IMM 54: The Conundrum of Japanese Inflation and Bond Yields

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International Monetary Monitor

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“Monetary policy is not about interest rates. It is about the rate of growth of the quantity of money.” Milton Friedman, interviewed on NBC’s Meet the Press, October 24, 1976.

For the past 2 years, Japanese M2 growth has been lower than pre-Covid…

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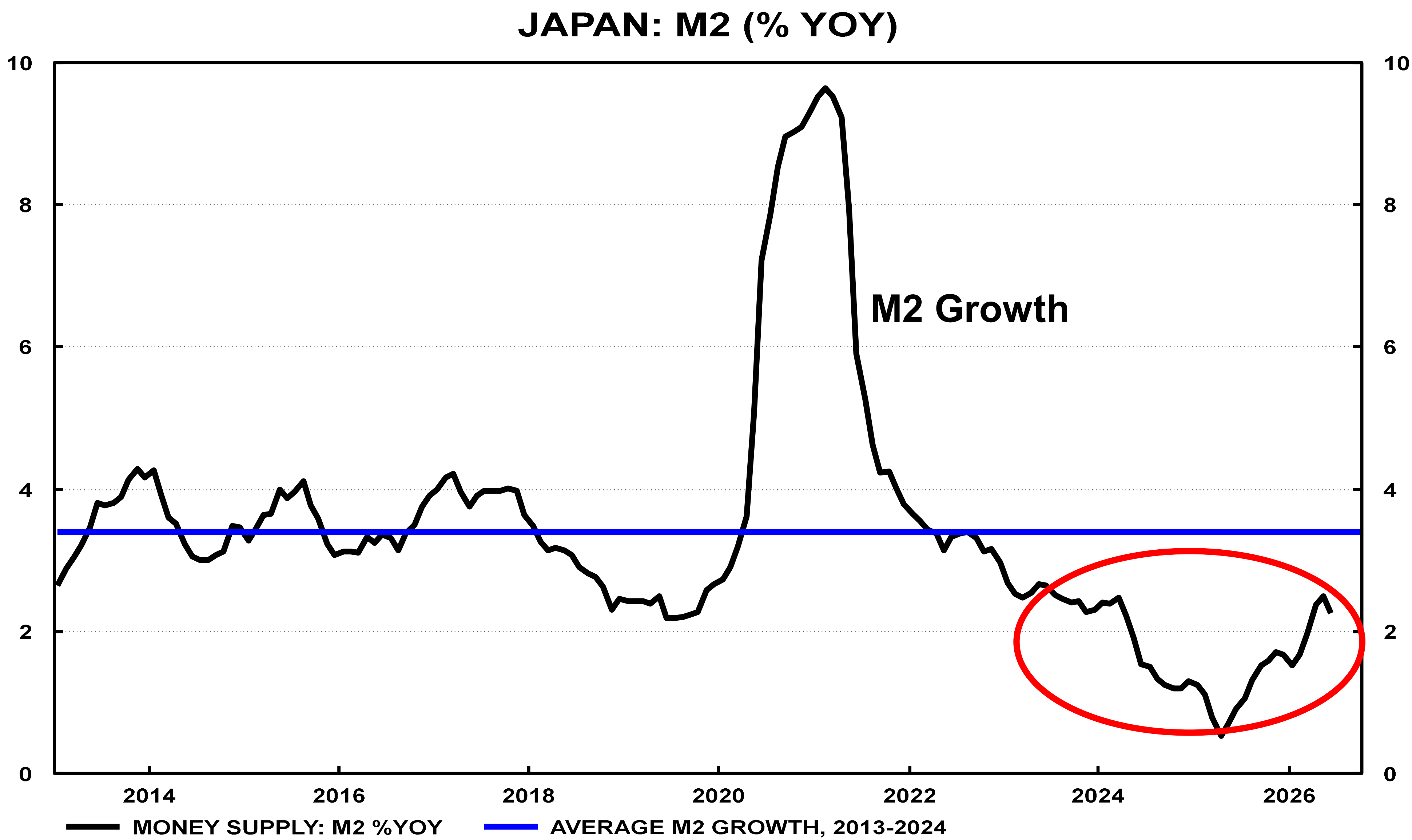

