Daiwa Securities

Daiwa's View

This spring, central banks will likely take action carefully and nimbly

- BOJ's Mar MPM will be positioned as opportunity to prepare release of Apr *Outlook Report*

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Russian ceasefire negotiations likely to take time

Faster pace of rise in crude oil prices should lead to revisions in economic/price projections

About three weeks have passed since the start of the Russian invasion of Ukraine on 24 February. With no hint of a resolution in sight, the rise in crude oil prices has accelerated. On 7 March, the WTI reached $130 at one point, but prices have gradually regained stability as shown by the recent drop to below $100. Nevertheless, we have to make upward revisions to crude oil prices, which are a precondition for economic/price projections for CY22 (overseas) and FY22 (Japan). However, the obvious differences between now and before are that: (1) inflation has been sustained due to supply constraints caused by the COVID-19 pandemic, since before the emergence of the geopolitical risk, (2) prices of resources other than crude oil have also been rising (greenflation), and (3) the pandemic cannot be said to have come under control just yet. Even if (1) the current surge in crude oil prices is temporary and (2) prices decline after peaking out, they may remain high.

In Europe, which is highly dependent on Russian natural gas, there are large disparities in inflation among nations

Tough negotiator ECB President Lagarde took a wonderfully balanced approach amid greatly divided opinions

Central banks should provide predictable path, without adding further uncertainty through their own actions

With Western nations gradually tightening economic sanctions against Russia, due to its geographic proximity to Russia, the resulting impact on the economy of Europe (especially Germany, the Netherlands, and Italy), which is highly dependent on Russian natural gas, will be large. There are large disparities among nations with regard to the rate of inflation with energy prices and the price of goods, so the emergence of differing opinions among ECB members is unavoidable. Under the circumstances, the ECB Governing Council meeting on 10 March decided to taper asset purchases ahead of schedule, moving against advance market projections. Meanwhile, the ECB separated the timing of rate hikes from the timing of the end of asset purchases by revising forward guidance for policy interest rates. Since her days working for the IMF, President Christine Lagarde has been well known as a tough negotiator. I respect the wonderfully balanced approach she took amid greatly divided opinions and escalating tensions in Ukraine. A hint of her courage and strong determination is evident in the following remarks she made during a Q&A session. Rather than doing what the market expects, it is important for central banks to provide a careful and predictable path, without adding further uncertainty through their own actions. I feel this also applies to the Fed and BOJ.

ECB President Christine Lagarde (10 Mar 2022)

(Question) I would like to ask you a question on the surprise factor you actually introduced today, because most of your watchers were completely convinced that you are going to pause and not change anything because of that heightened uncertainty. Perhaps you could elaborate a little bit on the thinking in the Governing Council on that issue to now reduce the pace of the APP, and why didn't you wait another month?

Suffice to say that watchers are not those who make Governing Council decisions. It is the Governing Council, 25 sensible people around the table, who look at what the mandate is, what the projections deliver, what the medium-term outlook for inflation looks like, what the risks are, what the uncertainty is, and on the basis of all that, who are trying to deliver a predictable course while being very cautious. That's really what we did and doing what you have to do should be the predictable thing. Adding uncertainty to an uncertain situation would not have been the right answer.

Fed Chair Powell suggested 25bp rate hike in Mar

Consecutive rate hikes are done deal; pace will likely be flexible, depending on price trends

Key words for Fed will be "careful" and "nimble"

Monetary policy is not a panacea

The FOMC meeting on 15-16 March is expected to decide to finally begin rate hikes. At the congressional testimony on 2-3 March, Fed Chair Jerome Powell repeatedly mentioned that he would "support a 25bp rate hike" at the March FOMC meeting. This reassured the market, indicating a careful first step by the Fed while beginning rate hikes in order to rein in inflation. The US CPI for February (released on the 10th) was +7.9% y/y (+7.5% for Jan). If crude oil prices continue to rise, CPI could rise to the 8% level. Therefore, the market has started to become concerned about further upside risk. While consecutive rate hikes appear to be a done deal, flexibility is required when considering the pace, based on price trends and resource prices. The key words will be "careful" and "nimble." A key focus of attention in the near term will be whether crude oil prices (WTI) stay fixed at a level above $100. Steering monetary policy is definitely difficult, but responding via monetary policy alone has always had its limits. When various risks emerge, the market tends to rely/focus on monetary policy. However, as a long-time central bank watcher, I think monetary policy is neither a panacea nor a magic wand. With the economic structure changing substantially due to the pandemic, things are not moving according to theory. This is even more so the case in the current urgent situation with the Russian invasion of Ukraine.

