

Daiwa's View

What's the BOJ to do? Price stability is its main mission

- BOJ likely to focus on reviewing financial and economic conditions and put policy on hold

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BOJ Governor Kuroda celebrates his 77th birthday on 25 Oct

Still watching closely to see whether inflation is transitory

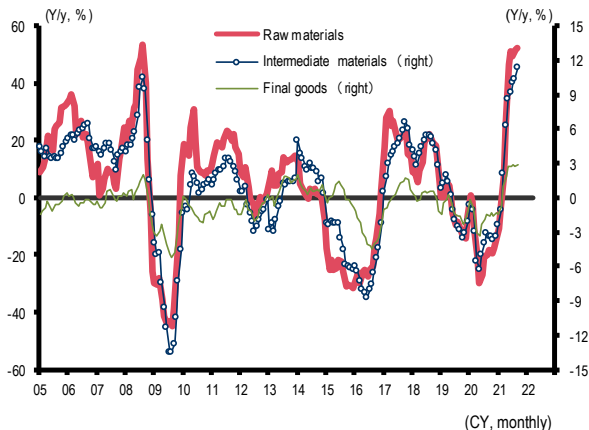
Nationwide core CPI for Sep shows first price increases for electricity and food in 18 months

Higher crude oil prices take about one month to show up in gasoline prices and 3 to 5 months to show up in electricity fees

What's the BOJ to do? Price stability is its main mission

BOJ Governor Kuroda celebrates his 77th birthday today, 25 October. Happy birthday, Mr. Kuroda. Asked about recent inflation worries at a press conference following the G20 meeting of finance ministers and central bank governors held in Washington DC on 13 October, Mr. Kuroda answered "price stability is our main mission and there should of course be a monetary policy response if that is under threat, but at this point central bankers worldwide believe that inflation is transitory." Confirming whether inflation really is transitory remains the task at hand for now.

Impacts from higher global commodity prices gradually spread from upstream to downstream prices, including in Japan. Japan's Corporate Goods Price Index showed a rise in raw materials and intermediate goods prices similar to what occurred when commodity prices rose in 2008, but price increases have not spread to final goods (Chart 1). That said, the y/y change in the nationwide core CPI (excl. fresh food) for September announced last week (22 Oct) came in at +0.1%, in line with market expectations and its first foray into positive territory in 18 months (Chart 2). The main components pushing prices higher were electricity fees and prices for such foods as coffee and pasta. Price increases were announced in October for cigarettes and some confectioneries. Last week on 20 October, crude oil futures (WTI) momentarily hit \$84.25/bbl, their highest in seven years. Meanwhile, Japan's nationwide average retail price for a liter of regular gasoline rose for a seventh consecutive week to Y164.6 as of 18 October. The impacts from higher oil prices show up in Japan's CPI data about one month later for gasoline prices and three to five months later for electricity fees. Japan's electric power and gas providers have already announced a fourth consecutive month of price increases out to December, and the rise in crude oil prices that began in October makes further price hikes from January likely.

Chart 1: Corporate Prices, Domestic Demand Goods in Japan


Source: BOJ; compiled by Daiwa Securities.

Core CPI could approach 1% during the winter

Winter price increases for gasoline and kerosene hit households hard and may weaken regional economies

BOJ analyzed impacts from rising global commodity prices in a Box in its July Outlook Report

BOJ showed considerable foresight, warning of prolonged inflationary pressures before Fed/ECB did

Japanese firms have been slower to pass on higher prices to customers than counterparts in Europe/US

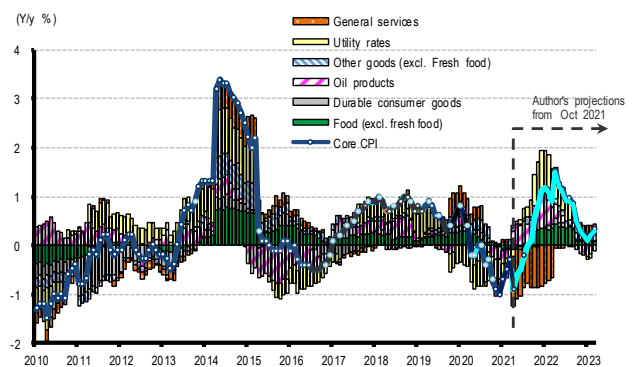
Restrictions on business hours at dining and drinking establishments lifted on 25 Oct

Delta Plus variant has been spreading in Russia and UK

We expect energy prices to drive the core CPI to nearly +1% y/y as early as this year and no later than January 2022 (Chart 2). Although Japan has less upward price momentum than the US or Europe, winter price increases for gasoline and kerosene will hit households hard and could weaken regional economies. There are strong expectations of pent-up demand from the fall as pandemic restrictions are eased, but with the possibility of buying restraint after that demand fades, price trends need to be watched closely.