Source: LSEG Datastream

…and as a result, CPI Inflation is falling, not rising

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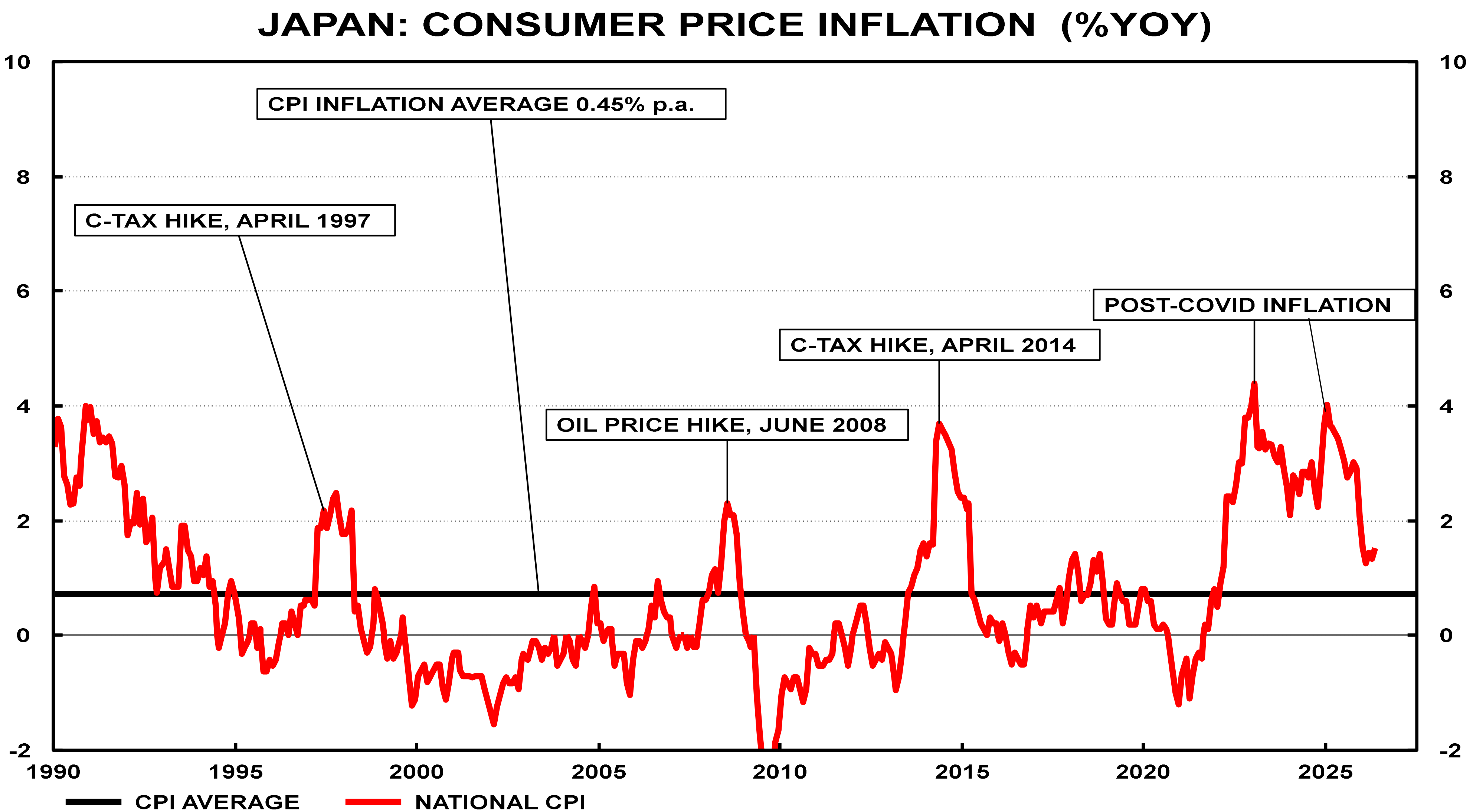

