Daiwa's Economic View

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Policy decisions following "Central Bank Week" ~ Crude oil, supply constraints, and forex intervention

- "June divergence" scenario for major central banks
- Uncertainties about crude oil, supply chain scenarios
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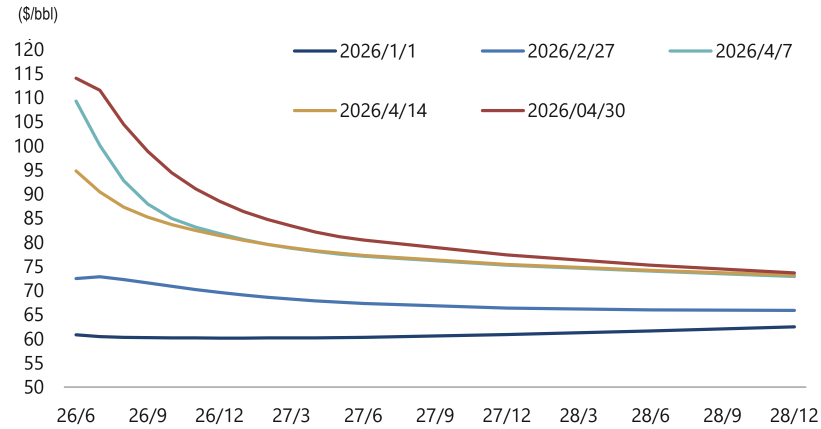
"June divergence" scenario for major central banks

The central bank meetings, commonly known as "Central Bank Week," have come to a close. The market's focus is now shifting from what will be decided next to which assumptions remain in place heading into June. Major central banks such as the FOMC, the ECB, and the BOE all refrained from making definitive decisions at their April meetings, while clearly communicating that key decisions are likely at their June meetings. At the same time, authorities in Japan have intervened on the forex market as a policy measure, bringing "financial conditions" to the forefront as a one aspect of the Bank's policy decision-making environment. Amid ongoing uncertainty surrounding crude oil prices and supply constraints, major central banks are transitioning to the next stage.

The underlying factors are the uncertainty surrounding crude oil prices and supply chains, stemming from the conflict in the Middle East. Current crude oil prices have not yet settled into either a scenario where supply recovers relatively quickly and prices fall, or one where supply constraints persist for a long time and prices remain high. At this juncture, there is not enough information to determine which scenario is more likely to unfold.

Brent Crude Oil Prices (futures curve)



Source: Bloomberg; compiled by Daiwa.

Considering this uncertainty, major central banks share the view that "it is not appropriate to lock in a policy stance at this point." The key to policy decisions lies not in the current economic indicators themselves, but in the nature and persistence of exogenous shocks.

At the FOMC meeting, Chairman Jerome Powell stated that the guidance could be revised as early as the next meeting, emphasizing that developments over the next 30 to 60 days could significantly alter the policy decision-making environment. The Fed clearly demonstrated that the focus of policy decisions lies not so much on whether the domestic economy is slowing down or picking up speed, but rather on the trends (outcomes) for exogenous factors such as energy prices and geopolitical risks.

At its April meeting, the ECB left its policy rate unchanged. However, in its risk assessment, it explicitly noted that higher-than-expected inflation risks and lower-than-expected growth risks are intensifying at the same time. It was notable that the ECB signaled its intention to reassess the underlying (precondition) scenarios at its June meeting, while deciding to postpone its decision.

All current indications suggest that the Board is leaning toward a "tap the brakes" rate hike in June. However, it is also clear that they do not want to commit to that decision at this juncture, considering that a great deal of new information is expected to become available by June. Rather than immediately linking rising energy prices to policy responses, the ECB seems to be attaching importance to the extent to which supply constraints are impacting the real economy in terms of volume and whether this will lead to secondary inflationary pressures.

The BOE similarly clarified a conditional framework under which its policy response would vary depending on crude oil price scenarios. Specifically, the BOE presented its discussions based on three scenarios regarding energy prices: Scenario A (optimistic case), in which energy prices fall relatively quickly; Scenario B (intermediate case), in which prices ease gradually; and Scenario C (pessimistic case), in which much higher prices persist over the long term.

The BOE suggested that if the Strait of Hormuz reopens following an agreement between the US and Iran, with energy prices stabilizing, there may be no need to raise interest rates this year. Meanwhile, the BOE also warned that if the Strait of Hormuz remains closed and energy prices rise further (and remain elevated), central banks will need to respond by "aggressively" raising interest rates. The focus is not so much on the level of crude oil prices, but rather on whether high energy prices will spill over into wage- and price-setting behaviors, ultimately impacting the underlying inflation trend.

In this manner, what the major central banks have in common is the recognition that they must assess the trajectory of the current shocks and whether the scale of such shocks will remain relatively limited or expand to a degree that constrains their policy decisions. June is seen as the timeframe during which the necessary information for making such assessments will become available.

Common evaluation framework for supply constraints

What we need to sort out is the concept of supply constraints. If the supply of crude oil or intermediate goods is disrupted, that does not necessarily mean the impact will immediately be reflected just in terms of prices. Initially, this is often absorbed through inventory drawdowns and logistics adjustments. Indeed, the impact on volume typically becomes apparent after a certain time lag.

That said, such adjustments are not permanent. If supply constraints persist for a long time, the buffer provided by inventory will gradually lose its effectiveness. In that case, the impact on supply volumes will begin to manifest in the form of suppressing production activity adjustments and demand. This time lag and nonlinearity are precisely why major central banks view supply constraints in parallel as risk factors for both inflation and growth.

