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Daiwa's View

FICC Research Dept

Second year of Ueda-led BOJ; April meeting focal points

- BOJ's April *Outlook Report*
  Expect underlying inflation to hold at around 2%
  For now, need to assess "second force" and consumption trends
- BOJ to closely monitor yen depreciation, may alter policy if weak yen leads to higher prices
  Room to reduce JGB purchases at discretion of Financial Markets Department
- Expect some hints about future at Ueda's regular press conference

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April BOJ meeting focal points; Expect underlying inflation to hold at around 2%

Kazuo Ueda was appointed BOJ Governor on 9 April 2023. He proceeded to make yield curve control (YCC) operations more flexible when the Bank released its *Outlook Report* on 28 July and 31 October of last year. Even though it took almost a full year, it is commendable that, based on the key data, the Bank was able to normalize policy by deciding on 19 March of this year to rework the framework for large-scale monetary easing, which included ending negative interest rates and eliminating YCC. Under "ordinary" monetary policy, policy decisions are based on economic, price, and financial conditions. Going forward, *Outlook Report* will become a more important means of communication with the market. April BOJ Monetary Policy Meeting (MPM) results and the *Outlook Report* will be released on 26 April. Just over one month has passed since the BOJ's major decision to normalize policy. As such, for now the Bank probably wants to assess the impact of its first interest rate hike in 17 years, as well as wage growth and price trends. So, we expect the BOJ will maintain the status quo at its April meeting.

Under these circumstances, focal points of the April BOJ MPM will likely be (1) price projections, (2) forex trends and their impact on monetary policy, and (3) the explanation of JGB purchases. First, we look at figures in the *Outlook Report*. The forecasted FY24 core CPI is expected to be revised upwards slightly from the +2.4% in the January *Outlook Report* considering (1) higher-than-expected wage hikes during the annual spring labor-management negotiations (+5.20% based on the fourth tally of responses by the Japanese Trade Union Confederation—Rengo), (2) the rise in crude oil prices over the past three months (WTI crude oil futures rose from the $72-78/bbl range in late January to the $81-87/bbl range), and (3) the passing on of higher costs to prices in the future (Chart 1). The BOJ's forecast for core-core CPI, which reflects underlying price trends the BOJ views as important, is expected to remain around 2% from FY24 to FY26. That would allow the 2% price stability target to be achieved, assuming a virtuous cycle is seen with wages and prices. We will have to try to determine if the likelihood of this happening continues to increase. Once again, the BOJ will probably use the wording "generally balanced" to describe upside and downside risks.

Chart 1: BOJ Policy Board Members' Projections (median, y/y %)

	Real GDP			Core CPI			Core core CPI		
	Jan 2024*	Apr 2024**	My forecast	Jan 2024*	Apr 2024**	My forecast	Jan 2024*	Apr 2024**	My forecast
FY23	+1.8 %	**+1.3 %**	+1.3 %	+2.8 %	**+2.8 %**	+2.8 %	+3.8 %	**+3.8 %**	+3.8 %
FY24	+1.2 %	**+0.8 %**	+0.7 %	+2.4 %	**+2.6 %**	+2.5 %	+1.9 %	**+2.0 %**	+2.0 %
FY25	+1.0 %	**+1.1 %**	+1.1 %	+1.8 %	**+1.8 %**	+1.9 %	+1.9 %	**+2.0 %**	+1.9 %
FY26	–	**+1.0 %**	+1.0 %	–	**+1.9 %**	+1.8 %	–	**+1.9 %**	+1.9 %

Source: BOJ, various materials; compiled by Daiwa Securities.
**BOJ projections. **My estimates for policy board member projections (highlighted in blue).*
Note: Upward revisions as of 19 Apr highlighted in yellow.

