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Economic Letter from Asia: Cherry Blossoms

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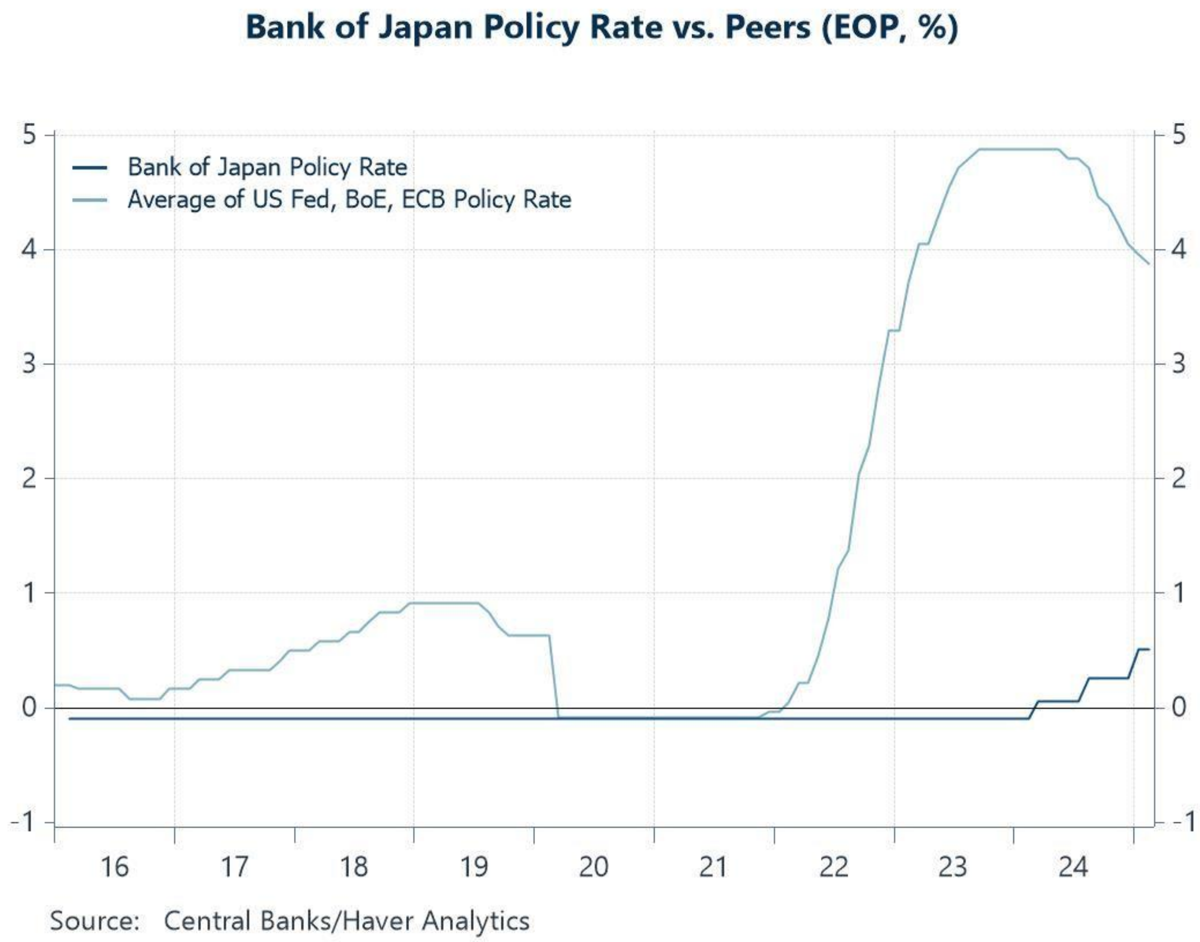
Written by Tian Yong Woon

