

Daiwa's View

What's the BOJ to do? Blueprint for 2022

- Price assessment in Jan *Outlook Report* is unlikely to lead to policy change

Fixed Income Research Section
FICC Research Dept.

Chief Market Economist
Mari Iwashita
(81) 3 5555-8852
mari.iwashita@daiwa.co.jp



Daiwa Securities Co. Ltd.

Japan expected to post substantial positive growth in Oct-Dec due to pent-up demand and catch-up production

In 2022, we need to take into consideration prolonged high resource prices

Since the start of the year, COVID-19 infections have been surging again; Japan is experiencing a double whammy from weaker yen and high resource prices

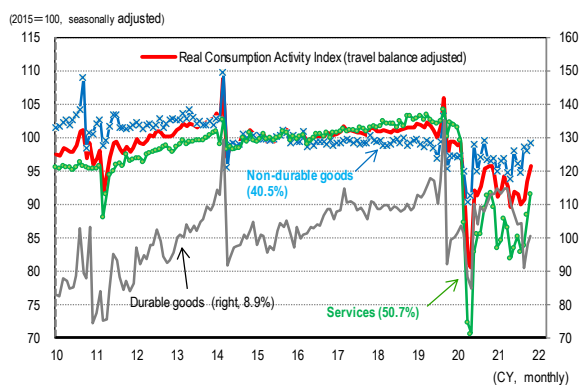
Cautious stance still necessary for economic outlook

What's the BOJ to do? Blueprint for 2022

Two and a half months have passed since the BOJ released its *Outlook for Economic Activity and Prices* report (*Outlook Report*) on 28 October. Japan's GDP for Jul-Sep turned negative (real GDP: -3.6% q/q annualized) due to three factors: (1) the fifth wave of COVID-19 infections, (2) difficulty in procuring automobile parts, and (3) the price of resources hovering at high levels. In the Oct-Dec quarter, (1) the state of emergency was lifted nationwide for the first time in six months at the beginning of October as the fifth wave came under control. Then, consumption started to recover thanks to pent-up demand. Looking at the Consumption Activity Index compiled by the BOJ, the average for Oct-Nov 2021 surged by 4.3% vs. the reading in Jul-Sep. With regard to (2), catch-up production of automobiles was seen from November due to a delay in the resolution of supply constraints of automobile parts. However, due to chip shortages, momentum is not being maintained in line with initial projections. Regarding (3), we need to take into consideration prolonged high resource prices (greenflation) in 2022. Nevertheless, we can expect substantial positive growth in Oct-Dec due to a recovery in consumption and production.

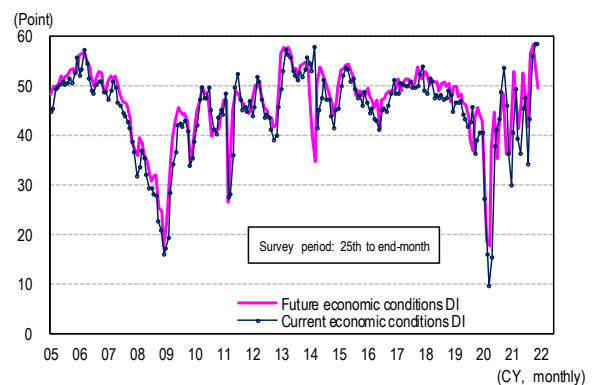
Since the beginning of the year, there has been a surge in COVID-19 infections (a sixth wave?) as the highly contagious Omicron takes over from earlier variants. In the December *Economy Watchers Survey* released on 12 January (survey conducted during 25-31 Dec), the current economic conditions DI improved only slightly, and the future economic conditions DI declined substantially (Chart 2). According to comments on the future outlook, people were already concerned about the spread of infections when the survey was conducted at end-2021, and high material prices also served as a weight. In addition, since the Fed showed a hawkish pivot in late 2021 (focus shifted to measures to rein in inflation), (4) the yen has been gradually weakening. As a net importer of resources, Japan is experiencing a double whammy from (3) and (4) (with trading gains deteriorating at a fast pace). Therefore, a negative impact on corporate earnings and household income are issues of concern. We still need to take a cautious stance for the economic outlook.

Chart 1: Consumption Activity Index in Japan



Source: BOJ; compiled by Daiwa Securities.
Note: Figures in parentheses show weights.

Chart 2: Economy Watchers Survey in Japan



Source: Cabinet Office; compiled by Daiwa Securities.

In BOJ's Jan Outlook Report, projection for FY21 growth rate is expected to be lowered, while that for FY22 is to be raised

The BOJ is to release the January *Outlook Report* next week (on the 18th) amid great uncertainty about the future outlook. The median estimate for the FY21 growth rate is expected to be lowered to the upper 2% level, while that for FY22 is anticipated to be raised to the lower 3% level (Chart 3). The downward revision to the FY21 figure is a technical one, reflecting the final data announced in December 2021. An upward revision is expected for FY22 due to expectations of progress with vaccinations and a resolution to supply constraints with the incorporation of a new economic package. With it still being a ways off, major revisions to FY23 are not anticipated. The BOJ will probably maintain an improvement scenario for the future. According to the January *ESP Forecast Survey* announced on the 13th (survey conducted during 24 Dec-7 Jan, 36 responses), the average forecast for real GDP was +2.72% for FY21, +3.07% for FY22, and +1.38% for FY23.

