Keys to the BOJ MPM (22-23 Jan)

BOJ Watch Commentary REPE810

Price outlook should be largely unchanged after an interval

- In *Outlook Report,* a slight increase in FY18 growth estimate is anticipated, but inflation projections should be largely unchanged
- Speculation of QE tapering sparked by its reduction of purchases has reduced the probability of the BOJ removing mention of its approximately Y80 trillion target
- At the press conference, the difficulty of adjusting the YCC target will be reemphasized

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We expect the BOJ to hold policy steady

In the *Regional Economic Report* (*Sakura Report*) announced by the BOJ on Monday, January 15, three of the nine regions raised their economic assessment. Comments from companies in each region were mixed, including mention that they were raising prices to offset higher wages and other costs, that it was impossible to offset cost increases just with laborsaving equipment, and that the continued frugality of consumers was putting downward pressure on prices. Although there are signs of change, it appears that an increase in the underlying inflation rate will take more time. Given these conditions, we expect the BOJ to decide at its Monetary Policy Board meeting on January 22-23 to persistently pursue the powerful monetary easing policies now in place to achieve the price stability target of 2%. We also expect it to extend by one year its fund-provisioning measures for strengthening growth foundations and encouraging loan growth to promote more aggressive use of accommodative financial conditions. In this report, we summarize the keys to the policy meeting in addition to those above.

***Outlook Report* (1): Revisions to the current assessment are likely to be minimal**

The regional assessments of demand components in the *Sakura Report* included some notable revisions to business investment, housing investment, and labor supply-demand, but we think it more likely that any revisions to the current assessment of the economy, in "The Bank's View" section of the *Outlook for Economic Activity and Prices* (*Outlook Report*), will be limited (Chart 1). Three regions raised their assessment of business investment: Hokuriku (from "at a high level" in October to "increasing" in January); and Chugoku and Kyushu-Okinawa (from "increasing moderately" to "increasing"). This suggests growth is gaining momentum. In the BOJ's written statement following the December policy meeting, it merely removed the word "moderate" from its description of business fixed investment having "continued on an (moderate) increasing trend," and this leaves it room to remove the word "trend" to put more emphasis on continued growth. If it makes a revision for a second consecutive policy meeting, it could probably be taken as evidence that it has become more confident that growth is sustainable. In contrast, three regions clearly reduced their assessment of housing investment: Hokkaido (from "more or less flat" to "declining moderately"); Hokuriku (from "increasing as a trend, albeit with fluctuations", to "more or less flat"); and Kanto-Koshinetsu (from "more or less flat" to "weakening"). Although housing starts are down slightly from their peak, they have remained high and mostly unchanging the past several months (Chart 2). This suggests the possibility that the current assessment in the *Outlook Report* will be left unchanged. Three regions upgraded their assessment of labor supply-demand, Hokkaido and Shikoku (from "improving steadily" to "tightening"); and Kinki (from "further tightening" to "steady tightening"), but the BOJ is running out of terms to emphasize the tightening of labor market. In light of the above, we think the most likely outcome for the overall economic assessment is that it is kept the same: "expanding moderately."

We expect the assessment of prices to be raised to "about 1%" to reflect the increase in the y/y change in the November core CPI to +0.9%. *The Opinion Survey on the General Public's Mindset and Behavior* released on January 11 (Thursday) last week, however, showed a slight increase in the percentage of respondents citing low price as a major factor when choosing goods and services over the next year. We think the BOJ will probably stick with its assessment that inflation expectations are “in a weakening phase.”

Outlook Report (2): We expect the BOJ to raise the FY18 growth forecast and leave the price forecast unchanged

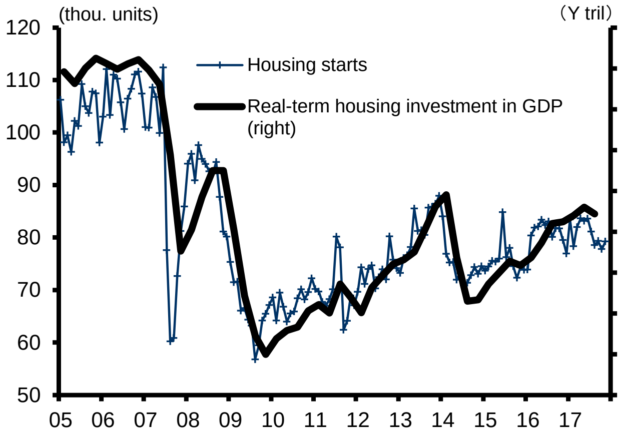
The forecasts are the meat of the _Outlook Report_, and there have been numerous media reports that the BOJ will raise its FY18 growth forecast, citing the recent strengthening of exports and the accelerated growth in business fixed investment. Global manufacturing sentiment has risen to its highest level in seven years (Chart 3). The environment has probably not changed enough for the BOJ to change its long-held expectation of “continued moderate economic growth”, however. Because the government expects continued strong

Chart 1: BOJ’s Assessment of Current Conditions at Previous MPM and Expected Changes in Jan MPM

	December 2017
Current condition	
Economy	"is expanding moderately, with a virtuous cycle from income to spending operating."
Exports	"have been on an increasing trend."
Industrial production	"has been on an increasing trend."
Capex	"has continued on an increasing trend with corporate profits and business sentiment improving." ⇒ **May remove the word "trend" to change it to "continued to increase."**
Private consumption	"has been increasing moderately, albeit with fluctuations, against the background of steady improvement in the employment and income situation."
Public investment	"has been more or less flat, remaining at a relatively high level."
Housing investment	"has been more or less flat." ⇒ **There may be room to lower its assessment to "slightly weakening."**
Labor market conditions	"have continued to tighten steadily." ⇒ **There may be room for it to raise its assessment to "tighten further ."**
Financial condition	"are highly accommodative."
Prices	"The year-on-year rate of change in the CPI is in the range of 0.5-1.0%. Inflation expectations have remained in a weakening phase." ⇒ **Will be revised upward to "around 1.0%."**
Outlook	
Economy	"is likely to continue its moderate expansion."
Prices	"The year-on-year rate of change in the CPI is likely to continue on an uptrend and increase toward 2 percent, mainly on the back of the improvement in the output gap and the rise in medium- to long-term inflation expectations."

