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Daiwa Securities

Daiwa's View

Japan-US/Europe monetary policy gap is difficult to close

- Priority issue in US/Europe is to tame inflation, while at BOJ it is to rein in rise in yields

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Jun again facing higher resource prices and US yields with stronger dollar

Resource inflation due to multiple factors to be prolonged

Monetary policy alone will not be able to deal with rising energy and food prices

With its next monetary policy meeting scheduled this week on 16-17 June, the BOJ entered its blackout period today. The +8.6% y/y US CPI for May (released on the 10th) exceeded projections. The rise in the price of a broad range of goods showed strong demand, with accelerated rent inflation. Due to the outlook that the Fed would be forced to continue with rate hikes to rein in inflation, US yields rose and the dollar appreciated. On the 13th, the USD/JPY exchange rate rose to the lower Y135 range for the first time in 24 years. After the Wall Street Journal reported that the Fed may implement a 75bp rate increase, the 10-year US yield rose to the 3.4% level at one point for the first time in eleven years. Resource prices started to rise again at around mid-May, and EU leaders have just decided to ban Russian oil imports at a meeting on 31 May. The COVID-19 outbreak has still not been declared to be over and ceasefire negotiations between Russia and Ukraine will likely be drawn out. Neither of these two issues will be easy to resolve. Assuming a prolonged period of resource inflation due to multiple factors, the US neutral interest rate (2-3%) could potentially shift upward within its range. However, monetary policy alone will not be able to deal with rising energy and food prices. The governments of various countries will probably need to work more closely with their central banks. On this front, influence in China and Russia is relatively small, but, as an oil producing country, the US has an advantage.

Japan's three-way meeting released statement to respond to yen depreciation, which is a world away from what it was before

US currency report suggests that currency intervention seems unlikely

Best response for Japan is to prevent rapid forex fluctuations

MOF is responsible for exchange rates, while priority issue at BOJ is to rein in rise in yields

Halting yen depreciation remains challenging as monetary policy gap between Japan and US/Europe is difficult to close

In Japan, the three-way meeting (Ministry of Finance, Financial Services Agency, and BOJ) was held in the late afternoon of the 10th, and a statement was released for the first time. Under the Abe administration, the meeting was established by then Chief Cabinet Secretary Yoshihide Suga in order to cope with the strong yen. The meeting had been held irregularly from 2016 when foreign exchange rates fluctuated widely (in the direction of yen appreciation), but it has become more regular. This time, the meeting was held to respond to yen depreciation, which is a world away from what it was before. The statement said that rapid progress in yen depreciation has been observed, which is a concern, and the government and the BOJ will work together closely and watch currency market trends and their impact on the economy and prices more closely. On the same day, the US Treasury Department announced a semiannual report on the macroeconomic and foreign exchange policies of major trading partners of the US. Japan, which has a large trade surplus with the US, remained designated in a Monitoring List. Regarding foreign exchange interventions, the report said that "intervention should be reserved only for very exceptional circumstances with appropriate prior consultations." With the US accepting a stronger dollar, which is effective in reining in inflation, the description indicates that intervention, as a tool for weakening local currency, seems unlikely. At this point, Japan has no concrete tools for reining in yen depreciation, and its best option is to prevent rapid fluctuations by emphasizing a stance of carefully watching trends. Some have started to once more expect policy revisions by the BOJ. However, it is actually the MOF that is responsible for exchange rates, with the priority at the BOJ being to rein in rising yields. After the 10-year JBG yield hit 0.255% on the 13th, the BOJ announced at 14:00 that it would conduct additional operations in the 5-year to 10-year zone on the 14th. If the rise in superlong yields does not stop, further additional operations will be implemented. After clarifying how it conducts fixed-rate purchase operations for consecutive days at its April meeting, the BOJ has repeatedly emphasized its continuation of persistent easing. Halting yen depreciation remains challenging as the monetary policy gap between Japan and the US/Europe is difficult to close.

BOJ Governor Kuroda's speech at Kisaragi-kai meeting entitled "The Bank's Thinking on Monetary Policy"

He clearly showed stance of persistently continuing with strong monetary easing

At the beginning, he explained three reasons why the BOJ considers it necessary to maintain easing

On the afternoon of 6 June, BOJ Governor Haruhiko Kuroda gave a speech at the Kisaragi-kai meeting, which was his last Kisaragi-kai speech before the end of his term in office. The title of the speech was "The Bank's Thinking on Monetary Policy," and from the outset he made clear the bank's stance to "persistently continue with aggressive monetary easing." Kuroda offered the following three reasons why the BOJ considers it necessary to maintain monetary easing: (1) Japan's economy has not yet recovered to pre-pandemic levels (2019 average GDP), (2) since Japan is a commodity importer, the economy has been under downward pressure from an outflow of income brought about by recent rises in international commodity prices, and (3) the 2% price stability target must be achieved in a sustainable and stable manner. Kuroda then carefully explained the differences in price developments between Japan, the US, and Europe and presented discussions from a BOJ price workshop ("zero-inflation norm"[1] and kinked demand curve). He also stressed the importance of higher wages.

