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Daiwa's View

BOJ meeting focal points: Interim assessment and QT strategy

- Jan-Mar GDP (2nd preliminary); Watch for downward pressure in next GDP reading
- Ongoing tariff talks: Japan/US tariff agreement unlikely before G7 Summit?
- BOJ to maintain wait-and-see stance at Jun meeting amid uncertainty
  Focus on interim assessment, revision to slower QT pace due to market considerations?

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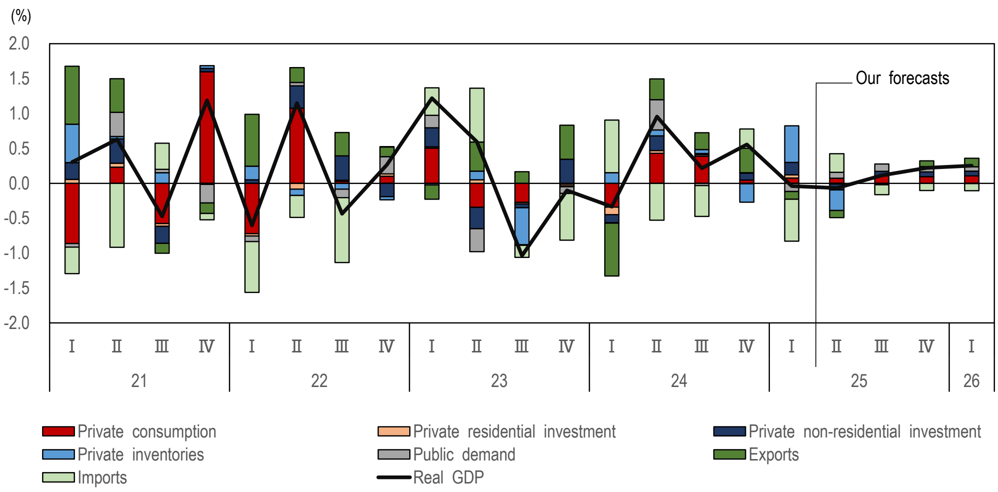
Jan-Mar GDP (2nd preliminary) revised upward on inventory fluctuation factors; Watch for downward pressure in next GDP reading

Japan's Jan-Mar 2025 real GDP (2nd preliminary estimate) released on 9 June was –0.04% q/q (–0.2% annualized), an upward revision from the first preliminary estimate of –0.2% (–0.7% annualized). However, this upward revision was mainly due to an upswing for raw material and product inventories within the private-sector inventory fluctuations, which were seen as provisional at the time of the first preliminary estimate. Therefore, as with the first preliminary estimate, there was no change to the assessment that, "While the Japanese economy is recovering moderately as of the January-March quarter, the recovery itself remains lackluster."

Furthermore, we should note that the large private inventory fluctuations during the Jan-Mar quarter will result in downward pressure on real GDP in the Apr-Jun quarter of 2025 (1st preliminary estimate due out on 15 Aug). Also, during the same period, there are concerns that exports will decline due to the Trump tariffs and that capex will be postponed due to heightened uncertainties. Based on these considerations, it is highly likely that the Apr-Jun 2025 quarter will mark the second consecutive quarter of negative growth. If the Apr-Jun GDP, which will be released after the July Upper House election and will reflect conditions after the tariffs take effect, is negative for the second straight quarter, fiscal policy would likely move in an expansionary direction. In terms of monetary policy, an early interest rate hike would also become more difficult.

If US tariff policy maintains the current tariff rate level (reciprocal tariff of 10% (no additions) + current product-specific tariffs), we expect Japan's GDP growth to land around +0.5% for FY25.

Chart 1: Breakdown of Contributions to Real GDP



Source: Cabinet Office; compiled by Daiwa.

Ongoing tariff talks: Japan/US tariff agreement unlikely before G7 Summit?

After the fifth round of US/Japan ministerial-level tariff negotiations on 5-6 June, Ryosei Akazawa, Minister of Economy, Trade and Industry, said "Japan and the US have not yet found a point of agreement. Even if Prime Minister Ishiba is able to immediately speak with US President Donald Trump, concluding any agreement still seems out of reach." In the fifth round of negotiations, the Japan-side appears to have reiterated its call for the US government to withdraw a series of tariff measures, citing the expansion of imports of agricultural products, a review of "non-tariff barriers" on automobiles, and cooperative measures to strengthen supply chains with China in mind.

