Daiwa Securities

Daiwa's View

The Kishida administration's appropriate policy mix

➢ While BOJ reins in rise in yields, government responds to inflation and yen depreciation through economic measures

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Substantial upward revision to FY22 price projection (to +2.9%) in Oct *Outlook Report*

Risks to economic activity are skewed to downside, but risks to prices are skewed to upside

Projected timing of output gap turning positive unchanged at around 2H FY22

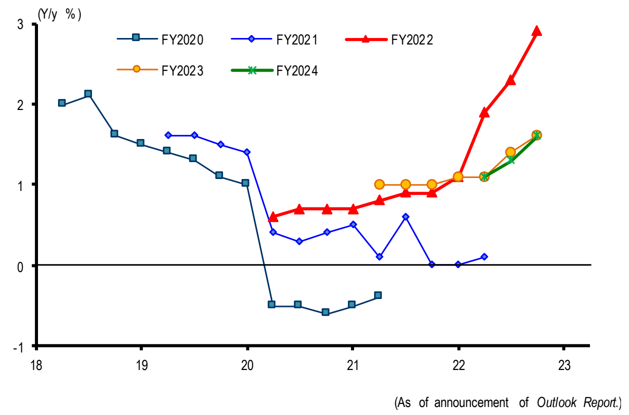
At its Monetary Policy Meeting (MPM) held on 27-28 October, the BOJ maintained the status quo through a unanimous vote, as expected. In its October *Outlook for Economic Activity and Prices* report (*Outlook Report*), the BOJ lowered its growth rate outlook for FY22 and FY23, but raised its price projections for FY22-FY24. In particular, the FY22 core CPI forecast was raised substantially to +2.9%, from +2.3% as of July (Chart 1). That figure is expected to slow to 1.6% in FY23, and the projection for core-core CPI is also +1.6% (same as core CPI projection), indicating an absence of a boost from energy factors. The BOJ expects price growth to slow towards mid-FY23. In this report, the wording regarding risk balance was simplified—risks to economic activity were expressed as being "skewed to the downside," and risks to prices were described as being "skewed to the upside." In both cases, the wording in the previous report "for the time being, but are generally balanced thereafter" was removed. This indicates a prolonged time frame until risks are balanced. Regarding the closely watched macro output gap (Chart 2), the BOJ maintained the wording in the July *Outlook Report,* again stating that the output gap is "projected to turn positive around the second half of fiscal 2022 and then continue to expand moderately" under its economic projections that are more bullish than those in the private sector. The output gap turning positive is something that is still awaited.

At press conference, Governor Kuroda was asked many questions about his awareness of yen depreciation and questions linking price projections with policy

Rapid depreciation of yen is not positive for economy

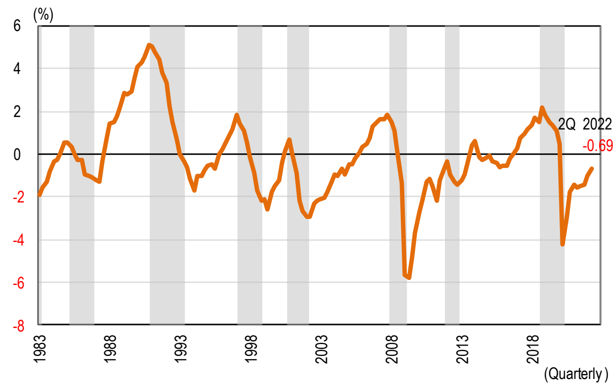
At his regularly scheduled press conference, Governor Haruhiko Kuroda was asked many questions about his awareness of yen depreciation and questions linking price projections with policy. He was first asked once more about the impact of yen depreciation on Japan's economy. He replied that he had previously said that, although, based on macro models, and the like, the weak yen's impact on the economy was positive overall, provided it was stable, the impact was uneven depending on sector, corporate size, and economic entity. He stated that the recent rapid depreciation of the yen was not positive for the economy. As for the factors behind the weak yen, he stated that it was one-sided to explain recent forex trends only by focusing on the interest rate differential between Japan and the US, and that the difference in inflation rates and the slowdown in the US economy due to rate hikes had been overlooked. He also expressed the opinion that YCC was not bringing about depreciation of the yen. Since its June meeting statement, the BOJ has added the following to the risk factor section: "It is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices." This wording has continued to be included since then. The BOJ is likely to keep a watchful eye on these developments.

Chart 1: Trend of Core CPI Projections* in BOJ *Outlook Report*



Source: BOJ; compiled by Daiwa Securities.
*Median of policy board members' forecasts.

