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Daiwa's View

Expectations of a BOJ pivot never stopped in 2022

➢ Even with an uneventful Dec policy meeting, expectations of the next BOJ Governor are rising

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Expectations of a BOJ pivot never stopped in 2022

The year 2022 was one of nonstop expectations of a BOJ pivot

BOJ policy board member Naoki Tamura broke the ice on discussing normalization

From your author's perspective, 2022 was a year of nonstop expectations of a BOJ pivot. From the beginning of the year, I had many inquiries on Japan's price trends, monetary officials' recognition of yen depreciation, and the BOJ's policy responses. This all continued unchanged in December. Policy board member Naoki Tamura broke the ice on discussing normalization inside the bank. Board member Naoki Tamura's first interviews with the media since taking office in July were reported late in the night of 2 December on Bloomberg (interviewed on 30 Nov) and in the morning edition of the *Asahi Shimbun*. In both cases, he shared his view that, "It would be appropriate to conduct a review at the right time, including the monetary policy framework and 2% inflation target." The author has likewise long argued that a review of the policy framework requires verification, that the government and the BOJ should discuss the 2% price stability target, and that the government should allow for flexible interpretations. I also see no reason for the BOJ to insist on an exact 2% price target. The author is encouraged by Tamura, who shares some of her views. Tamura will probably be a driving force for increasing BOJ policy management flexibility under the new governor.

Deputy Chief Cabinet Secretary Seiji Kihara says the government and BOJ may issue a new joint statement

Are there plans to change the joint statement once the next BOJ Governor is in place?

The purpose of changing the joint statement would be to broaden the BOJ's options, but many advise caution

According to a Bloomberg article published on the afternoon of 12 December reporting on an interview conducted in English in the preceding week, Deputy Chief Cabinet Secretary Seiji Kihara spoke not only about the selection of new BOJ leadership but also about the possibility of a new joint statement from the government and BOJ. The joint statement (Chart 5) cannot be changed solely at the behest of the BOJ but also needs consent from the government. We had noted previously that the change in governorship would present a good opportunity to modify the joint statement, and on the evening of 17 December Kyodo News reported that the government and BOJ are considering modifying the joint statement and loosening the 2% inflation target. Specifically, the Kishida administration has firmed its plans to modify the joint statement when the new BOJ governor takes over in order to broaden the BOJ's options. However, an article on page 3 of the 18 December morning *Nikkei* tempered the news of the government considering modification of the statement with a subheading noting that some are cautious about modifying it. That article noted that although it is possible that a review of the joint statement could lead to monetary easing policies being modified, it is unclear whether that will actually happen given there are some advising caution. Further twists and turns to this story appear likely.

Bloomberg article on 14 Dec suggests possibility of a policy review by the BOJ's new leadership team

There is unlikely to be a policy review until BOJ Governor Kuroda's term ends

According to a Bloomberg article published on the evening of 14 December and written based on interviews with individuals in the know, the BOJ is likely to conduct a policy review in 2023 after closely examining wage hikes in Japan and developments in overseas economies. The article came out right before the start of the blackout period for the December policy meeting. It appears that competition for writing speculations on the future has started because the December meeting would be uneventful. The article underscored the unlikelihood of an assessment and review of monetary policy before BOJ Governor Kuroda's term ends, and this may have quashed any expectations still lingering in the market of a policy pivot by March 2023. Conversely, it will probably strengthen expectations of the BOJ's new leadership from April.

It may take time for the joint statement to be modified

Governor Kuroda's last three policy meetings will be just for show

When Masaaki Shirakawa was the BOJ governor, it only took about a month to put together the current joint statement, but modifying it may take a while longer. With the LDP still unable to agree internally on how to fund the national defense buildup, there is likely to be strong opposition to modifying the joint statement, which would be interpreted as the BOJ becoming less reflationist. If the Kishida administration is looking at such modification as a package deal together with selection of the new BOJ Governor, it may take a while for their selection to be approved. At any rate, we think BOJ Governor Kuroda's last three policy meetings will be just for show, and once the new BOJ governor is in place, the future trends in prices, wages and the economy will be critical to the debate over modifying the joint statement.

