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Daiwa's View

BOJ's narrative unchanged despite persistent policy revision speculation

➢ Underlying inflation rate expected to fall below 2% from FY24

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July market swayed by hope, speculation amid persistent YCC revision expectations

Long-term yields should eventually be corrected first, but not now with data lacking

Slew of reports one week before July meeting predicting BOJ won't revise YCC

On 28 July, just four days away, the BOJ will announce the results of its July Monetary Policy Board meeting. Over the past month or so, we prepared for a JGB market swayed by hope and speculation up until this week's "decisive Friday" due to deep-seeded expectations that the BOJ will revise its yield curve control policy (YCC). However, this was the first time that I has seen such clearly diverging market views of the same indicators and statements from BOJ officials. Former BOJ Governor Haruhiko Kuroda left behind a negative legacy of frequent surprises and the market has since become suspicious of the BOJ's information dissemination. Unfortunately, the current BOJ led by new Governor Kazuo Ueda has so far failed to make a fresh start in terms of dialog with the market. As for the argument that the BOJ should revise its monetary policy, we believe that long-term and short-term yields should be differentiated and long-term yields should eventually be corrected first. That said, the timing is probably not right at this juncture, considering that the BOJ's economic, price, and financial preconditions have not changed significantly. Ueda, who stresses fundamentals, still needs to wait for more data. On 21 July, one week before the July meeting, there was a string of media reports conveying the view that the Bank will refrain from making any policy changes at the July meeting. For example, there was a Bloomberg report with the headline "BOJ sees little need to act on yield control for now, sources say" and a Reuters report with the headline "Bank of Japan leaning towards keeping yield control steady next week, sources say."

Important to first create highly accurate economic/price outlooks

How does BOJ view policy based on outlooks?

Information from corporate hearings is a BOJ strength

Need to discuss compound inflation impact in Japan as conditions possibly due to temporary supply shock

In order for the Ueda-led BOJ to make logical policy decisions, it is important for the BOJ to first produce highly accurate economic and price outlooks. Then, the only way to rebuild a relationship with the market based on trust is to carefully and clearly explain how the BOJ views policy based on outlooks, as well as the relationship to policy decisions, in a manner that market participants can easily understand. The BOJ has the advantage of having information from hearings with companies. For example, in a situation in which plans have already been announced to hike food prices through to October, by conducting thorough hearings with food makers, the BOJ would be able to project sustainability. Moreover, each branch should be working actively to collect regional information. In addition to its survey abilities, the BOJ has a theoretical expert team[1], and, therefore, an environment is in place for increasing the accuracy of price predictions. However, in his speech on 19 May, BOJ Governor Ueda explained that "the current rise in prices due to cost-push inflation is a temporary upward deviation from the Phillips curve." Given the fact that inflation has actually risen more than expected in the US due to the coronavirus outbreak and the war in Ukraine, and interest rates have continued to rise, I was somewhat concerned whether the assumption of temporary situation is correct and it is questioned. Even in Japan there is the need to discuss compound inflation (considering coronavirus, climate change, war). Rethinking price forecasting models would also be desirable.

[1] The Bank of Japan Working Paper Series *Nonlinear Input Cost Pass-through to Consumer Prices: A Threshold Approach* (published 22 May 2023) pointed out that "the pass-through to CPI inflation of increases in producer prices, exchange rates, and wages rises once the increase in each of these variables exceeds a certain threshold" and "the estimated impact of the nonlinear pass-through of wage growth tends to be persistent due to the observed higher inertia in wage growth."

BOJ may lower FY23 growth outlook in July *Outlook Report*

Market focusing only on prices, but economic trends key for policy decisions

Amid these circumstances, the BOJ will release its July *Outlook for Economic Activity and Prices* report (*Outlook Report*) on 28 July. We expect a downward revision for its FY23 economic growth rate forecast (median of majority of Policy Board members, Chart 1). The economy is unlikely to recover to pre-pandemic levels in the Apr-Jun 2023 quarter, which will serve as a rationale for the BOJ to maintain its monetary easing. For now, the BOJ will likely maintain its view that the downside risks for overseas economies are significant, while expecting moderate growth (slightly above 1%) to continue even from FY23. This time, we think the BOJ will revise its somewhat optimistic outlook, bringing it more in line with private-sector forecasts (such as *ESP Forecast* survey). Also, the macro-level output gap was -0.34% for Jan-Mar 2023 as estimated by the BOJ (Chart 4) and more time is needed before this gap can securely take hold in positive territory. The market focus is mainly on prices, but economic trends are also important in terms of making policy decisions.