This week, our focus turns to Japan as the Bank of Japan (BoJ) prepares for its key policy decision on Wednesday. While the BoJ has made meaningful progress toward monetary policy normalization, it remains an outlier among major central banks, many of which have already begun easing after previous tightening cycles (chart 1). The rationale for Japan’s shift is clear—after decades of chronic price stagnation during the so-called Lost Decades, the country has finally experienced sustained inflation, warranting a gradual recalibration of monetary policy (chart 2). That said, Japan’s inflation story is not without challenges. A rice shortage has driven prices sharply higher, underscoring supply-side pressures in an economy that remains vulnerable to commodity price fluctuations (chart 3). Meanwhile, wage growth is also picking up, with annual wage negotiations delivering encouraging preliminary results—this spring, it’s not just cherry blossoms that are in full bloom (chart 4). These developments have been reflected in rising Japanese government bond yields and a notable recovery in the yen against the US dollar (chart 5). However, part of this yen strength may also be linked to Japan’s recent divestment of US Treasuries, as the country has significantly reduced its holdings over the past year (chart 6). As the BoJ navigates its policy shift, the coming months will be crucial in determining whether Japan can sustain its inflation momentum without sacrificing economic stability.

Japan monetary policy

The Bank of Japan (BoJ) initiated a major shift last year, gradually moving away from its eight-year-long negative interest rate policy, signalling a transition from its ultra-loose monetary stance. Since then, the BoJ has raised interest rates three times, citing positive developments in inflation and wage growth—topics we will explore in more detail shortly. However, as shown in chart 1, the BoJ remains far behind its peers in the policy cycle. Major central banks like the US Federal Reserve, the Bank of England, and the European Central Bank have already completed their tightening cycles and are now easing, as inflation has become better-behaved. Moreover, Japan’s real policy rates remain deeply negative, with low policy rates persisting while inflation continues to rise. Despite this, investors do not anticipate another rate hike during this week’s BoJ monetary policy meeting, with the next tightening move expected sometime in Q3.