Three reasons why BOJ has maintained easing

The BOJ has cited the following three reasons why it has so persistently maintained its easing policy: (1) Japan's economy has not returned to pre-coronavirus levels, (2) need to mitigate downward pressure and negative impacts on the income-side due to rising resource prices, and (3) cost-push inflation is temporary and so must allow for gradual increase in underlying price tone. Furthermore, BOJ messaging includes the importance of wage increases. On this front, the spring annual labor-management wage negotiations must be carefully monitored. The decision days including the spring wage negotiations tend to be concentrated in mid-March, which means the results will not be known by the time the BOJ holds its policy meeting on 9-10 March 2023.

It is becoming more likely that Japan's economy will recover to pre-pandemic levels by end-FY22

Weaker demand for chips to suppress export/production momentum

Regarding the first reason for maintaining easing policy, the GDP level in FY20-21 was revised upwards due to the announcement of final FY21 GDP data on the 8th. As a result, provided that the current Oct-Dec quarter shows a clear recovery with domestic travel subsidies and demand from foreign tourists and the Jan-Mar 2023 quarter does not post a plunge, Japan's economy will likely return to pre-coronavirus levels, defined by the BOJ as the average level for 2019 (before the coronavirus outbreak), by end-FY22. The possibility of this happening has increased compared to before the release of the revised GDP data. However, the slowdown in the US and Chinese economies and weakening demand for semiconductors are starting to hamper the momentum of exports and production. How the BOJ describes these developments in its December economic assessment will be closely watched (Chart 6).

The current business conditions DI for the December Tankan shows a divergence between manufacturers and nonmanufacturers

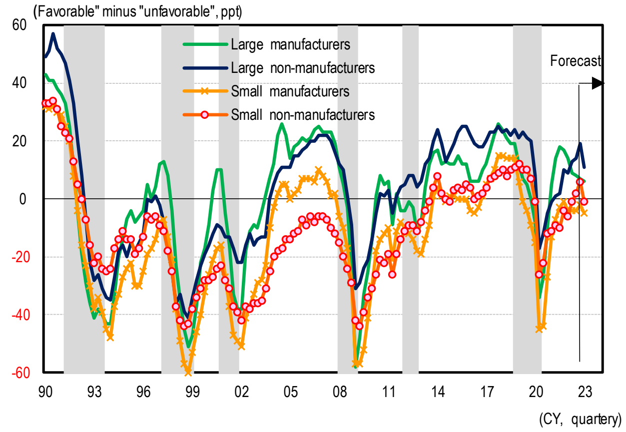
Forecasts are cautious, reflecting downside risks to overseas economies and impacts from rising prices

The December Tankan survey announced by the BOJ on 14 December (the deadline for survey responses was 28 November and the response rate was around 75%) showed a divergence in the current business conditions DI between manufacturers and nonmanufacturers, while forecasts were cautious because of uncertainties, including downside risks to overseas economies and impacts from rising prices (Chart 1). In the current DIs, large manufacturers raised the export portion of their sales forecasts, but the DI for overseas supply and demand conditions for products dropped steadily downward (Chart 2), showing worrisome weakness. Exchange rate assumptions were revised substantially[1], and there was a widening of the difference between large and small enterprises in the extent of downward revisions to 2H earnings forecasts[2]. Large enterprises do business globally and benefit from yen depreciation, whereas small enterprises, unable to sufficiently pass on higher input costs to their customers, are seen their earnings decline.

[1] The FY22 exchange rate assumption of exporters (large manufacturers) was a USD/JPY of 130.03, a Y7.30 weaker yen than the 122.73 assumption in the previous survey in September. That is still a conservative assumption, however, given that the USD/JPY was around 139 when survey answers were due.

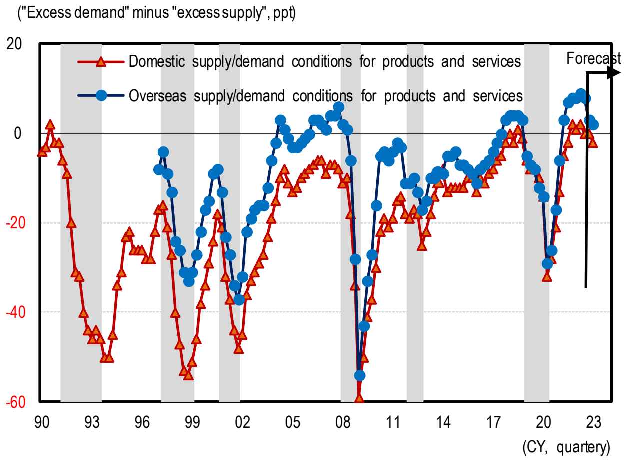
[2] The revision to recurring profit forecasts for 2H FY22 was a reduction of 0.7% by large enterprises in all industries but a much larger reduction of 2.3% by small enterprises in all industries.