Source: LSEG Datastream

Money (M2) leads Nominal GDP which leads Bond Yields…

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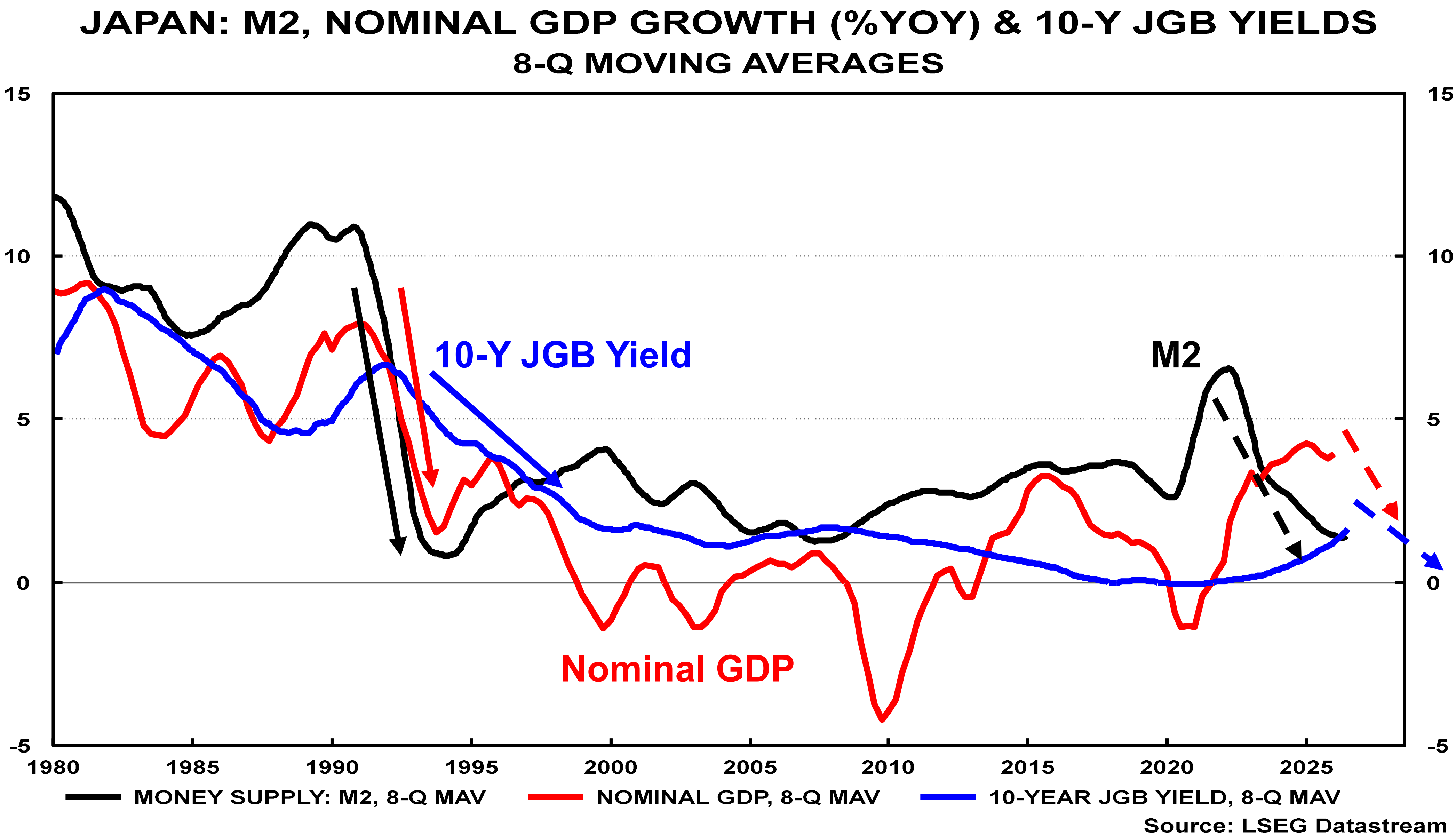
Current high bond yields reflect past inflation and previous high M2 growth; the next phase will be slowing nominal GDP and falling bond yields.



