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LSR Daily Note

November 15, 2017

Towards a more flexible Bank of Japan

- **Export strength preserving above-trend Japanese GDP growth**
- **Inflation pick-up could soon open the door to BoJ policy fine-tuning**
- **Yield Curve Control 'face-lift' possible in 2018 as the macro mix improves**

Exports in the driver's seat

Strong exports continue to be the driving force behind Japanese growth. Real GDP expanded at an above-trend 1.4% quarterly annualised rate in Q3, marking the longest period of expansion since 2001 and taking the Q1-Q3 average to 1.7%, close to the BoJ's forecast for the full year. What keeps falling short of the Bank's estimates is inflation. But what if this gap were to shrink over the coming quarters?

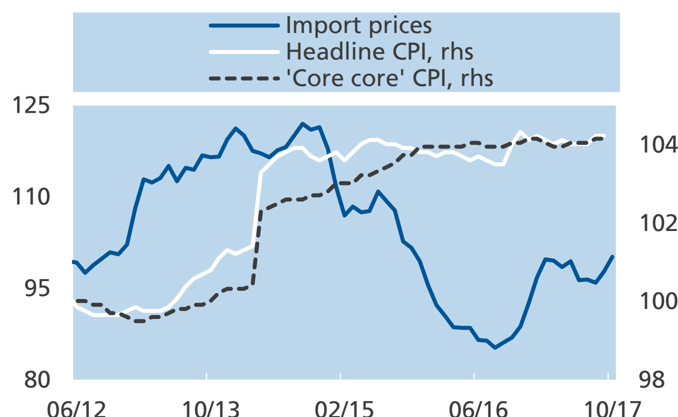
A pick-up in inflation?

Price pressures are mounting, albeit slowly. Headline CPI inflation has trended higher since turning positive in Q4 2016, and it looks like 'core core' inflation (ex food/energy) bottomed out in Q2 2017. Other measures, such as the BoJ's core and trimmed-mean CPI indices, point in the same direction. Surveys also suggest firms are under growing pressure to pass rising wholesale prices on to their customers. Against the backdrop of very tight labour market conditions, this could slowly pave the way for progressively larger base salary increases for full-time employees (for more, see our recent Macro Picture).

With the synchronised world economic recovery on a firm footing and base effects turning supportive going into 2018, annual Japanese CPI inflation could approach 1% by the end of Q1. If it stabilises around that rate, there is a decent chance that inflation expectations will shift higher in tandem, especially as PM Shinzo Abe appears intent on opening the fiscal taps somewhat. Survey-based measures of corporate and household

Japan CPI inflation *vs* import prices

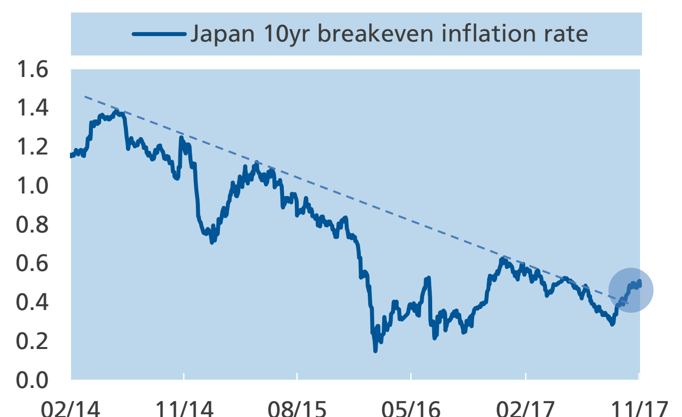
2012 average = 100, sa



Source: Datastream, TS Lombard

Signs of life in inflation expectations

Per cent



Source: Bloomberg, TS Lombard

inflation expectations still leave a lot to be desired, although they have improved since mid-2016. BoJ Governor Haruhiko Kuroda frequently refers to 'negative price shocks' that can mute the effect of forward guidance on inflation expectations, citing the deflationary impulse from collapsing crude prices during 2014/15 as a prime example. This time round, however, the oil market is working in the BoJ's favour. With the 10yr breakeven inflation rate recently climbing above the downtrend in place since mid-2014, the market may be sniffing a sea change.

BoJ policy fine-tuning on the cards

To be sure, there is still a long way to go until the 2% target is in sight and the Bank can declare success in dispelling the private sector's deflationary mindset. So the current policy framework can be expected to remain in force as far as the eye can see. But this does not preclude some policy fine-tuning to match the evolving domestic macro backdrop. Over the coming quarters, the BoJ may be in a position to upgrade its assessment of the risks to its inflation outlook from 'skewed to the downside' to 'balanced', paving the way for a reconfiguration of monetary settings – irrespective of whether or not Mr Kuroda is re-appointed.

A closer look at recent official rhetoric reveals a subtle shift in tone. Last month, Deputy Governor Hiroshi Nakaso said the "Bank will make adjustments to the shape of the yield curve as necessary…taking into account developments in economic activity and prices as well as financial conditions". Governor Kuroda echoed that view in a speech this week, in which he also delved deeper into the adverse financial impact of artificially low interest rates on the private sector. In the same vein, October's BoJ minutes mentioned that "additional easing measures will likely bring about side effects that outweigh positive effects". Board member Yukitoshi Funo has also suggested that the BoJ will not necessarily keep all its policy tools unchanged until 2% inflation is hit.

'Stealth' taper and the yield curve

The Bank has already achieved a 'stealth' QE taper that both alleviates scarcity concerns and removes tantrum risk by rendering exit talk redundant. While the ECB has taken pains to avoid setting an end-date for its QE, Governor Kuroda has managed to get away with not even announcing the start of his taper. Looking ahead, tweaking the parameters of Yield Curve Control (YCC) – for example, by raising the 10yr target and/or widening the band around it – in response to sustained improvement in the growth/inflation mix could make sense. First, it would signal a vote of confidence in the recovery. Second, it is attractive from a risk management standpoint, affording the Bank more room to respond to outsized moves in US yields – whether these are up (so the BoJ would need to ramp up JGB purchases by less) or down (so there would be more room for JGB yields to drop, protecting the yen from appreciation pressure). Third, the 'initial conditions' have changed since the launch of YCC in 2016: with dollar-yen up by around 12%, the BoJ is now more preoccupied with maintaining current levels than engineering yen weakness.

Global connections

The caveat to all this is, of course, that Japan's cyclical upswing hinges on external reflationary tailwinds, leaving both the economy and the BoJ's credibility vulnerable to a deterioration in global macro conditions. At the same time, however, the implications of the BoJ edging closer to 'turning the corner' go beyond Japan. So far, the bond market has focused primarily on the implications of moves in US/Bund yields for Japanese monetary policy. Evidence of even a minor shift in the BoJ's stance could trigger a pick-up in JGB volatility that reverberates globally.

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