G20 worried about global economic slowdown, high uncertainty, downside risks for economies

Ueda cautious about global economy, assumptions still weak

Ueda said after G20 that overall story intact as long as assumptions unchanged

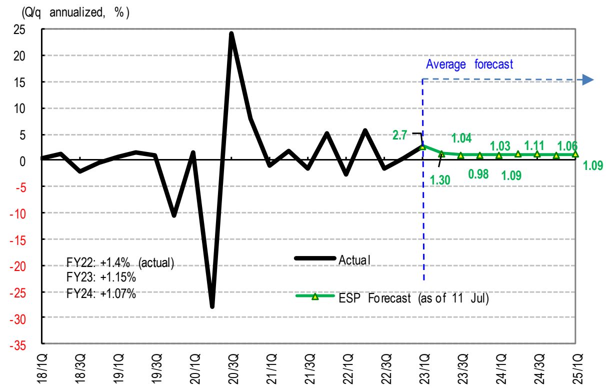
The G20 Outcome Document and Chair's Summary (announced on 18 Jul) clearly stated that "global economic growth is below its long-run average and remains uneven," "the uncertainty around the outlook remains high," and "with notable tightening in global financial conditions, persistent inflation, and geopolitical tensions, the balance of risks remains tilted to the downside." Once again, concerns were shared about the slowdown and high uncertainty for the global economy, as well as the downside risks to the global economy due to inflationary pressures. In a recent IMF blog, Managing Director Kristalina Georgieva wrote that strong actions from the G20 are needed. Specifically, she noted that international cooperation and coordination between monetary and fiscal policies are required. From the start, Ueda has been very concerned about the downside risks for overseas economies. For that reason, he has repeatedly made cautious statements about how the risk of missing a chance to achieve the 2% price target due to a hasty monetary tightening is much more significant than the risk of the inflation rate continuing to exceed 2%. This likely confirms that Ueda's cautious preconditions have not changed.
The BOJ probably will not revise policy at the July meeting given that Ueda said (at press conference after 18 July meeting of G20 finance ministers and central bank governors), "If our assumptions are unchanged, our overall narrative on monetary policy will remain unchanged."

Chart 1: My Estimates for BOJ Policy Board Members' Projections (median, y/y %)

	Real GDP			Core CPI			Core-core CPI		
	Apr 2023*	**Jul 2023****	My forecast	Apr 2023*	**Jul 2023****	My forecast	Apr 2023*	**Jul 2023****	My forecast
FY23	+1.4 %	**+1.2 %**	+1.1 %	+1.8 %	**+2.5 %**	+2.7 %	+2.5 %	**+3.0 %**	+3.4 %
FY24	+1.2 %	**+1.1 %**	+1.1 %	+2.0 %	**+1.9 %**	+2.0 %	+1.7 %	**+1.6 %**	+1.8 %
FY25	+1.0 %	**+1.0 %**	+1.1 %	+1.6 %	**+1.6 %**	+1.8 %	+1.8 %	**+1.8 %**	+1.8 %

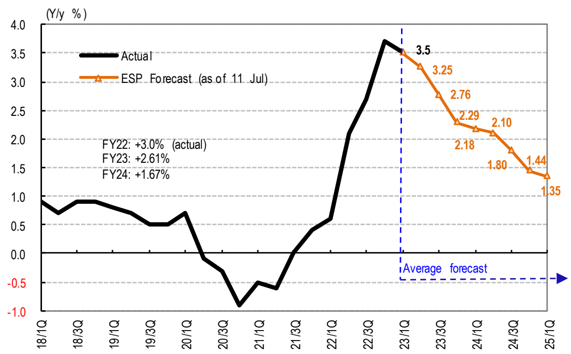
Source: BOJ, various materials; compiled by Daiwa Securities.
Note: Figure in yellow column was revised upward from estimate as of 18 Jul.
**BOJ projections.*
***My estimates for policy board member projections.*

Chart 2: Japan's Growth Rate Forecasts



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

Chart 3: Japan's Core CPI Forecasts



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

Will BOJ raise FY23 price outlook? Slower FY24 price growth vs FY23?

