

# Daiwa's View

## Governor Kuroda's ten years included surprises and miscalculations

- The surprise was the sharp fall in oil prices, the miscalculation was the entrenchment and normalization of deflation

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**No surprises from Kuroda's last BOJ policy meeting**

**Market's strong expectations for policy revisions led to 10-year JGB yield plunging after policy statement announcement**

**"Flight to quality" increased during overseas trading hours**

**There were many questions looking back on last ten years at Governor Kuroda's last regular press conference**

**Summing up last ten years, he stated that deflation had ended, and that easing was successful via revitalized economy**

## Governor Kuroda's ten years included surprises and miscalculations

At 11:30 a.m. on 10 March 2023, BOJ Governor Haruhiko Kuroda brought to a close his last meeting of the Monetary Policy Board, and, as expected, the board members voted unanimously to keep policy unchanged. With Governor Kuroda having developed a reputation over the past decade for liking surprises, there were strong expectations for policy revisions, even at Kuroda's last meeting. In the JGB market immediately after the announcement of the policy statement, we saw increased momentum with buying to cover short positions, which temporarily lowered the 10-year on-the-run issue yield to 0.385%. During subsequent overseas trading hours, the February US jobs report eased excessive concerns about wage inflation. Furthermore, due to the collapse of Silicon Valley Bank, a subsidiary of the medium-size SVB Financial Group, concerns emerged about the negative impact on the financial system, which bolstered a "flight to quality" (selling of equities/buying of bonds). On 10 March, the 10-year US yield declined to 3.67% at one point and the USD/JPY rate temporarily hit the lower 134 range. Going forward, the Fed is likely to face more difficulties in its policy operations. At the same time, the market is also expected to continue to be swayed by monetary policy. Naturally, unstable market trends are seen as a factor the new BOJ leadership under Ueda will assess carefully.

At Governor Kuroda's last regular press conference, there were many questions looking back on the last ten years. Governor Kuroda started by pointing out that deflation had ended, and summed up the last ten years, saying that the economy had been revitalized through dramatic changes since the previous deflationary period, and that employment had increased substantially due to the end of the "employment ice age," when it was very difficult to find employment, and that, in that sense, the potential of Japan's economy had been demonstrated, and easing was successful. He remained bullish until his last meeting, adding that side effects were dealt with in various ways, and that he felt the positive effects on the economy were much greater. He also voiced his expectations for the future, saying that, while it was regrettable that the price target was not achieved in a sustainable or stable manner, in terms of labor supply/demand conditions, it had become easier to raise wages, and that he thought the time was approaching when the price target would be achieved together with wage hikes, things that he had been expecting and striving for during the last ten years. He also stated that uncertainties nevertheless still remained, and it would be important to continue establishing an environment in which wage hikes were easily implemented by continuing the current large-scale monetary easing.

**Employment conditions are improving and wages are rising, but sustained increases are needed**

The jobs environment is clearly improving (Chart 1), and a growing number of large companies are increasing momentum for wage hikes in spring wage negotiations in 2023. Although base salary increases will be only about 1%, overall average wage growth is expected to be near 3% (Chart 2, wage negotiation results to be announced on 15 Mar at many companies). However, the BOJ's 2% price stability target will require both structural (i.e., spreading to SMEs) and sustained wage growth, and confirmation of that will take longer. The BOJ introduced its new phase of easing (first bazooka round) on 4 April 2013, noting that "we will not be firing further rounds," but about 18 months later it fired a second bazooka round, announcing its Halloween easing on 31 October 2014. That demonstration of its determination to achieve the 2% target proved to be a turning point and was followed by a long period of struggling to deal with the side effects, in your author's view.

**The second bazooka shot was the turning point, after which the struggle with side effects began**

**The first unexpected event during Mr. Kuroda's 10yr term was the sharp plunge in crude oil prices**

When asked about unexpected events that occurred during his 10-year term as BOJ governor, the first example he cited was "when crude oil prices, which were well above \$100/bbl, fell steadily down to around \$30 by 2016. This had a significant downward impact on the CPI." He also noted that "the two consumption tax hikes led to last-minute demand followed by a pullback, and that along with declining real incomes impacted prices." Demand weakened following the first consumption tax hike, which was implemented in April 2014. The sharp fall in crude oil prices (Chart 3), which occurred in the summer of 2014, had a downward impact on prices. That prompted the BOJ (with a bare majority vote of 5 to 4) to expand its quantitative and qualitative monetary easing on 31 October 2014, a decision that memorably roiled the market.

