Bank of Japan: The G-10 Outlier

Disruptive Forces in Investing **December 6, 2022**

Anu Rajakumar: Over the last few months, the G-10 Central banks led by the Federal Reserve have taken steps to normalize monetary policy by dialing up interest rates and tightening financial conditions. The Bank of Japan, however, has been an outlier holding tight on its policy of ultra-low rates, announcing further fiscal stimulus into its economy and intervening in its currency, which is now the weakest it's been since in 1980s. Many are wondering when will Japan shift its stance? And if or when it does, what will be the impact on global assets? My name is Anu Rajakumar, and today I'm joined by my multi-asset colleague, Fumi Kato, senior portfolio manager and head of portfolio construction for Multi-Asset Strategies who's here to share thoughts on what's next for the Bank of Japan. Fumi, thank you for coming on the show.

Fumi Kato: Thank you for having me.

Anu: All right, Fumi. So let's dig right in. There are a few different angles that make Japan very interesting from a macro perspective at the moment, particularly its dovish stance, but let's start perhaps with a brief macroeconomics lesson for our listeners. Tell us what's been happening in Japan recently and explain why it's important.

Fumi: Sure, a lot of things happening in Japan, and it's very interesting to see the dynamics happening between BOJ, the Central Bank of Japan, and the Japanese government. It's very different from other countries. And let's step back before we get into all the details. Certainly, Japan is one of the largest economy in the world. There are large investors such as pension funds, insurance companies and financial institutions. So any shift done by BOJ could have important implications on capital flows, asset prices, and a global market. And why Japan is interesting now and important, there are a few reasons. One, Japan just reopened, recently, by dropping all the restrictions from COVID. And the second, Japan has clearly been out of deflationary error. The inflation has been picking up and the recent headline CPI is at 3.7% and core CPI, this is excluding fresh food and also energy, is at 2.5%, exceeding 2% for the very first time in 30 years. And at the same time, the inflation in Japan has been much lower than US and Europe, for example, and this is really primarily due to fiscal subsidies the Japanese government is providing to control prices and cap energy and food prices. And, you know, the important question is where the money really comes from to fund such fiscal subsidies. That really leads to the third point, which is the bank of Japan still maintains accommodative monetary policy with negative rates and yield curve control and BOJ has been, buying JGB, Japanese Government Bond, significantly and at this point, BOJ has about 50% of entire JGB market. And this is because the BOJ, like to achieve sustainable inflation driven by the wage growth. So Governor Kuroda, keep repeating the message that BOJ needs to see a self-sustaining shift in inflation dynamics, but by meaningful wage growth. So that's really the goal. That's why BOJ still maintains very much, accommodative policy which is very different from other central banks are doing.

Anu: Great, thank you very much, Fumi. That's very helpful. And I just want to make sure I captured this right, you said that it exceeded 2% for the first time in 30 years, the inflation which so even though it's not as high as it is elsewhere in the world, it still is really important, like a sort of a threshold to note here. And you also mentioned yield curve control, which just make sure our listeners understand what that is.

Anu: It's like a cap on the 10-year JGB, the Japanese government bond, right?

Fumi: Yes. At 25 BPS.

Anu: Got it. Okay. Great. Thanks very much for the color.

Anu: So now, just dig into this a little bit more. So what forces would cause the BOJ to make a shift?

Fumi: Yes, that's a very, very, important question. Really difficult when they're going to shift, to be honest, but there are some pressures building, coming from politics. For example, Japanese government, they recently announced the additional fiscal stimulus to support the economy and also to support high inflation. Yes, you know, 3.7% headline inflation, 2.5% core inflation. That sounds low relative to what we see in US or in Europe, but looking at Japan, 2%, 3% inflation is very high.

Anu: Yeah, meaningful, right?

Fumi: Yes, meaningful. Therefore, the cost of living in Japan has been rising, primarily driven by energy price and the food price, but consumers, they are you know, seeing the pressure. Therefore, the, you know, Japanese government has to really help them, and also the approval rating of current Japanese administration, has been declining significantly. So the Japanese government, certainly are under pressure. And other variables on the pressure is that the BOJ, has seen the inflation number one, and also potentially this could lead to higher wages in Japan. In Japan, the wage has been subdued and it's been sort of flat, but more recently, there are some signs of higher wages. And the business leaders, for example, started to comment that when they have wage negotiation in March, next year, they have to reflect higher prices, higher inflation.

