22 March 2022
Japanese report: 22 March 2022

Daiwa Securities

Daiwa's View

Governor Kuroda demurs on defending the yen at his press conference

- Key developments to watch are inflation forecasts and secondary spillover effects

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BOJ holds policy steady at its March policy meeting

It lowered its overall economic assessment but used strong language on price increases

As expected, the BOJ made no policy change at its last policy meeting of FY21. It again lowered its economic assessment to reflect COVID-19 infection rates and the Ukraine conflict, this time to "Japan's economy has picked up as a trend." In contrast, it raised its price outlook and changed to stronger language to describe the CPI as "likely to increase clearly in positive territory." Based on these changes, we think the BOJ is considering lowering its FY22 growth outlook and raising its price outlook in the April 2022 *Outlook for Economic Activity and Prices* report (*Outlook Report*), which is due for release on 28 April.

There were numerous questions about inflation and yen depreciation at Governor Kuroda's press conference

As an importer of natural resources, the biggest impact on Japan from Russia's Ukraine invasion is through rising raw materials prices

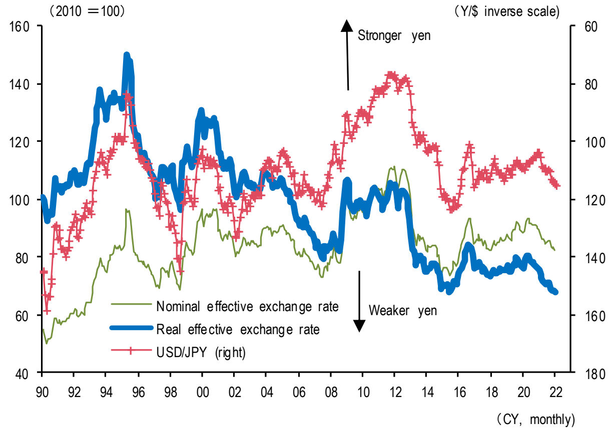
There were numerous questions about inflation and yen depreciation (Chart 1) at Governor Kuroda's regularly scheduled press conference. The first question was about the impact that the uncertainty about the Ukraine situation will have on the global and Japanese economies. Mr. Kuroda explained that broadly speaking, there are three transmission mechanisms for impacts from the war, specifically, (1) sharp increases in the price of commodities, including crude oil, natural gas, grains (wheat), and metals (nickel); (2) shrinkage of trade with Russia and supply chain disruptions; and (3) global financial market disruptions. Because Japan is an importer of raw materials, the biggest impacts will initially come from the first of these, rising commodity prices (Chart 2), and cost-push inflation will have longer-term downward impact on the economy by reducing corporate earnings and household incomes. The second channel will not have much impact because Japan's trade with Russia is minimal, although there will be indirect impacts from supply chain disruptions. The third channel is the undermining of household and business confidence. All three channels will put downward pressure on the global economy, particularly in Europe. Mr. Kuroda explained that Japan's economy could also be hurt by negative impacts on households' desire to spend and, if markets become unstable, by businesses delaying their investments. Mr. Kuroda provided only a brief summary of these three transmission channels, and we expect greater detail to come by way of a box analysis inside the April *Outlook Report*.

CPI may be at around 2% for some time from April

Yen depreciation is a positive overall, but has uneven effects for different industry sectors and company sizes

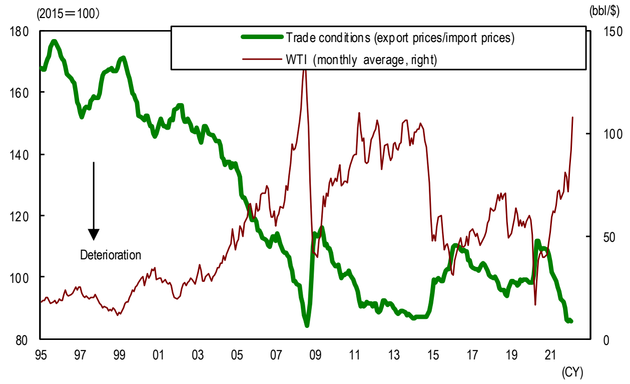
When asked about the rate of increase in the CPI and the BOJ's future policy stance, Governor Kuroda answered that the CPI "could be at around 2% for some time from April," wording that was somewhat nostalgic. Mr. Kuroda first used the phrase "for some time" in July 2018 when the BOJ implemented forward guidance on rates. While acknowledging that the unexpected 2% inflation rate could last for a while because of rising raw materials prices, he repeated his previous arguments that with wages rising, he is targeting mild inflation, and that the BOJ would remain patient and continue with its powerful easing. Asked about the weakening yen, he said "it is still a positive overall" but added that "its effects are uneven, depending on industry sector and company size."

Chart 1: Yen's Exchange Rate Trends (from 1990)



Source: BOJ; compiled by Daiwa Securities.

Chart 2: Japan's Trade Conditions, Crude Oil Price Trends



Source: BOJ, Bloomberg; compiled by Daiwa Securities.
Note: WTI data in Mar 2022 indicates average through 18 Mar.

