Daiwa Securities

Daiwa's View

FICC Research Dept

BOJ's next move at Jun meeting: Likely to discuss JGB purchase reductions

- Expect BOJ to maintain policy interest rate level at Jun meeting
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Expect BOJ to maintain policy interest rate level at Jun meeting

Less than three months have passed since the BOJ decided on 19 March to review its framework for large-scale easing, which included ending negative interest rates and eliminating its yield curve control (YCC) policy. Under normal monetary policy, the main policy tool is the manipulation of short-term interest rates. Here, policy decisions are based on economic, price, and financial conditions. In its April *Outlook Report*, the forecast for core-core CPI, the key underlying price trend that the BOJ focuses on, remained unchanged at +1.9% in FY24 and FY25, while the first forecast for FY26 was higher at +2.1%. These figures are based on the assumption that the 2% target can be realized in the second half of the outlook period. The BOJ will check for an increase in the certainty of this target going forward. Now is the time to assess the virtuous cycle of higher wages leading to higher prices, keeping an eye on the impact of yen depreciation, while remaining mindful of downside risks for the economy. At the June meeting (when data will not be fully available), we expect a unanimous decision to keep the policy rate at its current level. A rate hike at the June meeting seems to be out of the question.

Market changes since Apr meeting: further yen depreciation, higher 10yr JGB yield

BOJ Governor Kazuo Ueda's comments[1] at his regular press conference on 26 April were perceived as acceptance of yen weakness, which caused Japan's currency to weaken to the USD/JPY156 level. During overseas trading hours on that day, the yen further weakened to the USD/JPY158.0-158.5 level. Then at the start of the following week (29 Apr), the pair briefly moved beyond USD/JPY160 for the first time in 34 years. Currency movements since the beginning of April have been dominated by dollar-strengthening factors, triggered by the strength of US economic indicators and receding expectations for a US interest rate cut. However, there is no denying that Ueda's comments on 26 April were an additional yen-depreciating factor. Prime Minister Fumio Kishida and BOJ Governor Ueda met on the evening of 7 May after the Ministry of Finance intervened on the foreign exchange market[2] (dollar selling / yen buying). In light of the recent yen depreciation, there was the assumption that this meeting was an opportunity to confirm foreign exchange rate perceptions. After the meeting Ueda said that the BOJ would give sufficient, close attention to yen depreciation in its policy operations, in effect correcting his previous statement about the weak yen. Ueda will likely repeat this expression in the future.

[1] During Ueda's regular press conference on 26 April, a reporter asked, "Am I correct to assume that the impact of the yen's depreciation on the underlying inflation rate was negligible this time around?" Ueda's responded, "Yes."
[2] Announced by MOF on 31 May. Actual foreign exchange intervention from 26 April to 29 May came to about Y9.8tn. This exceeds the approximately Y9.2tn in the autumn of 2022.

On 13 May, one week after the meeting between Prime Minister Fumio Kishida and BOJ Governor Kazuo Ueda, the BOJ announced a Y50bn reduction for its JGB purchase (from Y475bn to Y425bn for JGBs with maturities of more than five years and up to ten years). In the Bank's prior "Schedule of Outright Purchases of Japanese Government Bonds," the purchase range for that maturity group was Y400bn to Y550bn with the purchasing amount increased or decreased at the discretion of the Financial Markets Department. The Y50bn reduction was within this range, which was within reason.