Of course, we are yet to see, whether we are going to see meaningful wage growth. However, tone has been shifting. Therefore, we may see a higher wage growth. And also there are side effects coming from these accommodative policies such as Japanese yen depreciated significantly throughout the year from 115 to 150 if you look at Yen, dollar-yen cross. So that's a significant move. And primarily, this move comes from differentials between, uh, the policies in Japan and US and elsewhere. And also that leads to, you know, the yield differentials between Japan and the rest of the world.

And weaker yen is something that, BOJ and Japanese government wanted to have to really help the Japanese companies to do well in that environment. Most of Japanese companies are export-oriented, and weaker yen would help, to boost the revenue, which, hopefully, lead to higher wages down the road. However, both BOJ and Japanese government don't like the speed and also the magnitude of move, so Japanese government intervened currency market twice, most recently by spending about $60 billion. So this significant move in yen is pressuring the BOJ, to potentially lead to one of the reasons why BOJ would shift. And another is higher input costs, this is pressuring for small medium companies, uh, and leading to the higher cost of living. And this is a little bit more technical, but higher currency hedge costs. So a lot of investors in Japan when they invest outside of Japan, especially in treasuries, government bonds, fixed income securities, they usually put on currency hedge. Because of the yield gap, because of the BOJ'S policy, the FX hedge cost has risen significantly. if you need to hedge, from Dollar to Yen you'd have to pay 4 to 5% annually, so that is a significant, cost, and you have to make more to really earn the positive return.

So these are the sort of, you know, immediate side effects coming from this policy and the BOJ, Governor Kuroda has to have balance between navigating through these pressures, but at the same time achieving their goal, 2% inflation and also significant meaningful wage growth.

Anu: Great. Thank you very much, Fumi. And you know, I know you mentioned that wage negotiations are happening next year, um, but also next year, I understand that Governor Kuroda is going to be stepping down from the Bank of Japan. Do you think that could be a point for the Bank of Japan to turn less dovish?

Fumi: Yeah, that's a great question, uh, in terms of timing. Yes, Governor Kuroda's term is ending on April 8th next year and they're going to choose the successor. And during this transition, I think a couple things is very important. One, Kuroda needs to see the wage growth, at least the expectation for meaningful wage growth. two, there might be some political pressure continue to build over the course of next, four or five month. And in three, yes, um, when, Kuroda steps down, he might want to start making a move claiming that Japan now clearly out of the deflation era, we achieved the inflation and from here, we would like to start normalizing the policy while supporting the economic growth. So this could be a potential key turning point for BOJ to make a move.

Anu: Terrific. That's great. We've touched on lots of really important things here from currency and debt levels and hedging costs and wages inflation, demographics. Putting this all together, Fumi, I guess what listeners really want to hear about is the impact, right? So if the BOJ were to become more hawkish, if we do see some of these adjustments happening, what do you think or what do you perceive the impact might be on both domestic Japanese assets as well as non-Japanese and international access? And I know this may be a case of if it's when or if it's if they do this but give us some thoughts about what may happen if we see a shift.

Fumi: That's a great question. Um, it's very difficult to predict when they're going to start shifting. But what we can do is we can really think of, certain scenarios if BOJ starts shift their policy stance. Before we think about the scenarios, we look at the markets and certain markets, started to price the potential move by BOJ. For example, if you look at, OIS swap market, which is pricing the JGB, 10-year yield to be at 50 BPS. Currently, the JGB yield is at, 25 BPS or so, but the swap market is pricing, 50 BPS. So what this mean is the swap market is sort of pricing the potential move by BOJ.

And the investors are demanding a bigger premium for the risk longer-dated bond yield spike as they expect the 10-year JGB bond yield will rise if BOJ tweaks yield curve control. So that's what we kind of see in the credit market in Japan as well. But as I said Japanese investors own significant portion of global bond for example.

So if BOJ shifts, the JGB yield expected to rise gradually. Japanese investors and financial institutions may potentially shift their allocation from U.S., or you know, anywhere outside of Japan, to the domestic bond market. That would imply significant capital flow out of global bond into Japanese domestic bond market. If that happens, certainly we see a significant move in currency. As we saw recently, the Japanese yen could appreciate significantly. And also can be relevant for Korean won, Chinese yuan. So that could have a significant impact on the currency market. At the end of the day, you know, we need to look at the markets where the Japanese investors have put their capitals in.

