

THE BANK OF JAPAN IS IN AN UNCOMFORTABLE SPOT

While the US Federal Reserve has begun raising its policy rate, the Bank of Japan continues to pursue a very accommodating monetary policy. The sharp depreciation of the yen leaves the BoJ less manoeuvring room to pursue its yield curve control policy. Some adjustments in its policy are expected. Economic support – both monetary and fiscal – will be maintained in 2022 in an environment that is especially tough for Japanese industrial companies, hard hit by global supply chain disruptions and the economic slowdown in China.

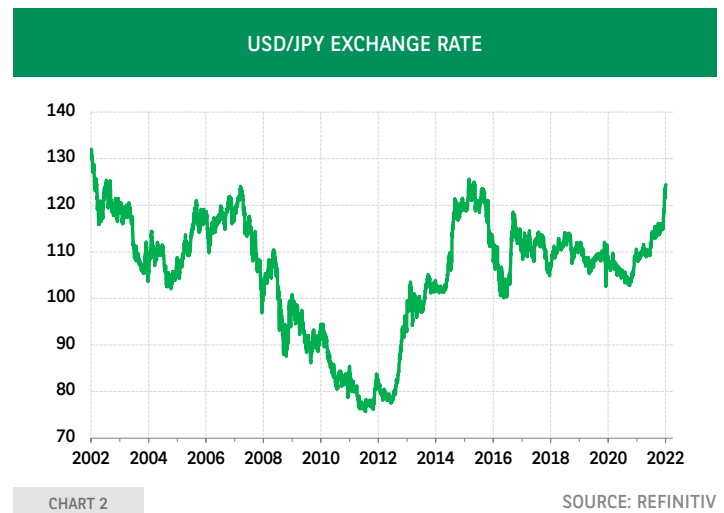
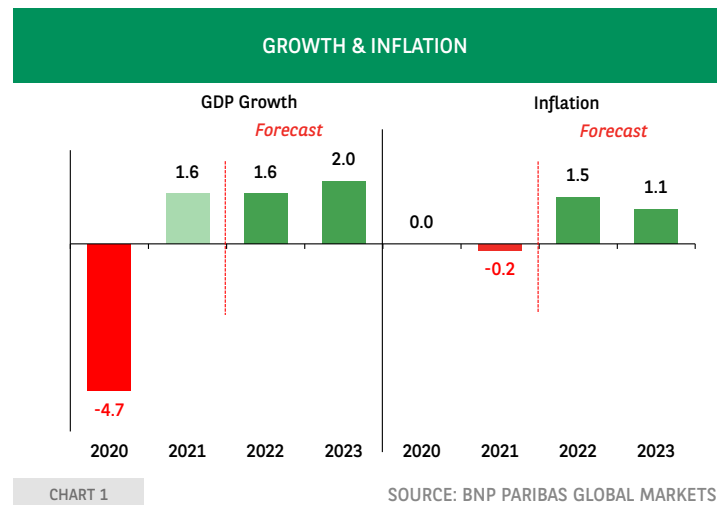
The latest Tankan survey reflects the concerns of Japanese business leaders. Although the overall diffusion index declined slightly, from 2 to 0 – indicating a balance between the number of respondents saying their situation had deteriorated with those saying it had improved – expectations for the next quarter deteriorated significantly in the sectors hit hardest by the increase or shortages of commodity prices. This is the case for major corporations in steel manufacturing, lumber and industrial machinery. Business confidence also declined in the paper and ceramics industries. Given industry's heavy weighting in the economy (21% of GDP in 2019) and its strong imbrication in global supply chains, Japan is highly affected by supply chain disruptions, notably in China, its biggest export market.

Moreover, the Japanese economy still has not fully recovered from the health crisis: last winter the country was hit by a new wave of Covid-19 cases due to the Omicron variant. After a very slow start, the vaccination campaign has accelerated. The vaccination rate is now high at 80%, which means that the economic recovery should become less erratic. Even so, Q1 activity was hampered not only by the pandemic but also by the first economic repercussions of the war in Ukraine. The economic rebound was already fairly sluggish at 1.7% in 2021, after a contraction of 4.5% in 2020.

THE YEN PLUNGES: A DILEMMA FOR THE BOJ?

The Japanese yen depreciated sharply at the end of March, falling below JPY 120 to the dollar for the first time in seven years. A key part of Abenomics, a reflation strategy launched in 2012, was based on the economic support provided by a weaker yen. The Japanese currency fell already sharply between September 2012 and May 2015 (see chart 2). Although this seems to have bolstered economic growth (the output gap has narrowed in recent years), the strategy may have reached its limits in the current situation. The major divergence between US and Japanese monetary policies is leading to a decline in JPY purchases. A weaker yen amplifies the increase in import prices, which are already very high, adding to inflation and the erosion of household purchasing power. The Bank of Japan is thus faced with a dilemma: it can maintain the status quo with its policy of controlling interest rates (which is very accommodating, but which is likely to extend the yen's decline) or proceed with a policy adjustment (halting the yen's depreciation, but at the cost of less advantageous borrowing conditions). It is anticipated that the BoJ will raise the yield cap, currently at 0.25 for 10-year bonds.

Inflation should accelerate sharply in April, approaching or even exceeding the BoJ target rate of 2%. This increase can be attributed to three factors: (1) a base effect on telephone rates (which dropped by nearly 40% in April 2021); (2) higher energy costs, which will have a more lasting impact on inflation throughout 2022; and (3) pricing pressures on other spending items (notably food products), which will



pick up gradually. It remains to be seen whether Japanese companies will be able to absorb these higher production costs and limit the pass-through to sales prices. Japanese companies still benefited from high margins in 2021¹, but they will have to cut them more drastically this year.

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¹ This is shown in both the finance ministry's quarterly survey (r3.10-12e.pdf (mof.go.jp)) and in the Tankan survey (<https://www.boj.or.jp/en/statistics/tk/gaiyo/2021/tka2203.pdf>).