As negative output gap is expected to continue, momentum towards 2% is not increasing

Turning to price (core CPI) forecasts, the negative output gap is expected to continue for now. Therefore, momentum towards 2% is not increasing. Given sluggish wage movements compared to the US, prices are unlikely to surge. However, regarding externals, crude oil prices hovering at high levels (WTI at around \$83 in late Oct recovering to around \$82/bbl now) and the weaker Japanese currency (the yen depreciating from the USD/JPY114 level to the USD/JPY116 level at one point at the beginning of the year) are both likely to exert upward pressure on prices. Recently, companies appear to be beginning to split into those that can pass on higher costs to their customers (companies with a global presence) and those that cannot. According to various media reports, the BOJ is likely to raise its FY22 price projection from +0.9% as of October to the lower 1% level (with a slight upward revision also expected for FY21: Chart 3), reflecting rising energy prices that were not included in October 2021, subsequent moves to pass on higher costs to customers (Chart 4), and announcements of markups by companies. With the impact from lower mobile phone charges having faded away, the y/y change in core CPI for April 2022 is expected to rise to the lower 1% range. If more companies announce markups from April onwards, the reading could stay at the 1% level in summer (my forecast shown in Chart 5).

High crude oil prices and weak yen would exert upward pressure on prices at some point

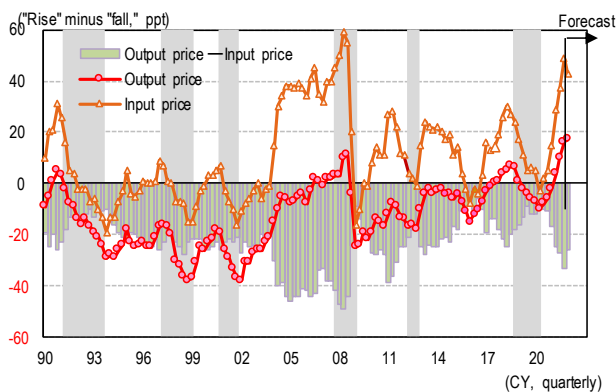
BOJ likely to raise price projections for FY21-22

Chart 3: Projections by BOJ Policy Board Members (median, y/y)

	Real GDP			Core CPI		
	Oct 2021*	Jan 2022**	Our forecasts	Oct 2021*	Jan 2022**	Our forecasts
FY21	+ 3.4 %	+ 2.7 %	+ 2.5 %	0.0 %	+ 0.1 %	+ 0.1 %
FY22	+ 2.9 %	+ 3.3 %	+ 3.4 %	+ 0.9 %	+ 1.1 %	+ 0.8 %
FY23	+ 1.3 %	+ 1.4 %	+ 1.5 %	+ 1.0 %	+ 1.1 %	+ 0.8 %

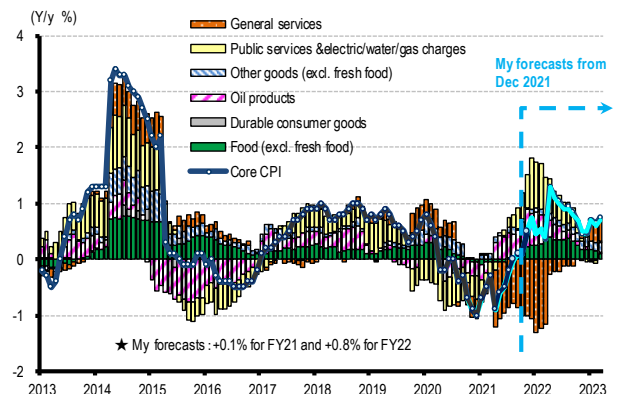
Source: BOJ, various materials; compiled by Daiwa Securities.
 *BOJ projections.
 **Our estimates for policy board member projections.

Chart 4: Price Dis at Large Manufactures in BOJ Tankan



Source: BOJ; compiled by Daiwa Securities.
 Note: Shaded areas indicate recessions.

Chart 5: Breakdown of Nationwide Core CPI (goods and services)



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

Yen's depreciation has effect of pushing up prices of durable consumer goods, and future trends need to be carefully watched

However, the rising price of products, mainly of daily necessities, amid the lack of wage hikes may rein in the expected recovery of consumption. In his speech on 23 December 2021, BOJ Governor Haruhiko Kuroda pointed out that “the effects of the yen’s depreciation in terms of pushing up prices of durable goods have increased in recent years. Accordingly, the yen’s depreciation might have an increasing negative impact on household income through price rises.” For now, the rise in the price of durable consumer goods is weaker than that in food industrial products, but future trends need to be watched carefully. By using wording that takes cost-push inflation into consideration, the BOJ showed its intention that it does not want to induce ‘bad depreciation of the yen.’ In the near term, the BOJ may not want to emphasize its dovish stance too much against the hawkish Fed.