Chart 1: Bank of Japan policy rate vs. peers

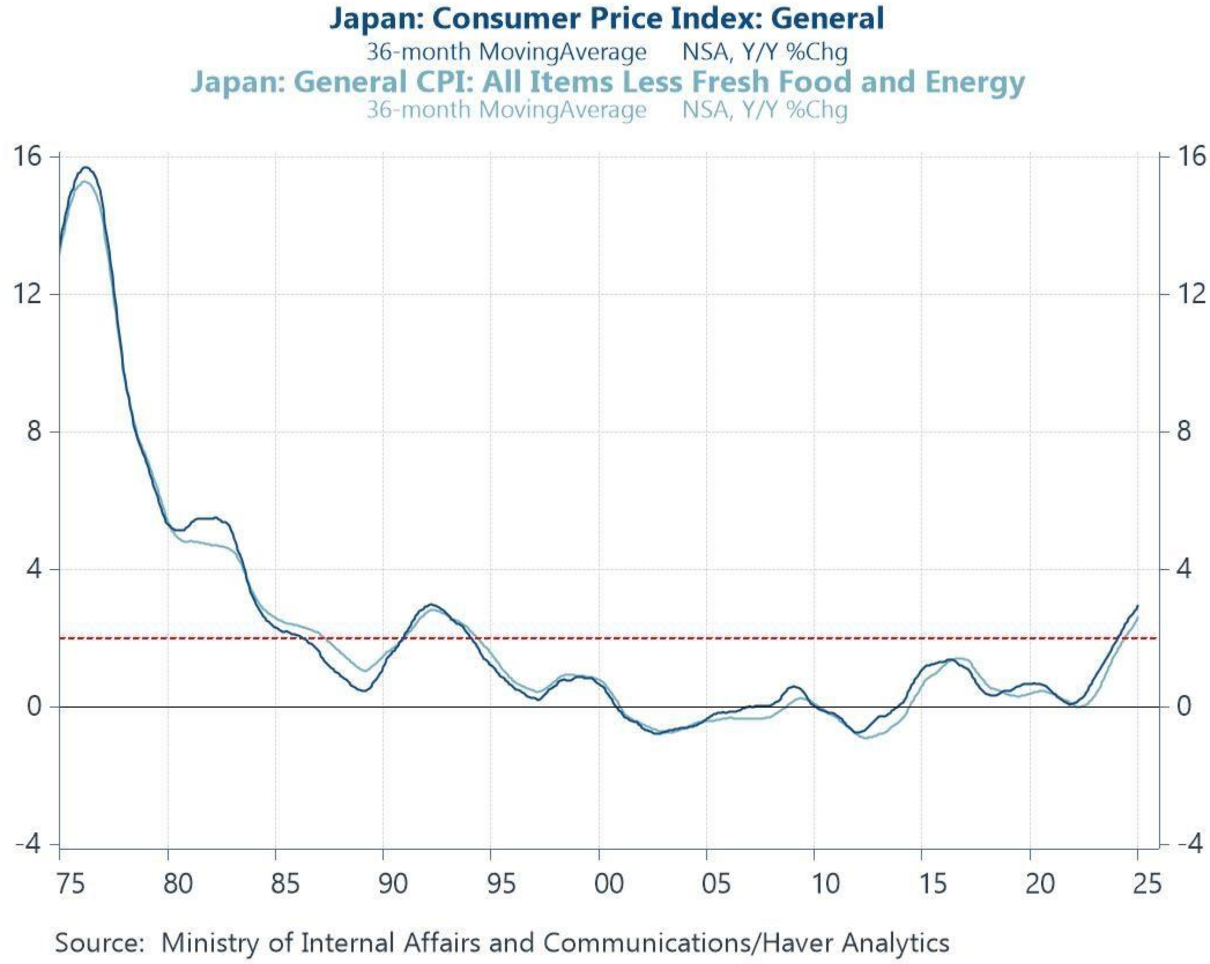


Inflation trends

The significance of Japan’s recent inflation trends should not be understated, especially considering its prolonged period of very low or even negative inflation during the "Lost Decades," a time marked by minimal price changes amid persistent economic stagnation. It was not until the implementation of former Prime Minister Abe’s "Three Arrows" strategy—including unconventional monetary policies like negative interest rates and massive quantitative easing—that inflation in Japan began to rise. Years after Abe’s term ended in

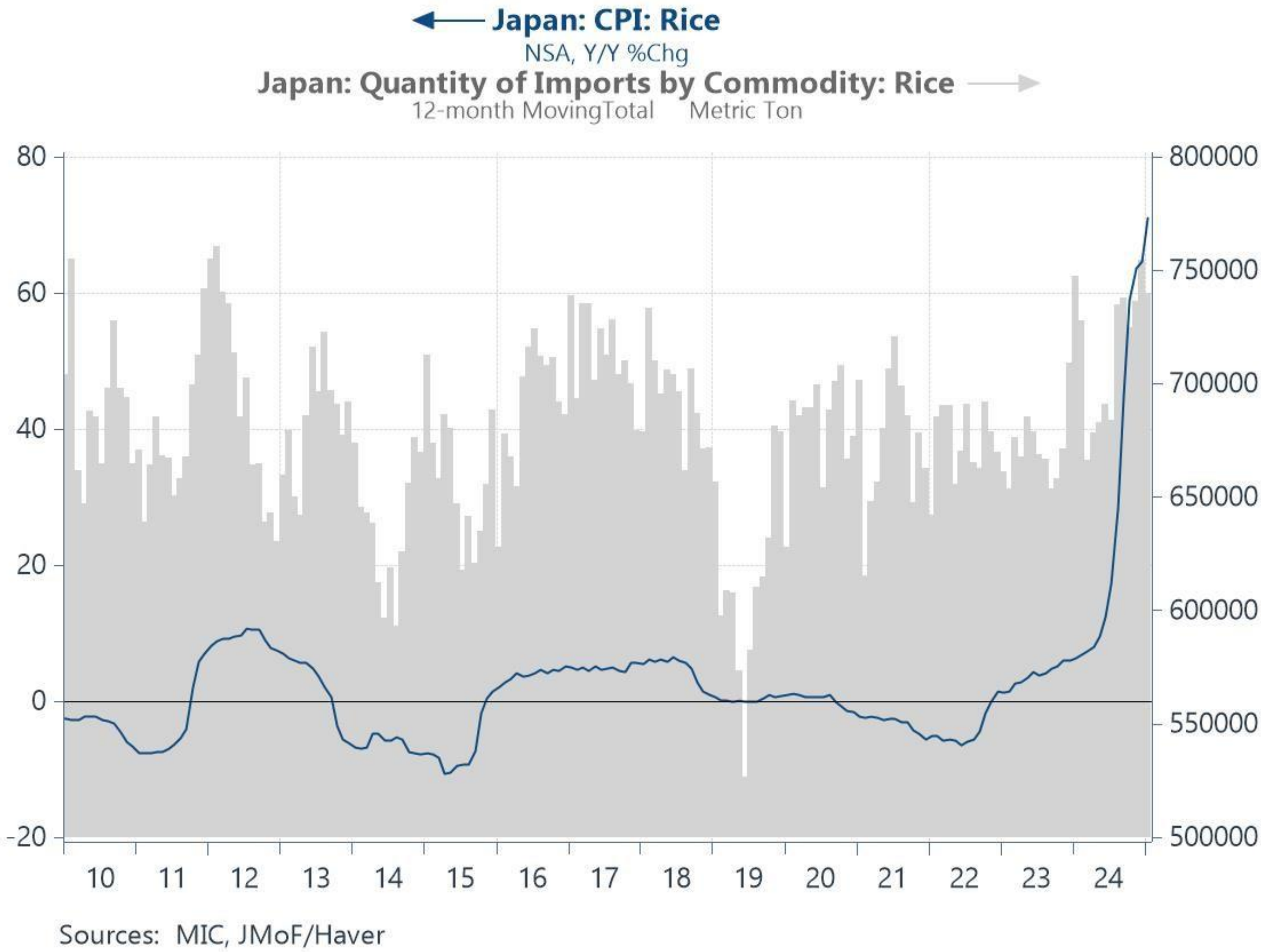
2020, with many of his strategy approaches—particularly ultra-loose monetary policy—remaining in place, Japan finally experienced a sustained reflationary trend, accompanied by higher nominal wage growth. Even more encouraging is that inflation has been rising in "core core" items, as shown in chart 2. Today, Japan has reached a point where inflation and wage conditions are deemed strong enough by the BoJ to support the gradual normalization of its monetary policy.

