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Daiwa's View

For BOJ, downside risks posed by overseas economies are a more significant factor than higher-than-expected prices

➢ Government and BOJ share a common view of the economic situation

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It is difficult to imagine BOJ leading efforts to prevent yen depreciation

BOJ Governor Kuroda celebrates his 78th birthday today, 25 October. Happy birthday, Mr. Kuroda. The market is continuing to pay close attention to the BOJ, which is stubbornly maintaining easing. At the end of last week, on 21 October, the USD/JPY rate temporarily rose to the Y151 level, the weakest level for the yen in 32 years. The strong dollar/weak yen trend, which is blamed on the US/Japan interest rate disparity and Japan's trade deficit, probably won't be easily resolved until certain US factors settle down. With the MOF being in charge of foreign exchange, it is attempting to protect the yen via currency intervention. However, it is difficult to imagine the BOJ leading efforts to prevent yen depreciation. At its Monetary Policy Meeting (MPM) to be held on 27-28 October, the BOJ is likely to maintain the status quo.

Government and BOJ share a common view of the economic situation

Impact of changes in financial and capital markets should be thoroughly monitored

According to a Reuters article dated 24 October, the government plans to explicitly state in the comprehensive economic package (to be decided on at the Cabinet meeting on the 28th) that global recession fears are heightening and that the government and BOJ share a common view of the economic situation. Reportedly, the government is likely to express its expectations that the BOJ will thoroughly monitor the impact of changes in the financial and capital markets, and that the central bank will conduct appropriate monetary policy operations in order to sustainably and stably achieve its price stability target. The BOJ must devise ways to prevent its messaging from contributing to yen depreciation. It must strive to do so at the regular press conference on the 28th, as well.

BOJ likely to lower FY22-23 economic growth outlook in October *Outlook Report*

Focus on timing for macro output gap turning positive and whether wording in report revised

Amid these conditions, the BOJ will release its October *Outlook for Economic Activity and Prices* report (*Outlook Report)* on 28 October. As for the economic growth forecasts (median of policy board members' forecasts), we note that production got off to a weak start in FY22 and consumption was sluggish in the Jul-Sep quarter. With the global economy further slowing, production and consumption forecasts are expected to be revised slightly lower even for FY23 (Chart 1[1]). In the July *Outlook Report*, the BOJ stated that the macro output gap is "projected to turn positive around the second half of fiscal 2022 and then continue to expand moderately." In the upcoming report, we are interested in seeing if the wording is again revised in step with a lowering of the BOJ's economic growth forecast for FY22. In the wording for this section, we can probably see the time frame for the continuation of persistent easing, which the BOJ believes is in line with fundamentals.

Chart 1: Projections by BOJ Policy Board Members (median, y/y %)

	Real GDP			Core CPI		
	Jul 2022*	Oct 2022**	My forecast	Jul 2022*	Oct 2022**	My forecast
FY22	+2.4 %	**+2.1 %**	+2.0 %	+2.3 %	**+2.6 %**	+2.6 %
FY23	+2.0 %	**+1.6 %**	+1.4 %	+1.4 %	**+1.4 %**	+1.5 %
FY24	+1.3 %	**+1.3 %**	+1.3 %	+1.3 %	**+1.3 %**	+1.4 %

Source: BOJ, various materials; compiled by Daiwa Securities.
**BOJ projections.*
***Our estimates for policy board member projections.*

[1] I revised CPI projections after announcement of Sep nationwide CPI data on 21 Oct.

BOJ likely to raise FY22 price outlook to upper 2% range

With BOJ likely viewing inflation as temporary, its FY23 price projection will probably be reduced to 1% level

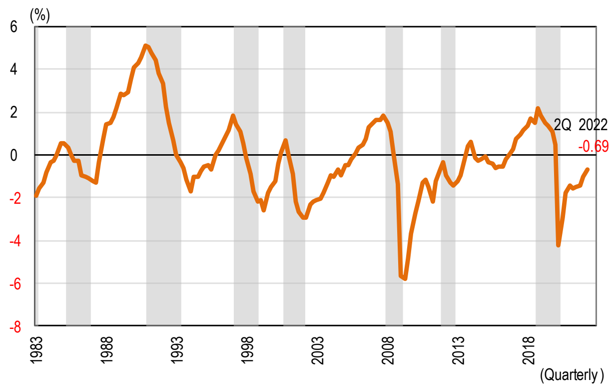
Turning to the price (core CPI) forecast, externals have changed over the past three months. While the crude oil price rise temporarily slowed (WTI fell from around $100/bbl in late Jul to below $90/bbl in mid-Oct), the yen has weakened (from just over USD/JPY138 to over USD/JPY148), and the exchange rate has been a major factor in pushing up import prices (Chart 3). According to various media reports, the BOJ will probably make upward revisions to its FY22 price projection, raising it to the upper 2% range from 2.3% as of July (Chart 1), reflecting rising commodity prices and moves to pass higher costs on to product prices as well as news about markups starting in autumn. With the BOJ unlikely to change its view that current inflation is temporary, its FY23 price projection will probably be reduced to the 1% level.