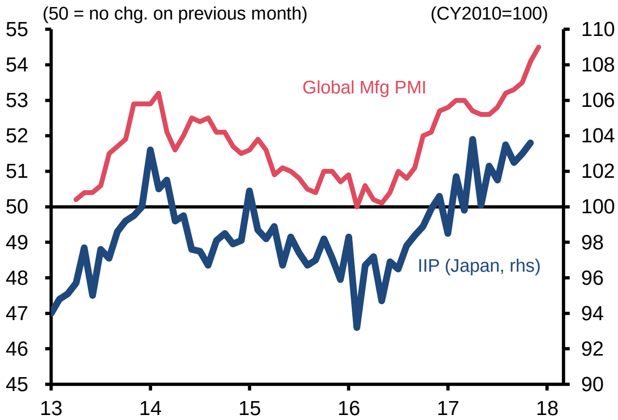
Source: BOJ, Daiwa Securities

Chart 2: Housing Investment



Source: Cabinet Office, MLIT; compiled by Daiwa Securities

Chart 3: Global Production Cycle and Japan’s IIP



Source: METI, Markit

growth into FY18, helped by the supplementary budget formed at end-2017 (real economic growth outlook of +1.9% in FY17 and +1.8% in FY18), we expect the BOJ will also raise its growth outlook, but only by about 0.2ppt (Chart 4).

In contrast, we think it is likely to stick with its price outlook throughout the forecast period of inflation reaching 2% by around FY2019. While Dubai crude oil priced at around $66/bbl, $5 higher than it was at end-October, is a reason for the BOJ to raise its FY18 price outlook, that outlook is already quite bullish relative to the market's. If it is going to revise that outlook, it would probably not do so until seeing how the spring 2018 wage negotiations end up.

Chart 4: Policy Board Members Outlook (median) and Our Forecast

(y/y % chg.)

	Real GDP		Core CPI	
	Oct. 2017	**Jan.2018***	Oct. 2017	**Jan.2018***
FY 2017	+1.9 %	**+1.9 %**	+0.8 %	**+0.8 %**
FY 2018	+1.4 %	**+1.6 %**	+1.4 %	**+1.4 %**
FY 2019	+0.7 %	**+0.7 %**	+1.8 %	**+1.8 %**

**Figures as of Oct. 2017 are the author's estimates of policy board member outlooks.*
Source: BOJ; compiled by Daiwa Securities
Note: Core CPI Outlook for FY2019 is the figure excluding the effect of consumption tax hike.

Written statement: The market disruptions triggered by its purchase amount reductions has reduced the likelihood of the BOJ removing its reference to a quantitative target

Up until now, we had thought that the BOJ might, at its January 2018 policy meeting, revise the reference to JGB purchase amounts in its written statement by removing the "increase its holdings at an annual pace of about Y80 trillion" portion and leaving only "conduct purchases at more or less the current pace." This is because we thought that, after confirming that its holdings did not even increase by Y60 trillion during CY17, the BOJ would conclude that the market has fully understood that BOJ is no longer focusing on the pace of JGB purchase amount, given the stable operation of its yield curve control policy using interest rate targets. When it reduced its purchases in the superlong zone on January 9 (Tuesday) last week, however, it sparked speculation over a rollback of easing, and this disrupted the market by causing long-term rates to rise and the yen to strengthen. The USD/JPY is currently trading above 110, very close to the exchange rate assumed by large manufacturers for FY17 (110.18) according to the BOJ *Tankan* (Dec17). This probably makes it more likely that the BOJ will try not to make any hasty revisions to its written statement to avoid the risk of further market turmoil.

Press conference: Will it highlight the difficulty of adjusting YCC targets?

The reduction in purchases is likely to become a major topic at the regularly scheduled press conference following the policy meeting. Because BOJ Governor Kuroda has on several occasions noted that if JGB supply-demand conditions were to tighten in response to an increase in the share of outstanding JGBs held by the central bank and stock effects worked firmly, the Bank could have the same degree of effect in lowering interest rate with a smaller amount of JGB purchases, we think it is fairly clear that the BOJ intends to gradually reduce its purchases as time passes under its yield curve control policy. Inflation remains fairly far from the 2% price stability target, however, and the BOJ has not wavered from its commitment to persistent and powerful monetary easing. Even still, if that leads to market volatility, there could be even larger market disruptions as the BOJ heads toward its planned exit strategy. If asked of his opinion of the risk that a sharp strengthening of the yen would keep pushing the exit farther into the future like a desert mirage, Mr. Kuroda would likely respond ambiguously, which is likely to reemphasize the difficulty in adjusting the YCC targets.

IMPORTANT

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

• In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥ 2 million (including tax) per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
• For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
• There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
• There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
• Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

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