Chart 2: Japan average CPI inflation



A deeper – more granular – examination reveals a particularly striking development: the sharp surge in rice prices in Japan. As shown in chart 3, consumer rice prices have surged at an accelerating rate, rising by over 70% year-over-year in January. This price increase was driven by a combination of supply-side disruptions and underlying structural vulnerabilities in the Japanese rice market. The record-breaking summer heat of 2023 severely impacted harvests, reducing domestic supply, while natural disaster warnings triggered a wave of panic buying, further exacerbating price pressures. Compounding these short-term shocks, Japan's historically low rice stockpiles and limited domestic production capacity have magnified the impact, leaving the market highly sensitive to even modest supply fluctuations. The situation has become so dire that the Japanese government has begun auctioning off part of its rice stockpile—a first-ever move aimed at alleviating supply-side concerns. While one might think that increasing rice imports could help address the issue, the reality is more complicated. Japanese consumers are accustomed to specific rice types, particularly short-grain rice, which is integral to their diet and traditional dishes. As such, imports from other countries do not always serve as perfect substitutes. Looking ahead, Japan's Ministry of Agriculture plans to nearly eightfold its rice exports by 2030. This initiative not only aims to expand Japan's rice export market but also serves as a strategy to reallocate rice production capacity for domestic consumption in case of another shortage.