The BOJ added language to its *Outlook for Economic Activity and Prices* report (*Outlook Report*) in July noting that corporate profits were "being pushed down by deterioration in the terms of trade that reflects a recent rise in international commodity prices." The rise in crude oil prices has steadily worsened Japan's terms of trade (Chart 3). Looking ahead, the BOJ's analysis of the impacts on corporate earnings and price trends from rising global commodity prices, detailed in a Box in its July *Outlook Report*, warned of the persistence of inflationary pressures before its central bank counterparts in Europe and the US did. This was actually outlined by the Research and Statistics Department in early July, but considering that the 10yr Treasury yield had declined from above 1.7% in the spring down to below 1.3% by then, primarily on supply-demand pressures, hats off to the BOJ for its prescience. The results of its analysis confirmed that the passing on of price increases to customers happens more slowly in Japan than in Europe and the US (Chart 4), and that the BOJ is more worried about corporate earnings declines than about propagation to the CPI. Ironically, Japan's CPI did not rise sharply above 2% and its prices have been stable.

Japan's fifth wave of infections has been subsiding and all state of emergency declarations have been rescinded as of October, the first time in six months. Furthermore, business hour restrictions at dining and drinking establishments were lifted on 25 October. Elsewhere in the world, however, spread of the Delta Plus variant, which is even more contagious than Delta, will trigger a lock down in Moscow from the 28th and has pushed the number of new cases daily back above 50,000 in the UK. The Kishida administration's biggest priority is on dealing with the pandemic, and it is bracing for a sixth wave over the winter. We expect increased spending on PCR and other tests, the rollout of vaccine passports, and a market-ready oral medication by end-December.

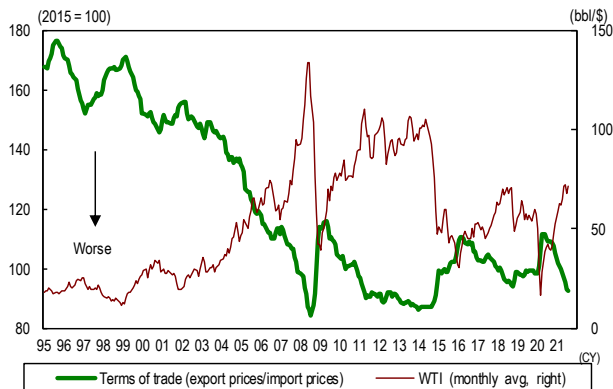
Chart 2: Breakdown of Nationwide Core CPI (goods and services)


Source: Ministry of Internal Affairs and Communications (MIC); compiled by Daiwa Securities.

Improvement scenario to be maintained in Oct Outlook Report

Amid such strong uncertainties about the future, the BOJ on 28 October will release its October *Outlook Report*. The Bank will most likely need to lower its FY21 growth and price forecasts due to the coronavirus fifth wave and the CPI base year revision. However, any such downward revisions should be temporary and the BOJ will likely maintain its scenario calling for better conditions going forward due to expected progress for administering vaccinations and the gradual easing of supply constraints.

Chart 3: Japan's Terms of Trade, Rising Crude Oil Prices



Source: BOJ, Bloomberg; compiled by Daiwa Securities.

We note wording used by BOJ in economic assessments to describe exports and production

Due to cuts in auto output, Jul-Sep production is likely to fall by around 3.0% q/q

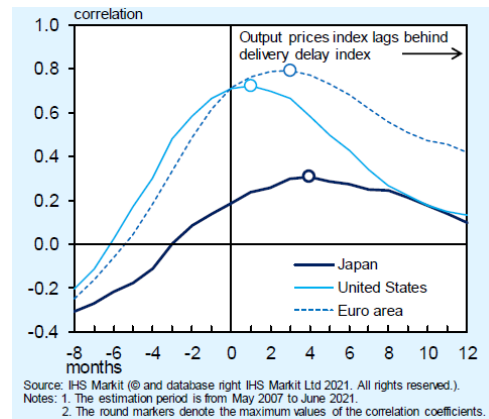
Toyota Motor views the worst stage as having ended despite outlook for production cuts in Nov

Catch-up production expected from Dec; there is a downside risk of COVID-19 spreading in winter in Asia

The *Monthly Economic Report* for October (released on 15 October) made no changes to its assessment of the Japanese economy, but tweaked the report's wording to say that the pace of recovery "has weakened." This report also described exports as "increasing at a slower pace," the first downward revision in seven months. We plan to carefully monitor the wording used by the BOJ in its economic assessments to describe exports and production (Chart 8).

