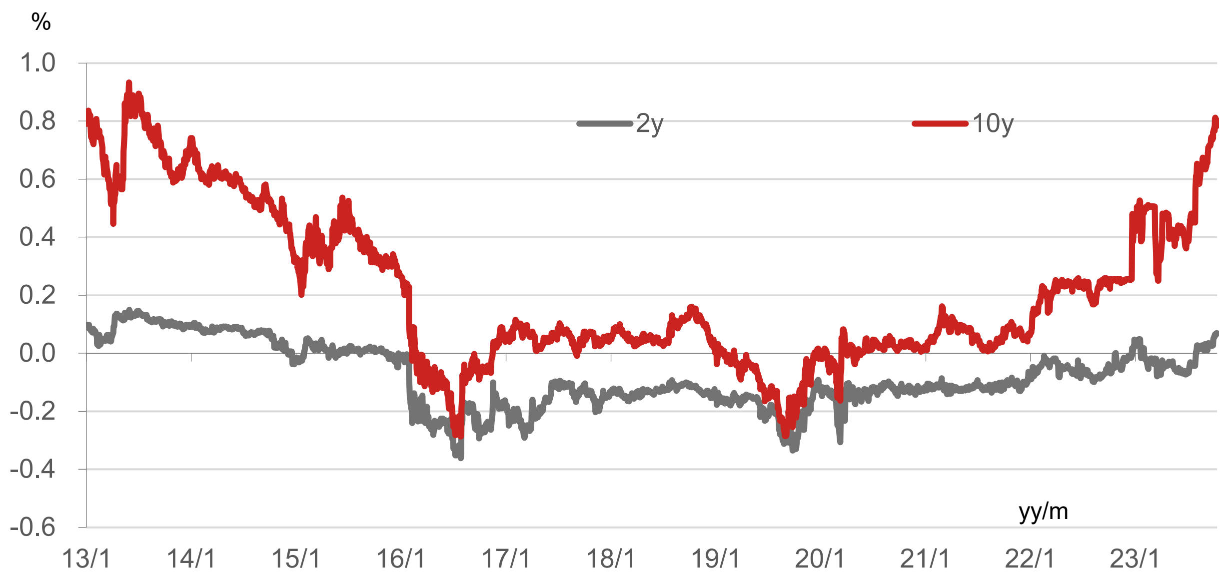


Source: Nomura, based on Cabinet Office and MIC data.

(2) Stage 2: "War of attrition"—comprehensive assessment and move to YCC

Over the course of all this, the BOJ was unable to achieve its price stability target within the two years it had initially strived for. At the same time, the excessive lowering and flattening of the yield curve following the introduction of NIRP (**Figure 9**) began to give rise to concerns about the sustainability of financial functions in a broad sense. Under these conditions, the BOJ carried out its comprehensive assessment, which aimed to analyze the reasons it had failed to achieve its price stability target alongside an analysis of the effects of QQE, while also looking for ways to rebuild its policies in a more sustainable way that reduced the concerns about financial functions (which were provisionally seen as side-effects of BOJ policy).

Figure 9: JGB 2y and 10y yield



Source: Nomura, based on Bloomberg data

Below, we look at the conclusions the BOJ came to in its comprehensive assessment regarding the effects of its policy and the reasons it had failed to achieve its inflation target.

One major discovery the BOJ made in its comprehensive assessment that it saw as providing hints for possible reforms to its policy was the peculiar nature of how inflation expectations form in Japan. It concluded that "adaptive" mechanisms influenced by past and present inflation conditions play a large role in the formation of inflation expectations in Japan. Raising inflation expectations based on these adaptive formation mechanisms involves uncertainty and can require considerable time. This raises concerns that financial functions could be affected during the time it takes to push up inflation expectations.

With this in mind, the BOJ concluded that it needed to revise policy toward a monetary easing scheme that was more sustainable and better able to adapt to changing conditions. It judged that it needed a policy structure that better balanced the benefits and side-effects of policy, and that worked more directly to achieve an appropriate yield curve in ways that would be sustainable over a relatively long period, while keeping in place the previous policies of NIRP and JGB purchases as appropriate.

This is how the shift to yield curve control (YCC) came about. As can be gleaned from the official name of the policy, "quantitative and qualitative easing with yield curve control", this policy regime kept some quantitative easing elements, but while it made no change to the annual pace or size of the roughly ¥80trn increase in JBG holdings, it changed the positioning of this JGB purchase policy from a target to an aim. The introduction of YCC thus effectively shifted the policy guidance target away from quantity and back to interest rates.