This evaluation framework also applies to Japan. The question is whether supply constraints remain merely hypothetical or whether they are already beginning to show up in the data for real economies.

Production trends in Japan: To what extent are supply constraints emerging?

When considering this point, current industrial production figures suggest that supply constraints are shifting from being merely "hypothetical" to having "initial impacts." Industrial production in March declined from the previous month. Sectors such as chemicals and petroleum/coal products, in particular, weighed on the overall results.

What these industries have in common is their high dependence on crude oil, as well as raw materials derived from crude oil. Supply constraints do not merely impact prices, but they also tend to impact production through procurement limitations. In fact, constraints regarding certain raw materials, such as naphtha, have been noted recently. Visualization of these developments as factors that exert downward pressure on production is emerging.

However, at this juncture, the impact on production remains limited thanks to inventory drawdowns and switching to alternative suppliers. While the situation has not yet led to widespread production halts, drawing down inventories is not sustainable. If supply constraints persist, the impact on production volumes could spread in the form of production adjustments.

Even though the Indices of Industrial Production Forecast points to increased production going forward, such plans tend to fall short of expectations during actual implementation. In the chemicals sector, in particular, production cutbacks are continuing. The focus going forward is on whether the impact of supply constraints will be limited to specific sectors or whether it will spread to other sectors.

In other words, this is not a case in which Japan's production is "collapsing overall." Rather, now is a stage at which reactions are starting to emerge, starting from those sectors that are susceptible to supply constraints. Depending on how the supply constraints unfold, Japan is now entering a stage where it must assess the full extent of this impact over the Apr-Jun quarter.

Currency intervention and its implications for BOJ: Potential "bridge" to BOJ rate hike

Amid the current situation, alongside uncertainties surrounding crude oil and supply constraints, forex market fluctuations and the authorities' response have come to the forefront as factors influencing the Bank's policy decision-making environment. This is because exogenous supply shocks do not end with a rise in crude oil prices alone. Rather, they can also spill over into import prices and inflation expectations through exchange rates.

At this juncture, media reports have emerged that the government and the BOJ had intervened in the forex market, causing short-term fluctuations for the yen. This intervention came immediately after a series of strong verbal interventions by Finance Minister Satsuki Katayama and Japan's top currency diplomat Atsushi Mimura, who had issued a "final" warning to traders just a few hours earlier. The US was notified in advance and, even though it did not raise any objections, it apparently did not participate in the intervention.

That said, generally speaking, while forex intervention can curb excessive volatility over the short term, its sustainability depends on whether it is consistent with the outlook for monetary policy and the direction of interest rate differentials. It would be more accurate to view forex intervention not as a means of determining market trends, but rather as a measure designed to buy time for market adjustments.

If high crude oil prices persist, concerns will likely grow that yen depreciation, driven by a deteriorating trade balance, will push up import prices. Crude oil and forex rates are not separate risk factors, but rather they are interconnected, influencing each other as the same supply shocks spread to prices.

The significance of placing currency intervention within the context of this decision-making environment is not to evaluate the success or failure of the intervention itself. Over the medium term (especially relative to the Fed), this cannot replace monetary policy unless the outlook changes or capital controls are introduced. What must be confirmed here is (1) the extent to which supply shocks can amplify price pressures through forex rates and (2) how heavily the BOJ treats such changes in monetary conditions as a prerequisite for policy decisions.

Japan: 5yr-forward 1mo OIS Rate

Source: Bloomberg; compiled by Daiwa.

Implications for BOJ: Reaffirming assumptions and "conditions"

The central projections for the economy and prices presented in the BOJ's latest *Outlook Report* are based on the assumption that supply-side disruptions will ease over time. Specifically, the baseline scenario assumes that the impact of the Middle East conflict will gradually subside, crude oil prices will trend downward, and there will be no major disruptions to supply chains.

However, Boxes 1~3 in the *Outlook Report* (full text) released on 30 April explicitly outline the risks associated with any deviation from this assumption. There are indications that if logistics constraints persist for an extended period, supply stagnation could occur not only for crude oil, but also for raw materials and intermediate goods, for which a high proportion is imported from the Middle East. If these constraints spread, plant utilization rates will decline, particularly in the materials industry, and the risk of an economic downturn will increase as a result of reduced production activity. Meanwhile, if supply constraints materialize, this could simultaneously heighten the risk of higher-than-expected inflation through higher prices for related products.

As a condition for hiking interest rates, BOJ Governor said, "While the risk of higher-than-expected prices is becoming apparent, the risks of a weaker-than-expected economy or major economic adjustments are somewhat limited." The assumptions and boxes in the *Outlook Report* are aligned with these conditions as a framework for examining how supply shocks can impact both the economy and prices.

In other words, the BOJ and markets have entered a stage for assessing this "situation in which the risks of an economic downturn or major economic adjustments are somewhat limited." At this juncture, while supply constraints are beginning to impact production in some areas, the impacts are currently being offset by measures such as drawing down inventories. However, Japan is at a stage where there is concern that the gap between production plans and actual results may widen during the Apr-Jun quarter. If crude oil prices and supply chain dynamics become clearer heading into June, the BOJ will need to determine whether it is facing a "major shock" or a "relatively minor shock," which will further constrain the environment for its decisions.

US Treasury Secretary Scott Bessent is scheduled to visit Japan in mid-May. Any comments he makes regarding monetary or exchange rate policies could influence market expectations for interest rate hikes. In this sense as well, the June meeting is not merely a matter of timing. Rather, it should be viewed as a stage for assessing the nature of the supply shocks and whether the conditions for a rate hike, as outlined by Ueda, have been met.

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