Regarding cost-push inflation, Kuroda thinks that impact of yen depreciation is very small

BOJ is unlikely to make any aggressive moves to prevent the yen's decline

Given that Mr. Kuroda had previously not gone beyond saying that a weaker yen is an overall positive, this indicates a slight change toward showing more concern. Nevertheless, when asked about the current cost-push inflation, he said "the rise in global commodity prices is having a significant impact but yen depreciation is a very small part of that," and therefore left the impression that he is not concerned about a further weakening of the yen. The USD/JPY rose back above 119 during the 18 March trading day in Europe and the US. It is actually the Ministry of Finance that is responsible for exchange rates, and the BOJ is unlikely to make any aggressive moves to prevent the yen's decline. It remains to be seen whether policymakers will respond if the USD/JPY rises above the 120 threshold. With Japan still posting trade deficits, the exchange rate is likely to pass right by 120.

Price increases at large companies resulting from the spring wage negotiations are set to be higher than they have been for a while

Wage increases for 2022 should be higher than 2% (vs. 1.86% in 2021)

The increase in global commodity prices is unlikely to be sustained

BOJ remains on hold for now, waiting to see the future expected inflation rate and secondary spillover effects

The trend in wages, a critical component of the moderate inflation sought by the BOJ, will depend on developments in the ongoing spring wage negotiations. Governor Kuroda noted that "the spring wage negotiations are not over yet, and we will have to wait and see whether wage hikes spread to SMEs and second-tier companies, but the wage hikes already agreed to by large companies are higher than they've been in a while. So far, it appears that wages will be raised at a relatively strong pace." On 16 March, the deadline for wage decisions at numerous companies, an unprecedented number of companies agreed to the full amount of increase requested (seven automakers and four electrical appliance manufacturers), with a stronger increase than the one in 2021 (above 2%, Chart 3). This is positive news. Unlike CPI inflation in Europe and the US, however, Japan's inflation is low and, because it is mostly due to rising commodity prices, unlikely to be sustained. Accordingly, in his opinion "there could be a monetary policy response in the event of secondary spillover effects from rising wages and rising inflation expectations caused by rising energy prices, but Japan is nowhere near such a scenario." The BOJ is likely to keep policy unchanged for the time being as it watches to see what happens to longer-term inflation expectations and whether there are secondary spillover effects. We want to wait for the price DIs in the March Tankan survey to be announced on 1 April (Chart 4) and for the company interviews in the *Sakura* report to be released on 11 April to confirm whether companies are passing on higher prices to their customers.

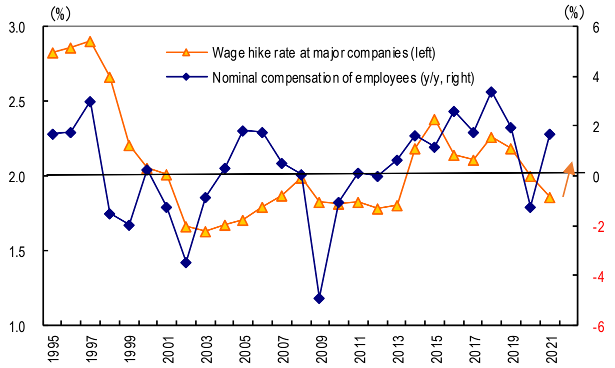
Multiple factors—the pandemic, green policies, and the war—are creating upward price pressure

Raw materials inflation cannot be dealt with using monetary policy alone

Longer-term, it is necessary to think about Japan's economic security

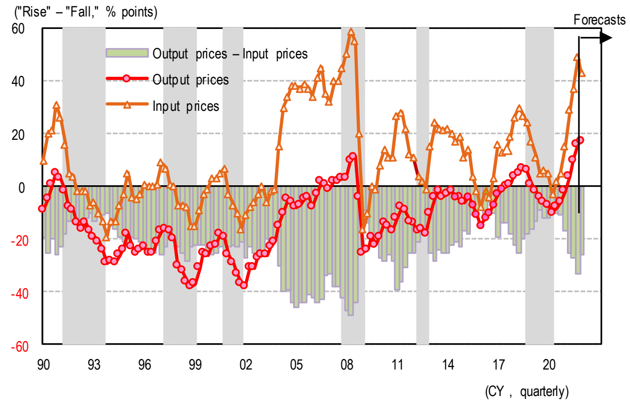
Mr. Kuroda stated confidently "global commodity prices are not going to keep rising at their current pace. They never have." We agree that the current rate of price increases is unsustainable, but there are multiple factors pushing inflation higher: supply chain constraints caused by the pandemic, greenflation caused by environmental policies, and war. Although the inflation rate may slow, there are likely to be secondary spillover effects if prices remain high. It is possible that inflation expectations in Japan will increase as the country moves away from its deflation mindset. In my opinion, raw materials inflation cannot be dealt with using monetary policy alone, and the government must play an important role. Although the Kishida administration has already implemented gasoline subsidies, Japan needs to think about its economic security from a longer-term perspective. Revising energy policies to take account of geopolitical risks, improving self-sufficiency in food, promoting the domestic production of semiconductors, and supporting the rebuilding of corporate supply chains are efforts that will take time, and therefore must be started soon.

Chart 3: Wage Hike Rate, Nominal Compensation of Employees



Source: Cabinet Office, Health, Labour and Welfare Ministry; compiled by Daiwa Securities.

Chart 4: Price DIs at Major Manufacturers in BOJ Tankan



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

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