Daiwa's View

Central bank week, viewing Japan in a global context

- Fighting multiple inflation factors, BOJ also needs to revise its price forecasting model

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Ongoing fight against multiple inflation factors (coronavirus, climate change, war)

Resource prices down, but still higher than pre-pandemic levels

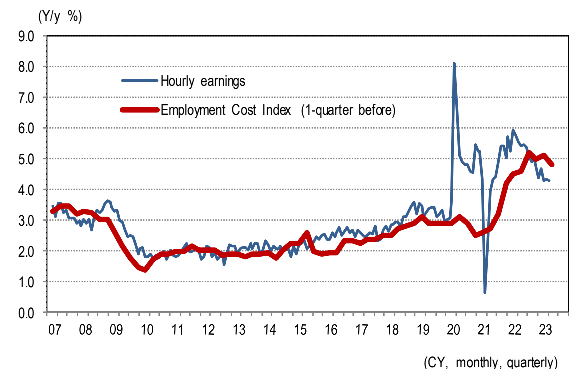
Wage inflation, fiscal inflation outlook

Since last spring, we have identified three factors that are all contributing to inflation at the same time, specifically (1) supply constraints amid the coronavirus outbreak, (2) greenflation brought about by measures to address climate change, and (3) the war in Ukraine. In the US, the prices of goods due to (1) have fallen, but labor shortages persist and service prices remain high due to wage inflation (Chart 1), which is a factor of demand. As for greenflation (2), energy price spikes have eased. That said, even though prices for agricultural goods and metals have fallen, they still remain higher than pre-coronavirus levels (Chart 2). Recent forecasts are calling for the emergence of the El Nino phenomenon[1] in 2023. As such, there are again concerns about higher prices for agricultural products amid the possibility of poor harvests due to unfavorable weather. As for the fighting in Ukraine (3), a ceasefire agreement seems unlikely to materialize any time soon. If economic sanctions against Russia by countries in the West continue and if trade becomes more fragmented under the strained US-China relations, inflationary pressures on goods could increase. Meanwhile, spending on national security could lead to fiscal inflation. The credit crisis that originated in the US in March led to increased US recession fears on the market, but the fight against inflation is still ongoing.

Third week in Jun is central bank week: BOJ, Fed, and ECB to chart different paths

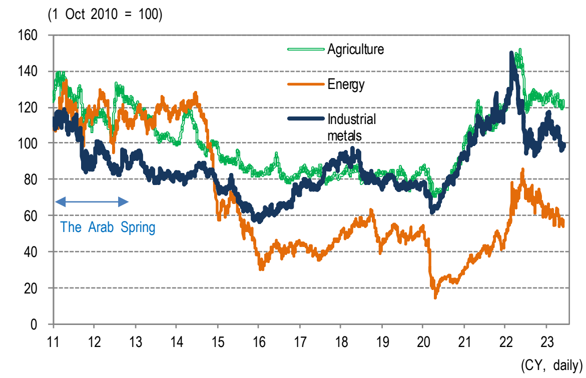
On 6 June, the Reserve Bank of Australia raised interest rates for the second straight meeting and, on 7 June, the Bank of Canada decided to raise interest rates for the first time in three meetings. This week, the third week of June, is central bank week with the Fed's FOMC meeting on the 13th-14th, the ECB's Governing Council meeting on the 15th, and the BOJ Monetary Policy Board meeting on the 15th-16th. These three central banks are expected to chart different paths with the Fed likely to hold off on hiking rates, the ECB expected to make another 25bp rate hike, and the BOJ likely to maintain its monetary easing. Currently, only the central banks of Japan and China are maintaining monetary easing policies.

Chart 1: Wages and Employment Cost Index in US



Source: US Department of Labor; compiled by Daiwa Securities.

Chart 2: S&P GSCI Commodity Index



Source: S&P, Bloomberg; compiled by Daiwa Securities.

[1] The Japan Meteorological Agency's "El Nino Outlook," updated on 9 Jun, sees a 90% probability that the El Nino phenomenon will continue into the autumn of this year.

Foreign investors stirring up speculating about potential BOJ policy revisions

No reason for prices/wages to not rise only in Japan

Core CPI in 4.0-4.5% range without government measures to offset high prices

Last year I spoke with foreign investors who were stirring up speculation about potential BOJ policy revisions. Many asserted that there was no reason why prices and wages should not rise only in Japan. Actually, even in Japan where inflation is lower than in Europe and the US, large companies have been passing on higher costs (higher resource prices, weaker yen) to the prices of their products/services. Indeed, January nationwide core CPI expanded to +4.2% y/y, the first increase in 41 years and four months (Chart 3). Government measures since February to take some of the sting out of rising prices have helped to control inflation, on the surface. However, price hikes are expected to continue through the fall, mainly for food products, as there are still delays passing on higher costs to product prices. April nationwide CPI also confirmed a spreading trend of service price increases from the start of the new fiscal year. Japan's Ministry of Internal Affairs and Communications calculated that government measures to offset rising prices (total contribution to electricity/gas bills) had a 1.00-point lowering effect in April. This means that without these measures, April core CPI would have landed at a lofty +4.4% y/y.