Private-sector average projection shows that growth is expected to continue in the 1-2% range from 2023

Downside economic-related risks possibly increasing more than before

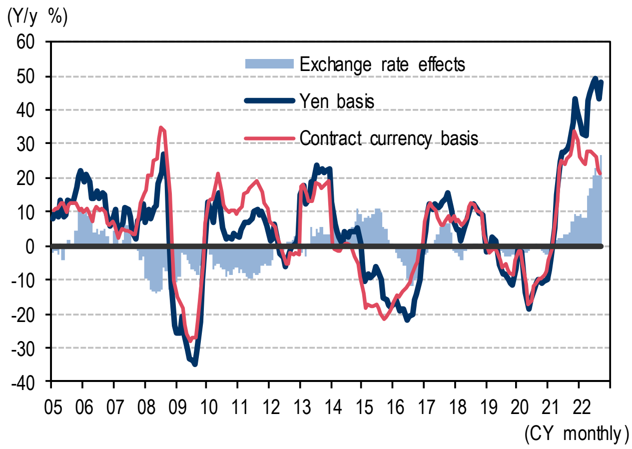
According to the forecast average of the *ESP Forecast* survey (27 Sep ~ 4 Oct survey period, 36 responses) released on 11 October, projections for Japan's real economic growth rate were +1.40% for Jul-Sep and +2.18% for Oct-Dec (q/q annualized). Jul-Sep GDP data (first preliminary) due out on 15 November will likely show that consumption over the summer failed to gain momentum under the seventh wave of coronavirus infections, but is expected to grow slightly due to catch-up production combined with strong exports and capital investment. The current Oct-Dec period is expected to see a stronger economic recovery due to support measures encouraging domestic travel along with the easing of restrictions on entering Japan (demand from foreign tourists). From 2023, growth is expected to continue in the 1-2% range. A meaningful decline due to external demand factors is not expected. However, in his speech on 19 October, monetary policy board member Seiji Adachi discussed the perception of risk as a precondition for monetary policy operations. He explained that downside risks for economic conditions could be building up more than before, which seems to represent the current thinking of BOJ governor/deputy governors. He specifically identified downside risks for Japan's economy from China (impacts of strict zero-coronavirus policy, real estate market pullback) and downside risks for the US economy (phase of further monetary tightening) with the potential for asset price pullbacks on a global scale. Here, we can find that the government and BOJ are sharing a common view of the economic situation.

Chart 2: Trend of Output Gap Estimated by BOJ



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

Chart 3: Japan's Import Price Index



Source: BOJ; compiled by Daiwa Securities.

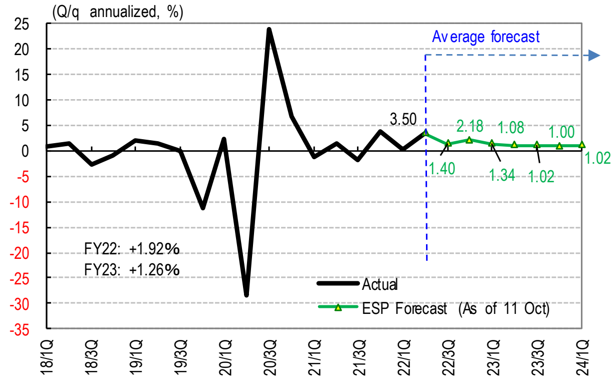
Japan core CPI forecast to remain above 2% until spring 2023

Division of roles between gov't and BOJ

BOJ persistently maintains monetary easing

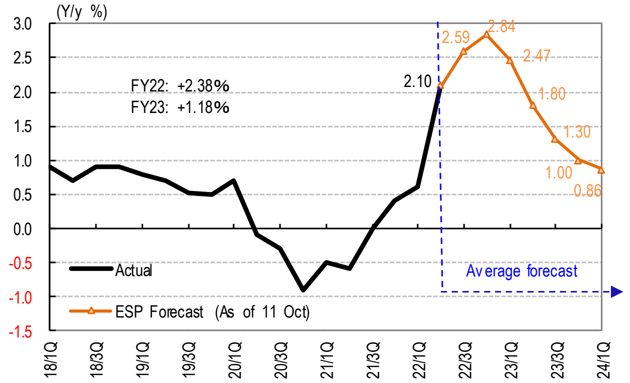
Turning to the outlook for core CPI in Japan, the forecast average of the October *ESP Forecast* survey is for inflation to peak at 2.84% y/y in Oct-Dec and remain just above 2% until next spring (Chart 5). Price growth could be even stronger than expected if the yen were to weaken over a prolonged period. The change in prices DI in the BOJ's Tankan survey shows that SMEs are lagging behind large enterprises in term of passing on higher costs to the product prices (Chart 6). The downward earnings revisions are also bigger for SMEs than large enterprise. Japan has a division of roles in which the government takes measures to prevent high prices (including support for SMEs), while the BOJ persistently maintains monetary easing, mindful of the downside risks to the economy. As such, BOJ upward revisions for its price forecast do not necessarily lead to policy changes.