JGB yields are dominated by trend-inflation, meaning that…

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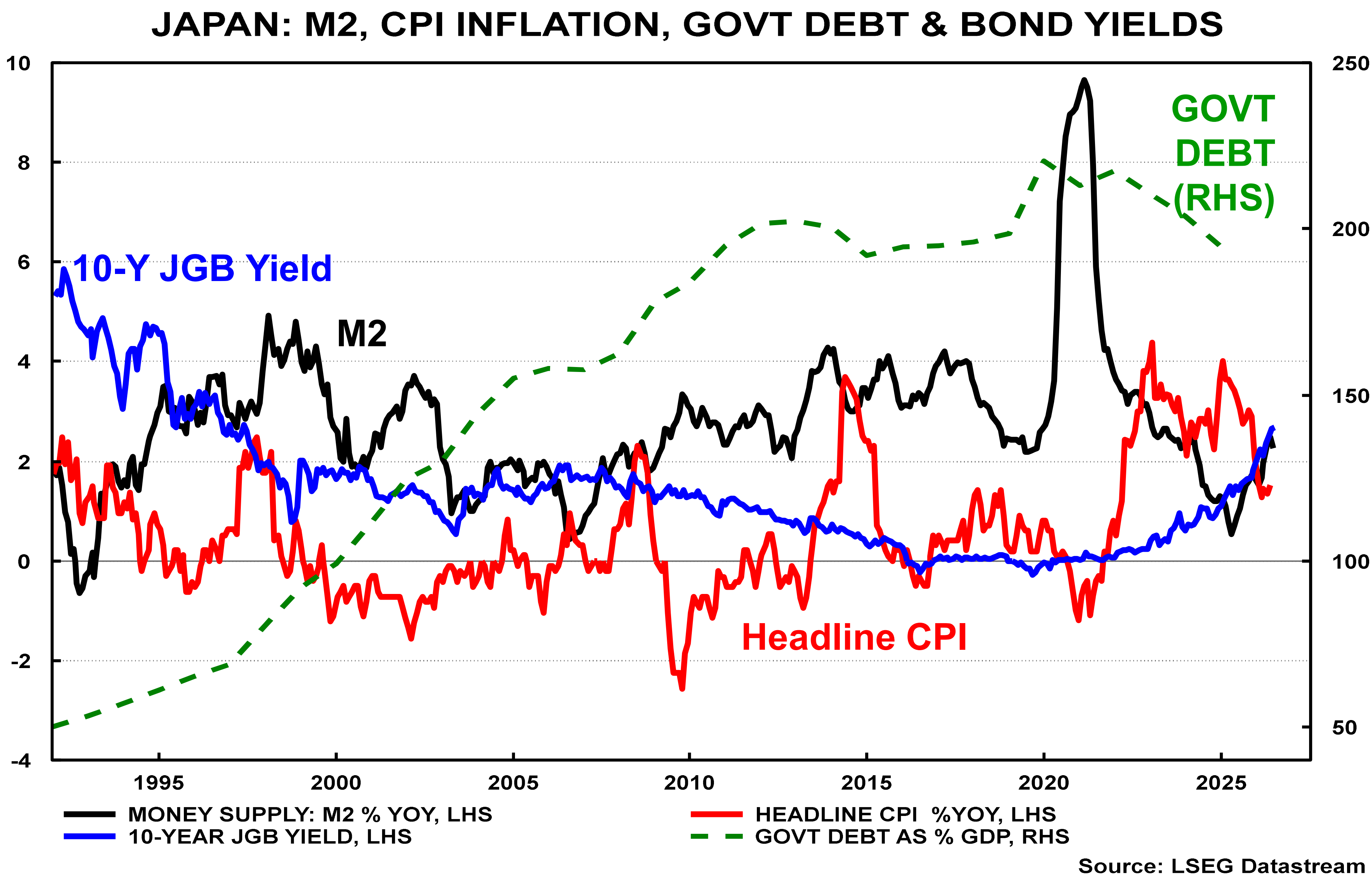

…Current high yields are reflecting the inflation of the past year or two.