Chart 1: Business Conditions DIs in BOJ Tankan



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

Chart 2: Supply and Demand Conditions DIs Among Large Manufacturers in BOJ Tankan



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

Overall, the change in the input prices DI is declining while the change in output prices DI is rising

We expect deterioration in profit margins to gradually ease

In contrast, the input prices DI by company size and industry shows an overall forecast of decline on the pause in rising commodity prices. For output prices, the current DI is rising overall but the forecast DI is declining for large enterprises and still rising for small enterprises. Small enterprises that have been slow to pass on higher prices remain worried, but they expect an easing of the deterioration in profit margins, which is the second of the reasons for continuing monetary easing (Chart 3). The government is providing short-term subsidies to ease the impact of inflation (including electric power and gas subsidies until mid FY23), and the BOJ is still providing support for small enterprises. The ball is now in the court of private sector companies, and the question is whether they can raise wages consistent with expectations, even if only slightly.

Japan's core CPI should remain close to 4% for the remainder of 2022 and then should weaken to below 3% early in 2023

The corporate price outlook in the Tankan has been above 2% for three consecutive quarters

There are signs that a virtuous cycle is forming between prices and wages

Turning to the third reason for maintaining easing, the core CPI was +3.6% y/y in October and is expected to remain close to 4% for the remainder of 2022. In its economic assessment for December, the BOJ raised its price level assessment, and we expect a gradual confirmation of this (Chart 6). Government subsidies to ease inflation should lower the core CPI to below 3% in early 2023, but companies have begun announcing rate hikes for March-April, signaling a major change in their price setting behavior. The overall 3-year forward corporate price outlook in the December Tankan was +2.2% y/y for all company sizes in all industries (vs. +2.1% in the last Tankan survey), a third consecutive quarter above 2% (Chart 4). Although Japan's upward price pressures are not as high as in the US and Europe, its medium-term inflation outlook is steadily rising. Additionally, as occurred in the US a year ago, wages for contingent workers have started rising amid a labor shortage. The sectors able to benefit from yen depreciation are also increasing their winter bonuses. Core CPI could hold around 2% next spring if we see more revisions to services prices in April 2023. There are signs that a virtuous cycle for wages and prices is forming and several bright spots are expected to fall into place around the time when the new BOJ governor takes office next spring. Given such signs for changes, the government and the BOJ need to discuss their views on prices once again.

We expect the BOJ to remain strongly committed to easing at its Dec policy meeting

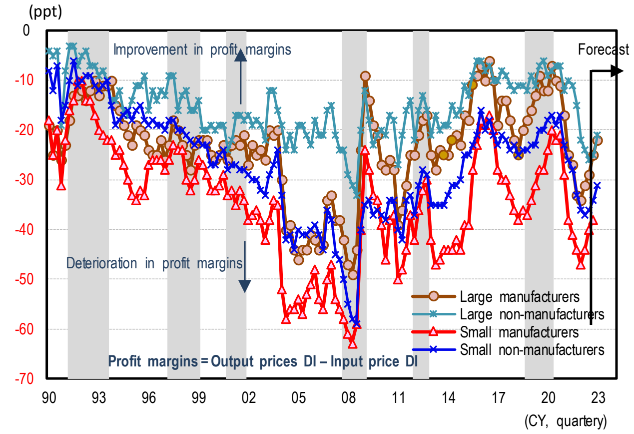
The Jan *Outlook Report* should be revealing as to how the BOJ conducts policy between now and next spring

At its last monetary policy meeting of the year, scheduled for 19-20 December, the BOJ will likely again focus its discussion on global inflation, the trajectory of monetary tightening in the US and Europe, downside risks to overseas economies, and impacts from higher prices. However, it has positioned the December meeting as a period of preparation prior to release of the *Outlook for Economic Activity and Prices* report (*Outlook Report*) in January 2023. We expect it to remain strongly committed to accommodative policies. Up until its January 2023 policy meeting, it will look broadly at the Oct-Dec quarter, before modifying its economic and price outlook, based on the government's comprehensive economic measures, the FY23 budget, and changes to taxation. Its price outlook and assessment should be particularly revealing as to its thinking on policy between now and the spring of 2023.

