Daiwa's View

Will we see BOJ's efforts on 22 Sep—'central bank day?'

- At Sep meeting, BOJ is expected to decide to end COVID-19 special financing operations, but it may consider support measures for SMEs

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Will we see BOJ's efforts on 22 Sep—'central bank day?'

Greatest focus of interest will be on results of Sep FOMC meeting and policy rate level at end-2023 to be released early in morning on 22 Sep Japan time

The difference between a Fed continuing to hike rates and a BOJ standing pat should become ever more clear

If the Swiss central bank eliminates its negative policy rate on 22 Sep, BOJ will be the last holdout

The results of monetary policy meetings at four major central banks will all come out this week on 22 September Japan time—results will be released early in the morning from the Fed, at around noon from the BOJ, in the late afternoon from the Swiss National Bank, and at night from the BOE. It will truly be 'central bank day.' The new policy rate forecast (dot chart) to be released at the September FOMC meeting is likely to be a particular concern as a catalyst that could drive the dollar higher. The forecast level of interest rates at end-2023 (and its consistency with the economy and prices) will be of greatest interest. Based on the strong commitment expressed by Fed Chair Jerome Powell at his Jackson Hole speech, the Fed is expected to keep the policy rate high for a while and considers it premature to cut rates. Those expecting a rate cut in 2023 will have to rethink their view if the forecast level at end-2023 is not any lower than that for end-2022. The dollar is likely to strengthen as the pricing in of future rate hikes changes. Due to the announcement of the results of the BOJ policy meeting at around noon, the difference between a Fed continuing to hike rates and a BOJ taking no action will become that much clearer. But that is not all. On the evening of 22 September, the Swiss National Bank is likely to abandon its negative interest rate policy, and this would leave the BOJ as the only major central bank with a negative policy rate.

USD/JPY is again closing in on 145 and reports of a "rate check" fueled concerns over intervention

Inflation-fighting US would not approve of intervention to weaken its own currency

BOJ should make effort to show stance of being concerned about currency fluctuation, instead of stubborn easing stance

Japanese officials became flustered watching the USD/JPY rise back toward 145 following release of the US CPI for August on 13 September. Asked about this at a press conference the next morning on the 14th, Vice Finance Minister Masato Kanda answered that Japan would respond appropriately without ruling out any options, and Minister of Finance Shunichi Suzuki later said the similar thing. Concerns over intervention in response to news of a sudden rate check sent the USD/JPY back to the mid-142 level. If you think about it, however, the US, which is focused on fighting inflation, cannot be expected to approve an intervention that would weaken its own currency. With the terminal rate now seen to be above 4%, intervention by Japan alone would not offset factors driving the dollar higher and would likely be ineffective. Meanwhile, it will take time before we see a change in the US monetary policy stance. With the MOF having jurisdiction over currency exchange rates, it will find this a troubling trend for the time being. The 22nd warrants special attention in particular. In BOJ Governor Haruhiko Kuroda's press conference on the 22nd, it would be wise to indicate a stance of being concerned about currency fluctuation, rather than emphasizing a stubborn stance regarding easing. This is the first thing that the BOJ should make an effort to do in order to avoid further depreciation of the yen.

Gov't has not changed expectations regarding BOJ's role

What BOJ can probably do is to provide indirect assistance to government's economic package

Article 4 of the Bank of Japan Act states that "Taking into account the fact that currency and monetary control is a component of overall economic policy, the Bank of Japan must always maintain close contact with the government and exchange views sufficiently, so that its currency and monetary control and the basic stance of the government's economic policy are mutually compatible." Governor Kuroda has been consistently indicating a stance of not conducting policy revisions for the purpose of preventing yen depreciation, which shows that the government has not changed its expectations regarding the BOJ's role. What the BOJ can do is to provide indirect assistance to the government's economic package to be formulated in October. This is the second thing that the BOJ should make an effort to do.

Three reasons behind persistent easing by BOJ

The BOJ has pointed to three reasons behind the persistent easing: (1) the economy has not recovered to pre-pandemic levels, (2) it is necessary to ease downward pressure and the negative impact on incomes from rising commodity prices, and (3) with cost-push inflation being temporary, the underlying tone of prices needs to be raised moderately. With market participants understanding that these factors will not be resolved easily and the BOJ will wait for next year's spring wage negotiations at the earliest based on its emphasis on wages, the view that the BOJ will take no action during Governor Kuroda's term is permeating the market.