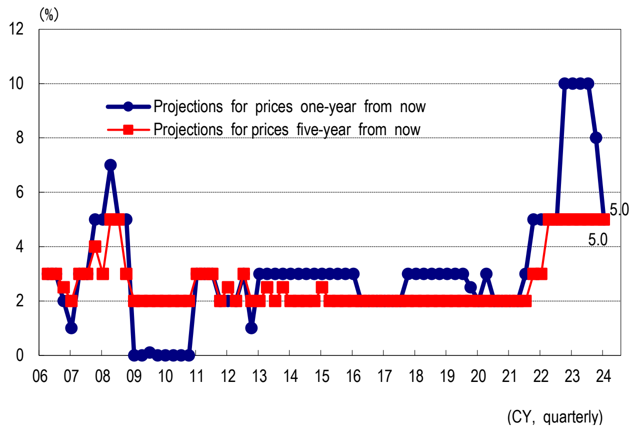
The BOJ released the results of its Opinion Survey on the General Public's Views and Behavior on 12 April. To gauge how respondents feel about prices, they were asked "By what percent do you think prices will change one year from now? Fill in the box below with a specific figure." The average was +9.4% (vs +10.0% in the previous survey) and the median was +5.0% (+8.0%; Chart 2). This slowdown was due to a lull in prices, mainly food prices. In contrast to that, survey participants were asked "By what percent do you think prices will change per year on average over the next five years? Fill in the box below with a specific figure." The results were largely unchanged with the average at +7.5% (vs +7.6% in the previous survey) and the median at +5.0% (+5.0%; Chart 2). Inflation expectations among households are still high.

Meanwhile, March nationwide CPI was released on 19 April. Core CPI was +2.6% y/y, growing at a slower pace compared to February (+2.8%), but still above +2.0% for two years. Core CPI excluding energy (core-core CPI) slowed to +2.9% (+3.2% for February), but remained at a high level. A lull in food and lodging price increases weighed on the March reading. Looking at general services, price increase growth has been slowing since the peak in Nov-Dec 2023 (Chart 3). In April, when the new fiscal year started, express mail delivery and other service prices were expected to increase. Since Tokyo CPI was strongly impacted by the move to make high school tuition free, the nationwide growth rate will not accelerate and is likely to remain in the mid-2% range.

Need to assess second force and consumption trends for now

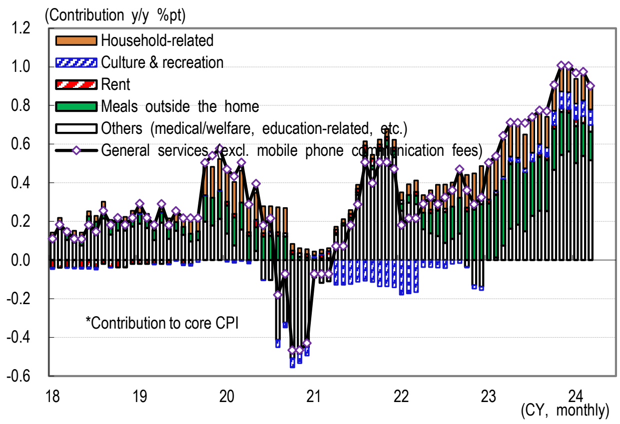
The key point to monitor prices from here is whether wage increases will translate into higher service prices. Under the Japan FTC's guidelines concerning price negotiation for the appropriate shifting of costs, it will take until the summer or early fall to determine whether small and medium-sized enterprises (SMEs) can actually pass on higher labor costs to their prices. The possibility of an upward swing in the underlying inflation rate will emerge as a result of a virtuous cycle between wages and prices. Meanwhile, the current high crude oil prices and prolonged weak yen levels may allow the first force (cost-push inflation) to come back to life. We must remain aware of the upside price risks over time. At the same time, considering the balance between the economy and prices, any weakness in consumption due to high prices would be a cause for concern. The Real Consumption Activity Index average for Jan-Feb fell 0.6% compared to Oct-Dec, implying weak consumption. We assume the real GDP growth rate for the Jan-Mar quarter (to be announced on 16 May) will become negative, reflecting weak production and consumption. Therefore, we will have to wait to see if there is steady consumption in the Apr-Jun data, achieving the combined effects of income growth going forward and the government's income tax cut (refunded in Jun). With regard to incomes (scheduled cash earnings in the Monthly Labour Survey), we will need to ascertain conditions up until July (released in early Sep), when SME wage increases will be reflected.

