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Daiwa's View

Has the world changed since the BOJ's April meeting?

- Main scenario for BOJ policy outlook: Raises 10yr JGB yield target range in Oct-Dec 2023

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Has the world changed since the BOJ's April meeting?

Yen depreciation, stock market gains accelerate since BOJ's April meeting

US/Japan monetary policy differences also changed significantly from last year with US entering final stage of rate hiking phase

Fed does not want to invite serious recession ahead of next fall's US presidential election

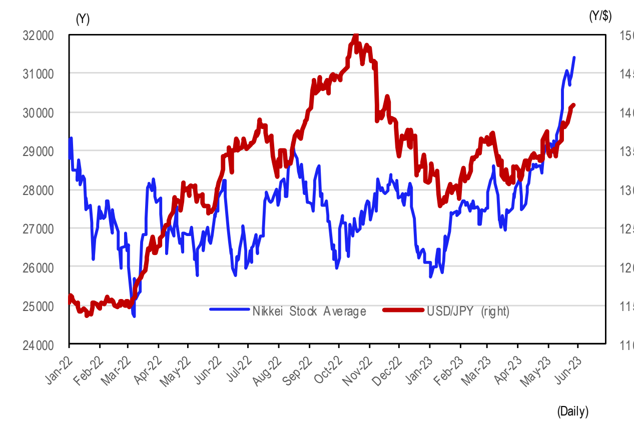
Since the BOJ's 28 April Monetary Policy Meeting (decided to maintain monetary policy status quo), yen depreciation and stock market gains have accelerated (Chart 1). Such developments on the foreign exchange market could be attributed to differences in US/Japan monetary policy approaches. The phrase "widening US/Japan interest rate gap" seems like a dose of déjà vu from last year. However, conditions for the US are now very different from those seen last year as the Fed has entered the final stage of its interest rates hiking phase. There has been a pull back from the excessive factoring in of early interest rate cuts following the credit uncertainties in March. Also, despite some upbeat data, the US economy is slowing due to the time lag for the cumulative effects of monetary tightening to date (Chart 2). The current situation appears to be so troubling that opinions among Fed members are becoming increasingly divided. Still, it would be reasonable to assume that Fed Chairman Jerome Powell wants to avoid inviting a serious economic downturn with the November 2024 US presidential election looming. So, rather than the US/Japan interest rate gap continuing to widen, it is better to view this as a continuation of high US policy rates to curb inflation, which will not narrow this gap anytime soon.

See FOMC maintaining view that rate cuts at June meeting would be premature

Weak US data, market instability justify continued BOJ easing

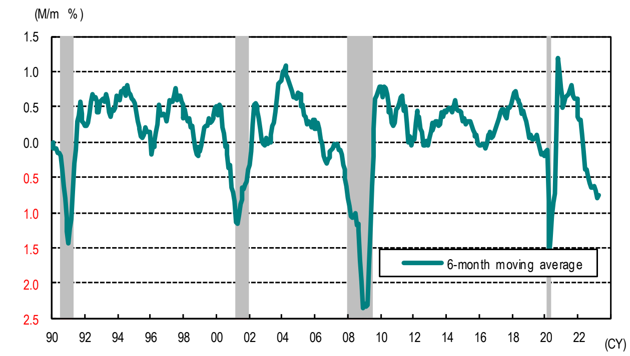
At its June meeting, the FOMC will be able to confirm employment and CPI data for May. If its end-2023 inflation outlook does not fall below 3% and the economy remains firm, the FOMC would likely maintain its view that a rate cut at that juncture would be premature. Still, while the Fed keeps policy rates high, the market will continue to be swayed by US economic strength and weakness for a period of time. Currently, there finally appears to be an agreement on raising the US debt ceiling, which is reassuring. However, looking ahead, the risks in Japan include stock prices pulling back from recent highs and big currency fluctuations. Weak US data and market instability will keep providing the BOJ with justification for continued easing.

Chart 1: Nikkei Stock Average, USD/JPY (from 2022)



Source: Bloomberg; compiled by Daiwa Securities.

Chart 2: US Economic Leading Index



Source: Conference Board of US; compiled by Daiwa Securities.
Note: Shaded areas indicate US recessions.

BOJ's Ueda tenaciously maintaining monetary easing

Deep-seated expectations for YCC revisions on view policy rate forward guidance removed to ensure flexibility

The BOJ leadership change stirred up strong expectations on the market for early policy revisions, but the Monetary Policy Board statement at the first meeting under new BOJ Governor Kazuo Ueda read, "The Bank will patiently continue with monetary easing." Indeed, he stuck to the approach of former governor Haruhiko Kuroda, who aimed to achieve the 2% price stability target in a "sustainable and stable manner." Ueda has repeatedly expressed his cautious stance against a hasty tightening of the Bank's monetary policy. I believe that the Bank has adopted a wait-and-see attitude, very wary of the risk of a downturn for the US economy. Still, deep-seated expectations for revisions of the Bank's yield curve control (YCC) policy persist as removal of its policy rate forward guidance in the statement for the April meeting has been viewed as a move to ensure more policy flexibility. Even if such changes do not come in June, many are on guard for some revisions at the July meeting, when the Bank will release its next *Outlook for Economic Activity and Prices* report (*Outlook Report*).

