Key Question in Japan – Is it Structural or Cyclical?

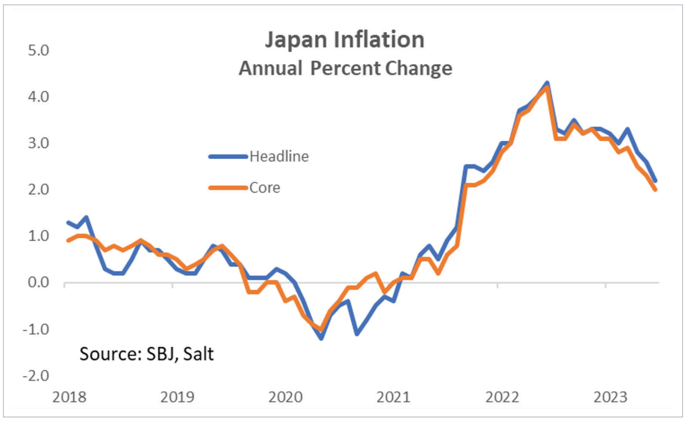
The Bank of Japan (BoJ) made a bold move this week in ending the world's last remaining "unconventional" monetary policy positions – Yield Curve Control (YCC) and their Negative Interest Rate Policy (NIRP).

In its decision the BoJ set the policy rate in the 0% to 0.1% range, up from -0.1%, and scrapped its Yield Curve Control policy. In terms of asset purchases, the BoJ will continue to purchase Japanese Government Bond's in "broadly the same amount as before", while Exchange Traded Fund (ETF) and Japanese Real Estate Investment Trust (JREIT) purchases have been scrapped.

This move has been well-flagged and long expected. Our view that the end was nigh for both YCC and NIRP was based more on conditions being right for the normalisation of policy, rather than the BoJ being necessarily concerned about the possibility of imminent run-away and persistent inflation.

Recent developments supportive of the normalisation of policy

Japan has seen a rise in inflation to levels not seen in many years. Japan-style core CPI (ex. fresh foods) topped expectations at 2.0% y/y in January, lower than the previous month's 2.3% but remaining at or above the 2% mark for a 22nd successive month. While much of the inflation coming from external shocks has dissipated, domestic drivers of inflation persist.

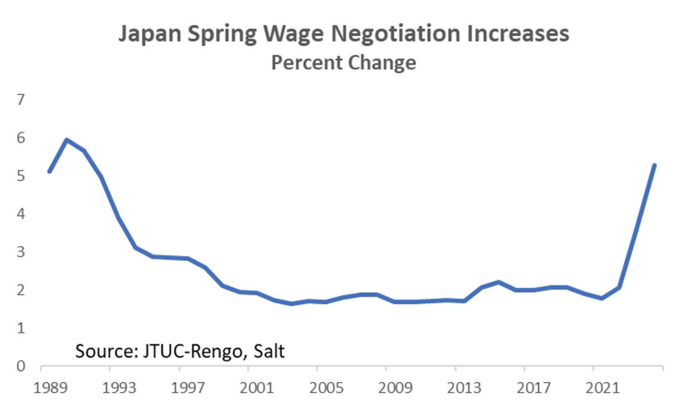


Labour market strength is notable. The unemployment rate fell to 2.4 percent in January from 2.5 percent in the previous month. Furthermore, the job availability ratio came in at 1.27 in December, meaning there were 127 jobs available for every 100 job seekers.

The tight labour market is supporting strong wage growth. Scheduled cash earnings on common sample basis increased +2.0% y/y in January. While this was modestly lower than the +2.2% in December, the highest level since its release on this basis started, it maintained +2% growth in four consecutive months.

In our view, it's the wage growth has been most critical. Japan's long-term battle against deflation has often been attributed mostly to challenging demographics, particularly the ageing population. Regular readers of our research will know we attribute the decades long problem to wage setting behaviour.

The sustained upward pressure on wages is leading to what the BoJ terms "a virtuous cycle between wages and prices." That's a view that would have been only emboldened by news just a few days prior to their meeting of the largest shunto spring wage increase in 33 years.



What happens next?

The BoJ offered little in terms of forward guidance in this week's meeting, other than continuing to commit to accommodative policy. That leaves the bigger question of the extent to which current better wage-setting/inflation dynamics are a blip, or whether something more fundamental has changed.

It's the nexus of productivity and wage growth that will inform how far above zero the policy rate can eventually go. Over the long run, nominal wage growth must equal inflation plus productivity growth.

Recent work undertaken by our partners at Morgan Stanley Investment Management shows that over the 2015-2019 period, the average annual growth in productivity, as measured by output per hours, was 0.76% in Japan.

In considering future productivity growth, disaggregating it between the goods and the services sectors provides insights as they tend to differ. The growth in goods productivity has usually been higher than in services, but this reversed in 2022. This growth in services productivity could continue to sustain aggregate productivity growth.

The surge in the growth of services productivity seems to be linked to the very tight labour market and thereby the virtuous cycle alluded to by the BoJ between domestic demand, prices, and wages. If nominal wage growth continues, and stronger domestic demand is here to stay – as is our call for Japan – then the likelihood of sustained inflation is higher.

The combination of challenging demographics and rising labour costs mean that we should also see businesses working to invest more in labour-saving technology, helping to boost productivity further.

The signs are good that Japan may be finally escaping its decades long reflation struggle with growth and inflation. Global investors appear to share this view, or that at the least, some very long-standing impediments to Japanese business conditions have recently eroded, or have been resolved - whether by policy choices, or simply by the passage of time.

Something is clearly "going right," as the long-dormant Japanese stock market has been on a tear. The Nikkei 225 Index has already soared 20% in 2024-to-date and is up by almost 50% over 12 months. Some of that performance is due to weakness in the Japanese yen aiding exporters, but a softer currency also exerts an upward influence on the domestic inflation picture.

However, structural changes take time to evolve, let along observe in the data. In the meantime, our impression from Governor Ueda's press conference is that the BoJ will remain very cautious in the setting of policy going forward.