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Daiwa's View

BOJ Governor Ueda interview

- Change to more balanced data-dependent stance

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BOJ Governor Ueda interview

Change to more balanced data-dependent stance

Last weekend the *Yomiuri Shimbun* carried an exclusive interview with BOJ Governor Kazuo Ueda for the first time since he took office. The title of this report (English edition) was "Bank of Japan Could End Negative Interest Rate Policy." The key takeaways from the interview were Ueda's comments that "Lifting the negative interest rate policy will become an option once we have confidence in achieving our price target" and "It is not impossible that we will have enough information and data by the end of this year (to determine whether Japan has a self-sustaining virtuous cycle of rising wages and prices)." These takeaways are key as they entail the aspect of laying the groundwork for ending the BOJ's negative interest rate policy (NIRP). Of course, they may also have the aspect of deterring yen depreciation.

Bloomberg conducted a survey of economists on 31 July, after the BOJ decided at its July Monetary Policy Board meeting to make the management of its yield curve control (YCC) policy more flexible. Here, 38 of the 41 surveyed economists (92.6%) forecast that the BOJ's next policy revision will come next year or later. As for the timing for ending NIRP, 57% said in 2024 and 43% said in 2025 or later, while none expect such a move in 2023 (one expects that move within FY23). As such, an early termination of NIRP would be a surprise for the market. On 11 September, our Chief Market Economist Mari Iwashita revised her outlook and now expects the BOJ to end NIRP in April 2024.

BOJ Monetary Policy (Chief Market Economist Mari Iwashita: as of 11 Sep 2023)

Main Scenario		The BOJ conducts a series of discussions on whether achieving the 2% price stability target is in sight each time it releases *Outlook Report* (Jan and Apr 2024 reports are particularly important). With the probability of a soft landing with the US economy increasing, overseas yields remain high. Due to higher crude oil prices and the yen remaining weak, prices in 2H FY23 are higher than currently projected levels. Therefore, momentum for wage hikes continues.
Probability	60%	In Apr 2024, the BOJ eliminates negative interest rates, issuing declaration that the 2% price stability target has been achieved. The framework for the YCC remains. Provisions remain for a reference range for the long-term interest rate target (for example, in the case of a hike to 0.25%, ±0.50% band = -0.25% to +0.75%). With achieving the 2% price stability target appearing imminent, it becomes desirable to provide a road map for monetary policy normalization to avoid market confusion.
Sub-scenario ①		Amid global complex inflation, policy interest rates remain high despite the end of monetary tightening in US and Europe. With the US economy being strong, appreciation pressure on the dollar and deprecation pressure on the yen does not stop. With Japan's economy continuing to recover steadily, 2% price growth is maintained even in 2H FY23. Sustainable wage hikes come into view. The BOJ is forced to eliminate negative interest rates earlier than planned.
Probability	20%	When negative interest rates are eliminated, a sharp rise in interest rates is curbed by messages indicating that rates will not be raised anytime soon. However, the market could press for the next round of rate hikes.
Sub-scenario ②		The BOJ proceeds with debate carefully while keeping an eye on the external environment. It remains wedded to continuing easing, and misses an opportune chance to make new changes until review is completed.
Probability	20%	With US economy losing momentum unexpectedly, rate cuts seem imminent. This and prolonged sluggishness of China's economy increase downward pressure on Japan's economy. Due to lower US yields, situation with strong dollar/weak yen is corrected. Inflation drops to the 1% level from 2H 2023, making it impossible for BOJ to make a move. BOJ is the only major central bank unable to normalize following crisis response.

Source: Compiled by Daiwa Securities.

The details of the interview suggest that the BOJ is not necessarily biased in favor of lifting negative interest rates, but rather has shifted its emphasis to a more balanced stance between upside and downside risks. Regarding the outlook for prices, this confirms a shift from a situation in which the Bank was particularly focused on downside risks due to the lack of room for easing, to a more balanced stance in which it continues to be wary of downside risks, but is also attentive to upside risks and falling behind-the-curve risks. Naturally, in the event that prices continue rise and this upward trend is confirmed early on, achieving the BOJ's price target could come into sight earlier than expected. In that case, the distance to ending negative interest rates would be closer. The *Yomiuri* interview reminded the market of this possibility. Also, if the risk of prices surprisingly rising more than expected is greater than previously assumed, then the cost-effectiveness of setting strict upper bounds within YCC would deteriorate. The setting of the YCC ceiling (upper bound of 10-year JGB yield permissible trading range) at 1.0%, which will not be reached soon, was probably a response to this shift in balance.