Meanwhile, as for US/China negotiations, a teleconference call between Trump and Chinese President Xi Jinping on 5 June triggered a meeting of relevant US/China ministers on 9-10 June. Apparently, "productive" discussions took place. That said, the talks are still "ongoing" and we believe that the US government has positioned the negotiations with China as a top priority. Such progress for US/China tariff talks diminishes the importance of any negotiating cards held by Japan. Indeed, the likelihood of a tariff agreement between the US and Japan before the G7 summit, to be held in Canada (15-17 Jun), is declining.

The Japanese government needs to speed up its tariff negotiations considering that the reciprocal tariff suspension deadline is 9 July and the Upper House election will take place on 20 July. However, considering the current progress for US/China tariff negotiations, there is little merit for the US government to rush into tariff negotiations with Japan. Actually, the Japanese government appears to be taking the position that it is also looking for an agreement in terms of significant reductions for any additional tariff rates. We think that the focus of future Japanese government demands will likely entail the extent to which new higher import tariffs and product-specific tariffs can be lowered.

BOJ to maintain wait-and-see stance at Jun meeting amid uncertainty

Amid these circumstances, the BOJ will hold its next Monetary Policy Meeting on 16-17 June. However, as mentioned above, it is unlikely that a US/Japan tariff agreement will be reached by the time of the meeting. So, the meeting is expected to be held amidst uncertainty, including the developments of the US/Japan tariff negotiations.

Meanwhile, even if progress is made in the US/Japan tariff negotiations by the June meeting, uncertainty surrounding the global economy will remain high. Under such circumstances, the BOJ will likely decide to maintain its existing rate-hiking policy, while taking a wait-and-see approach that includes maintaining the monetary policy status quo.

As for tariff policy trends going forward, the direction of tariff policy may become clearer to a certain extent in July and August. This is because the deadline for the suspension of reciprocal tariffs is 9 July and the deadline for suspension of the US/China tariff agreement is 12 August. Still, in addition to the possibility of a further tariff escalation, a high degree of global uncertainty stemming from tariff policies is expected for the time being. For example, inflation pressures could mount in the US due to tariff policy resulting in downward pressure on consumption after a certain time lag.

Under these circumstances, when determining the BOJ's interest rate hikes going forward, it will be important to assess (1) the reduction of uncertainty due to progress in tariff negotiations (neutralization of economy/prices risk balance) and (2) impact of tariff policy on the Japanese economy and prices, including the global economy. A period for carefully assessing these effects is expected to continue through the Jul-Sep quarter.

Meanwhile, current price trends continue to exceed expectations. In fact, in his 27 May speech, BOJ Governor Kazuo Ueda expressed concern about the impact of supply shocks on underlying prices, saying, "We need to be careful about how food price inflation will impact underlying inflation."

Under these circumstances, a noteworthy point on the price side is the spreading trend of passing on higher costs to prices, as well as the sustainability of that trend. That said, some media reports have indicated that the spot price of rice traded among wholesalers is on a downward trend following the release of government stockpiled rice. While we believe that some wholesalers have already purchased rice at high prices, it is necessary to closely monitor future trends to see to what extent these developments spill over to consumer prices. The BOJ's price recognition in light of the current rice price trends will also be of interest at its June meeting.

Jun BOJ meeting focal points: Interim assessment of JGB purchasing plan

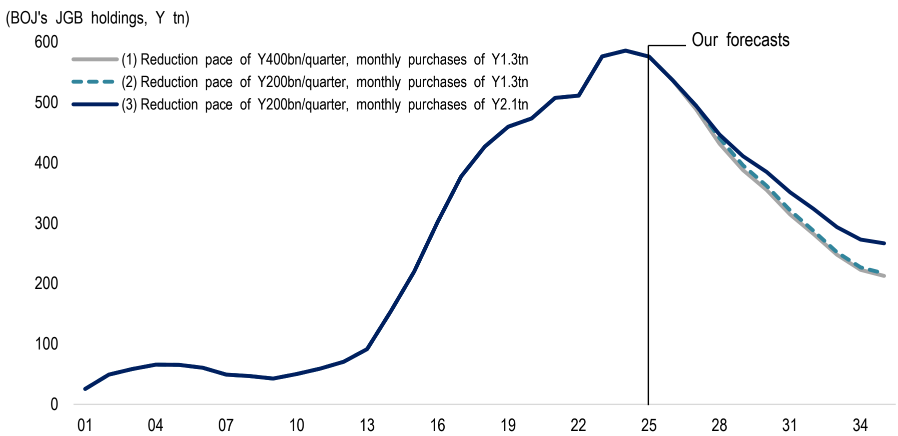
The BOJ's June meeting will include an interim assessment of its plan to reduce its purchases of JGBs. This will be the main focus of attention. As for this interim assessment, if we take into consideration the content of recent media reports and previous statements by senior BOJ officials, it is highly likely that the following decisions will be made at the June meeting: (1) maintain current JGB reduction plan through March 2026, (2) continue to reduce JGB purchases from April 2026, (3) determine a reduction plan through March 2027, one year ahead of the current plan (to ensure predictability), and (4) formulate a framework that allows for flexible operations and changes to the plan itself in the event of a sharp rise in long-term yields (to ensure flexibility).

