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BOJ takes significant yet incremental step on path back to "normal" rates

End of negative rates, yield curve control and ETF purchases smoothly digested

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The "trial balloons" of media announcements in advance of today's interest rate hike by the Bank of Japan (BOJ) —its first in 17 years—apparently did their job, as the end of its negative interest rate policy, yield curve control (YCC)[1] and ETF purchases were smoothly digested by markets. Indeed, the BOJ had already embraced greater flexibility on YCC and has significantly decreased its ETF purchases well prior to the policy decision. Neither the yen nor the Nikkei showed extraordinary movements, and Japanese Government Bond (JGB) 10-year yields so far remain contained below 80 basis points (bps).

In prior speeches (e.g. Deputy Governor Shinichi Uchida's much talked-about speech on 8 February), the BOJ made clear that it was watching the market for signals that its policy moves were well-anticipated, and this watchfulness appears to have paid off. The 7-2 vote also showed the comfortable majority whereby the decision was made. Overall, it is one significant yet incremental step on the path back to "normal" interest rates.

It is important to remember that shifting from negative to 0-10 bps overnight rates means more that the BOJ can return to operating policy via short-term rates, instead of via a set of unconventional policy tools, and that these rates remain extremely accommodative[2]. The BOJ is signalling to markets to expect accommodation to remain, and that

[1] **Yield-curve control (YCC):** It is a form of monetary policy tool, mainly associated with Japan, through which the BOJ caps the 10-year Japanese government-debt yield at around zero since 2016.
[2] **Accommodative:** The term is used to describe the monetary policy when a central bank seeks to expand the overall money supply through bond purchase with a view to lower interest rates sufficiently to spur an economy.

although Japan is closer to the "virtuous circle[3]" of reflation[4] that includes household willingness to shoulder higher prices, the achievement of these conditions is not immediate. We are now in wait-and-see mode, particularly given "uncertainty" coming not only from Japan, but also from overseas economies. As such, there remains no immediate catalyst for the BOJ to continue hiking.

Evidence of real income growth, ongoing productivity-enhancing investment and positive sentiment from corporates, recovery in domestic consumption remain to be seen before any next move, given reflation is happening in a manner conducive to withdrawing stimulus very deliberately. Also, we have not seen cash decisively leaving household balance sheets for more yield-bearing investments; so long as reflation remains intact, such a savings-to-investment move should be an eventual characteristic of Japan's "virtuous circle", helped along by the tax advantages afforded by 2024 "new Nippon Individual Savings Account (NISA)" enhancements. This would be the type of signal for the BOJ to proceed with further policy normalisation.

One thing to watch remains Japan's current account, which has benefitted from ultra-low rates domestically even as central banks tightened elsewhere. The main contribution to Japan's external surplus is now the income account, as one might expect from a country with lower rates than elsewhere in the world. This composition explains why the yen remains on the historically weak side.

It remains to be seen whether the ramifications of the termination of the world's last negative rate regime may be felt elsewhere. For now, with the BOJ reluctant to signal further policy tightening, markets do not appear ready to give up on the "carry trade[5]" just yet—immediately after the decision, the yen remained under pressure following the decision, one sign that it is still being used to purchase higher-yielding overseas assets.

Logistically, this frees the BOJ up to focus its full energies on the Outlook for Economic Activity and Prices next month. We anticipate this to underpin the central bank's decision to exit unconventional monetary policy. However, it may also draw attention to risks from overseas—as well as the dependency upon households' consumption and investment— (what they will actually do when real income appears to be growing at last) to carry the next "turn" of the "virtuous circle" on which further accommodation withdrawal[6] likely depends.

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[3] "**Virtuous cycle**": A chain of events in which one desirable occurrence leads to another which further promotes the first occurrence and so on resulting in a continuous process of improvement.
[4] **Reflation:** A set of expansionary economic policies (fiscal or monetary) designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. The term may also be used to describe the first phase of economic recovery after a period of contraction.
[5] **Carry-trade:** The practice of borrowing in a currency with low interest rates and investing the proceeds in a higher-yielding currency.
[6] **Withdrawal of accommodation:** Reducing the money supply in the system which will rein in inflation further.

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