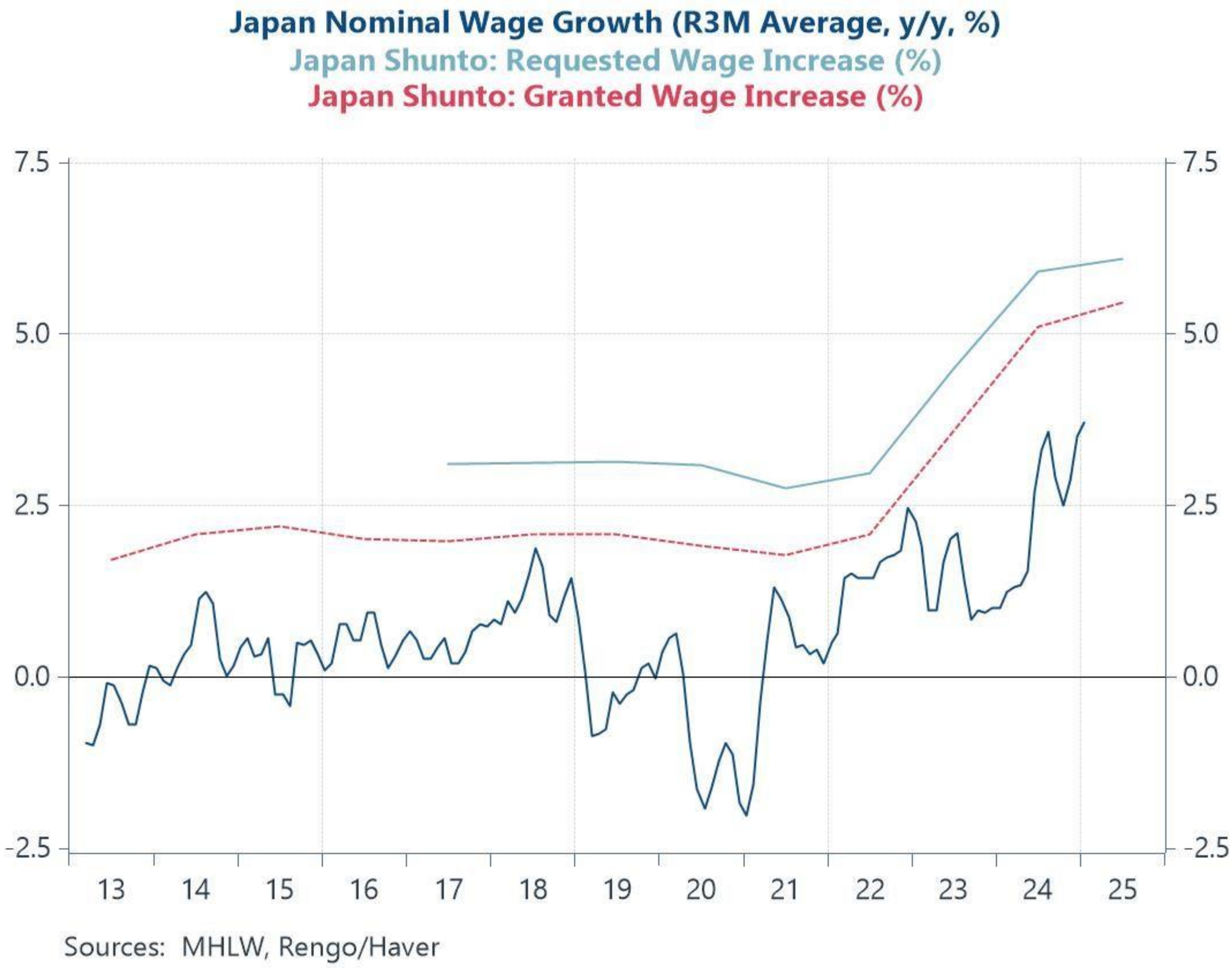
Chart 3: Japan rice prices and imports



Spring wage negotiations

The time has come again for Japan's annual spring wage negotiations, known as "Shunto." These negotiations have gained increasing attention in recent years, as the Bank of Japan (BoJ) emphasizes wage growth as a key indicator of its desired "virtuous cycles" between wages, inflation, and spending. Such cycles would support the BoJ's case for tightening monetary policy. Ahead of the national-level wage outcomes, investors closely monitor the results from major labour union groups, with RENGO being the largest. RENGO provides several preliminary reports before its final one, allowing investors to gauge wage growth trends throughout the process. This year, the preliminary results have been very encouraging. For the first time in over three decades, the weighted average requested wage increase has exceeded 6%, as shown in chart 4. Granted wage increases have also risen, reaching 5.5%. If the national-level figures follow the trends seen in RENGO's reports, it would further strengthen the BoJ's case for continued policy normalization.