Chart 2: Opinion Survey on General Public's Views and Behavior (perception of price levels, median)



Source: BOJ; compiled by Daiwa.

Chart 3: Factor Breakdown of General Service Prices in Nationwide CPI



Source: Ministry of Internal Affairs and Communications (MIC); compiled by Daiwa.

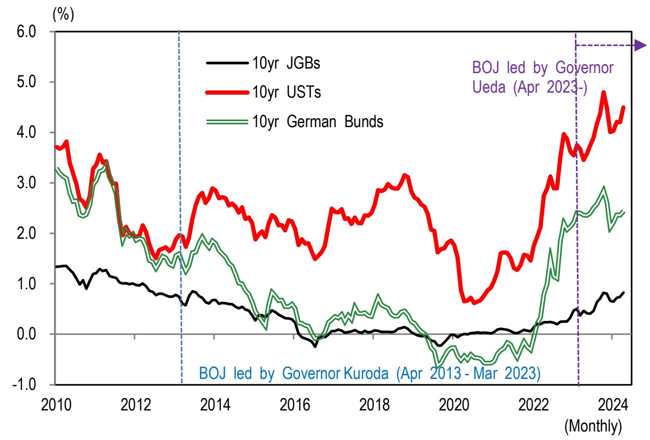
BOJ to monitor yen depreciation, may alter policy if weak yen leads to higher prices

The second focal point for the April meeting is (2) forex trends and their impact on monetary policy. The yen briefly appreciated to the USD/JPY146 level on 8, 11, and 12 March on expectations that the BOJ would end negative interest rates, but the yen did not appreciate beyond that level. Rather, the strong US February CPI released on 12 March caused expectations for an early interest rate cut to recede. Then on 15 March, the 10-year UST yield rose to the 4.3% level, pushing the dollar higher and the yen lower with the pair entering the USD/JPY149 level. On 19 March, when the BOJ's March meeting results were released, the yen weakened to just before the USD/JPY151 level during overseas trading hours on market recognition that the pace of Japan interest rate hikes will be slow after the BOJ ended negative interest rates. Since the start of April, there has been heightened awareness of possible forex market intervention. However, once again, the strong US March CPI, released on 10 April, pushed the 10-year UST yield up to the 4.5% level and the pair traded at the USD/JPY153 level. US retail sales for March, released on 15 April, exceeded expectations. The 10-year UST yield moved up to the 4.6% level and the dollar strengthened against the yen to the USD/JPY154 level (charts 4 and 5). Exchange rate movements are one of the BOJ's policy reaction functions, so it is important to note that this trend will likely continue.

Amid these conditions, Ueda on 18 April said during his press conference at the G20 Meeting of Finance Ministers and Central Bank Governors, in regards to higher prices brought about by the weak yen, "If the impact becomes too big to ignore, it might lead to a change in monetary policy." At that time, he explained that the Bank would analyze the impact of the yen's depreciation since January, leading to speculation that a numerical analysis (e.g., a BOX analysis) would be presented in the April *Outlook Report*. However, from what we have heard, this will likely be limited to an upward revision of the price outlook for FY24. It would be important to have concrete figures within the BOJ as one of its criteria for decision making. However, the BOJ could potentially lose some policy freedom once an official announcement of such figures easily create speculation on its action. That would be undesirable. At a seminar hosted by the Peterson Institute for International Economic on 19 April, Ueda said, "If underlying inflation continues to go up, we will very likely be raising interest rates." Ueda left the impression that he is more enthusiastic than before in regards to additional interest rates hikes. It does seem like he is giving lip service to exchange rate considerations. It will take some time to determine if the price increasing trend will continue.

