QNB Economics
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The Bank of Japan is set to navigate against global monetary trends

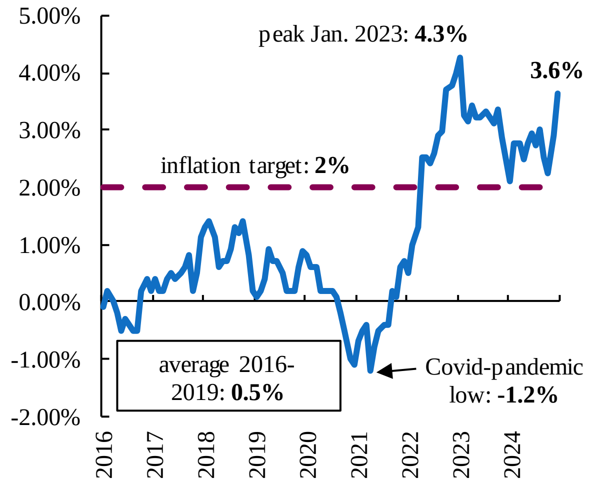
The aftermath of the Covid-pandemic brought inflation across advanced economies to skyrocketing levels not seen in decades. Following the pandemic and the Russia-Ukraine War, the “supply shock” of confinement measures and geopolitical disruptions were coupled with the “demand shock” from unprecedented policy stimulus, which drove inflation rates to multi-decade highs across the globe.

As a response, most major central banks, such as the U.S. Federal Reserve and the European Central Bank, embarked on aggressive monetary policy tightening cycles to control inflation. The Bank of Japan (BoJ) was a peculiar outlier, following a different policy path that reflected Japan’s decades-long struggle with deflation and stagnant economic activity. In stark contrast to its peers, the BoJ kept its negative short-term interest rate of -0.1% unchanged. This “ultra-loose” monetary stance led to a depreciation of over 40% of the Japanese Yen (JPY) against the U.S. dollar in October 2022. The sharp currency depreciation added to the different factors that pushed Japanese consumer price inflation to a peak of 4.3% year-over-year in January 2023, a level that had not been reached in this country in over three decades.

After years of negative policy interest rates, the BoJ finally reacted with a highly-cautious hike of 15 basis points (b.p.) in March 2024, signalling the beginning of a much-awaited process of monetary policy normalization. Over the last year, the BoJ implemented additional hikes of 20 and 25 b.p., taking the policy rate to 0.5% at a moment when the major central banks of the US and Europe were already moving in the opposite direction towards easing. In this article, we discuss why the BoJ will continue to move against the global trend, and maintain its gradual process of monetary policy normalization.

First, although inflation has come down from its peak, it remains stubbornly high with a recent upward tick that has renewed concerns. Inflation has remained above the 2% target of monetary policy for almost three years. Alarmingly, inflation surged to 3.6% in December last year, fuelled by higher food prices, the suspension of government energy subsidies, and wage increases. This new surge in prices reignited fears of a potential deanchoring of inflation expectations.

Consumer Price Inflation in Japan
(%, year over year)

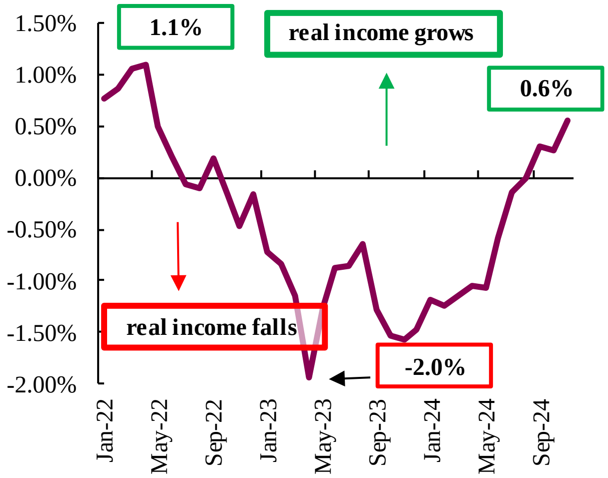


Source: Bank of Japan, Haver Analytics, QNB Economics

Additionally, the government is implementing significant expansive measures, including a record draft budget of JPY 115.5 Tn (USD 735 Bn) for the fiscal year 2025, and a stimulus package of around USD 90 Bn. The measures aim to support households and boost economic growth, which could further add to price pressures. Persistent inflation and renewed price pressures give the BoJ one of the key arguments in favour of additional monetary policy tightening.

Second, the Japanese economy is expected to show a recovery this year, with a more favourable external demand and improving real income. In this context, the current interest rate environment and expected monetary direction are accommodative. The yen has accumulated a depreciation of close to 40% in the last three years. A weaker currency is improving the competitiveness of export-oriented industry by making goods and services more affordable in the global market. The currency shift has notably benefited tourism, one of Japan's largest export sectors. In 2024, tourist spending reached USD 50.8 Bn, with an all-time high of 34 million visitors, underscoring the sector's substantial contribution to the economy. In addition, key export oriented industries, such as automotive, machinery, and electronics are benefitting from better price competitiveness.

Monthly Labor Income Adjusted by Prices
(% change year-over-year, 4-month moving average)



Source: Haver Analytics, QNB Economics

Gains in real income are providing an additional boost to the economy. Since mid-2024, growth in wages adjusted for prices began to recover, on the back of the "Shunto agreement" – the yearly negotiations between labor unions and corporate leaders – that led to average wage increases of 5.6%, the largest in 33 years. Going forward, the largest labor union federation aims to reach an agreement that would deliver another significant wage increase, which implies an improvement in the purchasing power of households and further support for consumption and economic growth. An improved macroeconomic outlook for this year gives the BoJ room to further increase its policy rates.

Third, in spite of the interest rate increases, monetary conditions remain highly accommodative. The current level of the policy rate at 0.5% is significantly below current and expected inflation rates, indicating that the real interest rate is deep in the negative range. Moreover, it is well below the level that is considered its "neutral" level for the economy (i.e., around 1.5%), which neither stimulates nor restrains economic activity. Similarly, although long-term interest rates have risen from their troughs around 0%, they still remain close to multi-decade lows. Long-term interest rates are key for the economy, given their influence on business investment and household demand. The current macroeconomic context suggests that the BoJ should move further towards normalizing currently stimulative financial conditions.

All in all, we expect the BoJ to continue its gradual process of interest rate normalization, with two additional 25 b.p. hikes this year that would take the policy rate to 1% on the back of still-high inflation, an improving macroeconomic outlook, and the need to adjust accommodative financial conditions.

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