Daiwa's View

BOJ still bullish on the economy, but far from 2% target

- Questions at Governor Kuroda's press conference focused on 2% inflation target shortfall

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Policy unchanged following April MPM, with only board member Kataoka dissenting

Virtuous cycle from income to spending should intensify from FY22

The 2% target is far away

The BOJ held its monetary policy Board meeting on 26-27 April, just about one month after the policy adjustments it made at the previous (policy review) meeting, and made no changes to policy (on an 8:1 vote, with Goushi Kataoka dissenting; new board member Asahi Noguchi voted yes). In its April *Outlook for Economic Activity and Prices* report (*Outlook Report)*, an important checkup of economic and financial conditions, the BOJ stuck with its recovery scenario, noting that while the economy has been stagnant since January, impacts from the pandemic "are waning gradually." The BOJ now expects an even bigger rebound in the economy from FY22, when the pandemic is expected to subside. This time, it included the phrase "a virtuous cycle from income to spending is expected to operate," which symbolizes normalization. Regarding prices, the BOJ noted that although prices in FY21 would be weaker because of the reduction in mobile phone charges, excluding those effects "the year-on-year rate of change in the CPI is expected to be steady." Even if that gradually pushes the CPI back up to 1% in FY23, it will still be far from the 2% target.

The balance of risks to the economy are changing in a positive direction, and should be roughly balanced between upside and downside factors in FY22

Increased mention of financial imbalances in its second perspective on monetary policy

The balance of risks to the economy changed in the positive direction. The BOJ modified its language to note that although risks are currently skewed to the downside, they are generally balanced for the middle of the projection period onward. However there are high uncertainties, both in Japan and overseas, regarding one of those risk factors, the economic impacts from covid-19, including whether the third state of emergency can be lifted on 11 May. Additionally, variant strains of the virus pose more of a threat now than they did when the last report was written. This latest *Outlook Report* has an increased number of references about differences in the pace of vaccinations by country and region and of comments on the sorts of impact on global economic activity that may arise. There are considerable uncertainties. Meanwhile, risks to prices are still skewed to the downside. On the other hand, in the latest *Outlook Report* there was an increase in references to financial imbalances within its second perspective on the conduct of monetary policy, evidence that the Financial System and Bank Examination Department has started providing a report. "The aggregate credit relative to the size of the economy has been increasing at a pace significantly above the past trend. This is because financial institutions have responded to demand for working capital, mainly by firms, which has increased due to the impact of COVID-19, and the increase in the aggregate credit therefore does not seem to show overheating of financial activities."

Chart: FY20-23 Forecasts of Majority of Policy Board Members (y/y % chg)

	Real GDP	CPI (all items less fresh food)
FY20	−5.0 ～ −4.9 [−4.9]	−0.4
As of Jan 2021	−5.7 ～ −5.4 [−5.6]	−0.7 ～ −0.5 [−0.5]
FY21	+3.6 ～ +4.4 [+4.0]	0.0 ～ +0.2 [+0.1]
As of Jan 2021	+3.3 ～ +4.0 [+3.9]	+0.3 ～ +0.5 [+0.5]
FY22	+2.1 ～ +2.5 [+2.4]	+0.5 ～ +0.9 [+0.8]
As of Jan 2021	+1.5 ～ +2.0 [+1.8]	+0.7 ～ +0.8 [+0.7]
FY23	+1.2 ～ +1.5 [+1.3]	+0.7 ～ +1.0 [+1.0]

Source: BOJ; compiled by Daiwa Securities.
Notes: (1) Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).
(2) The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.
(3) Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.
(4) The CPI (all items less fresh food) for fiscal 2020 is an actual figure.

Questions at Governor Kuroda's press conference focused on 2% target shortfall

At BOJ Governor Kuroda's regularly scheduled post-meeting press conference, questions were focused on why the BOJ still expects inflation to be below the 2% target in FY23. Mr. Kuroda, giving his answers without a mask on because clear plastic barriers were in place, answered meekly that "it is regrettable that it will take time (to reach the target)." This is a significant toning down of the rhetoric coming from Mr. Kuroda, who had shown a strong desire to hit the 2% target up until the BOJ's second bazooka shot (the "Halloween easing" in October 2014).

Reduction in mobile phone charges expected to depress CPI by 0.5-1.0ppt

This is much more downward pressure than previously estimated

To be confirmed with the 30 April release of the central Tokyo CPI for April

Asked about differences with overseas inflation rates, he started by noting that by some estimates, the reduction in mobile phone charges may lower the FY21 price outlook by 0.5-1.0ppt, and that without that downward impact, inflation would have been positive. There were media reports that the Ministry of Internal Affairs and Communications was thinking of conducting a survey of the low-cost mobile plans that are only available online, and this would create much more downward pressure than my estimate of 0.3-0.5ppt. The degree of impact can be confirmed when the April central Tokyo CPI is announced on 30 April, and it may show a much stronger downward impact than initially expected, reminiscent of the CPI surprise of August 2006. In preparation for that, the BOJ added in a footnote at the bottom of page 3 in the *Outlook Report* that there was a high likelihood of the CPI being revised downward when the index switches to a 2020 base this summer (starting with the July nationwide CPI set for release on 20 August). Although we trust that this is an excellent survey for monitoring prices, it is clear to everyone that inflation will lack upward momentum even after the temporary downward impacts fade.

Japan-specific reasons; inflation expectations are extremely sticky

Reaching the inflation target is the BOJ's mission and will be a major task for the next BOJ governor

Mr. Kuroda noted that another difference between Japan and the US besides the pace of vaccinations and size of economic stimulus is that inflation expectations in Japan are extremely sticky, making it difficult for economic activity to be conducted on the premise of rising prices and wages. There is therefore a need to stick with it, because by continuing with large-scale easing despite these conditions, the economy will recover and have a positive impact on prices. He added that the BOJ's mission is to make utmost effort to achieve that target no matter what. The BOJ governor emphasized that it was a "very correct" decision to target 2% and that a reduction of that target is not under consideration. Since this target is unlikely to be achieved during Mr. Kuroda's term (which ends on 8 April 2023), it will be a major task left over for at least the next BOJ governor.

US-specific reasons; differences in corporate setup

Contrast of near-term price trends: temporary increase in the US vs. temporary decline in Japan

In my many years of forecasting price levels in Japan, I have grown jealous of the US, where prices are actually rising, including because of base effects. Apart from the reasons why prices do not rise in Japan, there are two factors that make price rises easier in the US and explain the difference: (1) increases in purchasing costs are passed through to selling prices and (2) US corporations are set up differently than those in Japan, where an emphasis on job protection create stagnant wage growth. We expect contrasting price trends over the near term, with a temporary increase in the US vs. a temporary decline in Japan. There is more than a small possibility that one market factor will be the near-term differences in price trend, explained in part by differences in vaccination rates, between the Japanese economy, which is heading lower, and the US economy, which is heading higher. It is probably even more important to keep a close eye on trends in the US.

When the economy normalizes, it will become necessary to rethink the nature of inflation targets

In my opinion, the 2% target is too high given the underlying strength of Japan's economy. There is no need to stick with a 2% target when coping with a crisis like the current one. The BOJ's responsibility of highest priority is maintaining a stable financial system. That being said, once the pandemic subsides and the Japanese economy appears ready to start normalizing, there will probably be a need to rethink the nature of inflation targets. If targeting a level that is in line with the other major economies is significant (i.e., if it is important to avoid yen appreciation), we think it will be necessary to implement policy with a greater degree of freedom over the medium/longer term.

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February 2020

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