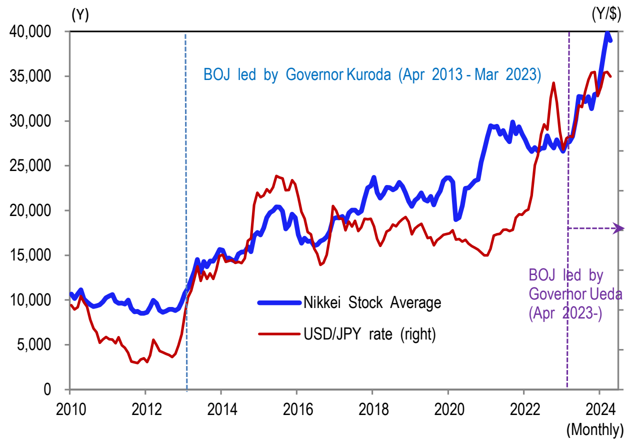
As the author had expected, the current US economy remains resilient and inflation remains tenacious. Looking ahead, attention will continue to focus on economic indicators to determine whether the US can start cutting interest rates (or if a rate hike is necessary) before the end of this year. The strength of the US economy will ease downside risks for the Japanese economy and provide tailwinds for the BOJ's efforts to normalize policy. If the US only makes a corrective rate cut, an additional rate hike by the BOJ would become a possibility.

Chart 4: Long-term Yields in Japan, US, Germany (from 2010)



Source: Bloomberg; compiled by Daiwa.
Note: Apr 2024 data uses average through the 22nd.

Chart 5: Nikkei Stock Average, USD/JPY Rate (from 2010)



Source: Bloomberg; compiled by Daiwa.
Note: Apr 2024 data uses average through the 22nd.

Room to reduce JGB purchases at discretion of Financial Markets Department

The third and final focal point pertaining to the April meeting is (3) explanation of JGB purchases. The JGB purchasing policy described at the March meeting as “roughly the same level as before” will likely be maintained at the April meeting. Under this policy and the JGB purchasing plan (purchases between Y4.81tn to Y7.01tn) prepared by the Financial Markets Department, there is still room to reduce JGB purchases at the discretion of the Financial Markets Department. On the afternoon of 18 April, Jiji Press ran an article titled, “Momentum Lacking for JGB Reductions at BOJ’s April Meeting.” This article said “BOJ reluctant to change frequent JGB purchase amounts,” “Plans to cautiously proceed with reductions,” and “Going forward, increases and decreases in JGB purchases will be determined separately from economic and price conditions.” The BOJ is not in a hurry to reduce its JGB purchases, which is the market’s immediate concern. Indeed, the sense that the BOJ is not in a hurry is palpable.

At the above-mentioned Peterson Institute for International Economics seminar on 19 April, Ueda said in regards to reducing JGB purchases, “We would like to find a way and timing to reduce the amount of JGB purchases.” While the Bank is willing to reduce its amount of JGB purchases, the timing and size of the reduction have not yet been determined. First, the reduction will proceed under the discretion of the Financial Markets Department. Even though the 10-year JGB yield has been trending gradually higher recently, the 1.0% ceiling set before YCC was eliminated is still far away. Depending on future 10-year UST yield trends, there could be upward pressure on JGB yields. So, it would be natural for the Bank to want to monitor supply and demand conditions a little bit more. Within the Apr-Jun quarter, JGB redemptions are more common in June and the tide may be turning.

Expect some hints about future at Ueda’s regular press conference

Based on the above, the BOJ will most likely unanimously decide to maintain the status quo at its April meeting. We do not expect any major surprises in the content of the Bank’s statement or the outlook figures in the April *Outlook Report*. Under these circumstances, Ueda’s press conference will again require a careful explanation of the outlook figures and policy decisions[1]. At the same time, some hints about the future (conditions for additional interest rate hikes) are expected. This will provide an opportunity to once again confirm Ueda’s resolve in taking steps to normalize monetary policy.

[1] The paragraph pertaining to prices in the summary section of the January *Outlook Report* included the new wording “The likelihood of realizing this outlook (for 2% price target) has continued to gradually rise.”

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