Daiwa Securities

Keys to the BOJ MPM (14-15 Jun)

BOJ Watch Commentary REPE823

BOJ likely to stay on hold even if data are somewhat weak

- ➢ The BOJ is likely to maintain in its policy statement its assessment of the economy and the target increase in the amount of JGB holdings.
- ➢ We want to see what BOJ Governor Kuroda says during his press conference on reductions of JGB purchases and the risks of trade frictions becoming serious.

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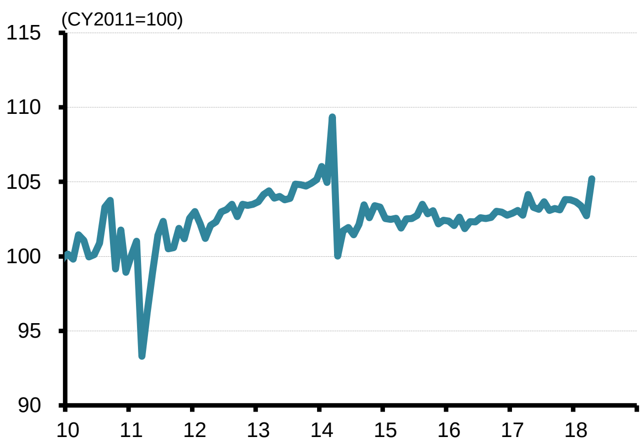
Likely to stay on hold

During a joint press conference on 2 June, following the conclusion of the meeting of G7 finance ministers and central bank governors in Whistler, British Columbia, BOJ Governor Kuroda said that the effects of protectionist trade policies need to be noted and that his view is still basically that Japan's economy is growing moderately. He acknowledged that price trends show some weakness, partly because of temporary downward pressures, but said that inflation is maintaining its momentum toward 2%. Given this assessment of growth and inflation, we think the BOJ is likely to decide to stay on hold at its policy meeting next week (14-15 June).

BOJ likely to stay on hold even if data are somewhat weak

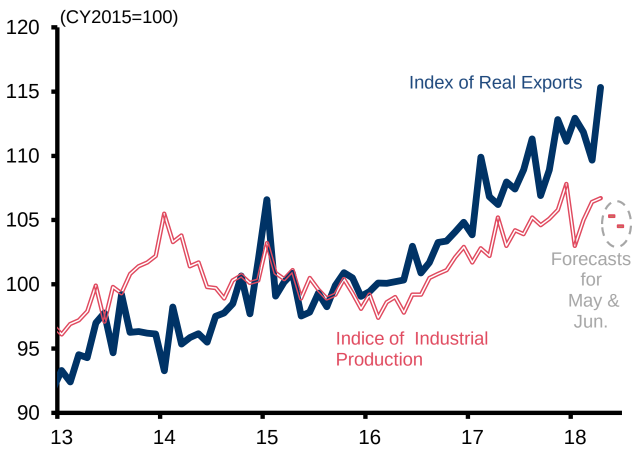
Key economic data that have come out since the last policy meeting show some weakness, but we think the BOJ will hardly change its previous assessment of the economy's current situation and outlook in its policy statement. First, amid several utility rate increases and a slight deterioration in various indicators of consumer sentiment, real consumer spending (households of two or more) in the *Family Income and Expenditure Survey* declined M/M, for a third consecutive month. However, the BOJ's Consumption Activity Index, a gauge of actual spending trends, has recently been up sharply (up 2.4% M/M in April; Chart 1). The BOJ is thus likely to maintain its current assessment that consumption has been increasing moderately, albeit with fluctuations. Production has increased in the past three months, but the April result was much weaker than the market expected, and the outlook for May-June is on the weak side. However, the index of real exports rose substantially in April. The BOJ is also likely to maintain its assessment of a basic uptrend in production, which is likely to be supported by an uptrend in overseas demand (Chart 2). Also, given the rebound in new housing starts, the BOJ may have room to raise its assessment of housing investment to

Chart 1: Consumption Activity Index (travel balance adjusted)



Source: BOJ

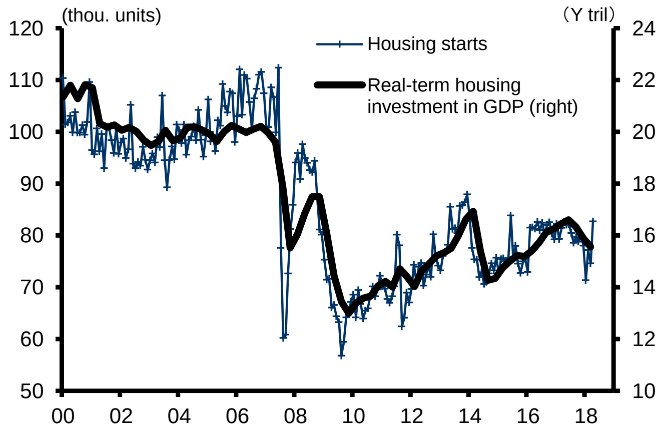
Chart 2: Real Exports and Industrial Production



Source: BOJ,METI; compiled by Daiwa Securities something along the lines of "it appears to have stopped weakening" (Chart 3). The BOJ is unlikely to change its overall assessment of the economy, though.