**In 2014, the consumption tax hike and sharp decline in oil prices prompted BOJ to surprise the market with its Halloween easing**

**In Oct 2014, Mr. Kuroda pointed out the risk of the change away from a deflationary mindset being delayed**

In the written statement issued with its Halloween easing, the BOJ wrote "if the current downward pressure on prices remains, albeit in the short term, there is a risk that conversion of deflationary mindset, which has so far been progressing steadily, might be delayed. To preempt manifestation of such risk and to maintain the improving momentum of expectation formation, the Bank judged it appropriate to expand the quantitative and qualitative monetary easing (QQE)." At his subsequent press conference, Governor Kuroda, noting that "the exit from deflation is at a critical juncture" and underscored that "the current measures are a further demonstration of the BOJ's unwavering resolve." Something your author can never forget was a speech given by Mr. Kuroda at the *Kisaragi-kai* five days later on 5 November. Entitled "Ensuring achievement of the price stability target of two percent," that was a speech she was in the audience to hear live. In that speech, he said, "in order to completely overcome the chronic disease of deflation, medicine should be taken until the end<sup>1</sup>," and the threatening and powerful punch from those words has been impossible to forget. With those words, he communicated a strong commitment to quickly achieving the 2% price stability target.

**The BOJ once again demonstrated its resolve**

**A Kuroda speech that your author will never forget is the one he gave in front of the *Kisaragi-kai* in Nov 2014**

**Governor Kuroda's miscalculation was that deflation became entrenched, and unexpectedly so**

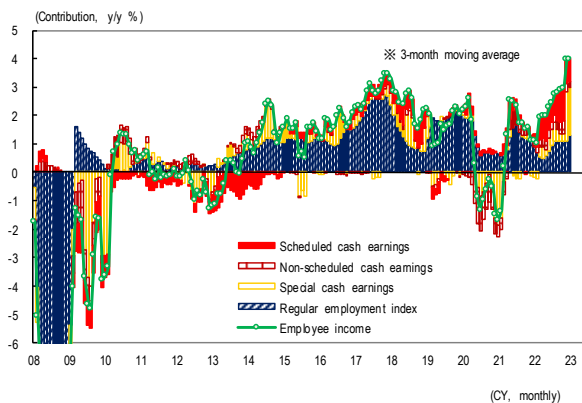
Mr. Kuroda said "the reference to around two years is about the resolute implementation of easing. At the time, that had considerable effect, and I do not think it was a mistake." He added that "deflation was entrenched for 15 years, which was longer than expected." Following his opening remarks at an international conference in June 2015, Mr. Kuroda was asked by a reporter, regarding his famous Peter Pan speech<sup>2</sup>, if "a change in the norm raised price expectations as a result of continuing to believe." Although Mr. Kuroda answered with a wry smile that the Peter Pan reference was not something he came up with but rather inserted into the speech by his staff, this quote has clearly left a lasting impression on the general public.

**Remarks made by the BOJ governor referring to the story Peter Pan in June 2015 left a powerful impression**

<sup>1</sup> Written in final part of speech materials [https://www.boj.or.jp/en/about/press/koen\\_2014/ko141105a.htm](https://www.boj.or.jp/en/about/press/koen_2014/ko141105a.htm)

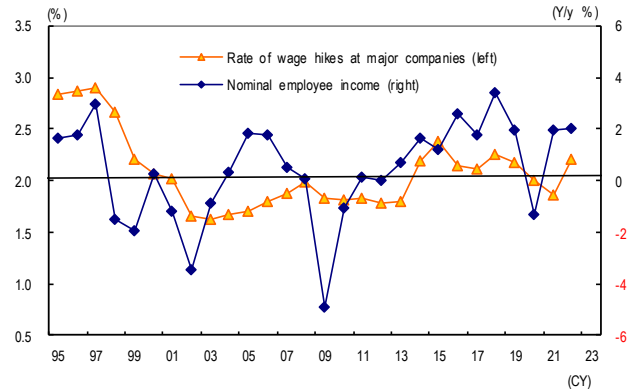
<sup>2</sup> "I trust that many of you are familiar with the story of Peter Pan, in which it says, 'the moment you doubt whether you can fly, you cease forever to be able to do it.' Yes, what we need is a positive attitude and conviction" written in concluding remarks in [https://www.boj.or.jp/en/about/press/koen\\_2015/ko150604a.htm](https://www.boj.or.jp/en/about/press/koen_2015/ko150604a.htm)

Chart 1: Breakdown of Japan's Employee Income



Source: Ministry of Health, Labour and Welfare (MHLW); compiled by Daiwa Securities.  
 Note: 3-month moving average.

Chart 2: Wage Hike Rate, Nominal Employee Income in Japan



Source: Cabinet Office, MHLW's "Situation of spring wage hikes at major private companies"; compiled by Daiwa Securities.

