Daiwa Securities

Daiwa's View

BOJ is marching in step with government

- They are working together to prevent depreciation of the yen

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The *Yomiuri Shimbun* ran an exclusive interview with BOJ Governor Kazuo Ueda on 9 September (the interview was conducted on 6 Sep). In the article, Governor Ueda made statements that seemed to be paving the way for elimination of the negative interest rate policy, including saying that there were various options available, including lifting the negative interest rate policy once the central bank was confident that Japan had achieved sustainable price increases accompanied by rising wages. (Refer to our 12 Sep 2023 report *Daiwa's View: BOJ Governor Ueda interview*.)

He also stated that the BOJ would lift the policy when it concluded that the price target could be achieved even after elimination of the negative interest policy, and that it was not impossible that the BOJ would have sufficient information and data by the end of this year, including about trends with wage hikes next spring. These remarks are garnering attention. In his 30 August speech, BOJ board member Naoki Tamura, seen as the most hawkish member on the board, touched on the 2% price target, saying that reaching the price target was clearly on the horizon, and that he expected that a clearer picture of the path towards achieving such inflation would be obtained sometime around January to March of next year, which garnered attention. Governor Ueda's remark that it would be the end of the year was earlier than Mr. Tamura's time frame, and appears to have been somewhat hasty.

Currently, he is maintaining the stance that the BOJ will continue tenaciously with monetary easing because there is still a ways to go before the price target is reached. However, while there may likely be some lip service involved here, this sudden hawkish shift by Governor Ueda admittedly feels rather sudden. In the interview, he commented on the recent depreciation of the yen, saying that the BOJ would remain in contact with the government to properly assess the impact on the economy and prices. The weaker yen would appear to be having a major influence on the BOJ's decisions.

Prior to the interview, a meeting between Ueda and Prime Minister Fumio Kishida took place on 22 August. On the evening of 22 August, Kishida ordered measures to deal with high gasoline prices (effective 7 Sep) and the compilation of economic measures during September. With the USD/JPY rate hitting a YTD high on 6 September, Vice Minister of Finance Masato Kanda stepped up the verbal intervention, emphasizing that rapid changes had been occurring since last year, and that if this trend continued, the government would take appropriate measures without ruling out any options. Ueda's interview with the *Yomiuri Shimbun* took place on the same day that the extent of verbal intervention was stepped up (although this could have just been a coincidence). It appears that the BOJ is marching in step with the government after Governor Ueda shared the understanding about the weaker yen at the meeting with Prime Minister.

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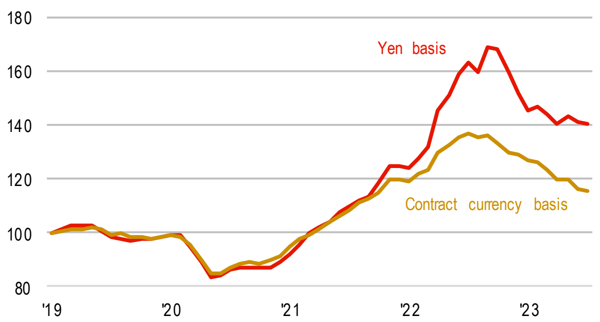
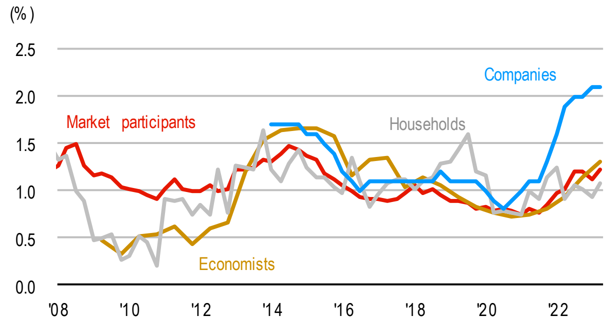
Chart 1: Import Price Index



Source: BOJ; compiled by Daiwa Securities.
Note: Index using data in Jan 2019 as 100.

Chart 2: Inflation Expectations



Source: BOJ, QUICK Monthly Market Survey (Bonds), ESP Forecast; compiled by Daiwa Securities.

The government is very cautious about yen depreciation. As the import price index on a yen basis remains high compared to the index on a contract currency basis, it is safe to say that the weaker yen is one factor behind the surge in gasoline prices, which became an issue recently (Chart 1). Basically, monetary policy and currency policy need to be aligned in the same direction. Therefore, if the government aims for currency appreciation, the BOJ should steer monetary policy towards tightening. It is right for both to take action together in order to prevent depreciation of the yen.

That said, a closer look at the interview suggests that Governor Ueda is not necessarily leaning in favor of lifting negative interest rates. He mentioned that he was forced to focus on downside risks because it was very difficult to deal with situations in which there was a price undershoot, due to the issue of the leeway available for monetary easing. However, he stated that that did not at all mean that they were completely ignoring upside risks, and that it did not mean that they actively accepted falling behind the curve in terms of monetary policy. He was indicating a stance of focusing on a balance of both the upside and downside regarding price projections, and simply taking a data-dependent approach.

The rise in inflation expectations (Chart 2) was one factor behind the decision to add flexibility to yield curve control (YCC) operations at the July Monetary Policy Meeting (MPM). In the near term, the MPM in October, when the *Outlook for Economic Activity and Prices* report (*Outlook Report*) is released, is likely to garner attention. Other important data will be the BOJ Tankan survey (due out 2 Oct) as well as the inflation expectations at companies and households in the Opinion Survey (due out 13 Oct). If that data confirms that inflation expectations remain high, it would increase expectations for elimination of the negative interest rate policy, which may intensify appreciation pressure on the yen.

In response to Governor Ueda's interview, the USD/JPY rate at the beginning of the week was corrected to around Y147 after posting a large gap with the closing rate at the end of last week. Then, the yen temporarily strengthened to below Y146 during European trading hours. With Governor Ueda stating the specific timing of the end of the year, the interest rate market is factoring in elimination of the negative interest rate policy by January 2024. Our main scenario in *Daiwa's View* puts elimination of the negative interest rate policy as occurring in April 2024. However, we need to keep in mind the possibility that policy revisions may be conducted earlier than expected if the BOJ takes currency exchange rate trends into consideration. Here, too, exchange rates are key.

There will be no problem if prices continue to remain on an uptrend and it appears imminent that the price target will be reached earlier than expected. However, if depreciation of the yen accelerates while there is still a ways to go before the exit is reached, the government and the BOJ will be forced to deal with a very difficult situation. We think that the authorities' first step to address the weaker yen would be currency intervention (refer to our 4 Aug 2023 report *Daiwa's View: BOJ, exchange rates, and MOF*). That said, if such intervention is conducted with poor timing, it would invite speculative investors. Therefore, it entails the risk of accelerating depreciation of the yen, as well as using up foreign currency reserves during a time when there are constraints on the amount of foreign currency reserves available.

If the BOJ takes action (such as eliminating negative interest rates) in order to address yen depreciation when there is a low possibility of achieving the price target, it is highly likely that the BOJ would be seen as sending the message that it will be very difficult to engage in additional monetary tightening measures (such as eliminating the zero interest rate) later on. If revisions to monetary easing were that limited, JPY rates would be unlikely to rise that much, and leeway for appreciation of the yen would likely be limited.

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