In September trade statistics (released on the 20th), exports of automobiles dropped sharply, while imports of crude oil increased, leading to a deficit for two consecutive months. We are continuing to see the suspension of plant operations in Southeast Asia due to the spread of COVID-19 since the summer, production cuts at Japanese automakers owing to sluggish procurements of auto parts, and a drop in exports. Due to this, industrial production in September (the statistics for which are to be released on the 29th) is expected to drop by around 3.0% m/m, and overall production in Jul-Sep is likely to post a large decline of around 3.0% q/q. It is possible that weakness will drag on into Oct-Dec. There was some encouraging news from Toyota Motor, which announced on the 15th that, although it would cut the volume of global production in November by 100,000-150,000 units compared to its initial plan, it viewed the worst stage as having ended and explained that it was making adjustments to determine how much catch-up production would be possible from December. Supply constraints have been resolved since October. If things go well, a return to the higher initial plan is likely in Jan-Mar 2022. However, the main premise for this is that the pandemic is brought under control. Based on lessons learned from the cutoff of supplies this summer, there is a downside risk of COVID-19 spreading in winter in Asia.

Chart 4: Correlation Between Delivery Delays and Output Prices



Source: IHS Markit (© and database right IHS Markit Ltd 2021. All rights reserved.).
 Notes: 1. The estimation period is from May 2007 to June 2021.
 2. The round markers denote the maximum values of the correlation coefficients.

Source: Extracted from BOJ's Jul 2021 Outlook Report (B3-5 on page 66).

Economic growth forecasts: downward revision for FY21, but upward revision for FY22

FY23 projection will provide some glimpse of BOJ's thoughts on appropriate post-coronavirus levels

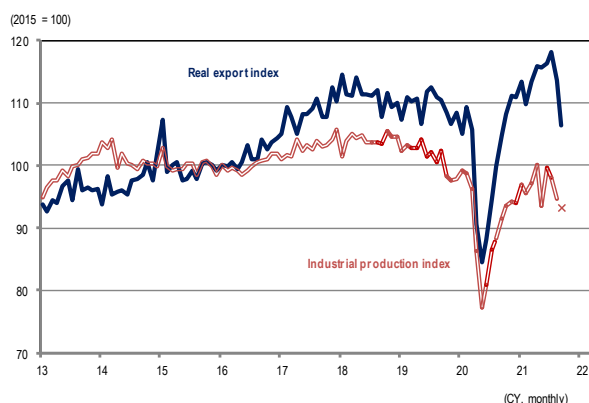
Due to revision to base year, FY21 price projection to be lowered

Higher crude oil prices and weaker yen both likely to exert upward pressure on prices

In the October *Outlook Report*, the BOJ will likely lower its FY21 economic growth forecast (median of Policy Board members' forecasts) and raise its FY22 forecast (Chart 7). In addition to depressed consumption due to the state of emergency declaration, the novel coronavirus has continued spreading in Southeast Asia, which has produced supply constraints making the procurement of automobile parts more difficult, which in turn has weighed on production and exports. Jul-Sep real GDP (to be released on 15 Nov) is expected to turn to negative growth. On the other hand, the BOJ is expected to revise upward its FY22 forecasts on (1) expectations for fresh economic measures following the Lower House election, (2) strong likelihood that more than 70% of Japan's population will soon receive their second coronavirus vaccination, and (3) economic normalization on the resolving of supply constraints. The BOJ will probably not change its forecasts for FY23, which is still a way off, but will probably provide some glimpse of its thoughts on appropriate post-coronavirus levels.

Turning to price (core CPI) forecasts, the negative output gap is expected to continue for now, but the 20 August CPI base year revision resulted in a steep 0.7-point downward CPI revision due mainly to lower mobile phone charges. Downward revisions for FY21 are now unavoidable due to this technical factor (Chart 7). Still, even when excluding impacts from lower mobile phone charges, inflation in Japan is close to 1%. While much smaller than the US inflation rate, conditions are such that a return of deflation in Japan seems unlikely. Rather, the externals of higher crude oil prices (WTI rose from \$70/bbl in mid-July to \$83/bbl now) and a weaker Japanese currency (yen depreciated from just over USD/JPY111 in mid-July to just over USD/JPY114 at one point) are both likely to exert upward pressure on prices.

Chart 5: Real Exports and Production in Japan



Source: BOJ, Ministry of Economy, Trade and Industry (METI); compiled by Daiwa Securities.

Note: X indicates METI's Sep forecast (mode) of -1.3% m/m.