Even after the introduction of YCC, the BOJ has been hit with multiple negative inflation shocks, i.e., shortfalls in economic growth and inflation. The BOJ did not respond to any of these shocks by revising the YCC scheme itself, but rather by flexibly adjusting policy with the bounds of this scheme. For example, in the summer of 2018, it bolstered its stance on keeping interest rates low across the entire yield curve through YCC by way of forward guidance, while also showing a willingness to address downside risks to the economy and prices. In the face of the downside risks to the economy and prices from the yen appreciation seen heading into autumn 2019, the BOJ changed its forward guidance (at the October 2019 MPM) to explicitly state that it would "not hesitate to take additional easing measures if necessary", while Governor Kuroda hinted at the possibility of taking rates further into negative territory. It then addressed the shock from the COVID-19 outbreak in 2020 with a statement that it was removing the upper limit on long-term bond purchases, alongside moves to fill out the financial safety net. Given the limited potential for further easing measures, the BOJ looks to have done well by taking advantage of YCC's inherent sustainability and ability to flexibly address changing conditions.

3. BOJ confronted with the global inflation shock: Preparations for a retreat from unprecedented monetary easing and policy outlook

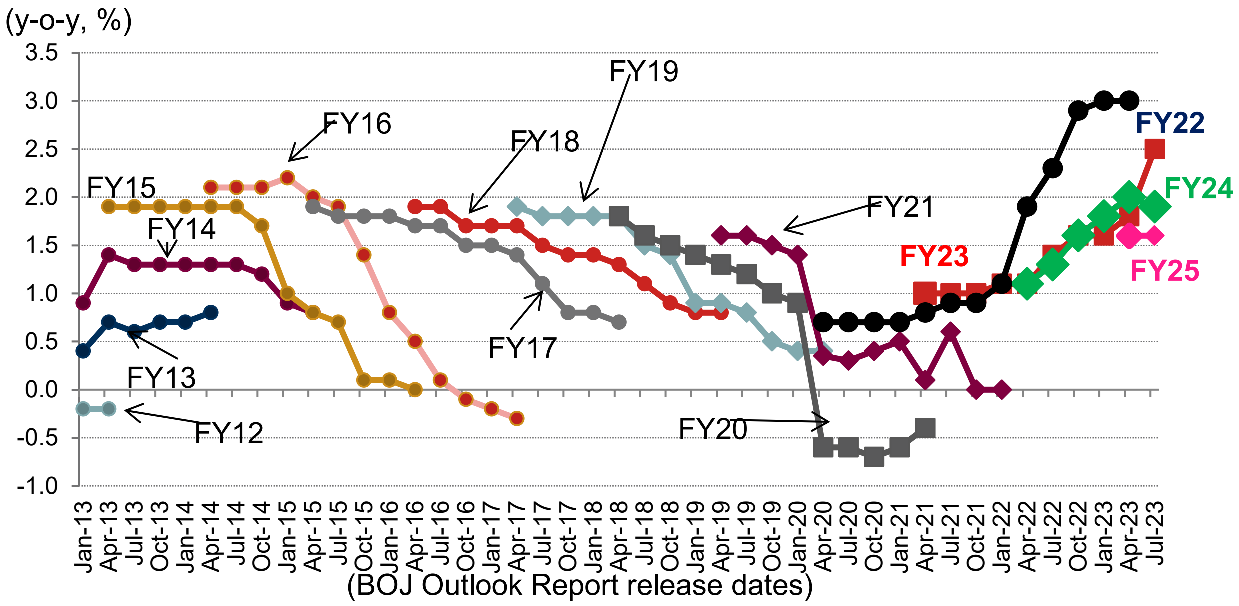
The global acceleration in inflation since 2021 and its ripple effects on inflation in Japan has given rise to speculation that the BOJ may need to shift away from the drawn-out easing strategies it has pursued under the YCC framework. Particularly given the experience of the US Fed and other central banks in more advanced economies, which had initially dismissed the pick-up in inflation as transitory but then had to tighten monetary policy at a rapid pace beginning in March 2022 (roughly a year after inflation began to accelerate), many observers apparently think the BOJ is at risk of falling into similar circumstances. Against this backdrop, Governor Kuroda reached the end of his term of office in April 2023, and the BOJ moved to a new leadership structure with Mr. Ueda as governor and Shinichi Uchida and Ryozo Himino as deputy governors. Markets saw this change of BOJ leadership as an opportunity for change in the BOJ's policy stance