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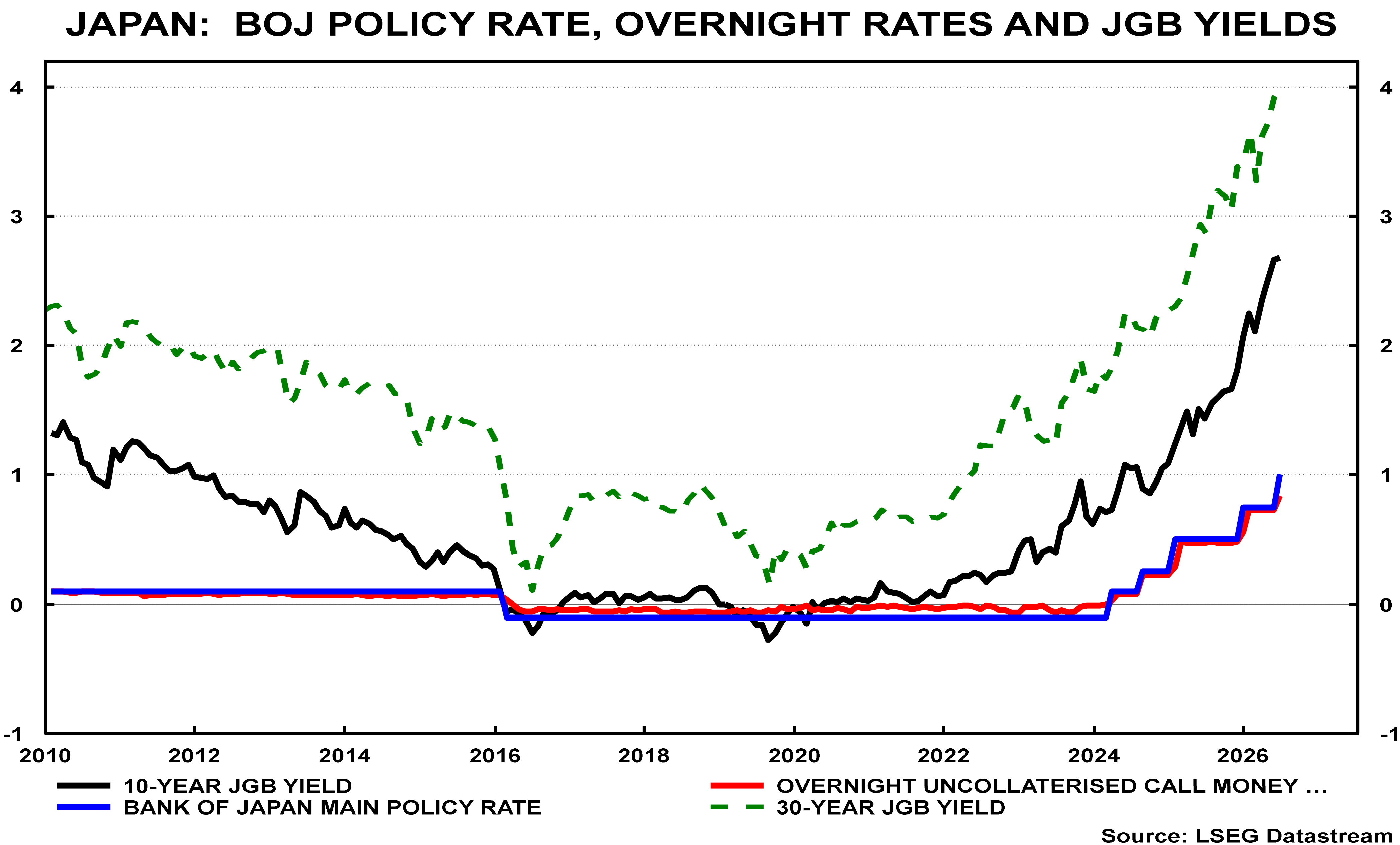

Unless money growth accelerates again, inflation and bond yields will fall.