Chart 2: Trend of Output Gap Estimated by BOJ



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

BOJ intends to continue to provide support towards achieving virtuous cycle with wages and prices

Meanwhile, when asked about the latest upward revision to price projections, he explained that while it was true that we had drawn slightly closer to the 2% target due to slight upward revisions to FY23 and FY24 figures from previous projections, this meant that core CPI growth would not reach 2% even in FY24. He also stated that, it was desirable to achieve a virtuous cycle with wages and prices, so authorities were conducting monetary policy with that as their aim, and that, as such, the BOJ had a stance of continuing to provide support until then. He emphasized that, for that reason, he did not think that we would see interest rate hikes or an exit right away. However, he stated that he wanted to continue to give full consideration to the functionality of the bond market.

BOJ revised operation schedule, increasing JGB purchases in superlong zone from Nov

At 17:00, after the press conference by Governor Kuroda, the Financial Markets Department announced a partial revision to the *Quarterly Schedule of Outright Purchases of Japanese Government Bonds (Competitive Auction Metho*d) for Oct-Dec 2022. For November and December, the number of offers in the 10-25 year zone was revised to three times per month (two times in Oct, with purchase size per auction maintained at Y250bn). The number of offers in the over-25 year zone was revised to three times per month (two times in Oct, with purchase size per auction maintained at Y100bn). Compared to the previous figure, the total purchase amount in the superlong zone was increased by Y350bn. Due to this, it can be said that the BOJ showed its intention to rein in distortion of the yield curve and an excessive rise in yields in the superlong zone.

Gov't decided on comprehensive economic measures at Cabinet meeting

Scale of measures appears to have expanded in the end

Likely to prop up Japan's economy in FY23

The key will be whether wage hikes continue while gov't implements inflation measures

At a Cabinet meeting after 17:30, the Kishida administration decided on comprehensive economic measures to ease the impact on consumers of soaring prices and achieve economic revitalization. The scale of the measures appears to have expanded in the end, as shown by all projects amounting to Y71.6tn with fiscal spending of Y39.0tn (Y29.1tn in the general account of the second preliminary budget). Given the fact that a large portion of the budget was not used up in the past and was carried forward to subsequent fiscal years, we think that the effect of boosting GDP by 4.6% (estimate by the Cabinet Office) is excessive. Nevertheless, there are items whose budgets are likely to be used in a planned way, such as subsidies, COVID-19 measures, and infrastructure spending to make Japan more disaster-proof. This is likely to prop up Japan's economy amid a slowdown in the global economy in FY23. Measures to cope with inflation are expected to reduce the total burden of Y45,000 per standard household during Jan-Sep 2023 via (1) the introduction of measures to ease the burden of electricity and gas charges and (2) the continuation of the scheme to ease the drastic change in gasoline and kerosene prices. It is estimated that these measures will rein in the rise in headline CPI by around 1.2ppt. Reportedly, this figure does not include the effect of the support measures encouraging domestic travel (which pushed down Oct CPI in the ward-area of Tokyo by 0.2ppt). Based on these measures, the BOJ is expected to lower its FY22-23 price projections (shown in the October *Outlook Report)* in January 2023. Japan will be tested to see if it can achieve the virtuous cycle with wages and prices that the BOJ wants via continuous wage hikes by private-sector companies while the government implements inflation measures until 1H FY23.

The following is clearly stated in the final paragraph of page six in the document attached to economic measures.

> The government and BOJ share a common view of the economic situation, and work together closely through an appropriate policy mix of fiscal policy and monetary policy.
>
> The government expects the BOJ to thoroughly monitor the impact of changes in the financial and capital markets, and conduct appropriate monetary policy operations in order to sustainably and stably achieve its price stability target.

Top priority at BOJ is to rein in rise in interest rates

Gov't will respond to inflation and yen depreciation via economic measures, which is appropriate policy mix

It is difficult to imagine BOJ taking action during Governor Kuroda's term in office

Previously, I have pointed out that the BOJ would not change unless the Kishida administration changed its expectations of the central bank's role. The statements above show that the top priority at the BOJ is to rein in the rise in interest rates. Even if this leads to depreciation of the yen and inflation, the government will respond through inflation measures (gasoline subsidies and support for electricity/gas charges) and measures to cope with the weak yen (stimulation of inbound demand, expansion of exports, and support for a return to investment in Japan). The government appears to have clearly stated that this division of roles is just the right policy mix of fiscal policy and monetary policy. In the near term, Japan's inflation is expected to rise towards the upper 3% range. However, the rise will be contained from January 2023 onwards due to government measures to cope with inflation. Some market participants (mainly overseas investors) have firmly rooted expectations for policy revisions by the BOJ. However, the BOJ is unlikely to take action while Governor Kuroda is in office. Amid expectations for positive developments with next year's annual spring wage negotiations, the focus is expected to shift to the selection process for the next BOJ governor and deputy governors.

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