Signs of Changes in Inflation Expectations

Despite change in responses to latest surveys, it is important that changes lead to full-fledged rise in wages

Kuroda retracted his remark, which proves that Kishida administration and BOJ have become increasingly unified

However, the final item in his speech, with the sub-heading "Signs of Changes in Inflation Expectations," was slightly different in tone from his message of emphasizing a stance of continuing with monetary easing. This section included information from the most recent *Survey on Households' Response to Price Increases*. This survey asked households what they would do if the price of a product they always buy at the same supermarket were to increase sharply. Kuroda presented a change in recent consumer behavior, as more than half of the survey participants responded that they would continue to buy the same product (at a higher price) at the same supermarket, which was up from the previous survey (Chart 1). Kuroda cautioned that, "the results should be interpreted with considerable latitude," and definitely did not conclude that households had become more tolerant of price rises. He explained that "the point to consider for the time being is how Japan" can use these developments to bring about "a full-fledged rise in wages." However, only parts of his comments were used, and they were interpreted as meaning that households had become more tolerant of price rises, which sparked a firestorm of criticism on social media. As a result, Kuroda took the unusual step of apologizing and retracting his remark. The speech writers' intention to include the latest data is understandable, but it was somewhat overeager. With the survey results lacking consistency with his explanation about continuing with easing that he had made up to that point, the speech appeared to need a bit more firming up. As a result, Kuroda took the unusual step of apologizing and retracting his remark. This, which seemed driven by concerns about a potentially negative impact on the Kishida administration just before the Upper House election, proves that the BOJ and the current administration have become increasingly unified.

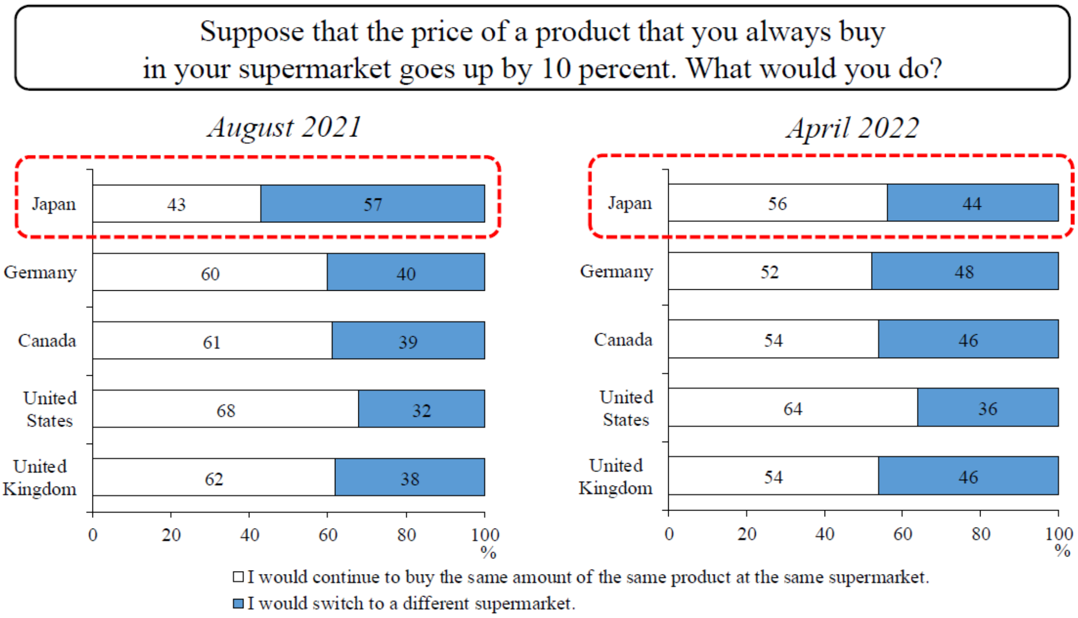
Picture of post-COVID Japan emerging, but no end in sight for battle against resource inflation

Timing of policy revisions by BOJ depends on Prime Minister Kishida

Currently, there is a division of roles in Japan, with the government taking measures to address soaring prices and the BOJ supporting the economy by providing loose monetary conditions. On 10 June, Japan started procedures to allow foreign visitors to enter Japan for sightseeing purposes. Therefore, post-coronavirus Japan is finally coming into view. However, an end to the battle against resource inflation remains out of reach. Considering that the price situation has changed significantly, I believe that now is the time for the government and BOJ to seriously consider a new phase for their policy coordination to end deflation. As the market is moving quickly, they cannot wait until next year's wage hikes come into view. I hope that the Kishida administration will bring some originality to this policy coordination after the Upper House election. The timing of policy revisions by the BOJ depends on Prime Minister Kishida.

[1] Japan's "zero-inflation norm" refers to conditions in which roughly the same consumption behaviors are maintained on the assumption that prices will not rise. Kuroda concluded that the main reason for the failure to achieve the 2% price target was an extremely strong "zero-inflation norm."