Will Japan's economy return to pre-pandemic levels in second half of year?

July *Outlook Report* could lift FY23 inflation forecast from +1.8% as of April

Possible lowering of FY24 forecast if traditional pathway is maintained

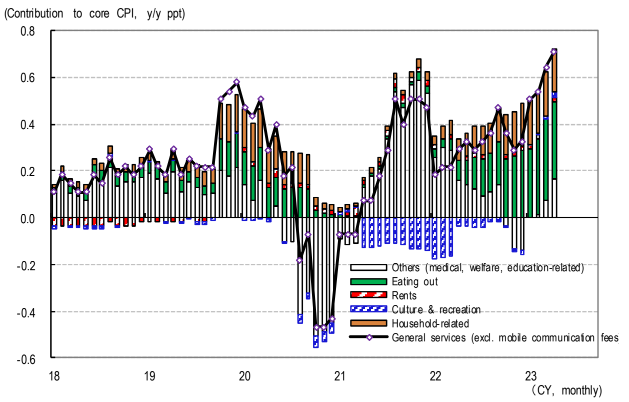
During 25 May interview, Ueda touched on potential YCC revisions, but it appeared to be merely model answer

Japan's actual GDP for FY22 was +1.2%, in line with the forecast in the April *Outlook Report*. The economy is returning to a post-coronavirus economic trajectory, as two major domestic demand drivers offset foreign demand weakness. Still, the Japanese economy will probably not return to pre-coronavirus levels (2019 average) until the second half of the year. On the other hand, inflation has been held in check (on the surface) by the government's price-control measures, but price hikes are expected to continue, particularly for food products. April nationwide CPI confirmed spreading service price increases since the switch from FY22 to FY23 (Chart 3). Also, electricity rates are officially set to increase from June. In its July *Outlook Report*, the BOJ is likely to raise its inflation (core CPI) forecast for FY23 from +1.8% (median forecasts of majority of Policy Board Members) as of April. That said, during a 25 May interview with the media (published on 26 May), Ueda said that inflation in Japan will return to the conventional trajectory, noting that, "As the price increases for raw materials and fuels overseas have started easing, the inflation rate will fall" (Chart 4). If this view is maintained, the BOJ could raise its inflation outlook for FY23, but lower it for FY24. However, Ueda also said during this interview that, "The possibility that my expectation is wrong is not zero. If it's wrong, I would like to act quickly." Also, regarding the conduct of monetary policy, he said, "YCC policy modifications are possible if there is a change in the balance between the policy's benefits and side effects." When asked about shortening the maturity of the JGB used to influence the interest rate target, he said, "That is among the available options," but regarding this point, he did not seem to actively speak out in his own words.

Important to check corporate earnings, ability to pass higher costs onto product prices, and sustainability of wage hikes heading into next year

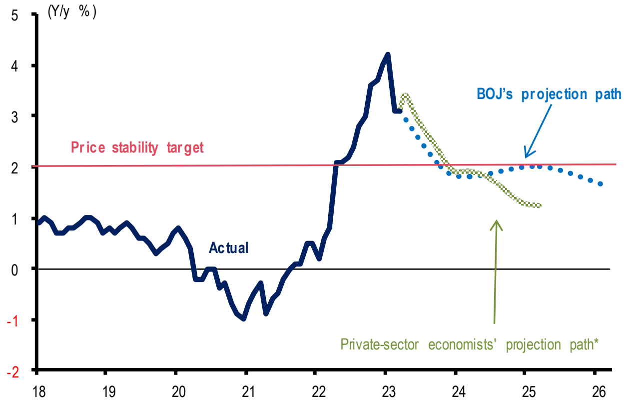
Wage hikes in spring wage negotiations reached a 30-year high (3.67% in the fifth summary by the Japanese Trade Union Confederation). Therefore, higher income is expected to ease downward pressure on consumption amid higher prices. Unless consumption declines substantially, companies are likely to continue passing higher costs onto product prices. This would prevent a sharp drop in corporate earnings. As a result, the momentum behind wage hikes could be sustained heading into next year. I think it will be important to check BOJ Tankan surveys for trends in corporate earnings and the ability of companies to pass higher costs onto product prices (price DIs).

Chart 3: Factor Analysis of General Service Prices in Nationwide CPI



Source: Ministry of Internal Affairs and Communications (MIC); compiled by Daiwa Securities.