Core-core CPI stressed by BOJ may fall below 2% from FY24

Turning to price forecasts, Bloomberg reported on 24 July that the BOJ will likely significantly raise its core CPI growth forecast for FY23 to around 2.5%, citing multiple sources. We were surprised by the Bank's low core CPI growth forecast of only 1.8% as of April. However, due to the subsequent spreading of price hikes to services and the increase in electricity prices, the BOJ is likely to raise its projection to around 2.5%, close to the private-sector forecast, in July *Outlook Report* (Chart 3). Still, the momentum for last year's high resource prices and weak yen has slowed, while import prices have turned sharply negative y/y. Therefore, the BOJ's main scenario will probably call for only a temporarily CPI rise with the y/y rate of increase peaking[2]. The rate of increase in FY24 will be lower compared to FY23 (Chart 3), suggesting that the FY23 increase was temporary. At the 28 June ECB Forum on Central Banking, BOJ Governor Kazuo Ueda said, "The underlying inflation rate is below 2%." We expect core-core CPI, which the BOJ emphasizes, to fall below 2% in FY24 and beyond, even if the level for FY23 is high.

Lacking data needed to increase certainty of wage growth sustainability

Need to view monthly labor data through July (reflects 80% of wage hikes)

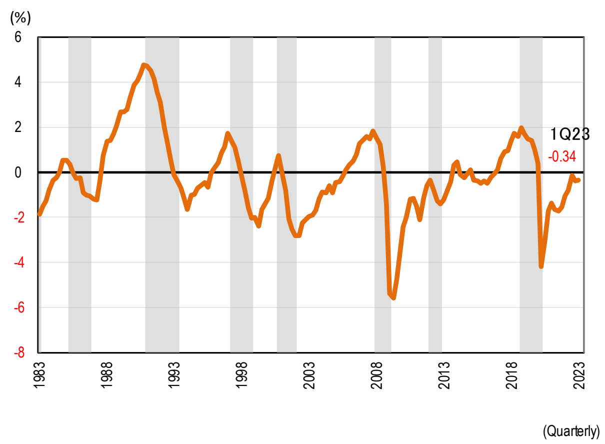
Nevertheless, it is highly likely that a virtuous cycle with wages and prices will be achieved and that there is a high risk that prices will continue to rise mainly because (1) companies are continuing to pass higher costs onto consumers in a way that is different from before, albeit with a time lag due to small and medium-size companies being late to join in, and (2) momentum for wage hikes has spread. It is also true that there is now greater hope than before of achieving the 2% price stability target. However, we don't yet have enough data in order to be more certain about the sustainability of wage hikes and the passing of higher costs onto customers. The y/y change in real wages announced on 7 July was -1.2%, less negative than the -3.2% in April, but it is necessary to wait until September for release of the July data, which should reflect 80% of the largest *Shunto* wage increase in 30 years (the Japanese Trade Union Confederation final tally was +3.58%). For the time being, both downside economic risks and upside price risks merit further watching.

Responding to YCC revision calls, BOJ likely to remain cautious with overall assessment

It would be a good idea to gradually water down YCC

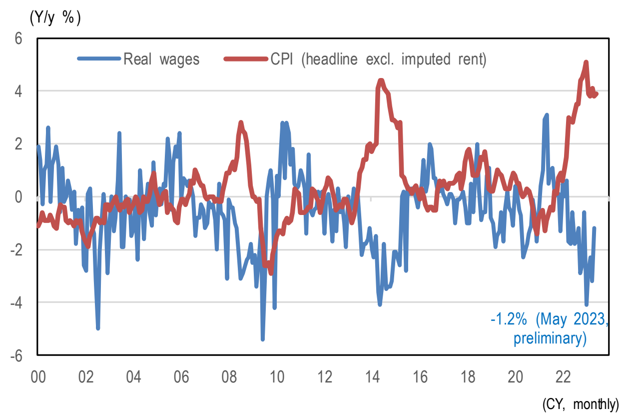
In response to the argument that YCC must be revised at an early date, I expect BOJ Governor Ueda to remain cautious and take a holistic approach to policy decisions that balances the economy, prices, and financial conditions. Still, we suspect the market will continue to speculate about potential BOJ moves at each meeting until the Bank actually revises policy. If the BOJ were to consider revising YCC, it would be a good idea for it to gradually water down YCC by reducing its grip in stages in order to avoid major market confusion. Rather than removing YCC all at once, the BOJ should think of other ways to handle the situation, such as providing a reference rate.

Chart 4: Output Gap Estimated by BOJ



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

Chart 5: Japan's Real Wages, CPI



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

[2] While there have been reports of further price hike plans through October, mainly for food products, BOJ expects prices to settle down thereafter. It will be interesting to see if the BOJ changes its expression "expected to fall below 2% in the second half of fiscal 2023."

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