BOJ takes a slow, steady approach to reducing bond purchases

Slow stance may disappoint some, but the BOJ is relatively more flexible with time

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The Bank of Japan (BOJ) kept interest rates on hold at its June meeting as widely expected. However, the decision mildly disappointed market participants who had expected an imminent reduction in the BOJ's monthly Japanese government bond (JGB) purchases. They anticipated a decrease from the current Japanese yen (JPY) 6 trillion to a range of JPY 5 to 6 trillion, and the ensuing disappointment drove dollar/yen modestly higher. The BOJ did indicate that it planned to reduce its bond purchases, but not until its next policy meeting in July along with the release of the next quarter's Outlook for Economic Activity and Prices.

The market had also anticipated a more detailed guidance on upcoming rate hikes, given the overnight rate's central role as the BOJ's main monetary policy tool. The central bank, however, did not provide such guidance. At the post-policy meeting press conference, BOJ Governor Kazuo Ueda did not give much further forward guidance either regarding the central bank's balance sheet reduction or rate hikes. Ueda clarified that plans to reduce the BOJ's balance sheet is to return interest rates and bond price determination to the market. When asked about factors that could drive the next rate hike, including a weak yen, Ueda gave a very general reply. The governor said that the BOJ would remain dependent on data, particularly on whether there is an increased likelihood of achieving its 2% inflation target (if inflation rises in line with the central bank's outlook). Ueda did not rule out the possibility of a rate hike in July if the data justified such a move.

Until the BOJ provides more details in July, the central bank will continue its JGB purchases as announced at the March policy meeting, which marked the end of its negative interest rate policy, yield curve control (YCC) scheme and purchases of ETFs and REITs. The central bank governor reiterated at the post-meeting press conference that the BOJ will consult market participants and thereupon announce a plan following its July policy meeting to reduce bond holdings on the BOJ's balance sheet over the next one to two years.

Unlike the Fed and ECB, the BOJ has more flexibility with time

Indeed, the BOJ's reluctance to provide additional guidance on bond purchase reductions contrasts with the more time-sensitive opinions expressed at its April meeting. It was stated at the time that given the gradual exit from YCC facilitated a smooth exit from the previous policy framework, it was important for the BOJ to proceed reducing its JGB purchase amounts in a timely manner.

Nonetheless, as one policy board member had pointed out at the time of the BOJ's departure from its prior policy framework in March, the risk of falling into wage inflation—as seen in the US and Europe—was low and there was time to encourage more lasting pass-through by small and mid-size firms in particular.

Additionally, amid a generally robust recovery picture, there remain a few uncertainties regarding the domestic as well as external outlook that might have been behind the BOJ's decision to buy additional time before withdrawing additional stimulus. For example, consumption and private investment dragged Q1 Japanese GDP into negative territory, although it remains to be seen how much of this was the impact of temporarily-stalled auto production.

Additionally, while there is ample evidence of labour supply shortages and upward wage pressures, led by the "Shunto" round of wage negotiations in spring, increases in real wages have yet to materialise. This is because consumption has primarily increased as households have reduced their savings. The next turn of the "virtuous circle", including actual rises in real wages, remains to be seen, although it is reasonable to expect these increases to occur eventually.

Referring back to the Summary of Opinions from the BOJ's April meeting, a key factor in considering further adjustments to monetary accommodation was the central bank's need to observe "positive corporate behaviour through this summer". Specifically, the BOJ was looking for continued solid business fixed investment and an improving trend in private consumption led by wage hikes toward the second half of this year. This point is consistent with the BOJ's decision to remain on hold until July when additional data on corporate and household developments may be available.

What about dollar/yen?

Although the temporary spike in dollar/yen to above 160 was met by intervention from the Ministry of Finance, the BOJ has remained much more circumspect about the potential for yen weakness to damage Japan's purchasing power. Looking beyond short-term cost-push factors, the BOJ also highlighted in its April Summary of Opinions the potential benefits of increasing production and income, such as a rise in inbound tourism and manufacturers moving their overseas production sites back to Japan.

As we highlighted in our article The yen: how weak is too weak?, the Japanese currency weakening slightly from current levels may not be sufficient enough to undermine Japan's virtuous circle. The BOJ would likely be more concerned about a sustained trend toward further yen weakness, rather than the dollar/yen pair briefly spiking to new highs.

What's next? QT in July less likely to disappoint

What we do know is that the BOJ, given all else remains equal, had signalled a reduction of bond purchases in July. We believe that such a reduction is likely to be less disappointing for market participants than today's meeting. The reason for this is that the BOJ's plans to conduct "Bond Market Group" meetings with bond market participants, who might express their expectations to the central bank. Given that the BOJ is keen to avoid causing dislocations in the bond market, we believe that the primary function of these meetings is for the central bank to gauge expectations about the magnitude and timing of quantitative tightening (QT), so as to align their proceedings closely with market expectations.

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