Chart 4: Japan's Growth Rate Forecasts in *ESP Forecast* Survey (Oct 2022 survey)



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

Chart 5: Japan's Core CPI Forecasts in *ESP Forecast* Survey (Oct 2022 survey)



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

In Oct *Outlook Report*, growth outlook to be revised downward, while near-term price outlook to be revised upward

Downside risks posed by overseas economies bigger factor than wage growth importance

As mentioned above, Japan's economic growth outlook for FY22-23 is expected to be revised downward, while the FY22 price outlook is expected to be revised upward in the BOJ's October *Outlook Report*. Japan's economy has yet to recover to its pre-coronavirus level and worsening terms of trade have resulted in income outflows, which are particularly damaging for SMEs. For 2023, we have started to see concerns about downward pressure from external demand due to a global economic slowdown. Previously, there was the impression that the reason for maintaining persistent easing was the need for a gradual increase in the underlying tone of prices and the importance of wage growth. However, we can read from these comments that the downside risks posed by overseas economies is now a more significant factor. This point is expected to be emphasized by Governor Kuroda at his regular press conference, which is likely to express a sense of unity between the government and BOJ.

Medium/long-term inflation outlook also up, Kuroda's easing has sufficiently filled its role

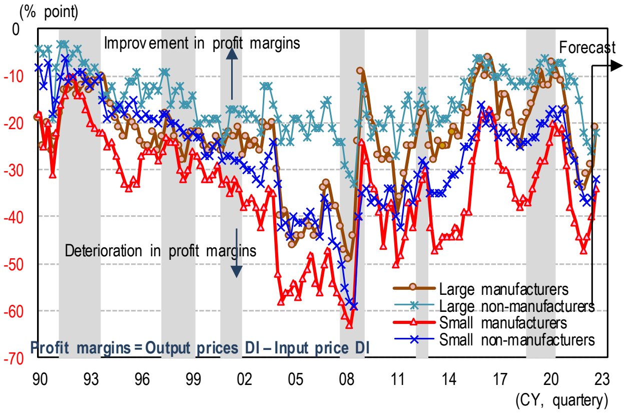
Still, this summer, some sectors (lodging, beverages, temporary staffing) began to see an increase in non-regular wages due to labor shortages resulting from the recovery in demand. Winter bonuses are also expected to improve in those sectors benefiting from a weaker yen. Next year's annual spring wage negotiations are also likely to produce some improvements on the wage front, albeit at a slow pace. Meanwhile, the medium/long-term (5-year) inflation outlooks for all enterprises/all industries in the Tankan survey reached 2% for the first time (Chart 7). The conditions surrounding prices in Japan have changed dramatically. We can probably conclude that the role of the monetary easing implemented by BOJ Governor Haruhiko Kuroda was successfully fulfilled, provided that the economy recovers to it pre-coronavirus level in FY22, the output gap turns positive, and core CPI is around 2%.

Yield curve distortions and poor market liquidity and functioning demonstrate limits of YCC

BOJ needs to carefully explain reasons for capping 10-year JGB yield at 0.25%

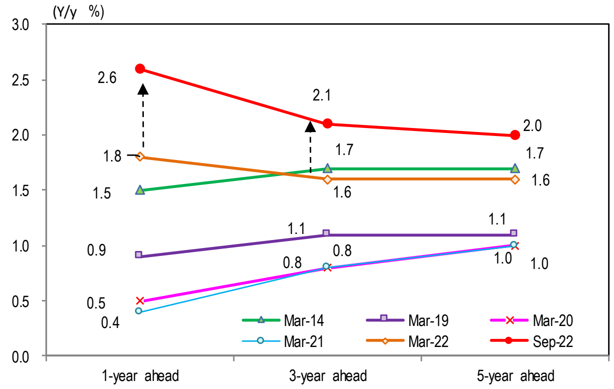
In April 2004, the BOJ published a research paper entitled *Kokusai Shijo to Nihon Ginko* ("The JGB market and the BOJ") in which, three important roles of the JGB market were given as being (1) to indicate a risk-free rate level, (2) to serve as a source of information for making judgments about monetary policy, and (3) to serve as a place for implementing monetary adjustments. The paper stated that this is premised on high market liquidity and functionality. Despite major structural changes in the global economy, the BOJ continues to insist on capping the 10-year JGB yield at 0.25%, making it difficult to stop the rise for super-long JGB yields, which are influenced by conditions overseas. Thus, the JGB yield curve has become quite distorted. Bond market liquidity and functioning have been greatly diminished and the limits of the YCC policy have become more obvious. We believe that the BOJ needs to carefully explain not only the reasons for its continued tenacious easing, but also its reasons for capping the 10-year JGB yield at 0.25%.

Chart 6: Profit Margins by Corporate Size/Sector in BOJ Tankan



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

Chart 7: Inflation Outlook of Enterprises in BOJ Tankan (all-size enterprises/all industries)



Source: BOJ; compiled by Daiwa Securities.

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