Fed Chair Jerome Powell (2 Mar 2022)

- The near-term effects on the U.S. economy of the invasion of Ukraine, the ongoing war, the sanctions, and of events to come, remain highly uncertain. Making appropriate monetary policy in this environment requires a recognition that the economy evolves in unexpected ways. We will need to be nimble in responding to incoming data and the evolving outlook.

Japan's sixth wave of COVID-19 infections appears to have peaked

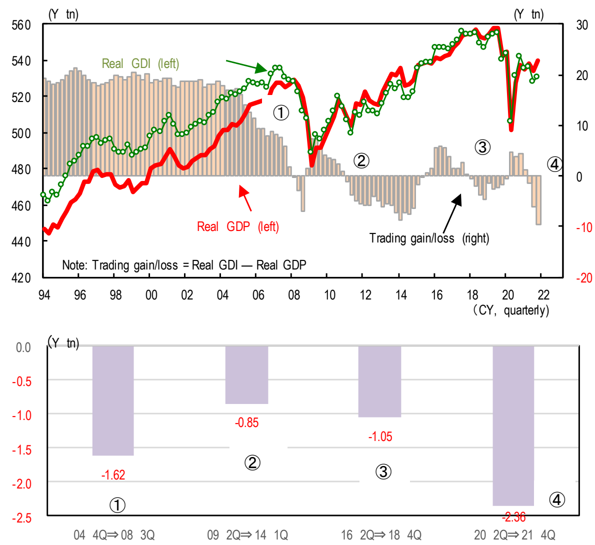
Japan should take measures early on to revise energy policy and improve food self-sufficiency

In Japan, the sixth wave of COVID-19 infections that began at the beginning of 2022 appears to have peaked. However, due to the double whammy of the current rise in resource prices and the weaker yen, worsening terms of trade due to cost-push inflation will likely reduce corporate profits and hit household incomes in Japan, which is a resource-importing country. After the lifting of restrictions on daily activities, this could restrain the pace of economic recovery from April. These new uncertainties will make economic and price forecasting even more difficult. Over the medium and long term, we think Japan needs to take measures early on to revise its energy policy and improve food self-sufficiency.

BOJ likely to downgrade assessment of private consumption in Mar economic assessment

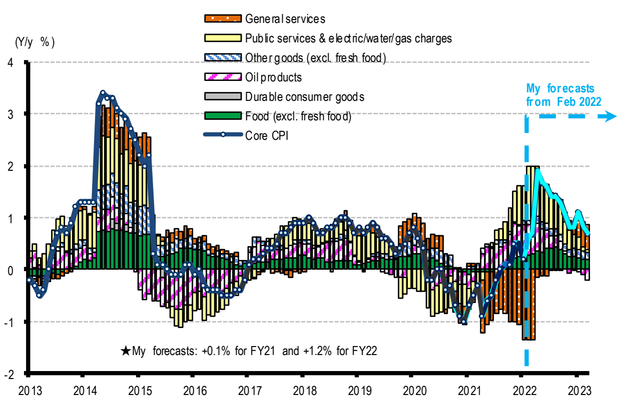
According to a 7 March Reuters report entitled "BOJ may offer bleaker view on economy," the BOJ will likely downgrade its assessment of private consumption. This report also pointed to the potential for concerns about an economic slowdown (due to tensions in Ukraine) acting as a factor that could potentially lead to a downgrade of its overall assessment (Chart 3). However, the BOJ is likely to maintain a subsequent recovery scenario.

Chart 1: Japan's Trading Gain/Loss



Source: Cabinet Office; compiled by Daiwa Securities.