Key is whether Japan's economy can recover to pre-pandemic level within FY22

If timing with which output gap shifts to positive territory is delayed, possibility of achievement in 2H FY22 would decline

If slow and cautious approach is taken, the time will not be ripe until mid-2023

Regarding the first reason, the BOJ defines pre-pandemic economic levels as the average in 2019. Under the current situation, the key is whether the recovery will be achieved within FY22. September *ESP Forecast* survey announced on the 14th (survey period 2-9 Sep, 36 responses) showed an average real GDP growth forecast (q/q annualized) for Jul-Sep of +1.54%, down 1.19ppt from the previous survey (Chart 1: +1.93% for FY22 and +1.28% for FY23). Amid a seventh wave of COVID-19 infections and bad weather, including hot summer temperatures and heavy rains, consumers remain very defensive, and this weakened spending on services in Jul-Aug. September consumption is also likely to be sluggish as a typhoon hit Japan during the three-day weekend. Growth is expected to be lower than it was in Apr-Jun (+3.5%). If the Jul-Sep GDP growth rate were to slow down, the timing with which the output gap (estimated by BOJ) shifts to positive territory would be delayed. This would reduce the chances of it turning positive in 2H FY22 (Chart 2). If the BOJ needs to discern FY22 data (Jan-Mar 2023 data is to be announced in mid-May), it will be incapable of taking action during Governor Kuroda's term in office and also soon after the new Governor takes office. If a slow and cautious approach is taken, the time will not be ripe until mid-2023. If the US enters a full-scale recession by then, the BOJ will miss its opportunity for normalization.

Currency issues are gradually becoming a bigger factor regarding deterioration of Japan's terms of trade due to rising commodity prices

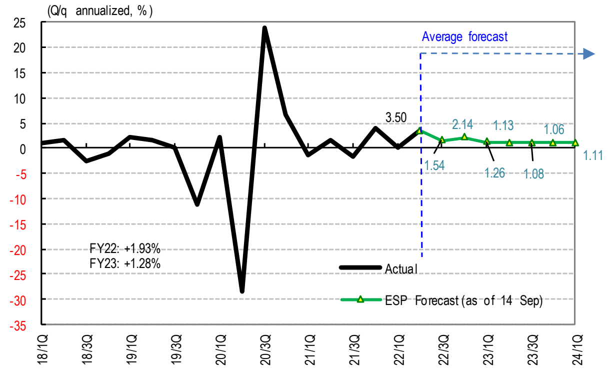
Chip shortages and Chinese factors are making export trends unstable

Soaring price of raw materials ranked as top issue for SMEs

Will BOJ think of some measures to support SMEs?

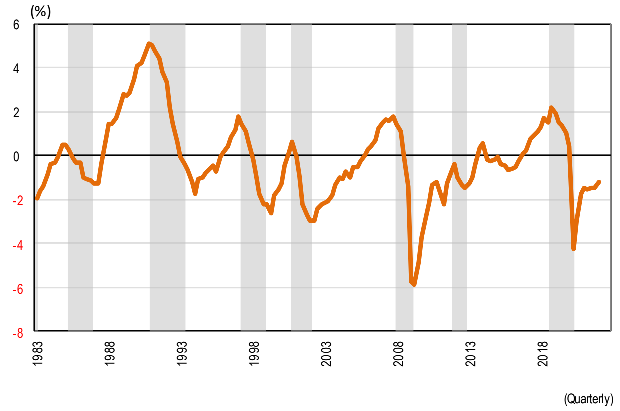
As for the second reason, the rise in crude oil prices let up in early June, and prices are now moving towards a downtrend. Regarding the deterioration of Japan's terms of trade, the BOJ must recognize that currency issues are gradually becoming a bigger factor than high commodity prices. The BOJ's stance of persistent easing based on its explanation that the exchange rate is due to US factors could eventually result in a paradoxical situation in which it promotes downward pressure on incomes. Nevertheless, the weak yen leads to a boost in GDP in the macro model assuming that sectors that can benefit from the weaker yen become more motivated to increase exports and capex. However, current export trends are more unstable than model-based estimations due to chip shortages and Chinese factors. Meanwhile, a survey by the Small and Medium Enterprise Agency states that the soaring price of raw materials ranked as the top issue for businesses. The impact on SMEs dependent on domestic demand has started to become increasingly large compared to that on large companies, which can conduct operations globally. Looking at profit margins (Output price DI - Input price DI) in the BOJ's Tankan (Chart 4), SMEs also lag behind large companies with regard to passing higher costs onto customers. Caution is advised, as this could lead to earnings declines and an increase in the number of bankruptcies. Therefore, it would be natural to think that the BOJ may consider some measures to support SMEs together with the government's comprehensive economic package.

Chart 1: Japan's Growth Rate Forecasts in *ESP Forecast* Survey (Sep 2022 survey)



Source: Cabinet Office, Japan Center for Economic Research; compiled by Daiwa Securities.

Chart 2: Trend of Output Gap Estimated by BOJ



Source: BOJ; compiled by Daiwa Securities.
Note: Shaded areas indicate recessions.