Increased wage hike momentum at end of last year; Japan's adaptive expectations working

Biggest wage hike in 30 years at spring wage negotiations, US/Japan alliance bolstered, rising growth expectations for Japan firms

Meanwhile, there has been unprecedented momentum for wage hikes since the end of last year. I began to have hope for a rising wage trend when the Japanese Trade Union Confederation (*Rengo*) demanded a 5% wage increase at the end of last year, with adaptive expectations working against rising prices in Japan. Later, I was asked for the first time to give an economic lecture at a Japan Business Federation (*Keidanren*) labor-management forum[2]. This provided an opportunity for me to advocate the need for wage increases. I was convinced that the mood was changing in regards to accepting wage hikes. The annual spring labor-management wage negotiations produced the biggest wage hike in 30 years (Japanese Trade Union Confederation (*Rengo*) won 3.67% wage hike as of fifth tally of responses), which exceeded expectations. Prices and wages in Japan went up, as foreign investors expected, more so even than Japanese investors, who were more cautious. At the same time, the Japan-US alliance has been bolstered in terms of addressing geopolitical risks and security. This suggests that growth expectations for Japanese firms have increased in the stock market.

Monthly labor statistics through Jul reflect 80% of wage revisions

Want to monitor monthly labor statistics up through the final report

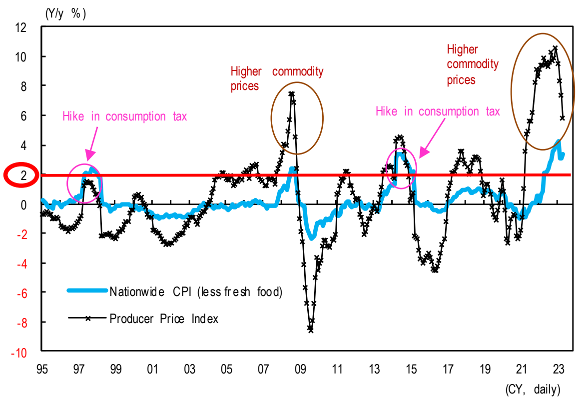
The monthly labor statistics for April (preliminary, released on 6 Jun) showed that real wages, which reflect price increases, were down 3.0% y/y, falling for the 13th straight month (down 2.3% in Mar). This discouraged the market to some extent as income growth did not keep pace with price increases (Chart 4). However, as the BOJ indicated in one of the "boxes" in its April *Outlook for Economic Activity and Prices* report (*Outlook Report)* (used to provide analyses of important topical issues), many SMEs with low labor union organization rates conduct wage negotiations from April onward, and the monthly labor statistics reflect 80% of wage revisions if viewed through July. The July preliminary figures will be released on 8 September and the July final figures will come out on 26 September. This statistic tends to have large discrepancies between the preliminary and final data due to low response collection rates. As such, there is the need to monitor labor statistics up through the final report.

Wage growth sustainability into next year; must check corp earnings, ability to pass on costs to prices

If consumption remains solid due to rising incomes, and if companies can pass on higher costs to their prices, corporate profits would most likely increase. That would act as the sustaining force for wage growth over the next year. We believe it will be important to check corporate earnings and progress passing higher costs onto prices in the BOJ's Tankan survey (prices DI).

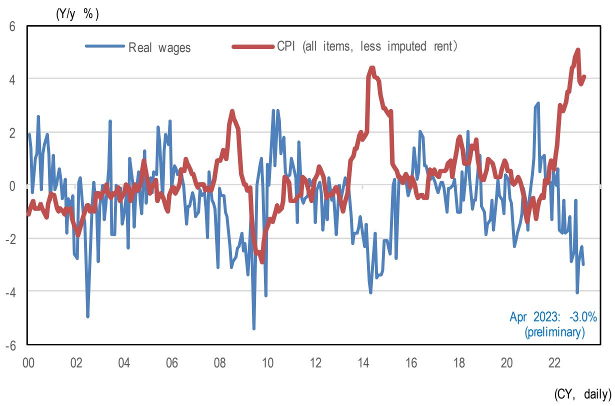
[2] Keidanren's "126th Labor-Management Forum" held on 24 Jan 2023.

Chart 3: Japan Upstream and Downstream Prices



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

Chart 4: Real Wages and CPI in Japan



Source: MIC, Ministry of Health, Labour and Welfare (MHLW); compiled by Daiwa Securities.