(1) Unexpectedly dovish start to Governor Ueda's tenure

Considering the market's expectations and forecasts ahead of time, the Ueda-led BOJ had an unexpectedly dovish start. At the April 2023 MPM, the first under Governor Ueda, the BOJ left its policy in place, including YCC. A close look at the monetary policy statement released after the meeting revealed that the wording tying policy rates to the COVID-19 pandemic was removed from forward guidance, but the pledge to "not hesitate to take additional easing measures if necessary" was left in place. Keeping the wording stating that the BOJ would continue with QQE with YCC as long as needed to achieve the price stability target in stable manner further emphasized that the BOJ was committed to persisting with monetary easing to achieve the 2% price stability target in a sustainable and stable manner that included rising wages.

This unexpectedly dovish stance was based on the BOJ's own conservative and cautious views on prices despite the global inflation shock. The median core CPI (all items less fresh food) inflation forecasts in the BOJ's April 2023 Outlook for Economic Activity and Prices (Outlook Report) were revised up for both FY23 and FY24 from the previous report in January, bringing the FY24 forecast to +2.0% y-y, matching the price stability target. However, the report also included a new forecast for FY25 of +1.6% y-y, some distance below the 2% target (Figure 10). The report's qualitative assessment of price trends indicated that the BOJ expected the impact of the inflation shock from overseas to weaken, saying "the year-on-year rate of increase in the consumer price index (CPI, all items less fresh food) is likely to decelerate toward the middle of fiscal 2023, with a waning of the effects of a pass-through to consumer prices of cost increases led by a rise in import prices."

Figure 10: BOJ's core inflation forecasts in Outlook Reports



Note: Excluding the impact of consumption tax hike and free education
Source: Nomura, based on BOJ data

Another factor that made this unexpected dovishness stand out was the BOJ's risk balance assessment when it came to mistakes in policy judgments. In a speech on 19 May [5], Mr. Ueda said, "the cost of impeding the nascent developments toward achieving the 2 percent price stability target, which are finally in sight, by making hasty policy changes would likely be extremely high. While there is an opposite risk that inflation will remain above 2 percent if a change in policy falls behind the curve, the cost of waiting for underlying inflation to rise until it can be judged that 2 percent inflation has fully taken hold is not as large as the cost of making hasty policy changes." Neither Mr. Kuroda nor the BOJ under his leadership had ever made such an explicit statement about the risk balance. On the other hand, Mr. Ueda, who was a policy board member at the time, voted against ending ZIRP in August 2000 on the grounds that the cost of waiting would not be high. It may be that Mr. Ueda's own sense of the risk balance made the BOJ's unexpected dovishness stand out even more than it otherwise would have.

(2) Signs of "retreat" from unprecedented easing measures

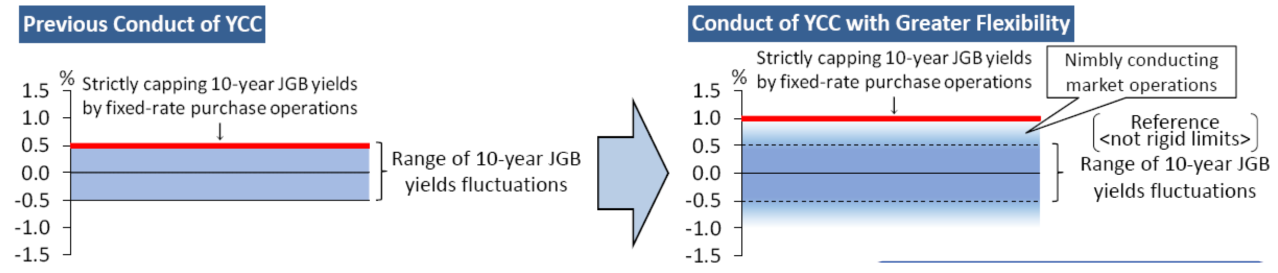
This "dovish stance" of the Ueda-led BOJ is already showing signs of change. In Chapter 2, we discussed Kuroda-led BOJ monetary easing moving from "all-out attack" to "war of attrition". If we follow that line, BOJ monetary easing could now finally be in "retreat" mode.