BOJ Governor Kazuo Ueda (9 Sep 2023)

Price Outlook

While positive signs are emerging towards achieving the inflation target (2% in a sustainable and stable manner), we are not yet at the stage where reaching that target is in sight. **Reaching the inflation target will become imminent when we see a self-sustaining virtuous cycle with higher prices and higher wages even without monetary easing.** Reflecting on the BOJ's price projections, I think the figures underestimated the inflation rate and inflation expectations among individuals and companies. This resulted in a series of shocks involving a price overshoot. **With regard to the virtuous cycle with higher prices and higher wages, wages rose from this spring to this summer, and this has been reflected somewhat in services prices. We are now at the stage where we will carefully watch whether this will lead to wage increases next year.** There is even a small possibility that we will have sufficient information and data (to make a judgment about this) by the end of the year.

Negative interest rate policy (NIRP)

Once we gain confidence regarding sustained inflation together with wage increases, various options (incl. elimination of NIRP) can be considered. At the moment, it is not possible to decide how much interest rates should be adjusted or whether multiple policies will be modified if there is an overshoot with regard to economic and price conditions. **Raising interest rates has a negative impact on aggregate demand (consumption)**, but if we judge that the inflation target can be achieved even after eliminating negative interest rates, we will eliminate NIRP.

Yield curve control (YCC)

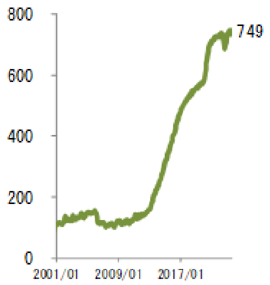
We have added flexibility to YCC operations because we could face a situation in which the BOJ cannot defend the upper limit in the case of an inflation overshoot. The risk that the BOJ could find itself forced to eliminate YCC unintentionally was not zero. As there would be little point in setting a strict upper limit, we set an upper limit of 1%, which is unlikely to be reached anytime soon. We created leeway for a rise in the long-term interest rate in the future. We do not view recent developments with the long-term interest rate as moving too fast. In essence, we will tolerate increases in interest rates by adjusting for speed. We do not envision strict control between 0.5% and 1%.

Near-term operation policy

As there is still a ways to go before the price target is reached, we will continue tenaciously with monetary easing. There is the issue of how much leeway exists for monetary easing, and it is very difficult to deal with situations in which there is a price undershoot. **We are forced to emphasize downside risks.** That said, **this does not at all mean that we are completely ignoring upside risks.** It does not mean that we actively accept falling behind the curve in terms of monetary policy.

In our report at the end of last week, we estimated a 10-year JGB yield of 1.15% when the BOJ ends its NIRP and YCC. Of course, if the current YCC is not eliminated or changed when negative interest rates are eliminated, and if fixed-rate purchase operations for consecutive days are activated at the 1% ceiling, the rise for the 10-year JGB yield would stop at 1%. However, in that case, the BOJ's balance sheet would take on the upward pressure of the 15bp portion exceeding 1% in our estimate. Also, even though this estimate assumes that only the termination of NIRP would lead to a rate hike, it would be unnatural to assume that the monetary policy normalization would be limited to just ending NIRP if Japan's 2% price target is realized by next spring. If the BOJ were to not only end NIRP, but also implement a significant positive rate hike while maintaining YCC, the pace of expansion for the BOJ's balance sheet could be accelerated.

BOJ's Balance Sheet (Y tn)



Source: Bloomberg; compiled by Daiwa Securities.

Ultimately, the BOJ's balance sheet is the dependent variable under the YCC framework. As such, the greater the market selling pressure, the more the BOJ's balance sheet will expand. There is no "free lunch" for policy. Indeed, if the BOJ decides to maintain YCC to "stay on the safe side" after eliminating NIRP from the perspective of providing a safety net for public debt management, the growing quantitative easing effect brought about by the unintended balance sheet expansion could offset the yen appreciation effect expected from terminating NIRP.

Ueda's comment in the *Yomiuri* interview that, "A stage has not yet been reached at which the Bank can make a definite decision" echoes Deputy Governor Uchida's comment on 7 July that "We want to make a balanced decision" (on tweaking policy). The best options will be explored until the very last minute, taking into account the balance between effects and side effects, how much to move (interest rates), and whether to move multiple (policies), while keeping an eye on future domestic price conditions and overseas conditions. In this sense, it is clear that the BOJ has adopted a more data-dependent stance than in the past.

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