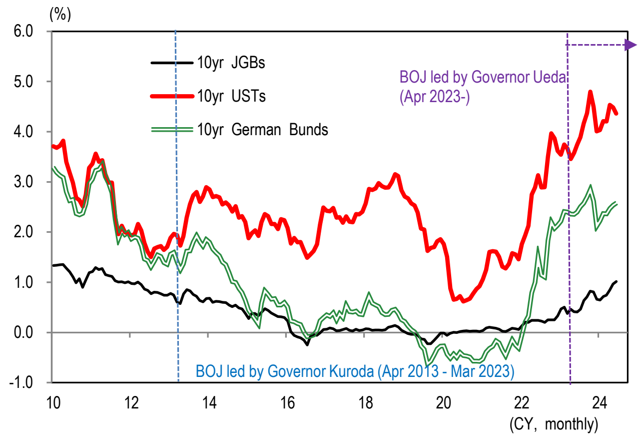
However, this timing caught the market by surprise. That, in turn, ramped up speculation that the BOJ would reduce its JGB purchases in earnest early on and raise its interest rates to prevent further yen depreciation. On 22 May, the 10-year JGB yield rose to 1% for the first time in eleven years. The yield hit 1%, the upper limit before elimination of the Yield Curve Control (YCC) policy, about two months after the decision to change policy at the March meeting. Just one week later, on 30 May, the 10-year yield temporarily rose to 1.1% for the first time in 12 years. However, at the 1.1% level, repurchases were observed, as expected. The US long-term yield declined due to weak indicators in the US that were announced later, which accelerated a drop in yields in Japan, as well. On 6 June, the 10-year JGB yield suddenly declined to 0.955%. However, the yield rose once again to 1.015% on 10 June in response to the strong US jobs report for May (released on 7 Jun). The reason for the BOJ emphasizing the discontinuity of JGB purchases in the first place was to prevent a surge in the long-term yield. It sought to stabilize the long-term yield, which caused fluctuation in foreign exchange rates. If the yield holds around 1%, the BOJ will likely sit on its hands, leaving yield formation to the market.

To what extent will BOJ explain gradual JGB purchasing reduction at Jun meeting?

The spotlight at the June meeting will be on the direction of discussions for reducing the Bank's purchases of JGBs[3]. The "Summary of Opinions" for the BOJ's April meeting included three opinions regarding the purchasing of JGBs. Without providing specific levels, the Bank repeated its view that "It is important to indicate its intention to reduce its purchase amount of JGBs." While the BOJ has decided that it will eventually reduce its purchases of JGBs, it is in no hurry. The BOJ will likely proceed slowly while keeping an eye on supply/demand conditions and market trends. That said, if, at the June meeting, the BOJ decides that (1) it must provide a skeptical bond market with some answers and (2) it would be better to present its own thinking sooner rather than later, it will likely indicate a policy of gradual reduction in JGB purchases by deleting an additional explanation in the April statement. During his 8 May speech, Ueda said, "It is natural for long-term interest rates to fluctuate in response to developments for overseas interest rates and changes in the outlook for economic activity and prices" and "It is appropriate for the Bank to reduce the amount of its JGB purchases as it proceeds with its exit from large-scale monetary easing." One approach could be to newly incorporate the latter wording in the Bank's statement. If a specific amount (e.g., a very gradual pace, such as a Y1.0tn reduction in one year) were to be indicated to enhance predictability, it is conceivable that this could only reveal the distance from the excessive expectations of the market and consequently prompt further reductions. The BOJ will want to avoid its own curse. As such, it would probably be better if the BOJ does not provide any specific amounts.

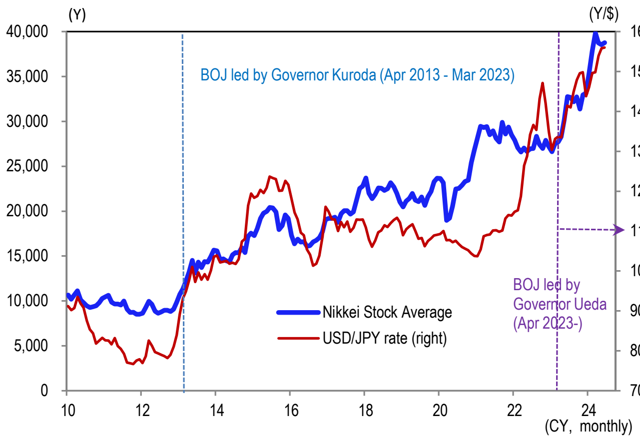
[3] The following is the additional explanation provided in the April statement: "Regarding purchases of Japanese government bonds, CP, and corporate bonds, the Bank will conduct the purchases in accordance with the decisions made at the March 2024 Monetary Policy Meeting."

Chart 1: Long-term Yields in Japan, US, Germany (from 2010)



Source: Bloomberg; compiled by Daiwa.
Note: Jun 2024 data uses average through the 10th.

Chart 2: Nikkei Stock Average, USD/JPY Rate (from 2010)



Source: Bloomberg; compiled by Daiwa.
Note: Jun 2024 data uses average through the 10th.