Chart 4: BOJ's and Private Sector's Projection Paths of Japan's Core CPI



Source: MIC, BOJ, Japan Center for Economic Research; compiled by Daiwa Securities.
**ESP Forecast survey (May 2023) figures.*

Data for explaining policy revisions will not be available until autumn, at the soonest

As mentioned above, the BOJ does not yet have sufficient data to conduct policy revisions. It will probably take until the beginning of autumn, at the soonest, in order to confirm overseas economic trends, recovery of Japan's economy to pre-pandemic levels, stabilization of the output gap in positive territory, and a virtuous cycle with wages and prices (using the BOJ Tankan surveys in Jun and Sep).

BOJ is likely to draw distinction between short-term rate and long-term rate

Negative interest rates will be eliminated once review is completed and US rate cuts end

Long-term rate target expected to be raised to +0.25% in line with changes in economic and price conditions

Assuming Governor Ueda comes to logical conclusions, he is unlikely to decide to make sudden policy revisions. Given his remarks thus far, we forecast that the BOJ will draw a distinction between the short-term rate and the long-term rate in its policy responses. Until the completion of a long-term and broad-perspective review, the BOJ is unlikely to move the target for the short-term rate. Furthermore, it is difficult for the BOJ to conduct rate hikes that run counter to rate cuts in the US. Therefore, negative interest rates will not be eliminated until the US stops cutting rates. Meanwhile, with regard to the long-term interest rate, the BOJ is likely to first confirm the sustainability of wage hikes by this autumn. If the US economy were to remain solid and its policy interest rates were to stay high until then, although it could prove challenging, the BOJ would have a chance to consider revisions to the long-term interest rate as a measure to mitigate side effects on the assumption of continued easing (Chart 5). As the current long-term rate target of about 0% is no longer in line with actual levels, levels are unlikely to change substantially even if the target were raised to +0.25% in line with changes in economic and price conditions.

Main scenario is revision to long-term rate target in Oct-Dec, but probability is low at 50%

As Governor Ueda and Deputy Governor Uchida are cautious, BOJ may miss opportunity

However, Governor Ueda emphasized that "the cost of impeding the nascent developments toward achieving the 2% price stability target ... by making hasty policy changes would likely be extremely high." He also stated that "it is appropriate to take time to decide on revisions to monetary easing toward a future exit." Given these remarks, we forecast that the time for this will be the Oct-Dec quarter. The probability of my main scenario is low at 50% because both Governor Ueda and Deputy Governor Uchida appear to be quite cautious (dovish) and wary about an economic downturn. If the BOJ adopts an overly cautious stance, we will have to realize that it might miss the timing for sub-scenario 1. This would be an unavoidable option if employment and other areas are affected by major negative impact. Meanwhile, if sticky inflation continues throughout the world longer than expected, and if prices in Japan rise together with wage hikes, the BOJ will be required to take action quickly.

Chart 5: BOJ Monetary Policy Outlook for 2023 (as of May 2023)

Main Scenario		In every *Outlook Report,* BOJ continues discussing whether the 2% price stability target is within reach. (October assessment may be critical.) Prices are higher than current projections. Overseas interest rates remain high. Due to risks of yen appreciation and downsides with overseas economies, measures to mitigate side effects are compiled under assumption of continued easing. **Target range for the long-term interest rate is raised.**
Probability	**50%**	Raises long-term rate target from 0 to +0.25%, and indicates a reference range at that level (e.g., ±0.50% from 0.25% = −0.25% ~ +0.75%). **The BOJ must strengthen its coordination with the MO**F's debt management policies **to build a system more resilient to market fluctuation**. **The BOJ distinguishes the short-term rate from the long-term rate.** After announcing review, it considers monetary policy normalization via elimination of negative interest rates. Monetary policy is normalized after the US stops cutting rates.
Sub-scenario ①		It will proceed with debate carefully while keeping an eye on the external environment. **It remains wedded to continuing easing and misses an opportune time for making new changes** until review is completed. A US recession strengthens expectations of early rate cuts, and this increases downward pressures on Japan's economy.
Probability	**40%**	Inflation drops below 2% in 2H 2023, making it impossible for the BOJ to make a move. The BOJ becomes the only major central bank that has been unable to normalize from a crisis response.
Sub-scenario ②		Helped by a tailwind, the BOJ feels strongly that 2% price stability target will be achieved by next spring. Changes course on continued easing and revises the policy framework. **Eliminates both negative interest rates and the long-term rate target.** **Fears of a US recession proof unfounded and the Japanese economy continues a brisk recovery.**
Probability	**10%**	Inflation remains high globally and monetary tightening continues in the US and Europe, putting downward pressure on the yen. Japan's inflation stays at around 2%, even in 2H FY23. Sustained wage growth looks achievable. When eliminating negative interest rates, sharp increases in interest rates are suppressed by indications that rates will not be raised anytime soon.

**I modified my outlook on 15 May, after the April BOJ MPM.*

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