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Bank of Japan Doubles Down on Easy Monetary Policy

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Summary

- Even with the Japanese yen coming under pressure this year, the Bank of Japan (BoJ) has opted to stick with its strategy of accommodative monetary policy. At today's announcement, the BoJ kept policy rates steady; however, it reinforced its plan to limit the rise in Japanese Government Bond (JGB) yields by offering to purchase bonds through fixed-rate purchase operations.
- Japan's economy is still subdued, and macroeconomic conditions do not warrant an adjustment of policy settings. In our view, only operational or implementation issues of the bond purchasing plan would prompt the BoJ to even consider adjusting policy. We estimate the BoJ owns around 50% of the outstanding JGB market, and after today's announcement, we believe BoJ policymakers are comfortable with some further increase in the ownership share of the Japanese sovereign debt market, if needed.
- Going forward, as long as the BoJ is willing to cap JGB yields, yen weakness will largely depend on the evolution of U.S. Treasury yields. Verbal intervention to prevent a more significant yen depreciation is possible; however, we suspect meaningful FX intervention would not take place until the yen reached JPY140.00, possibly even higher. As supportive BoJ policy stays in place, the yen should continue to weaken. Our medium-term USD/JPY target is JPY133.00 target and, indeed, significant upside risks to that forecast exist.

Bank of Japan Pledges to Keep Bond Yields Low

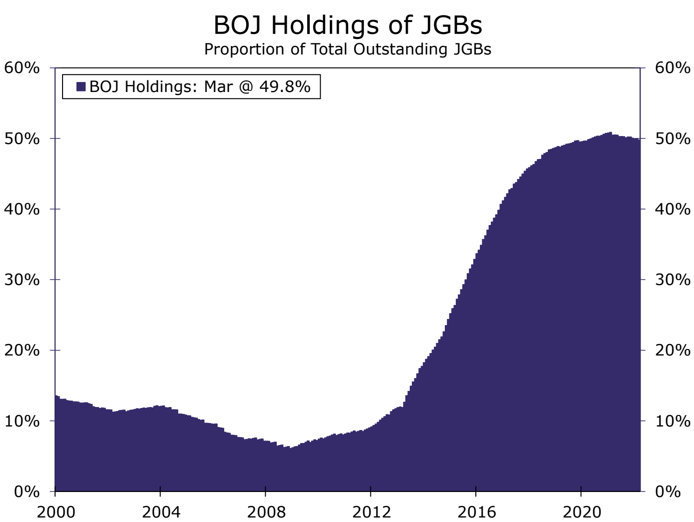
The Bank of Japan (BoJ) held its monetary policy stance steady at today's announcement but, in a significant development, reinforced its pledge to cap any rise in Japanese bond yields. In terms of the particulars of today's announcement, the Bank of Japan:

- Maintained its policy rate at -0.10%.
- Kept its target for 10-year Japanese government bond (JGB) yields at 0.00%.
- **Most significantly, BoJ policymakers said the central bank would purchase a necessary amount of government bonds, without setting an upper limit, so that 10-year JGB yields would remain near that target. In particular, the BoJ said it will offer to purchase 10-year JGBs at 0.25% every business day through fixed-rate purchase operations.**

In particular, the guidance of the fixed rate purchase operations attracted the attention of market participants. It also prompted a sharp weakening of the yen, with the yen 2% weaker on the day and the USD/JPY exchange rate trading beyond JPY130.00 for the first time since 2002.

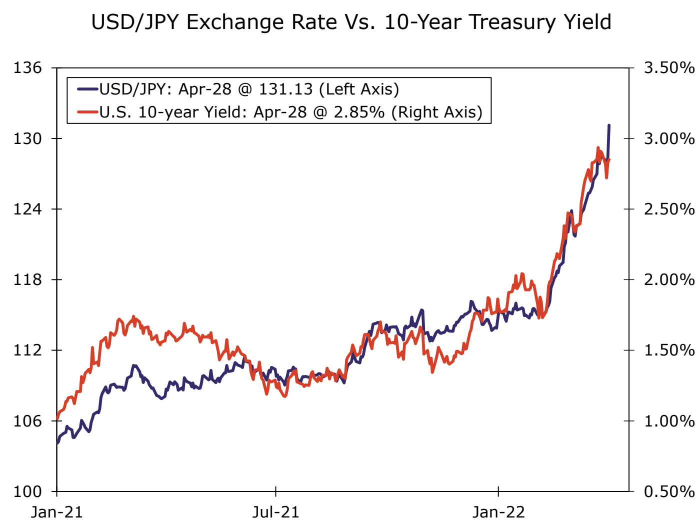
Purely from a macroeconomic point of view, the Bank of Japan is clearly comfortable with its accommodative monetary policy stance. Economic conditions, in our view, do not warrant and are unlikely to trigger a shift in Bank of Japan monetary policy for the foreseeable future. The economy has started 2022 on a subdued note, including a softening in the Q1 Tankan survey, and mixed data on retail sales and industrial output. Meanwhile, although inflation has quickened, the acceleration has been modest. The March CPI rose 1.2% year-over-year but, excluding food and energy, the CPI actually fell 0.7%. These trends are reflected in the Bank of Japan's updated economic projections, with the GDP growth forecast for FY2022 lowered to 2.9%, while the core CPI forecast for 2022 was raised to 1.9%.

Figure 1



Source: Datastream and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Instead, we believe the only factors that would prompt the Bank of Japan to even consider adjusting policy would be operational or implementation issues. For example, the proportion of outstanding JGBs held by the Bank of Japan has risen sharply over the past several years. We estimate the BoJ currently owns close to 50% of total outstanding JGBs (Figure 1). While ideally we suspect the BoJ would prefer that figure did not move substantially higher, today's announcement indicates the central bank is prepared to accommodate some further increase in its ownership of the JGB market. Moreover, we note the government's JGB issuance plan for FY2022 envisages new JGB issuance of ¥36.9 trillion. Should the BoJ want to keep its ownership at around half of outstanding JGBs, it would thus want to limit its net JGB purchases to around ¥18.5 trillion for the fiscal year. That is broadly similar to the pace of purchases that has prevailed in the most recent years. Whether the BoJ can keep its net purchases around that pace could depend in part on whether U.S. Treasury yields move sharply higher from current levels. That said, so long as there was not a further sharp spike in U.S. yields, and given the BoJ indicated its willingness to cap the rise in JGB yields, we do not anticipate any change in the zero percent 10-year JGB yield target, with a tolerance range of +/-25 bps, for the foreseeable future.

The other consideration is that the weakness of the yen could prompt a meaningful FX intervention response from Japanese authorities, in the context of verbal warnings today from both Japan's Ministry of Finance and, to a lesser extent, the Bank of Japan. Again, so long as the Bank of Japan continues to cap JGB yields, yen weakness will largely depend on how much higher U.S. Treasury yields move. The Japanese yen has sold-off almost in lockstep with the rise in U.S. Treasury yields for well over a year at this point, and we expect those same dynamics to continue going forward (Figure 2). While we expect further jawboning is possible, we do not envisage meaningful FX intervention from Japanese authorities to support the yen until the USD/JPY exchange rate reaches JPY140.00, or perhaps higher. The bottom line is that, with the Bank of Japan doubling down on its easy monetary policy and JGB yields not likely to rise from current levels, the forces driving a softer yen will likely persist, suggesting significant upside risk to our medium-term USD/JPY exchange rate target of JPY133.00.

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