Japan's core CPI of 3% is just a matter of degree, and is lower than in US and Europe

"Zero-inflation norm" is primary reason for being unable to achieve BOJ's price stability target of 2%

BOJ emphasizing importance of wage hikes amid insufficient rise in price of services

Focus of attention is shifting to selection process for next BOJ governor and deputy governors

Regarding the third reason, if October nationwide core CPI rises to around 3% and the USD/JPY rate stays at the Y140 level going forward, core CPI will stay at the 3% level for a longer period of time. Even if core CPI is slowed down, it may stay at the upper 2% range by end-2022 and stay at the 2% level in Jan-Mar 2023. In the September *ESP Forecast* survey, the average core CPI forecast rose to +2.64% for Oct-Dec, but steadily declined after that (Chart 3: +2.38% in FY22 and +1.18% in FY23). However, if the rise were limited to that level, Japan's inflation rate looks much lower compared to the +8-9% in the US and Europe. The BOJ will likely judge that this is a temporary rise in goods. According to the BOJ, the primary reason for being unable to achieve the price stability target of 2%, despite the fact that the central bank has carried out large-scale monetary easing for over nine years, is the extreme persistence of the "zero-inflation norm," i.e., no one is changing price tags. I think that prices in Japan are changing because (1) companies have been passing higher costs onto customers more than before, (2) trimmed mean is on a clear uptrend, and (3) the general price outlook (three years ahead) at corporations of all sizes (in all sectors) has risen to 2%. However, price trends have not yet caught up with the BOJ's expectations. With the BOJ apparently feeling that the rise in the price of services has been insufficient compared to the US, it has been repeatedly emphasizing the importance of wage hikes. I think that the government and the BOJ should first create opportunities to discuss price assessments, and then make BOJ's policy operations more flexible. However, the focus of attention seems to be shifting to the selection process for the next BOJ governor and deputy governors.

At Sep meeting, BOJ is expected to decide to continue with persistent easing stance

Oct *Outlook Report* will be important when considering policy operations heading towards next spring

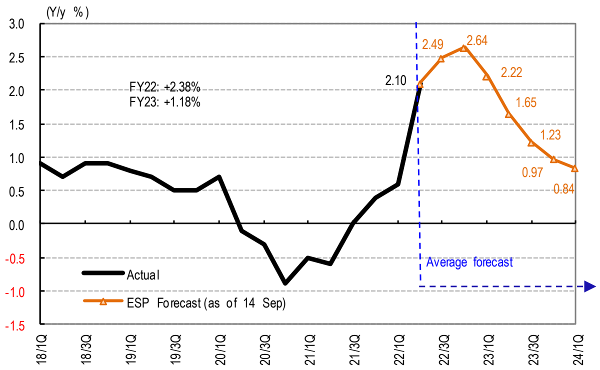
At its September monetary policy meeting on 21-22 September, the BOJ is likely to again discuss how to view the sustainability of global inflation and rising yields and the impact on Japan's economy from the deterioration of the terms of trade, based on market trends (US long-term yield and USD/JPY rate levels) following the September FOMC meeting. Nevertheless, the September meeting is positioned as a time of preparation for the announcement of the October *Outlook for Economic Activity and Prices* report (*Outlook Report*). The BOJ is expected to decide to continue with the same persistent easing stance as before. We will have a rough idea of the overall picture in Jul-Sep in the lead up to the October meeting. Economic/price projections and economic assessments will send an importance message when considering policy operations heading towards next spring.

BOJ will likely end special COVID-19 financing program in line with gov't policy to stop offering interest-free and unsecured loans

In return, BOJ may consider financing support measures for SMEs

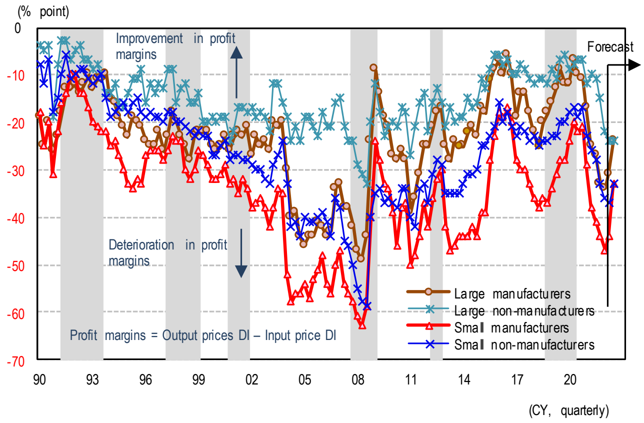
This time around, the BOJ is expected to decide to end its "Special Program to Support Financing in Response to the Novel Coronavirus," which is set to expire at end-September. The central bank will end the crisis response program, given the government's decision to stop offering interest-free and unsecured loans at end-September (announced on 8 Sep) amid the winding down of demand for corporate loans. According to a Jiji Press article on 16 September, the BOJ is expected to determine that the bad situation in sectors hit by the COVID-19 pandemic (such as the face-to-face services sector) has peaked and that the possibility is emerging that the BOJ will consider financing support measures in consideration of rising costs at SMEs. This is probably what the BOJ can do in cooperation with the government's comprehensive economic package. It is possible that the BOJ will revise the wording for forward guidance for policy interest rates in line with the end of the special COVID-19 financing program, but its bias towards easing seems likely to be maintained. The BOJ's stance of maintaining its current policy will not change.

Chart 3: Japan's Core CPI Forecasts in *ESP Forecast* Survey
(Sep 2022 survey)



Source: Ministry of Internal Affairs and Communications, Japan Center for Economic Research; compiled by Daiwa Securities.

Chart 4: Profit Margins by Corporate Size/Sector in BOJ Tankan



Source: BOJ; compiled by Daiwa Securities.
Note: Shaded areas indicate recessions.

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