BOJ is unlikely to make meaningful revisions to outlooks from FY22, viewing high resource prices and yen depreciation as temporary

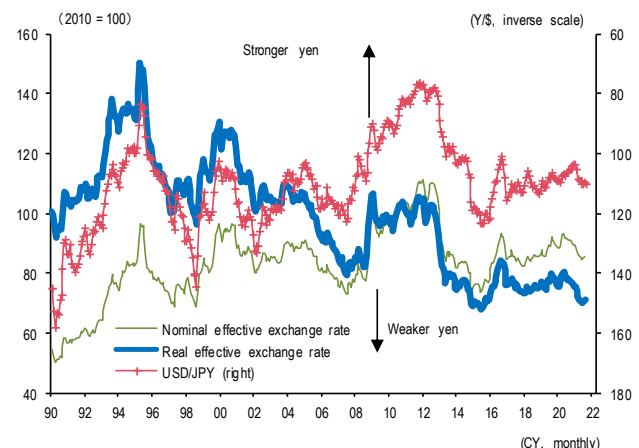
IMF Fiscal Monitor says that "fiscal policies will remain crucial"

In Japan, economic measures after lower house election are awaited

Core CPI, including mobile phone charges, will likely gradually move toward 1% this winter, provided upward energy price momentum persists. Meanwhile, a continuation of low-price plans for mobile phone charges and a relaunching of the government's *Go To Travel* campaign will likely exert downward pressure on prices. Currently there are no solid grounds for assuming a prolonging of high resource prices and yen depreciation, so the current trends will probably be viewed as temporary. We do not expect meaningful revisions to outlooks from FY22 considering the high level of uncertainty.

The IMF *Fiscal Monitor* released on 13 October included the opinion that "Even now fiscal policies will remain crucial to address the impacts of the ongoing pandemic." In Japan, political parties are asserting their positions on coronavirus and economic measures ahead of the 31 October Lower House election and new economic measures will probably be formulated after this election. For now, fiscal policy will play a key role. Prices, particularly energy prices, will require careful monitoring for now, but conditions are not such that inflation in Japan will quickly move towards 2%. Also, interest rates and foreign exchange trends are both currently within tolerable ranges (Chart 6) so actions on those fronts are probably not needed.

Chart 6: Forex Rates



Source: BOJ; compiled by Daiwa Securities.

Bank's focus will be on inspecting financial/economic conditions; wait-and-see stance expected

The BOJ's Monetary Policy Meeting (MPM) on 27-28 October will be held just three days before the Lower House election. The Bank's focus will be on calmly inspecting financial and economic conditions, and we expect it to maintain its wait-and-see approach to policy. During this period in which the government is enhancing its coronavirus measures, the BOJ will likely be unable to scale back its own crisis response measures. Regarding a decision on whether it will extend its Special Program to Support Financing in Response to the Novel Coronavirus, which is set to expire at the end of March 2022, it will probably make a decision at the December MPM after carefully monitoring the situation.

Chart 7: Projections by BOJ Policy Board Members (median, y/y)

	Real GDP			Core CPI		
	Jul 2021*	Oct 2021**	Our forecasts	Jul 2021*	Oct 2021**	Our forecasts
FY21	+3.8 %	+ 3.4 %	+3.2 %	+0.6 %	+ 0.4 %	+0.4 %
FY22	+2.7 %	+ 3.0 %	+2.9 %	+0.9 %	+ 0.9 %	+0.8 %
FY23	+1.3 %	+ 1.4 %	+1.5 %	+1.0 %	+ 1.0 %	+0.8 %

Source: BOJ, various materials; compiled by Daiwa Securities.

*BOJ projections.

**Our estimates for policy board member projections.

Chart 8: Description of BOJ's Economic Assessment on Current Conditions

Sep 2021	
Current condition ⇒ Anticipated revisions in Oct	
Japan's economy	Has picked up as a trend, although it has remained in a severe situation due to the impact of the novel coronavirus (COVID-19) at home and abroad. ⇒ Unchanged or addition of recent weakness?
Overseas economies	Have recovered on the whole, albeit with variation across countries and regions. ⇒ Unchanged
Exports	Have continued to increase despite some exports having been affected by supply-side constraints. ⇒ Downward revision to "recent slowdown in upward pace"?
Business fixed investment	Has picked up, although weakness has been seen in some industries. ⇒ Unchanged Corporate profits and business sentiment have continued to improve on the whole. ⇒ Unchanged
Private consumption	Has remained stagnant due to continuing strong downward pressure on consumption of services, such as eating and drinking as well as accommodations. ⇒ Unchanged
Public investment	Has continued on a moderate uptrend. ⇒ Unchanged
Housing investment	Has picked up. ⇒ Unchanged
Industrial production	Have continued to increase despite some production having been affected by supply-side constraints. ⇒ Downward revision alongside exports?
Financial conditions	Have been accommodative on the whole, although weakness in firms' financial positions has been seen. ⇒ Unchanged
Prices	Y/y change in CPI (all items less fresh food) has been at around 0%, mainly due to a rise in energy prices, despite being affected by COVID-19 and a reduction in mobile phone charges. Meanwhile, inflation expectations have been more or less unchanged. ⇒ Unchanged

Source: BOJ; compiled by Daiwa Securities.

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