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



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

Earnest discussion about price momentum not possible unless private consumption returns to recovery path

Over the past year, private consumption has been bumpy from quarter to quarter as Japan has struggled to contain the coronavirus. Japan's GDP growth rate tends to swing up and down depending on trends with consumption, which accounts for just under 60% of GDP and can lead to forecast revisions. As such, the wording used for economic assessments has been revised repeatedly. We feel that earnest discussion regarding price momentum towards the BOJ's 2% inflation target, as well as a "virtuous cycle," is not possible unless private consumption stabilizes and returns to a recovery path. In terms of these bumps, consumption should pick up in Apr-Jun after a slump in Jan-Mar. Then, the real test will be whether consumption can continue growing (avoid declining) in Jul-Sep. This will probably depend on the situation in Ukraine settling down and a lull in the sharp rise in energy prices.

Real test will be whether consumption can continue growing in Jul-Sep

Mar MPM is positioned as opportunity to prepare release of Apr *Outlook Report*

At the Monetary Policy Meeting (MPM) on 17-18 March, the BOJ will once more discuss the economic impact from rising prices/interest rates globally and the situation in Ukraine, given market trends (especially USD/JPY exchange rate levels) following the March FOMC meeting. In any event, the March MPM will be positioned as an opportunity to prepare the release of its April *Outlook for Economic Activity and Prices* report (*Outlook Report*). Current policies are expected to be maintained. With new economic/price projections (FY24 projections to be established), full-fledged discussions will be had in April. If we continue to face high resource prices and yen depreciation, cost-push inflation is likely to serve as a factor in pushing down the economy. Instead of well-balanced 2% inflation due to wage hikes and a narrower GDP gap, bad inflation—an inflation rate staying at the 1% level after rising to 2%, which is a scenario the BOJ does not anticipate (Chart 2)—may be prolonged unexpectedly. Currently, with Japan's economic activity still not having returned to pre-coronavirus levels, Governor Haruhiko Kuroda is likely to stress the need for continued easing at his press conference. Thus far, Kuroda has repeatedly mentioned his opinion that the weak yen is generally positive. However, he needs to take a careful approach in order to prevent his own messages from leading to bad inflation. With the risk of further depreciation of the yen being one of the factors for uncertainty regarding the rise in inflation in Japan, expressing an opinion that takes that risk into account would be one option. Also, if the USD/JPY exchange rate tops Y120, it will be important to emphasize a stance of carefully watching the rate by holding three-way meetings between the Ministry of Finance, the Financial Services Agency, and the BOJ.

BOJ needs to take careful approach to prevent its own messages from leading to bad inflation

One option would be to express an opinion that takes into account risk of weaker yen

Important to emphasize stance of carefully watching the USD/JPY rate by holding three-way meetings

Chart 3: Change in Description of BOJ's Economic Assessment on Current Conditions

	Jan-22
Current conditions	Text in red shows revisions in Jan ⇒ Expected revisions in Mar
Japan's economy	A pick-up has become evident as the impact of COVID-19 at home and abroad has waned gradually ⇒ Due to resurgence of Covid-19 infections, the situation is severe. This may lead to downward revision to "has picked up as a trend"
Overseas economies	Have recovered on the whole, albeit with variation across countries and regions ⇒ Addition of language on the situation in Ukraine?
Exports	Have continued to increase as a trend, despite the remaining effects of supply-side constraints ⇒ Unchanged
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	A pick-up has become evident, with downward pressure stemming from COVID-19, particularly on services consumption, waning ⇒ Resurgence of infections may lead to downward revisions—e.g., from "waning" of downward pressure to "intensifying", as well as from "evident pick-up" to "treading water"
Public investment	Has been relatively weak, albeit at a high level ⇒ Unchanged
Housing investment	Has picked up ⇒ Unchanged
Industrial production	Have continued to increase as a trend, despite the remaining effects of supply-side constraints ⇒ Same as exports
Financial conditions	Have been accommodative on the whole, although weakness in firms' financial positions has remained in some segments ⇒ Unchanged
Prices	Y/y change in CPI (all items less fresh food), despite being affected by the reduction in mobile phone charges, has been slightly positive, reflecting price rises of energy and other items. Meanwhile, inflation expectations have risen moderately ⇒ Unchanged or may touch on the situation in Ukraine

Source: BOJ; compiled by Daiwa Securities.

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