

Daiwa's View

Summertime for the central banks

- BOJ likely to take no action amid stable exchange rates; tenacious policy and economic assessment expected

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Summertime for the central banks: The yen is not strengthening rapidly in the currency market

Will the BOJ persist with the current monetary policy?

Following last week's ECB Governing Council meeting on 25 July, the BOJ's monetary policy meeting and the FOMC meeting are scheduled for 29-30 and 30-31 July, respectively, this week. The ECB revised its forward guidance to one with rate cut scope, opening the door to additional easing. At the FOMC meeting, a 25bp preemptive rate cut is almost certain. Even factoring in these factors, the yen has not strengthened in the currency market.

Four reasons for lack of progress in yen appreciation: strong demand for dollar funds, concern about fiscal deterioration in the US, a pause in yuan depreciation, etc.

The first reason for the lack of progress in yen appreciation is strong demand for dollar funds as money has been flowing into US assets on expectations of US rate cuts. The second reason is concern about fiscal deterioration in the US. Regarding the US federal debt ceiling, US President Donald Trump and congressional leaders on July 22 agreed to extend the borrowing authority and set spending caps for the next two years. Although the avoidance of the US debt default risk is a positive, concern about fiscal deterioration is likely to curb a substantial decline in US long-term interest rates. This would result in a slowdown in the pace at which the US-Japan interest rate differential is narrowing, and avoid appreciation pressure on the yen. The third reason is a pause in yuan depreciation due to the resumption of the US-China trade talks on 30 July, which is expected to avoid risk off-driven yen appreciation. The fourth reason is due to a structural change in which Japan's trade surplus is decreasing and the income balance supports the current account surplus, which curbs yen appreciation over the medium/long term.

The BOJ would have no need to hastily implement additional easing measures unless the USD/JPY rate strengthens and stays below 100

I think the BOJ has no need to hastily implement additional easing measures alone unless (1) the USD/JPY rate strengthens and stays the below 100 or (2) the BOJ receives a request for cooperation from the government when an economic recession comes into sight. In the Cabinet Office's *FY18 Survey on Corporate Behavior*, exporters (all industries) assumed the breakeven USD/JPY rate to be 99.8 (100.6 in FY17). We should be confident about the fact that Japanese companies are becoming better able to withstand yen appreciation every year, due to efforts to cut costs. These assumptions suggest that the warning zone for yen appreciation is perceived to be a USD/JPY rate of 100 in nominal terms. In the June BOJ Tankan, the FY19 projection for the USD/JPY rate by large manufacturers was 109.35. If the yen strengthens beyond this level, earnings would be revised downward compared to the initial plan. However, this would not necessarily cause a recession immediately.

G7 Chairman's summary: Fiscal policy needed if downside economic risks emerge

The Chairman's summary for the July 17-18 meeting of G7 Finance Ministers and Central Bank Governors held in Chantilly France included the statement, "Fiscal policy should be flexible and growth-friendly, while rebuilding buffers where needed." The summary also read, "Monetary policy will continue to support economic activity, while remaining mindful of financial stability and recognizing that monetary policy alone cannot address all economic challenges." The US is in a position to make preemptive rate cuts for the sake of the global economy as its policy rates are relatively high. However, for Japan and European countries where rates are already negative, fiscal policy steps will be needed if downside economic risks emerge.

The term “trend” in the BOJ’s overall economic assessment is a modifier for justifying standing pat

Since April, the BOJ’s overall assessment of Japan’s economy has been that it is “on a moderate expanding trend.” Looking back at its previous overall assessments, the central bank has used the term “trend” to justify standing pat. During Apr-Jun, the global economy continued to slow down, while Japan’s exports were also weak and a recovery in production after the drop in Jan-Mar (down 2.5% q/q) appears to have been slow. Under the assumption of a reactionary decline in production and consumption in June, the real GDP growth rate in Apr-Jun is now expected to be around zero. Amid lingering uncertainty about the outlook, downside risk in the overseas economy is increasing slightly. Meanwhile, positive factors are (1) the shift in production bases by Japanese companies and the appearance of last-minute demand and (2) anticipated avoidance of a recession in the US and Europe due to the Fed’s preemptive rate cut and the ECB’s additional easing coming in sight.

Downside risk in the overseas economy is increasing in Apr-Jun

July Outlook report likely to maintain recovery scenario despite pushing back timing of recovery

Based on the above considerations, we believe that, compared to April when the previous *Outlook for Economic Activity and Prices* report (*Outlook* report) was compiled, the BOJ has grown aware of increasing downside risks for the economy, similar to the IMF, and in the July report could push back its timing for a recovery (revise downward its growth rate forecasts; see chart below) while sticking with its moderate economic recovery scenario. According to various media reports, the BOJ is apparently mulling a downward revision for its FY19 price outlook. Improvement in the output gap has paused, but the reading remains positive. Momentum towards its 2% price stability target has been maintained. The crucial test for Japan’s economy will come during the Oct-Dec quarter when the growth rate could pull back sharply on poor external demand overlapping with a drop off in domestic demand after the pre-consumption-tax-hike spending surge. In that case, a fiscal policy is likely to play the main role and a coordinated fiscal policy/monetary policy response would be advisable.

Fiscal policy to play the main role in next recession stage

Kuroda raised three monetary easing considerations in recent speech

On 22 July, BOJ Governor Haruhiko Kuroda made a speech entitled “Overcoming Deflation: Japan’s Experience and Challenges Ahead” in Washington, which included expressions similar to those in overseas speeches by former governor Masaaki Shirakata. He pointed out three key considerations when maintaining powerful monetary easing—(1) communication & expectation management, (2) securing effective policy measures, and (3) examining financial functioning. He indicated that for (1), forward guidance plays an important role. For (2), he noted that yield curve control allows for both maintaining the minimal market functioning while controlling the long-term interest rates appropriately. Regarding (3), he specifically said, “Excessively low interest rates could make financial institutions reluctant to lend, such as through capital constraints, and thereby diminish the monetary easing effects” (Reversal Rate theory).

Best approach for the BOJ is to tenaciously maintain the current monetary easing policy; fiscal/monetary policy coordination would be advisable

I think that the best approach for the BOJ is to tenaciously maintain the current monetary easing policy. If the BOJ takes account of side effects the most, it should not deepen negative interest rates or lend money in negative territory, as shown in the *Summary of Opinions at the June Monetary Policy Meeting*. Regarding a revision to the forward guidance, the BOJ has to compare the benefit of showing an easing stance early on with the benefit of leaving limited additional measures amid stable forex rates. This would be a difficult decision. Either way, Mr. Kuroda is likely to repeat that “the BOJ can conduct large-scale easing further if needed.”

Chart: Median Forecasts by BOJ Policy Board Members (y/y)

	Real GDP			Core CPI		
	Apr 2019 (BOJ forecasts)	Jul 2019 (Our projections for policy board member forecasts)	Our forecasts	Apr 2019 (BOJ forecasts)	Jul 2019 (Our projections for policy board member forecasts)	Our forecasts
FY19	+0.8 %	+0.7 %	+0.5 %	+1.1 %	+1.0 %	+1.0 %
FY20	+0.9 %	+0.8 %	+0.5 %	+1.4 %	+1.4 %	+1.1 %
FY21	+1.2 %	+1.0 %	+0.8 %	+1.6 %	+1.6 %	+1.0 %

Source: BOJ, various materials; compiled by Daiwa Securities.

Note: Core CPI includes effects of consumption tax hike.

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[Standard & Poor's]

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