Daiwa Securities

Daiwa's View

FICC Research Dept

BOJ becoming aware of both upside, downside risks

- One reason behind July rate hike was "risk management approach"
- As Japan (BOJ) has seriously monitored only downside risks for past 25 years, we have impression that market slow to follow BOJ's recent change to also monitoring upside risks
- Increased political uncertainty (US presidential election, LDP presidential race) to reinforce need for risk management; does not necessarily mean setback for BOJ rate hikes

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At its July Monetary Policy Meeting, the BOJ said (1) "We will continue to raise rates if our outlook for economic and price data is on track," (2) "Yen depreciation is a factor that increases upside risks for the price outlooks," and (3) "We are aware of upside risks to prices." This recognition and these policy reaction functions were reiterated by both BOJ Governor Kazuo Ueda during his testimony before a closed Diet session on 23 August and BOJ Deputy Governor Ryozo Himino during his 28 August speech. In addition, their statements completely adhered to the basic awareness presented in BOJ Deputy Governor Shinichi Uchida's 7 August speech in which he said, "When there is instability in the international financial and capital markets, we will closely monitor the effects and reflect them in our policies" and "We are not behind the curve at all and can choose the best time." These statements by Governor and deputy governors contained no contradictions and were completely predictable. After all, the only real changes from the July meeting are points pertaining to market fluctuations (particularly exchange rates). The BOJ's stance itself appears to be essentially unchanged from the July meeting.

Market yet to digest BOJ's "risk management approach"

We feel that since the July meeting, the market has not fully digested the Bank's new references such as balancing "upside risks" and "falling behind the curve," or in other words, its new "risk management approach." Over the past quarter century, the BOJ has been seriously concerned about only the downside risks. Therefore, we are left with the impression that market participants have yet to catch up with the BOJ's shift to focusing more on "upside risks" along with "downside risks."

It is almost obvious that the BOJ is currently not behind the curve. Meanwhile, there have been structural changes to Japan's labor market, as well as new changes in the form of a stronger impact from the weaker yen on prices. As such, it has become harder to say for sure that the possibility of the BOJ falling behind the curve in the future, triggered by the emergence of upside risks due to the excessive yen depreciation and other factors, is zero. In that case, "From the standpoint of the risk-management approach, only the appropriate, risk-neutral level of the policy interest rate should rise" (from June meeting minutes). It was probably one of the main themes at the July meeting, as there was excessive yen depreciation beyond the USD/JPY160 level since the June meeting.

The BOJ's handling of both upside and downside risks is a natural change as Japan transitions to a "world with interest rates" and there is probably a need to become accustomed to that change. If the "upside risks" and "behind-the-curve" status mentioned by Ueda during his press conference after the July meeting feel like changes, in a sense, we could say that it was a necessary reaction.

Dealing with rising political uncertainty

We have now entered September and there are just four months remaining before the end of 2024. The focus of attention this week will be on whether US jobs indicators (employment statistics, JOLTS, ISM manufacturing/service employment DI) impact the degree to which the Fed cuts rate. The world's biggest political event for this year, the US presidential election, is just two months away. Meanwhile, in Japan, the ruling LDP's presidential election, which will effectively decide Japan's next prime minister, will be held later this month (which could be followed by dissolving the Lower House for a snap election). Naturally, the BOJ is keenly aware of this political uncertainty, in addition to economic trends. This is especially true if the BOJ adopts a stronger risk-management approach that takes into account both upside and downside risks.

However, strengthening its risk management approach and being cautious do not necessarily mean that the BOJ's rate-hiking ambitions will stall. Upside risks are likely to decrease due to the recent rapid appreciation of the yen, which has corrected the excessive yen depreciation back to a level almost in line with corporate expectations. At the same time, Himino clearly confirmed in his speech that the Bank's on-track progress (= rate-hiking path) is not being impeded. After all, the only thing that has changed since the July meeting is the part related to market fluctuations (particularly exchange rates). The reduction in upside risk brought about by the correction for the excessively weak yen has given the BOJ more time to take a somewhat wait-and-see stance from a risk management perspective. At the end of last week, the BOJ released a new research paper on trends and functionality of short-term financial markets under excess reserves. It will be important in the long run for the BOJ to properly finish the broad-perspective review of its monetary policy within this year and allow the market time to digest that view.

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