Board member Adachi represents thinking of Governor and deputy governors with regard to BOJ's thinking about yen weakness

BOJ Policy Board member Seiji Adachi gave a speech in Kumamoto on 29 May. Adachi, who was chosen in the spring of 2020 as an intellectual with a reflationary viewpoint, now represents the thinking of the Governor and deputy governors. While one might easily assume that the BOJ would try to prevent the yen from depreciating, he pointed out that, based on the concept of the "trilemma of international finance[4]," if monetary policy were used to respond to short-term exchange rate fluctuations, price stability would be impacted. He also noted that even a prolonged period of excessive yen depreciation would come with a time lag in terms of its spread to prices, and that if the expected inflation rate were to fluctuate significantly, it would be possible to consider a monetary policy response. In any case, he suggested that a reasonable amount of time would be required. During that time, the BOJ would have no choice but to carefully monitor trends with yen depreciation. This is in stark contrast to the desire for speed in the bond market which is eager for rate hikes. Regarding the outlook for prices[5], he specifically pointed to the possibility that prices would begin to rise again in the summer and fall of this year, which is in line with our assumptions. The data will not be available until early autumn. The BOJ is in no hurry to raise interest rates further. If this view is correct, Governor Ueda's post-meeting press conference in June is unlikely to suggest the possibility of additional rate hikes at the July meeting.

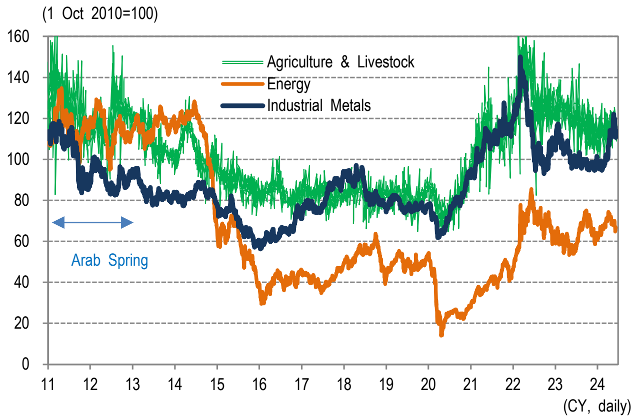
For now, BOJ to assess "second force" and consumption trends

In the reports on price hikes since April (actual implementation in Jul-Sep quarter), an increasing number of companies are citing the impact of rising logistics costs due to Japan's unique logistics "2024 problem." In addition, the so-called "first force" (cost-push inflation) could come back to life as a result of higher grain prices due to unfavorable weather conditions (Chart 3) combined with prolonged yen depreciation. We must be aware of the upside risks for prices over time. Still, companies should be able to pass on higher costs to their prices assuming that (1) wage increases are not limited to large manufacturers benefiting from the weak yen, but also spread to non-manufacturing companies and SMEs and (2) private consumption does not falter. For now, the BOJ will assess trends for corporate earnings, the ability to pass on higher costs to prices, wages, and service prices. According to the sixth tally of responses from the spring 2024 labor-management negotiations announced on 5 June by the Japanese Trade Union Confederation (Rengo), the average wage hike was 5.08%, down from 5.28% as of first

[4] The "trilemma of international finance" refers to the inability to simultaneously achieve monetary policy independence, the free movement of capital, and exchange rate stability.
[5] We believe that "flexible consumer prices" tend to track import price movements with a time lag of about six to nine months.

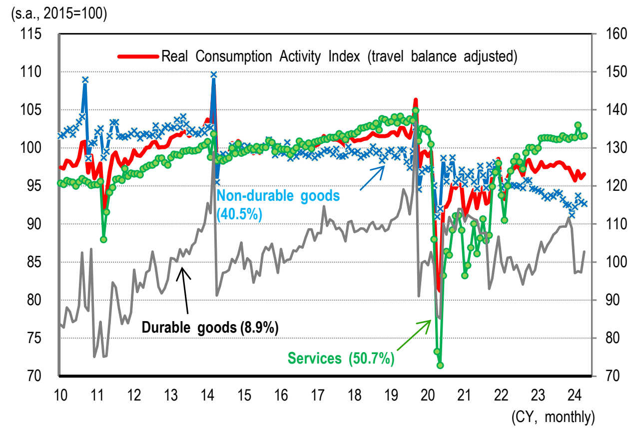
tally, but still holding at the highest levels in 33 years. The basic salary hike also remained high at 3.54%.