Chart 4: Japan wage increases

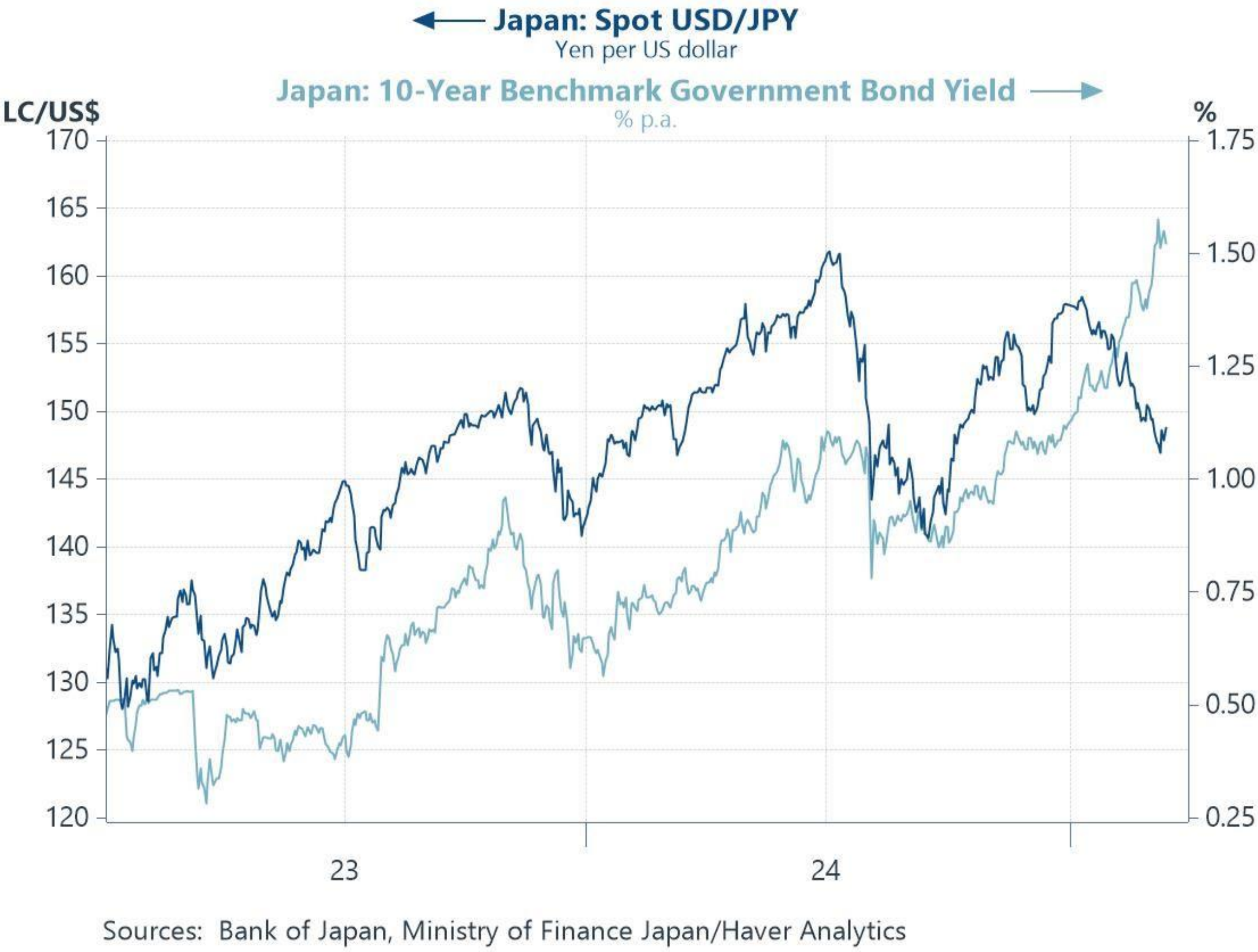


Japanese yields and the yen

The yen has surged against the US dollar this year, recovering much of the ground it lost in 2024, although a complete recovery has yet to materialize. This rally has largely been driven by rising Japanese yields, while US yields have fallen, making the yield spread more favourable for the yen. Several factors likely contributed to the increase in Japanese yields, including market expectations for higher BoJ policy rates, rising inflation in Japan, and a shift in investor sentiment towards the Japanese economy. These factors have helped strengthen the yen despite the broader global economic environment. As shown in chart 5, the correlation between the USD/JPY exchange rate and 10-year Japanese government yields has weakened in recent months. This shift highlights an interim decoupling between US and Japanese yields, suggesting that the recent increase in

Japanese yields may not have been directly influenced by the fall in US yields, as has often been the case in the past.