For example, Japanese own about 20% of Australian bond market. This include the credit. That's a significant portion. So if Japanese investors, no longer need to invest outside of Japan, or even a portion of it, capital flow, in this case, outflow, out of, Australian bond market would have a huge implication on the prices.

Anu: And Fumi, just of curiosity, you know, you covered, credit markets and some thoughts on the currency. And I know you've talked about your thoughts on credit markets and currency markets but also curious about equities, both domestic equities in Japan as well as around the world.

Fumi: Yes. That's a very important question as well. So if you look at a Japanese domestic equity market, if rates rises, certainly banks would benefit, especially regional banks. They have been really suffering this low rate, negative real rate environment because lower rate would impact on their profitability. So if rates rises certainly, the side effect will be removed, therefore they will get benefit.

But at the same time, it's hard to predict. But if rates are to rise, and if BOJ tighten the financial conditions on a relative basis, certainly that will pressure the equity market. So the Japanese capital flows out of global bond market into Japanese JGB market. would imply potentially higher rates in fixed income treasury market. And that would simply put pressure on equity market.

Anu: Terrific. Thank you very much. Appreciate that. Now, Fumi, as we wrap up here, we'd love to get some of your final thoughts just on the outlook of the BOJ as well as, um, you know, what you think could be on the horizon, summarize some of your final thoughts.

Fumi: Sure. There are a few takeaways, at least a few items that we are looking into. One, certainly, it is very important to look at what's happening in Japan, inflation dynamics, growth outlook. Of course, this is related to what's happening outside of Japan. And also, certainly it's not easy to forecast when the BOJ is to make a move. As I said, you know, we can make scenarios if BOJ starts shifting and any policy shift by BOJ could have important implications. You know, the currency market may have the large impact and immediate, impact from the BOJ shift, but also the capital flow, and impact on the global rates, and then also the risk assets such as equity, as you said. So it's really, uh, key move that everyone's focusing on. Of course, it's very difficult to, again, predict, but the pressure is building, and BOJ may start making a move.

Anu: Perfect. Thank you very much. Well, Fumi, I can't let you go today without a bonus question. So, um, you know, I know that you went back to Japan earlier this year. And I also happen to know that you're a foodie. Uh, and so I'd love to know about your favorite foods that you love to eat when you're in Japan. Anything that's like a comfort food that you love to enjoy when you go back home?

Fumi: Uh, that's a great question. Uh, yes. I-I spend a little time in Japan and, uh, yes, the weaker yen helped-

Anu: [chuckles] I bet, yeah.

Fumi: -because I'm getting paid in dollar. [chuckles] Uh, so I was able to buy, um, extra toys for my, uh, little ones.

Anu: [chuckles] Good.

Fumi: Um, but uh, what I like to eat in Japan, all the food I like, um, of course, sushi's great. But, my mom's cook is the best.

Anu: Yes.

Fumi:	And that's not something that I can get anywhere outside of Japan.
Anu:	Great. Did she have a particular dish that you really love?
Fumi:	Um, so she-she makes this broth with all the veggies and meat with a soy base broth. And that's a, uh, it's really yummy.
Anu:	That sounds delicious, Fumi. And is there a specific name for that dish?
Fumi:	Yeah, uh, it's called Chikuzenni.
Anu:	Great. All right. Well, I'll have to see if there's any restaurants in New York that have that. [laughs]
Fumi:	I really enjoy it.
Anu:	Good. Well, I hope you got a lot of that when you went back home. Fumi, this has been such an interesting conversation with wide ranging implications, cross-asset implications based on, you know, potential policy shift by the BOJ in the coming months. So really appreciate hearing your take on it, on your home country and hopefully our listeners had something important to take away from today's conversation. Thank you again for being here.
Fumi:	Thank you very much.
Anu:	And to our listeners, if you've enjoyed this episode of *Disruptive Forces*, I encourage you to subscribe to the show via Apple Podcast, Google Podcast, or Spotify, or you can visit our website, www.nb.com/disruptiveforces for previous episodes, as well as more information about our firm and offerings.

.