JAPAN ECONOMICS UPDATE

Yield Curve Control is effectively over

- **The Bank of Japan announced today that it will allow 10-year yields to rise above the 0.5% ceiling – which it says it is retaining – to a new "just-in-case" cap of 1.0%. With signs mounting of a virtuous cycle between inflation and wages, the chances of the Bank lifting its short-term policy rate as well are rising**. **However**, **we still think that a slowdown in inflation will convince the Bank to refrain from further policy tightening over the coming months.**
- Only a minority of analysts polled by Refinitiv expected the Bank to tweak Yield Curve Control today. We were in the majority that expected policy settings to remain unchanged. The Bank stressed that this move was intended to make monetary easing more sustainable rather than to tighten policy given "that sustainable and stable achievement of the price stability target of 2 percent has not yet come in sight."
- As widely anticipated, the Board's median forecast for inflation excluding fresh food for the fiscal year that ends in March rose sharply, from 1.8% to 2.5%. What's more, the Bank noted that "signs of change have been seen in firms' wage and price-setting behaviour".
- To be sure, the median inflation forecast for FY2024 declined from 2.0% to 1.9%, while the median forecast for FY2025 remained unchanged at 1.6%. Indeed, inflation will slow over the coming months as lower import prices weigh on goods inflation, which has driven most of the pick up in underlying inflation. In fact, the Tokyo CPI released earlier today showed that non-food industrial products inflation has already slowed from 6.0% in May to 4.5%. And if the economy enters a recession in the second half of the year as we anticipate, the case for policy tightening will diminish. **Our forecast is therefore that the Bank won't make any further formal adjustments to Yield Curve Control and keep its short-term policy rate at -0.1%.**
- However, **our own forecast is that inflation excluding fresh food will average 2.9%: if we're right, the Bank will need to revise up its forecasts further**. What's more, there's a threat of higher inflation being sustained: the July Tokyo CPI also showed a further pick-up in underlying inflation, driven by faster services inflation. (See Chart 1.) The latter is now close to the BoJ's 2% target and with wage growth increasingly driven by efforts of trade unions and workers to offset rising living costs rather than the health of the labour market, there's a growing chance that above-target inflation will be sustained even as goods inflation comes off the boil. (See here.) Accordingly, **the longer inflation stays above target and the economy is holding up, the greater the chances that the Bank of Japan may eventually tighten monetary policy in earnest**.
- 10-year yields jumped ahead of the meeting on the back of a leak of the upcoming announcement, breaching the 0.5% ceiling and forcing the Bank to buy 10-year JGBs via its fixed-rate auctions for the first time in four months. But in contrast to December, when the widening of the yield cap to 0.5% was accompanied by a move in yields nearly as large, yields have risen to just 0.57% today, far below the new 1.0% cap. (See Chart 2.) The Bank seems to be confident that the new ceiling won't be breached soon: In contrast to December, when it accompanied the widening of its tolerance band with an increase in scheduled bond purchases, it kept its purchase schedule for August unchanged today.
- **In practice, today marks the effective end of Yield Curve Control**. The policy no longer meaningfully constrains yields. If the new effective 1% cap were tested repeatedly, the BoJ has demonstrated over the past year that it would respond by relaxing it again. One consequence is that the Bank won't be forced to make major JGB purchases. The Bank's holdings of JGB already fell in June by the most since the launch of the YCC policy. Barring any renewed surge in yields, we suspect the Bank will run down its holdings further over the coming months.

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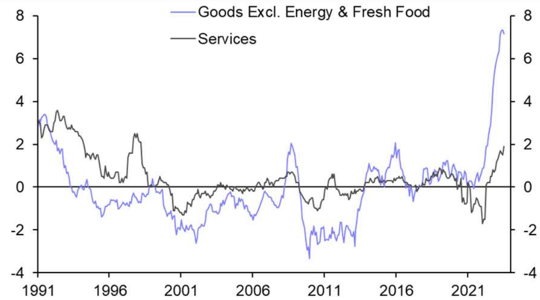
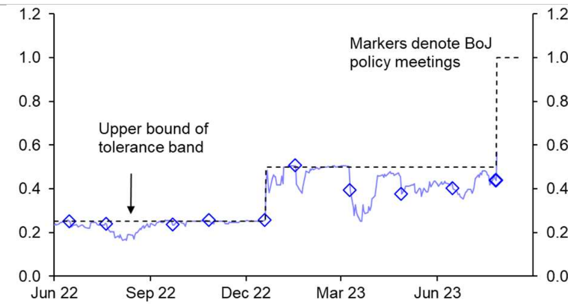
Chart 1: Tokyo Consumer Prices (Excl. Tax, % y/y)



Sources: Refinitiv, Capital Economics

Chart 2: 10-year JGB Yield (%)



Source: Refinitiv

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