JAPAN: YIELD CURVE OUT OF CONTROL?

Monetary policy desynchronization between the Federal Reserve and the Bank of Japan (BoJ) has become huge. This has caused a significant weakening of the yen. Higher US yields have also exerted upward pressure on JGB yields, which in turn has forced a gradual adjustment of the BoJ yield curve control policy (YCC). Inflation developments in Japan increase the likelihood of a policy rate increase but policy normalization is a delicate task for domestic reasons as well as international spillovers. The BoJ has chosen a cautious approach, with very incremental steps, but in the meantime the yen has continued to weaken, creating the risk of a snapback once policy is tightened. Acting sooner rather than later seems to be the recommended route for the BoJ.

Monetary policy desynchronization between, on the one hand, the Federal Reserve, the ECB, the Bank of England, and other central banks in advanced economies and, on the other hand, the Bank of Japan (BoJ) has become huge. Unsurprisingly, this has caused a significant weakening of the yen.

Chart 1 shows that the depreciation of the yen versus the US dollar has gone hand in hand with a widening of the yield differential between US Treasuries and Japanese government bonds (JGBs). The rise in US Treasury yields has exerted upward pressure on JGB yields, which in turn has forced a gradual change in the yield curve control policy (YCC)[1] (chart 2). One would expect that this monetary desynchronization will peak in the not-too-distant future based on the view that the Federal Reserve has (almost) reached its terminal rate and that the Bank of Japan may finally raise its policy rate, something we consider possible as of March next year. Indeed, headline inflation, which has been above the 2% target since April 2022, has since last February stabilized slightly above 3.0%. This elevated inflation is, for a part, imported inflation, linked to the JPY depreciation. Core inflation has been even higher than 3.0% since the start of the year and is now above the 4.0% mark. Alternative measures of inflation used by the BoJ -trimmed mean, median, mode- are also above target. Wage growth however has been below inflation since early 2022 and it seems that a rate hike will depend on whether the BoJ is sufficiently confident that the spring wage negotiations (*Shunto*) of 2024 will bring enough of an increase to justify such a move.

Normally, when a central bank hikes its policy rate and its peers leave their policy unchanged, the former's currency should appreciate. Consequently, one would expect that a rate increase by the BoJ would be supportive for the yen, despite the rate differential with the US remaining important[2].

USD/JPY AND BOND YIELD DIFFERENTIAL

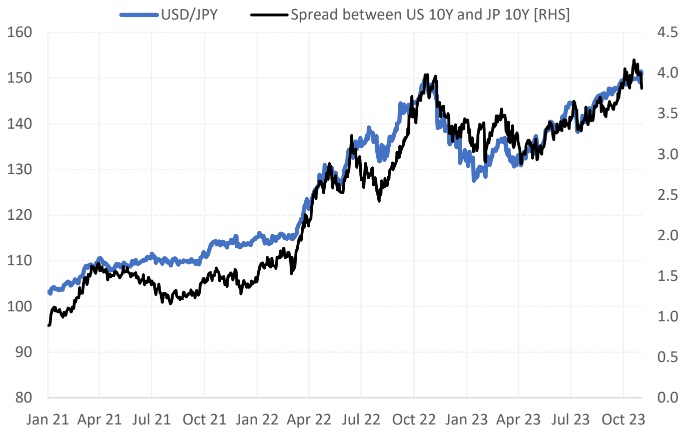

CHART 1 SOURCE: REFINITIV, BNP PARIBAS

What complicates matters in the case of Japan is the fact that through a combination of negative official interest rates and YCC, monetary accommodation has been extreme and so for a long time. This makes policy normalization a very delicate task. Key questions in this respect are the extent to which the yen has been used as a funding currency in carry trades[3] , whether Japanese investors will invest less abroad when domestic interest rates are moving higher when YCC has been stopped -a flow argument- or even decide to repatriate capital invested abroad -a stock argument.

1Yield curve control was introduced in September 2016 in reaction to inflation remaining stubbornly below target and a decline in inflation expectations. In addition, pursuing a volume based monetary policy ('traditional' QE based on buying a certain amount of JGBs or other instruments per month) would have become increasingly difficult to maintain as the remaining stock of JGBs was declining. There was also concern that too flat a yield curve would have a detrimental impact on banks and insurers so the combination of a negative rate on policy-rate balances in current accounts held by financial institutions at the BoJ and a policy of targeting the 10-year yield would, by maintaining a sufficiently steep curve, enable to soften the impact of negative policy rates on the financial sector. For more detail see William De Vijlder, *Japan - Monetary policy: let's give it another try*, Ecoweek, BNP Paribas, 23 September 2016.

2 What matters for the change in the exchange rate is the (expected) change in the rate differential. The fact that the yen has weakened significantly against the US dollar reflects that investors are already positioned to benefit from the sizeable interest rate differential. The prospect of a reduction of this differential may push them to take profits and sell the US dollar versus the yen.