Chart 1: Survey on Households' Response to Price Increases



Source: Watanabe, T., "'5-kakoku no kakei o taishō to shita infure yosō chōsa' (2022-nen 5-gatsu jisshi bun) no kekka," May 30, 2022, https://www.centralbank.e.u-tokyo.ac.jp/wp-content/uploads/2022/05/household_survey_May_2022.pdf.

Source: Excerpted from Chart 9 in Speech at the Kisaragi-kai Meeting "The Bank's Thinking on Monetary Policy" on 6 Jun 2022.

Jun MPM is preparation for release of Jul *Outlook Report*

Revenge consumption is expected in Apr-Jun, but consumption in Jul-Sep is important

GDP may not recover to average in 2019 until end-2022

At its Monetary Policy Meeting to be held on 16-17 June, the BOJ is likely to discuss the sustainability of global inflation and higher yields as well as the impact on Japan's economy, under the assumption of a prolonged war in Ukraine, based on market trends after the June FOMC meeting (US long-term yields, USD/JPY exchange rate level). That said, a wait-and-see stance is expected for the June meeting as the meeting is positioned as preparation for the release of the July *Outlook for Economic Activity and Prices* report (*Outlook Report*). Full-fledged discussions are expected in July based on the new economic and price projections. In the current economic assessment, so-called "revenge consumption" is expected in Apr-Jun. However, an important point for the recovery path in Japan is consumption in Jul-Sep, when a hot summer is anticipated due to La Niña. However, the BOJ regards pre-pandemic economic activity levels as being the average GDP in 2019, and we may not see a recovery to that level until end-2022.

Amid chip shortages, production is not strong in Apr-Jun

BOJ will likely lower assessment on production

Price projections will be lifted as inflation is actually observed

Amid chip shortages, the momentum behind catchup production in Apr-Jun is not strong. While lockdowns in Shanghai were lifted on 1 June, China's Zero-COVID policy continues, so it will take more time before we see normalization of production and distribution that have become stagnant. According to various media reports, it is highly possible that the BOJ will lower its assessment on production (Chart 2). Meanwhile, Japan's core CPI for April finally reached 2.1% y/y in the absence of the impact of cuts in mobile communication fees. Stating this fact in a matter-of-fact way will result in price projections being revised upwards. However, unless this comes together with wage hikes, cost-push inflation will create downward pressure on the economy, and downside risks to the economy will remain. Nevertheless, I expect core CPI to remain at around 2% by end-2022, so it would be better to stop referring to inflation as being temporary.

Current policies to be maintained, but it is uncertain whether decision on COVID-19 special operations will be made at Jun meeting

The BOJ is expected to keep current policies at the June meeting. With the deadline for the Special Funds-Supplying Operations to Facilitate Financing in Response to the Novel Coronavirus for SMEs currently set at end-September, the BOJ needs to decide whether the program should be ended or extended no later than the July meeting. It is uncertain whether the central bank will be able to make a decision on the matter at the upcoming meeting. At a post-meeting press conference, Governor Kuroda is likely to emphasize the continuation of persistent easing. Questions are expected to focus on yen depreciation, and it would be good for him to present a thoughtful opinion, and avoid saying that "the weak yen is generally positive."

Chart 2: Descriptions of BOJ's Assessment on Current Economic Conditions in Apr, Expected Revisions in Jun

	Apr 2022
Current conditions	Text in red shows revisions in Apr ⇒ Expected revisions in Jun
Japan's economy	Has picked up as a trend, although some weakness has been seen in part, mainly due to the impact of COVID-19 and the rise in commodity prices ⇒ Unchanged
Overseas economies	Have recovered on the whole, albeit with variation across countries and regions ⇒Unchanged
Exports	Have continued to increase as a trend, despite the remaining effects of supply-side constraints ⇒May be revised downwardly to "weak" due to impact of China's zero-COVID policy and supply constraints such as chip shortages
Business fixed investment	Has picked up, although weakness has been seen in some industries ⇒Unchanged Have improved on the whole, but business sentiment has seen a pause in its improvement recently, mainly due to the impact of COVID-19 and the rise in commodity prices ⇒Unchanged for corporate profit, while assessment on business sentiment may be improved
Private consumption	Has started picking up again, with downward pressure stemming from COVID-19, particularly on services consumption, waning ⇒Continuing to pick up
Public investment	Has been relatively weak, albeit at a high level ⇒ Unchanged
Housing investment	Has been more or less flat ⇒ Unchanged
Industrial production	Have continued to increase as a trend, despite the remaining effects of supply-side constraints ⇒May be revised downwardly similar to 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 in the range of 0.5-1.0%, reflecting price rises in energy and other items. Meanwhile, inflation expectations, particularly short-term ones, have risen. ⇒May be revised upwardly from "0.5-1.0%" to "around 2%"

Source: BOJ; compiled by Daiwa Securities.

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