BOJ takes cost-push inflation into consideration, trying to avoid inducing ‘bad depreciation of the yen’

Summary of Opinions at BOJ’s Dec meeting suggested adequacy of examining price risk assessment

In the prices section of the Summary of Opinions at the BOJ’s December Monetary Policy Meeting, it was written that “In the next Outlook for Economic Activity and Prices (*Outlook Report*) to be released in January 2022, it is necessary to examine whether the current assessment that risks to prices are skewed to the downside will remain appropriate, considering, for example, the recent rises in inflation expectations and raw material costs.” We presume that analyses in the *Outlook Report* will focus on prices in order to examine this. We wonder how the risk assessment in the upcoming report might change from the previous “risks to prices are skewed to the downside.” If the BOJ were to state that upside/downside risks are balanced with an upward revision to price projections, that would give us a somewhat bullish impression. Even if so, such a revision would not lead to a policy change because, with the CPI failing to recover to the 1% level and the economy failing to recover to pre-pandemic levels, there is no momentum towards 2%. At BOJ Governor Haruhiko Kuroda’s regular press conference on the 18th, we should focus on how he will explain the relationship between prices and policy decisions.

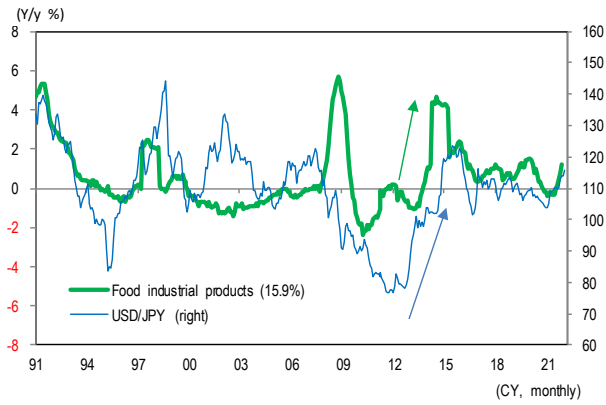
A change in price risk assessment would not lead to a policy change

We should be mindful of Apr 2023, when Kuroda’s second term in office will end

In terms of considering BOJ monetary policy, we have remained mindful of April 2023, when Kuroda’s second term in office will end, ever since he was reappointed BOJ governor in April 2018. In order to quickly move forward with a policy framework review once the governor is replaced, the BOJ will need to start laying the groundwork about six months in advance. In Japan, the Upper House election is slated for July 2022. Until then, it would be difficult for full-fledged discussion regarding monetary policy normalization to move forward. In the first half of 2022, we should carefully watch the US economy, which appears to be slightly overheated, and the sustainability of inflation. In the US, it is highly likely that the pace of rate hikes and the schedule of balance sheet runoff will change according to the extent of a slowdown in inflation in the Apr-Jun quarter onwards. Nevertheless, in order for the BOJ to start laying the groundwork for policy changes, it is desirable for the normalization of monetary policy in the US to proceed smoothly without overkill the economy after the start of rate hikes. I expect Japan’s economy to recover to pre-pandemic levels in the Apr-Jun quarter 2022. Judgments based on data related to that will be made from autumn onwards. The release of the October *Outlook Report*, which is still a long way off, will be an important time. In addition, we need to confirm whether core CPI can maintain the 1% level after reaching it in Apr-Jun. The key timing for evaluating progress will likely be spring in the US and autumn in Japan.

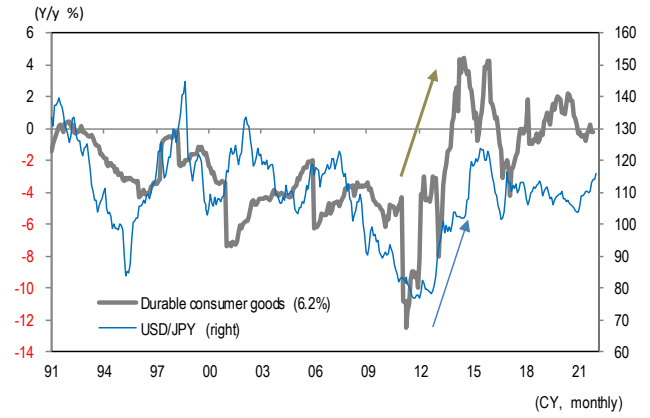
Regarding policy framework review at time of change in Governor, BOJ will need to start laying groundwork about six months in advance

Chart 6: Food Industrial Product CPI, USD/JPY Rate



Source: MIC, Bloomberg; compiled by Daiwa Securities.

Chart 7: Durable Consumer Goods CPI, USD/JPY Rate



Source: MIC, Bloomberg; compiled by Daiwa Securities.

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