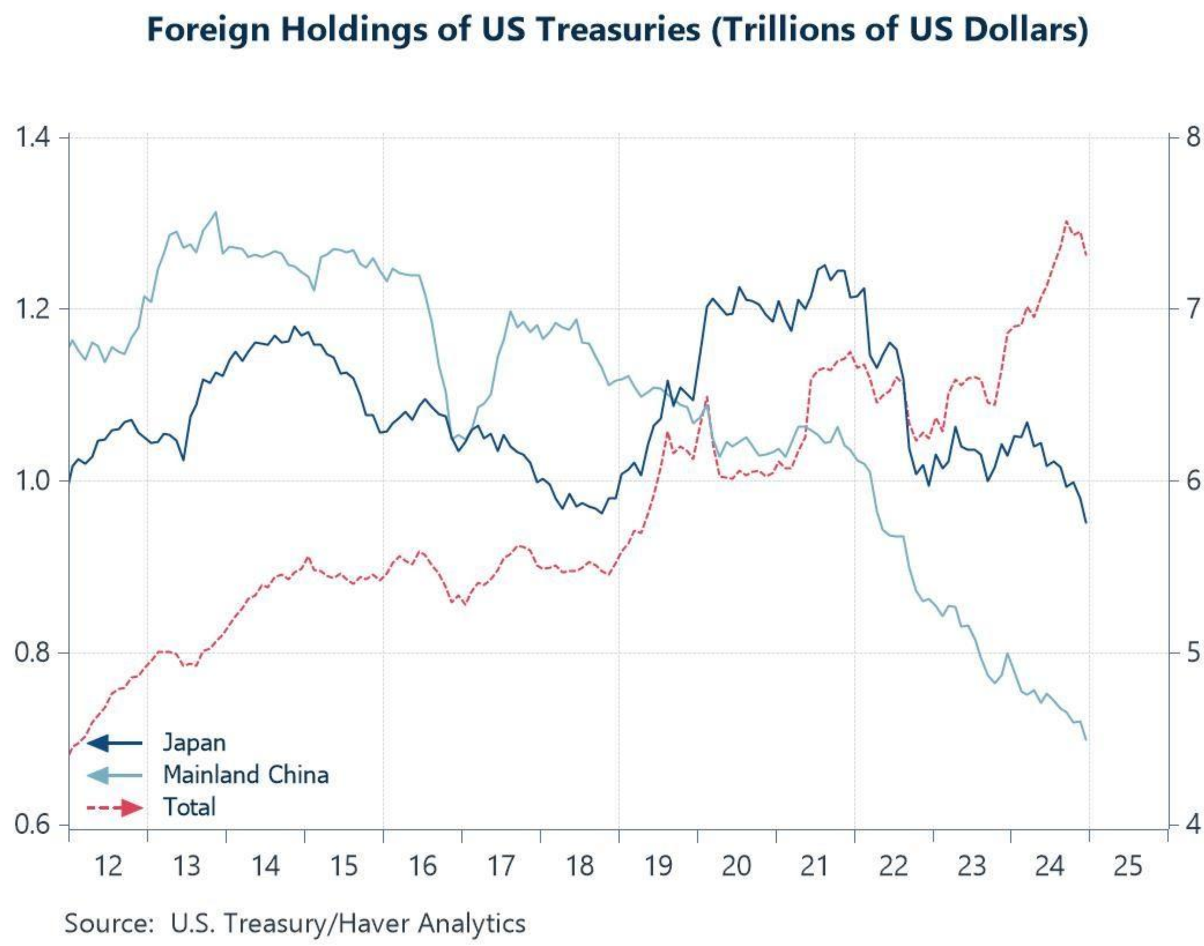
Chart 5: Japanese yields and the yen



Asia's US Treasury holdings

Recent trends in Asia's US Treasury holdings highlight that Japan and China remain two of the largest foreign holders. As such, meaning any significant shifts in their positions can directly influence US yields. China has been steadily reducing its US Treasury holdings over the past decade, with more pronounced divestments since 2022. Japan, meanwhile, has seen a renewed wave of Treasury sales since 2024, marking a shift after a period of relative stability. Interestingly, despite these reductions from two of the largest Asian holders, overall foreign ownership of US Treasuries has continued to rise, suggesting that other buyers have more than offset these sales. While the exact motivations behind China's and Japan's drawdowns remain difficult to pinpoint, several key factors could be driving these moves. These include efforts to stabilize domestic currencies against a strong US dollar, shifting expectations around US inflation and interest rate policy, concerns over the long-term stability of the dollar, or a broader strategic push to diversify foreign exchange reserves. Each of these dynamics has significant implications for global capital flows and the future trajectory of US bond markets.