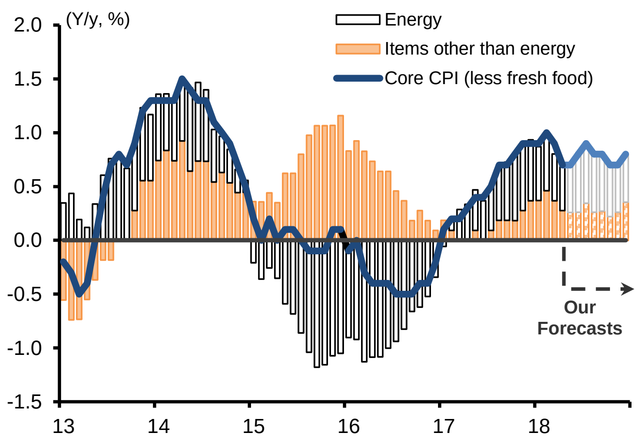
The April increase in the nationwide core CPI was 0.7% Y/Y, which might barely qualify as "around 1%." The increase is down from the recent peak of 1.0% (February 2018), indicating a soft patch in the inflation trend, but with a likely boost again from energy prices, the April-May levels could be close to the bottom for the year (Chart 4). We thus think the BOJ is likely to stick with its current assessment. It will probably maintain its assessment that "inflation expectations have been more or less unchanged." While focusing on prices, consumers appear to be still spending selectively and some major retailers have been discounting consumer staples, in light of consumers' focus on economizing.

Chart 3: Housing Investment



Source: Cabinet Office, MLIT; compiled by Daiwa Securities

Chart 4: Nationwide Core CPI



Source: Statistics bureau, Daiwa Securities

Missed opportunity to change reference amount in policy statement

The policy statement has long mentioned "an annual pace of increase in the amount outstanding of [the BOJ's] JGB holdings of about Y80 trillion," even as the actual pace of purchases has been very different.[1] The wide gap could be misinterpreted by nonresident investors and others as an indication that the BOJ is backing away from aggressive easing. However, the Policy Board is apparently confident that the market will sufficiently understand that the BOJ is currently focused on yield curve control, not quantity. The reason is that if the gap between the actual and target pace of JGB purchases is viewed as a problem, it would be desirable to revise or delete the reference amount at a time when the policy implications would not be questioned, and in this regard, the April meeting, the first one for the two new deputy governors, was a good opportunity to do so. The policy statement for that meeting omitted references in the *Outlook for Economic Activity and Prices* to the likely time frame for inflation to reach the 2% target, citing issues with communications with the market, but maintained the reference to Y80 trillion. We think the BOJ is likely to maintain the target amount for the time being.

Governor's press conference: Reduction of amount of purchases, risks of trade frictions becoming serious

In a paper on FY2017 market operations, released on 28 May (Monday), the BOJ notes that it flexibly adjusts the amount of its purchases of long-term JGBs, depending on market factors at the time, specifically 1) interest rate levels, 2) the direction of rate changes, 3) the pace of rate changes, 4) volatility, 5) whether the trend in rate changes is temporary, 6) the supply-demand situation for JGBs, and 7) the results of operations so far (the pro-rata rate, the average successful bid rate, the allocation on a pro-rata basis rate, the bid-to-cover ratio, and the core bid-to-cover ratio). As the assessment is an overall one, the market apparently has difficulty gauging when the BOJ decides to reduce the amount of its JGB purchases, including the reduction on 1 June (Friday) (from Y450 billion to Y430 billion, targeted at JGBs with more than 5 years but less than 10 years to maturity). However, as the BOJ's share of JGB ownership rises, the impact of its operations on the bond market becomes

[1] The annual increase in the amount outstanding as of end-May was almost Y50 trillion.

more difficult to ignore. The "*Bond Market Survey*" released on 1 June shows a decline in the perceived degree of bond market functioning.[2] During his press conference after next week's meeting, BOJ Governor Kuroda might stick to his previous response regarding adjustments of the BOJ's amount of JGB purchases, that they are determined based on practical considerations and are not indications of its future policy stance.[3] Nevertheless, we want to see if he provides any hints on further reductions.

There is also likely to be much interest in any remarks on the risks of trade frictions worsening. We would like to hear more detailed remarks than those made at the Whistler joint press conference (on Saturday, 2 June) on any changes in views on global economic trends, based on the recent exchange of views among G7 policymakers.

Reference: BOJ's Assessment of Current Conditions at Previous MPM and Expected Changes in June MPM

	April 2018
Current condition	
Japan's economy	"is expanding moderately, with a virtuous cycle from income to spending operating."
Overseas economies	"have continued to grow firmly on the whole."
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 maintaining their improving trend."
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 weakening somewhat." ⇒ **There may be room for it to raise its assessment to "appears to have stopped weakening."**
Labor market conditions	"have continued to tighten steadily."
Financial condition	"are highly accommodative."
Prices	"The year-on-year rate of change in the CPI is around 1.0%. Inflation expectations have been more or less unchanged."
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

2 The current net assessment of "low" for the perceived degree of bond market functioning has improved slightly. However, the change in the DI (from three months earlier) shows a rise in the net assessment of "has decreased."

3 He made the remarks during his 23 January 2018 press conference.

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[Standard & Poor's]

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[Moody's]

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[Fitch]

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May 2018

IMPORTANT

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• 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.

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