3 This strategy consists of borrowing in a currency with very low interest rates, such as the yen, and investing in a high-yielding currency. In case of a sudden appreciation of the yen, investors would be forced to close this position in order to avoid huge losses. In doing so, they would accelerate the appreciation of the yen.

> The weak yen implies a risk of more inflation. Further weakening could be perceived as an overshooting of the currency, implying a bigger risk of a significant snapback once policy is tightened. Acting sooner rather than later seems to be the recommended route for the BoJ.

Depending on the answers to these questions, international spillovers could be large and in its Financial Stability Review of May this year, the ECB has expressed its concern. *"If the Bank of Japan decides to normalise its policy, this might influence the decisions of Japanese investors who have a large footprint in global financial markets, including the euro area bond market*[4]." The fact that the ECB is reducing the size of its balance sheet, which influences the level of bond yields, complicates matters. *"Japanese investors withdrawing abruptly from the euro area bond market could have a material effect on prices, particularly in more concentrated market segments. Such dynamics could be amplified by the increased net supply of these bonds resulting from quantitative tightening by the ECB."*

Faced with these risks -both domestically via mark-to-market losses on bond portfolios when yields increase and internationally due to spillovers-, the caution of the BoJ doesn't come as a surprise. However, this slow approach is raising concerns. The risk of a sudden appreciation of the yen ('snapback') due to the formal end of YCC followed by a rate hike will be bigger when the Federal Reserve will have stopped hiking. If the BoJ had started to normalize its policy whilst the Fed was still hiking, the impact on the exchange rate would probably have been smaller due to the synchronized tightening. In addition, investors may continue to be disappointed by too much caution. Such a reaction would lead to more yen depreciation. This is exactly what has happened in recent days in the run-up to the latest BoJ meeting. Initially, based on an article in the Nikkei newspaper, investors expected a decisive change to YCC, but the decision that was taken was considered to be too soft[5]. Consequently, the yen weakened significantly, before recouping part of its losses (chart 3).

Clearly, the weak yen implies a risk of more inflation. Moreover, further weakening could be perceived as an overshooting of the currency, implying a bigger risk of a significant snapback once policy is tightened. Acting sooner rather than later seems to be the recommended route for the BoJ.

William De Vijlder

US AND JAPANESE GOVERNMENT BOND YIELDS

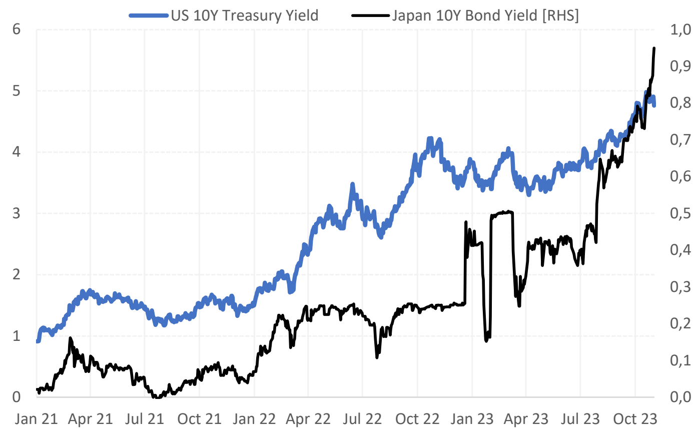

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

USD/JPY

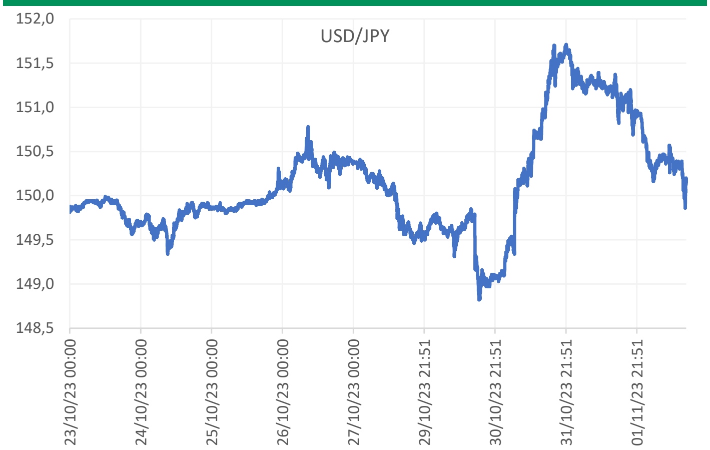

CHART 3 SOURCE: BLOOMBERG, BNP PARIBAS

4 ECB, *Financial Stability Review*, May 2023.
5 The BoJ has introduced a reference ceiling of +1.0% for the 10-year JGB yield, without however committing to strictly controlling this level.