Chart 6: Foreign holdings of US Treasuries



About the author

Haver Analytics is pleased to bring Tian Yong Woon's commentaries on the state of the global economy to its clients.

Tian Yong joined Haver Analytics as an Economist in 2023. Previously, Tian Yong worked as an Economist with Deutsche Bank, covering Emerging Asian economies while also writing on thematic issues within the broader Asia region. Prior to his work with Deutsche Bank, he worked as an Economic Analyst with the International Monetary Fund, where he contributed to Article IV consultations with Singapore and Malaysia, and to the regular surveillance of financial stability issues in the Asia Pacific region. Tian Yong holds a Master of Science in Quantitative Finance from the Singapore Management University, and a Bachelor of Science in Banking and Finance from the University of London.

Series info:

Chart 1: Bank of Japan policy rate vs. peers
Series 1: N158RTAR@G10
N158RTAR@G10 [Japan: Bank of Japan Policy Rate (EOP, %)]
Series 2: (((N111RTAR@G10 + N112RTAR@G10) + N023RTAR@G10) / 3)
N111RTAR@G10 [U.S.: Federal Open Market Committee: Fed Funds Target Rate (EOP, %)]
N112RTAR@G10 [U.K.: Official Bank Rate (EOP, %)]
N023RTAR@G10 [Euro Area 11-20: Deposit Rate (EOP, %)]
3

Chart 2: Japan average CPI inflation
Series 1: movv(JYCIJ@JAPAN,36)
JYCIJ@JAPAN [Japan: Consumer Price Index: General (NSA, Y/Y %Chg)]
Series 2: movv(JPGCIJEF@JAPAN,36)
JPGCIJEF@JAPAN [Japan: General CPI: All Items Less Fresh Food and Energy (NSA, Y/Y %Chg)]

Chart 3: Japan rice prices and imports
Series 1: JYNC4@JAPAN
JYNC4@JAPAN [Japan: CPI: Rice (NSA, Y/Y %Chg)]
Series 2: movt(IM009RI@JAPAN,12)
IM009RI@JAPAN [Japan: Quantity of Imports by Commodity: Rice (Metric Ton)]

Chart 4: Japan wage increases
Series 1: movv(MEFAC@JAPAN,3)
MEFAC@JAPAN [Japan: Annual Chg of Cash Earnings [5/More Empl]: All Surveyed Inds(NSA,Y/Y%Chg)]
Series 2: JPASTOPX@JAPAN
JPASTOPX@JAPAN [Japan: Shunto: % Increase in Wage Requested by Union Member (%)]
Series 3: SHWIPA@JAPAN
SHWIPA@JAPAN [Japan: Shunto: % Increase in Headline Wage Granted (%)]

Chart 5: Japanese yields and the yen
Series 1: X158JBB@INTDAILY

X158JBB@INTDAILY [Japan: Spot Yen/USD Exchange Rate: 17:00 in JST (Yen/USD)]
Series 2: R158GA@INTDAILY
R158GA@INTDAILY [Japan: 10-Year Benchmark Government Bond Yield (% p.a.)]

Chart 6: Foreign holdings of US Treasuries
Series 1: FH158LT@USINT
FH158LT@USINT [Japan: Holdings of US Long-Term Treasury Securities (EOP, Mil.$)]
Series 2: FH924LT@USINT
FH924LT@USINT [China: Holdings of US Long-Term Treasury Securities (EOP, Mil.$)]
Series 3: FH001LT@USINT
FH001LT@USINT [Foreign Holdings of US Long-Term Treasury Securities (EOP, Mil.$)]

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