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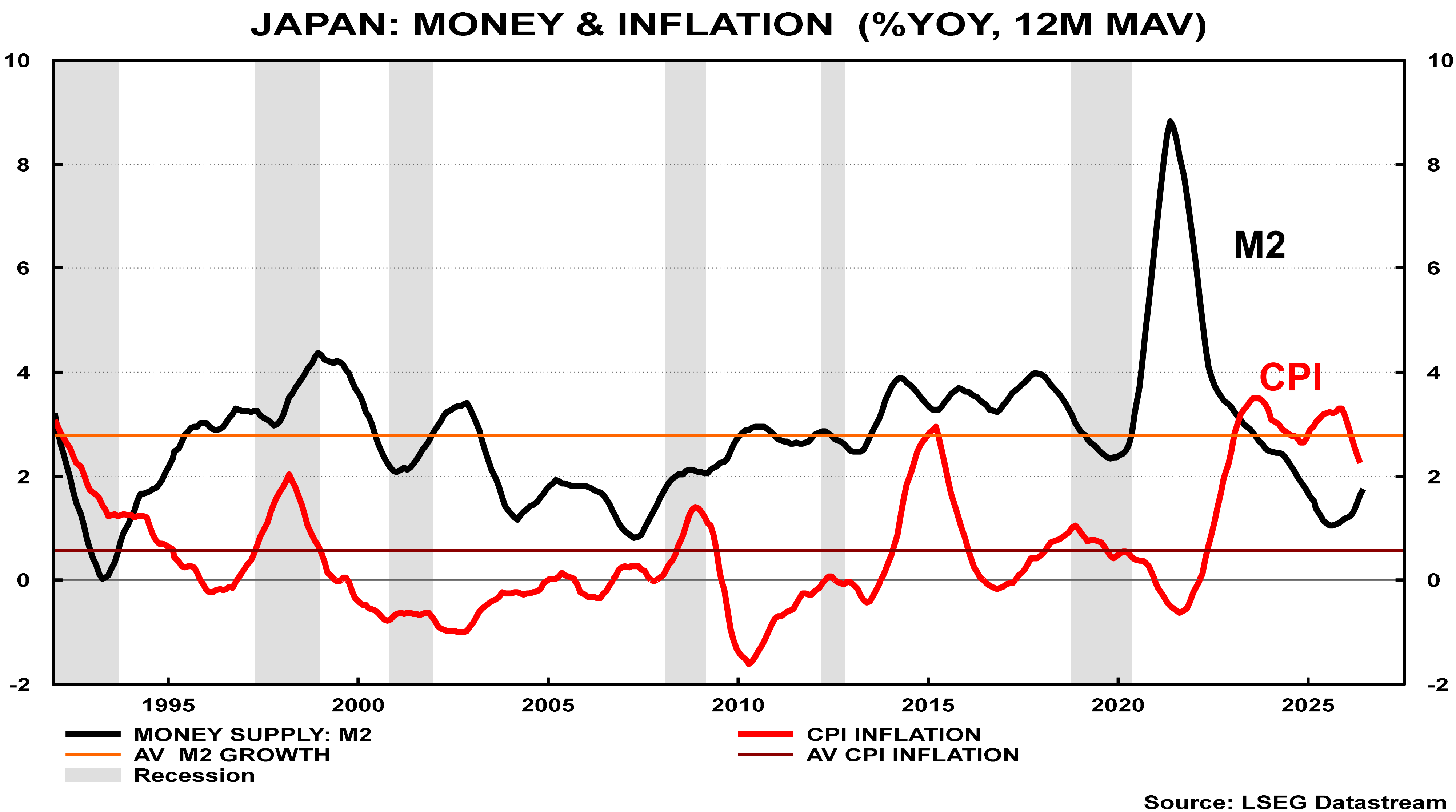

Summary and Conclusion

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- The lags in effect between M2 growth and changes in nominal GDP and inflation in Japan are unusually long due to the extended history of very low inflation in the past 35 years.
- Current bond yields, which tend to track nominal GDP trends, are still reflecting the rise in inflation during Covid.
- However, monetary policy (i.e. M2 growth) is no longer as expansionary as it was during Covid. M2 growth has returned to pre-Covid low growth rates.
- As a result, ***overall*** CPI inflation is now slowing, not rising, no matter what ***relative*** prices (energy, imports, wages etc) are doing.
- Unless M2 growth accelerates to 5% or more, inflation will continue to fall.
- In turn, this means that, at some point, Japanese bond yields will start to fall, not continue to rise.