Chart 3: S&P GSCI (Goldman Sachs Commodity Index)



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

Chart 4: Consumption Activity Index in Japan



Source: BOJ; compiled by Daiwa.
Note: Figures in parentheses show weights in index.

The key thing to keep an eye on going forward will be trends with the second force—whether wage increases lead to higher service prices in the future. With the Japan FTC's guidelines, it will probably take time, from summer to about early autumn, to determine whether SMEs will be able to pass on higher labor costs to prices. It will take time to confirm whether the underlying inflation rate will maintain a level at around 2%.

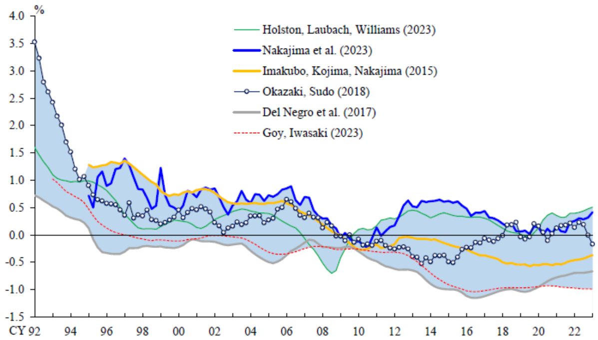
Meanwhile, when considering the economy/price balance, the weakness in consumption due to high prices is a cause for concern. The real consumption activity index for April was up 0.3% from Jan-Mar, but the consumption of services increased only slightly against a large increase in durable goods consumption, while the consumption of non-durable goods such as daily necessities remained weak (Chart 4). There are expectations for future income growth due to the effects of the government's income tax cuts (tax refunds started in June), and data for the Apr-Jun quarter will shed some light on the resilience of consumption. With regard to incomes (scheduled cash earnings in Monthly Labour Survey), we will need to ascertain conditions up until July (released on 5 Sep), when SME wage increases will be reflected. Meanwhile, the recent certification irregularities among Japanese automakers have added to the bad news since June pertaining to weaker-than-expected automobile production, increasing the risk of a downturn for the economy overall. With continued weakness in both production and consumption, data-oriented Governor Ueda will likely struggle to make a decision on an additional interest rate hike.

Still, as we assumed, the US economy currently remains resilient and inflation remains tenacious. Looking ahead, attention will continue to focus on economic indicators to determine whether the US can start cutting interest rates before the end of the year. The strength of the US economy should help to mitigate downside risks for the Japanese economy, while providing a tailwind for the BOJ's policy normalization efforts. If the US only makes a corrective rate cut, the possibility of an additional rate hike by the BOJ would increase.

Must communicate policy normalization distance to market

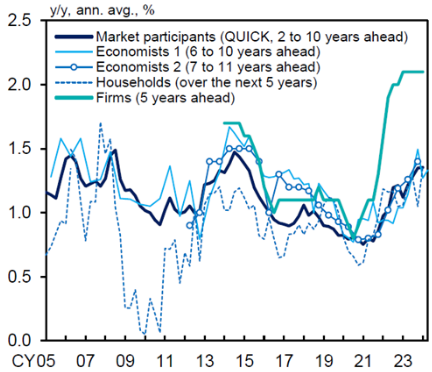
Based on the above considerations, even though the policy rate will likely remain unchanged at the BOJ's June meeting, attention will turn to the wording in the statement about JGB purchases. At Ueda's post-meeting press conference, we can expect a detailed explanation of his policy decisions and some hints about the future. Based on the BOJ's second conference for its broad-perspective review (21 May) and the speech by BOJ Deputy Governor Shinichi Uchida at an international conference (27-28 May), we can sense that it is important for the Bank to anchor inflation expectations at 2%, as in the US and Europe, and so it intends to maintain an easy monetary environment for that purpose (charts 5 and 6). The BOJ must try to convey to the market a sense of distance for promoting policy normalization going forward.

Chart 5: Estimates of the Natural Rate of Interest for Japan



Source: Reprinted from 5 May 2024 speech by BOJ Governor Kazuo Ueda (Chart 11).

Chart 6: Inflation Expectations in Japan



Source: Reprinted from BOJ's Apr 2024 Outlook for Economic Activity and Prices (Chart 39).

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