First news of the BOJ's new leadership team will likely come around 10 Feb

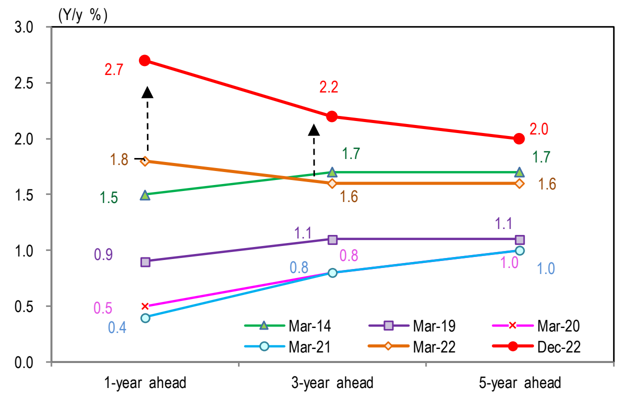
News regarding candidates for the BOJ's new leadership team acceptable to the Diet should start coming out when the regular session of the Diet convenes in January. In most years, the first announcement is usually made around 10 February. Your author would like to see a new BOJ Governor with a strong global sense and ability to dialogue with the market.

Chart 3: Profit Margins by Corporate Size/Sector in BOJ Tankan



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

Chart 4: Inflation Outlook of Enterprises in BOJ Tankan (all-size enterprises/all industries)



Source: BOJ; compiled by Daiwa Securities.

Chart 5: Joint Statement of the Government and the Bank of Japan on Overcoming Deflation and Achieving Sustainable Economic Growth (22 Jan 2013)

In order to overcome deflation early and achieve sustainable economic growth with price stability, gov't and BOJ will ensure closer policy coordination and work together as follows.

★BOJ
BOJ recognizes that rate of inflation that allows sustained price stability will rise as efforts by wide range of entities toward strengthening competitiveness and growth potential of Japan's economy make progress. Based on this recognition, BOJ sets **price stability target at 2% in terms of on-year rate of change in consumer price index**.
Under price stability target specified above, BOJ will implement monetary easing and **aim to achieve this target at earliest possible time**.
Taking into consideration that it will take considerable time before effects of monetary policy are visible in economy, BOJ will confirm any significant risk to sustainability of economic growth, including widening of financial imbalances.

★Gov't
Gov't will, in order to revitalize Japan's economy, not only flexibly implement macroeconomic policy but also **strongly promote policy mix for improving competitiveness and growth potential of Japan's economy** under leadership of Headquarters for Japan's Economic Revitalization. Those measures include all possible decisive policy actions for **reforming economic system**, such as concentrating resources on innovative research and development, strengthening foundation for innovation, carrying out bold regulatory and institutional reforms and changing tax code. In addition, in strengthening coordination between the government and the Bank of Japan, the government will steadily implement measures aimed at meaningfully improving fiscal sustainability with a view to **ensuring the credibility of fiscal policy**.

Source: Partially excerpted from Cabinet Office and MOF materials.

Chart 6: Change in Description of BOJ's Economic Assessment on Current Conditions in Oct 2022

Current conditions	Text in red shows revisions in Oct ⇒ shows expected revisions in Dec
Japan's economy	Despite being affected by factors such as high commodity prices, has picked up as the resumption of economic activity has progressed while public health has been protected from COVID-19 ⇒ No change
Overseas economies	Have recovered moderately on the whole, but slowdowns have been observed, mainly in advanced economies ⇒ No change
Exports	Have increased as a trend, with the effects of supply-side constraints waning ⇒ Weak demand for chips may be included as weakness in some sectors
Business fixed investment	Has picked up, although weakness has been seen in some industries ⇒ No change Business sentiment has been more or less unchanged ⇒ No change Corporate profits have been at high levels on the whole ⇒ No change
Private consumption	Has increased moderately, despite being affected by COVID-19 ⇒ Inclusion of stronger momentum in services expenditures due to domestic travel subsidies
Public investment	Has been more or less flat ⇒ No change
Housing investment	Has been relatively weak ⇒ No change
Industrial production	Have increased as a trend, with the effects of supply-side constraints waning ⇒ Weakness in some sectors may be included, similar to exports
Financial conditions	Have been accommodative on the whole, although weakness in firms' financial positions has remained in some segments ⇒ No change
Prices	Y/y rate of change in the CPI (all items less fresh food) has been at around 3% due to rises in prices of such items as energy, food, and durable goods. Meanwhile, inflation expectations have risen. ⇒ Upward revision from "around 3%" in Oct to "upper 3% range"

Source: BOJ; compiled by Daiwa Securities.

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