Seeing gradual change in practices of upward rigidity in wages and prices

Wage hikes are spreading in regions enjoying strong inbound demand

Inflation to peak out y/y, but level may overshoot

At the committee on financial affairs of the House of Councillors on 6 June, BOJ Governor Kazuo Ueda said that "we are seeing a gradual change in the practices of upward rigidity in wages and prices." According to the BOJ's April *Regional Economic Report*, wage hikes due to labor shortages in the accommodation services sector have spread to SMEs in regions enjoying strong inbound demand (the extent differs by region), and such a trend appears to be continuing (to be confirmed by the July report). When making a judgment on trend inflation, the BOJ takes into account information based on surveys from companies.[3] It appears that the central bank is sensing a change in the current situation. Thus far, the BOJ projected that prices would decline below 2% in 2H FY23 on the back of import prices turning negative y/y. However, it is highly likely that inflation will stay at around 2% (overshoot the level) due to a broader range of items showing an increase in prices and the sustainability of the movements to pass higher costs onto product prices. Thus, it would be better for the BOJ to change its wording at an early stage.

In Jul *Outlook Report,* FY23 core CPI projection is expected to be raised from +1.8% as of Apr

Jun BOJ meeting is positioned as preparation for Jul *Outlook Report*

Due to the aforementioned factors, the BOJ is likely to raise its inflation (core CPI) forecast for FY23 in its July *Outlook Report* from +1.8% (median forecasts of majority of policy board members) as of April. Nevertheless, if it maintains the view that core CPI will peak out y/y (Chart 5), it can lower its FY24 projection and not consider policy revisions. Moreover, the June meeting is positioned as preparation for the announcement of the July *Outlook Report* amid rumors about the possibility of the dissolution of the lower house and general election in an early stage. With distortion of the yield curve having been resolved, the decline in the function of the bond market has improved. Thus, the BOJ does not need to take action in a rush. Consequently, the BOJ is expected to maintain status quo for its policy.

[3] The tentative due date for submitting responses of BOJ's Jun Tankan (to be released on 3 Jul) is expected to be around 12 Jun, and branches are collecting information within their jurisdiction.

Is assumption that "inflation is temporary" really correct?

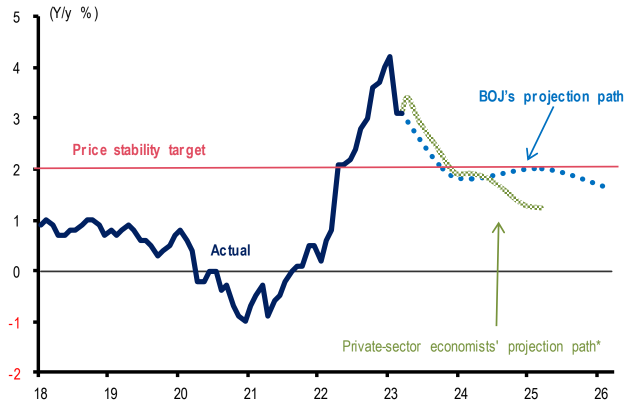
Impact of compound inflation should be discussed more

Highly likely that price projections based on Phillips Curve will be wrong

BOJ would be better to revise price projection model to increase prediction accuracy.

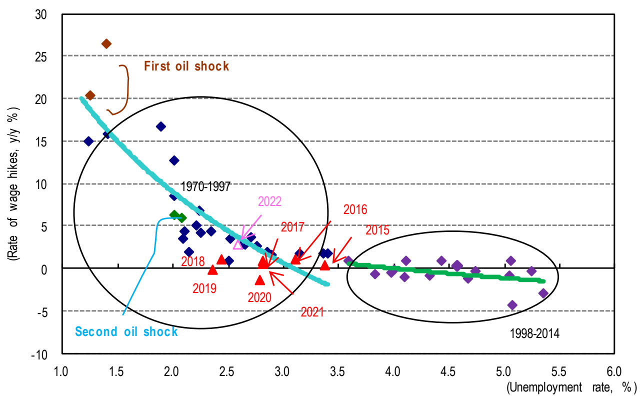
The BOJ is likely to conduct full-scale discussions under the updated economic/price projections from July onwards. In his speech on 19 May, Governor Ueda explained that "the current rise in prices due to cost-push inflation is a temporary upward deviation from the Phillips curve." Given that the US has continued rate hikes thus far due to the overshoot in inflation, I think there should also be more discussion in Japan regarding the impact of compound inflation as well as about whether the assumption of "temporary" is really correct. Although Japan's unemployment rate for April declined to 2.6%, the output gap for Oct-Dec 2022 is in negative territory at -0.43% (estimated by BOJ) and the figure is expected to finally turn positive in around mid-FY23. Improvement in the output gap is seen later than the decline in the unemployment, which is a lagging indicator. As such, the conventional relationship between the economy and prices is not working, which raises the possibility that price projections based on the Phillips curve will be wrong. It is natural to think that the current condition is different from the past because companies' price setting behavior differs from previous situations. When there is a big change in the economic structure, historical empirical rules and theories no longer work. I think that the BOJ would be better to revise its price projection model in order to increase prediction accuracy. I suggest that revising this model should be one of challenges addressed in the policy review process.

Chart 5: 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.*

Chart 6: Phillips Curve in Japan



Source: MIC; MHLW, compiled by Daiwa Securities.

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