Among these four decisions, of particular interest is (2) continue to reduce JGB purchases from April 2026. According to media reports, slowing the pace of JGB purchase reductions from the current Y400bn per quarter has been considered. These discussions have centered on whether to halve the amount to Y200bn or maintain the current pace. Adjustments within a range of Y200-400bn are expected.

Here, we simulated several patterns for the future pace of JGB purchase reductions and the monthly purchases at the end of the plan (Chart 2). Specifically, we envision the three patterns of (1) case in which the pace of JGB purchase reductions remains at the current level of Y400bn per quarter and monthly purchases are reduced to Y1.3tn in the Jan-Mar 2027 quarter and that level is maintained, (2) case in which the pace of JGB purchase reductions from April 2026 is reduced to Y200bn and the monthly purchases are reduced to Y1.3tn in the Jan-Mar 2028 quarter and then maintained at that level, and (3) case in which the same Y200bn reduction is followed by a reduction in monthly purchases to Y2.1tn in the Jan-Mar 2027 quarter and that level is maintained.

These estimates show that within the quantitative tightening (QT) progress, there is no significant difference in terms of whether the pace of JGB purchase reductions from April 2026 is Y400bn or Y200bn. Rather, the monthly purchase amount at the end of the plan is more important.

Chart 2: QT Simulations



Source: BOJ, MOF; compiled by Daiwa.

Under these circumstances, it is the government's move that is noteworthy when considering the contents of the JGB purchasing plan interim assessment. In response to the current deterioration in the JGB supply/demand balance and the rise in super-long JGB yields, a statement on stable issuance of JGBs is expected to be included in the "Basic Policies for Economic and Fiscal Management and Structural Reform." Also, as for the revision of JGB issuance by maturity in the FY25 JGB issuance plan, there is growing awareness within the government of the need for stable JGB issuance. Indeed, there were media reports on 9 June that the government may buy back low-yield, super-long JGBs issued in the past.

Meanwhile, BOJ Deputy Governor Shinichi Uchida said in a speech on 7 June that the Bank's JGB purchases and holdings are only part of its monetary policy. Even for the process of exiting monetary easing, the Bank will implement appropriate policies in relation to the economy and prices. Here, he stressed that the BOJ must ensure that fiscal considerations do not overtake its mandate.

However, it is a matter of principle that JGB purchases by the BOJ are not used for the purpose of financing the government. If the market actually views this as financing the government, that could lead to problems such as higher inflation, erosion of confidence in the currency, and ultimately a decline in the independence of monetary policy. It is only natural for a central bank to focus on how the economy and prices are impacted during the process of exiting from monetary easing. That said, if fiscal concerns increase, the real economy will be impacted in the form of (1) financial instability due to yen depreciation and falling stock prices and (2) higher borrowing costs due to rising long-term yields. As such, the fiscal situation must be indirectly taken into account.

In this manner, when considering the pace of JGB purchase reductions, balancing concerns about financing the government with consideration of the market will come into play. However, any impacts from limiting the pace of JGB purchasing reductions to Y200bn, at least from a QT perspective, would be limited. Also, considering the potential impact of financial instability on the real economy and other factors, we believe that there is a strong possibility of revising QT to the most gradual pace as possible, with an emphasis on consideration of the market. In this case, the amount of JGB purchases at the end of the plan will likely be indicated at the time of the next revisions for the plan.

In addition, the BOJ's Uchida also stated in his 7 June speech that, "Many of them (central banks) will not return to conventional money market approaches." The BOJ currently guides interest rates by attaching interest to its current deposits. However, prior to the introduction of quantitative easing in 2001, the BOJ had guided short-term interest rates, such as the call rate, in a manner that finely adjusted the supply and demand for funds and provided little excess reserves.

From the standpoint of predictability, it is essential to indicate the "excess reserves that should be targeted over the long term" (appropriate size of balance sheet), but it is difficult to state a specific level at this time. That said, the content of Uchida's speech seemed to suggest that a certain level of excess reserves will be maintained going forward.

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