### Governor Kuroda's Peter Pan speech and strong commitment was critical

### The core CPI is likely to become less positive between now and mid-FY23

### It is premature to start discussing an exit strategy

### Governor Kuroda revealed that communication with the market was a common concern at the BIS All Governors' Meeting

### First issue new BOJ leadership under Ueda must address is re-establishing communication with market

### Focal point will be how BOJ explains relationship between policy decisions and economic/price projections in its Apr Outlook Report

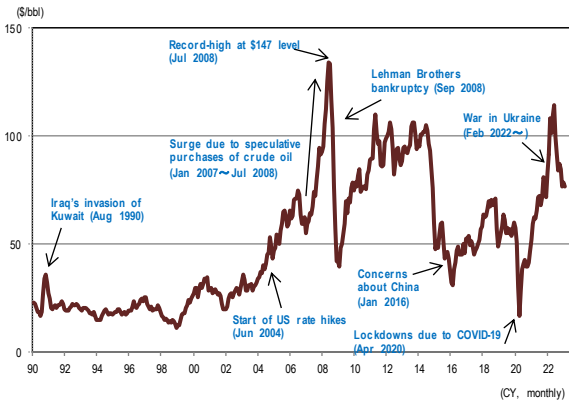
In response to a question, Mr. Kuroda said "it is necessary to clarify goals and intent regarding monetary policy, and that definitely includes stating what we do not think and do not believe. It is important to make a strong commitment to do whatever it takes to achieve the 2% target." Nearly seven years have passed since he made those comments, and amid a pandemic and the outbreak of war in the Ukraine, Japan's core CPI rose above +2.0% y/y in April 2022. Inflation has since accelerated, albeit not to the extent that it has in the US and Europe, and the CPI climbed to +4.2% in January 2023 (Chart 4). The BOJ considers this to be cost-push inflation that is transitory, and expects it to weaken. It is likely that inflation peaked in January and will start coming down from February until mid-FY23 in response to the government's measures to ease the pain of inflation, and the most likely scenario after that is a gradual increase in prices. This is why Mr. Kuroda has not changed his view that it is premature to start discussing an exit strategy.

On the other hand, when asked about the lasting impression that the BOJ has struggled to dialogue with the market over the past ten years, Mr. Kuroda gave an interesting answer. "Difficulties with communication were also expressed by the other central bank governors at the BIS's All Governors' Meeting, and this was instructive. I think what is most important is that when implementing policy, central banks do their best to communicate clearly what their objective is and how they propose to achieve it. I have personally given it my best effort, although I do not think I have always been able to communicate perfectly with the market." Mr. Kuroda is in Switzerland from 11 to 15 March to attend his last All Governors' Meeting. This is the first time he has said that such worries are a common thread across central banks. Compared with BOJ Governor Kuroda, who is now nearing the end of his term, the worries are probably much more serious for ECB President Christine Lagarde and Fed Chairman Jerome Powell, both of whom are still hiking rates to combat inflation. Meanwhile, Mr. Kuroda himself has acknowledged that he has not been that skillful in communicating with the market.

Governor Kuroda's last meeting once again highlighted the differences in perception between the BOJ and the market. Since the beginning of 2022, speculation about policy revisions by the BOJ has been strong mainly among overseas investors, but they were getting ahead of themselves. Due to the BOJ's surprise decision at the December 2022 meeting, market participants have been thinking that anything goes, and tending not to take information from the BOJ at face value. The first issue the new BOJ leadership under Ueda must address is re-establishing communication with the market. To make logical policy decisions, the BOJ must first construct a highly accurate outlook for the economy and prices. It must then provide a careful and easily understood explanation to market participants of how its outlook relates to policy decisions, i.e., how it will approach policy based on that outlook. We would like to see Kazuo Ueda, the next BOJ governor, leverage his strengths as an academic to restore the BOJ's credibility with the market. As he is from academia, we expect him to put the priority on analyzing fundamentals and making careful decisions. The key test will be the April *Outlook for Economic Activity and Prices* report

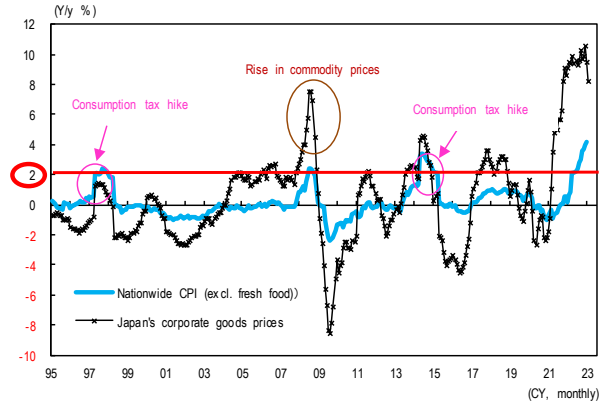
(*Outlook Report*) to be released on 28 April at the first meeting under the new leadership led by Ueda.

**Chart 3: Trends in Crude Oil Prices (WTI Futures) Since the 1990s**



Source: Bloomberg; compiled by Daiwa Securities.

**Chart 4: Upstream and Downstream Prices in Japan**



Source: BOJ, Ministry of Internal Affairs and Communications; compiled by Daiwa Securities.

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