At the monetary policy meeting of 27–28 July, 2023 the BOJ decided to conduct yield curve control with greater flexibility, while maintaining the status quo with the overall monetary policy framework, including short- and long-term policy rates. Specifically, the BOJ said it would offer to purchase 10-year JGBs at 1.0% through fixed-rate purchase operations every business day except those on which it deems it highly likely that no bids will be submitted, raising the yield level for fixed-rate purchase operations from 0.5% previously, while keeping the allowable range for fluctuation in long-term yields at ±0.5ppt, as before. With room for fluctuation in the yield on 10yr JGBs being widened anew to the +1.0% range, from +0.5%, the yield on 10yr JGBs has been in excess of +0.5% since end-July (**Figure 11**).

The aim of conducting YCC with greater flexibility is to increase the sustainability to enable the continuation of monetary easing by reducing impacts on market function, etc., that could arise particularly in the event economic activity/prices were to exceed expectations. As long as this is taken at face value, increased flexibility in conducting YCC does not necessarily assume the scrapping of monetary easing; nor is it a means to that end. The BOJ could have considered the possibility that it would come under pressure from markets to lift monetary easing if economic activity/prices were to continue to exceed expectations. Even in such a case, the BOJ could have positioned greater flexibility in YCC operations as a preventive measure that could thwart discontinuity or sudden changes in yield fluctuation in the JGB market in particular.

We see some moves indicating that Governor Ueda's assessment of the balance of risks related to policy decision mistakes has been changing. Governor Ueda is quoted in a 9 September, 2023 Yomiuri Shimbun article as saying that he does not necessarily proactively tolerate policy being behind the curve, and that data dependency (of monetary policy decisions) has been growing. He also said the decision in July to make YCC more flexible was a matter of risk management, as the risk that the BOJ would be forced to abandon YCC unintentionally in the event economic activity/price prospects exceeded expectations was not zero. Our interpretation is that the explanation in the policy statement emphasizes being prepared for the event in which it is forced to abandon monetary easing, over the aim of continuing monetary easing by reducing the impact on market function of prices and interest rates exceeding expectations. This indicates to us that the BOJ has started making preparations with "retreat" from the unprecedented easing at the top of its mind.

Figure 11: Conduct of Yield Curve Control (YCC) with Greater Flexibility(Explanatory chart by BOJ)



Source: Nomura, based on BOJ data.

We forecast that the number of visitors to Japan from overseas will recover to pre-COVID levels from around mid-2023 onwards as the Japanese government eases its border controls aimed at limiting the spread of the virus in Japan and China relaxes its so-called zero COVID strategy. We expect this to go some way toward putting the brakes on the deterioration in Japan's balance of payments brought about by the terms-of-trade shock. In addition, in our US recession scenario (in which real GDP growth is negative on a q-q basis for five consecutive quarters starting in 2022 Q4), USD/JPY could turn downwards (i.e., the yen could start to strengthen versus the US dollar) even if the Fed continues to hike interest rates, because market interest rates start to fall and spreads between Japanese and overseas interest rates start to narrow. In this scenario, we think concerns that the weakening of the yen caused by the terms-of-trade shock could continue ad infinitum might avoid becoming a reality, at least for the time being.

(3) Outlook for BOJ monetary policy

Finally, we consider the outlook for BOJ monetary policy based on BOJ policy thus far and an assessment of current inflation and inflation prospects for Japan. We look again at the BOJ's own price expectations, which are the basis for its policy decisions.

Numerically, one cannot say that the BOJ assumes the 2% per annum price stability target to be attainable, with a median forecast for average core CPI inflation in FY25 of +1.6%. In the Outlook Report's discussion of the median forecast for prices, it says "the rate of increase is projected to accelerate again moderately, as the output gap improves and as medium- to long-term inflation expectations and wage growth rise, accompanied by changes in factors such as firms' price- and wage-setting behavior". If we see evidence that the low inflation "norm" has been overcome via the realization of stable wage increases and changes in firms' price-setting behavior, which we mentioned in Chapter 1 as being keys to changing the low inflation trend in Japan, we think the BOJ might end monetary easing if prospects for attaining the stable price target come into sight.

We think specific conditions in that case are the realization of wage increases in 2024 spring labor wage negotiations that are similar to or better than those achieved in 2023, and maintenance of steady growth in household demand, in particular, while wage growth is stable or gaining momentum. If it was only to see evidence of 2024 spring labor wage negotiation results, the conditions for lifting monetary easing could be in place by Apr–Jun 2024, but scrutinizing the latter condition could take longer. In particular, real private consumption fell 0.6% q-q in Apr–Jun 2023, according to published statistics, which looks weak to us considering that this is when the reopening of the economy following the pandemic went into full swing, and concerns are emerging that economic growth in Japan could briefly slow from late 2023 to early 2024 on the back of factors including slowing overseas economic activity.

The BOJ said in the Outlook Report that the risk of the underlying economy falling short of expectations is large, on which basis we think the BOJ is likely to put on hold any judgment of whether downside risk in the underlying economy has manifested until at least Oct–Dec 2024. On this basis, our main scenario is that the BOJ will not decide to end YCC via the scrapping of long-term policy rate targets any earlier than Oct–Dec 2024. We think the allusion to an early lifting of the negative rates policy by Governor Ueda in an interview carried in the 9 September issue of Yomiuri Shimbun was possibly nothing more than him stating his general belief that nothing should be ruled out, and has larger implications for putting a damper on the sharp weakening of yen. In reality, lifting the negative rates policy would have to come before YCC is lifted, and it would be unlikely that they would be lifted concurrently, in our opinion, and we think the lifting of the negative rates policy is unlikely to be decided until it is confirmed that the underlying economy is steadily recovering in the run-up to 2025.

Conclusion

In this report, we looked at whether the global inflation shock since 2021 will lead to a turnaround in the low inflation trend in Japan and whether it will lead to the end of years of bold monetary easing policies by the BOJ. In this vein, we considered the possible changes that could come with the April 2023 appointment of Governor Ueda, while looking back at monetary easing carried out by previous Governor Kuroda since 2013.

The global inflation shock has been increasing goods inflation accordingly in Japan, while a pick-up in services inflation remains weak compared to the marked pick-up in inflation in the West and other regions. We think the low inflation "norm", such as careful price-setting behavior at companies, needs to be shattered, while at the same time wages are raised in a stable manner, for Japan to break out from the low inflation trend, including for services. For now, we see the beginnings of this movement, with the increase in base pay having improved in the 2023 spring labor wage negotiations and more and more companies passing through higher costs to their customers. We think it will take time to see evidence that wage increases and changes in corporate price-setting behavior are sustainable.

Bold monetary easing launched by the BOJ along with the appointment of Governor Kuroda in March 2013 initially changed the main policy target to the (pace of growth in the) volume of the monetary base, from the guidance of market rates (uncollateralized overnight call rates), as it strived for something unprecedented in terms of quantity and quality with the aim of turning around market and economic expectations. The Kuroda-led BOJ repeatedly injected bold and massive policy resources, as before, until the negative interest rate policy was adopted in January 2016 (we term this the "all-out attack" in this report), and shifted to a monetary easing strategy of "war of attrition", which sought policy sustainability, with the switch to yield curve control following the September 2016 comprehensive assessment, after failing in its effort to achieve the stable price target in the period of about two years and at a time when the ills of excessive yield curve flattening started to become apparent.

The BOJ under Governor Ueda, who entered office in April 2023, initially took a dovish stance focused on removing risks of an early lifting of monetary easing instead of risks of being a step behind inflation buoyancy. However, in the wake of its decision on 28 July to become more flexible in its conducting of YCC, we think the BOJ is starting to show readiness for the lifting of monetary easing if it is driven to do so because of higher-than-expected inflation. As for the lifting of YCC, our main scenario is that it will come no sooner than Oct–Dec 2024, as we think the BOJ will at least wait to make sure wage increases and improvement in the underlying economy are sustainable.

References and notes

1. See article about moving away from the custom of leaving prices unchanged in the Economics Classroom column in the 25 July, 2016 morning edition of the *Nikkei Shimbun*, as well as various discussions elsewhere. Among general books, a typical example is *Sekai Infure no Nazo* (The Riddle of Global Inflation), Kodansha Gendai Shinsho (October 2022).

2. “Basic Thinking on Monetary Policy and the Outlook for Economic Activity and Prices,” speech given by BOJ Governor Udea at a meeting held by the Naigai Josei Chosa Kai (Research Institute of Japan), May 19, 2023, https://www.boj.or.jp/en/about/press/koen_2023/ko230519a.htm

3. Review of Monetary Policy from a Broad Perspective
https://www.boj.or.jp/en/mopo/outline/bpreview/index.htm

4. Comprehensive Assessment: Developments in Economic Activity and Prices as well as Policy Effects since the Introduction of Quantitative and Qualitative Monetary Easing (QQE), https://www.boj.or.jp/en/mopo/mpmdeci/transparency/rel160930d.pdf

5. Same as in note 2.