Daiwa's View

Mr. Kuroda's final response and assessment as Governor

➢ How to sum up ten years of unprecedented easing

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Governor Kuroda's last MPM is on 9-10 Mar

Last decision by BOJ under Kuroda to be announced in early afternoon on 10 Mar, together with formal approval of new leadership led by Ueda

The BOJ Monetary Policy Meeting (MPM) scheduled for 9-10 March will be Governor Kuroda's last meeting. This is earlier than usual because the terms of the two deputy governors, Masayoshi Amamiya and Masazumi Wakatabe, will end on 19 March. BOJ Governor and two deputy governors' nominations, which were proposed to the Diet on 14 February, are expected to be decided and confirmed on 9 March in the lower house and on 10 March in the upper house. The last decision made by the BOJ under the leadership of Haruhiko Kuroda is to be announced in the early afternoon on 10 March. Around that time, news will also be announced about the formal approval of the new leadership led by Kazuo Ueda. In the lead up to the first change in BOJ Governor in ten years, an article in English in the IMF's quarterly magazine contributed by former BOJ Governor Masaaki Shirakawa (released on 1 Mar) garnered attention. Shirakawa referred to the unprecedented easing by Kuroda's BOJ as a "great monetary experiment," and concluded that the impact on inflation and growth rates was "modest." At his last regular press conference on 10 March, I want to see (1) how Governor Kuroda sums up the past ten years in response to the article and (2) how he assesses the current situation. This will be his final response and assessment as Governor.

Several board members have given speeches over the last two weeks, repeating unified message of no action at Mar MPM because of the need to assess impact of revision to YCC

Several board members have given speeches over the last two weeks, Naoki Tamura on 22 February, Junko Nakagawa on 1 March, and Hajime Takata on 2 March. Their unified message was that it is still necessary to maintain monetary accommodation and that now is not the time to act because it will take time to assess the impacts from the change in YCC modification announced at the December 2022 policy meeting. This further reinforced the message that the BOJ will not take action at its March policy meeting. If the BOJ did trigger a rise in interest rates between now and the end of Japan's accounting year on 31 March, it would worsen the business environment for financial institutions, particularly the regional banks. In addition, US and European yields are on the rise due to expectations of continued rate hikes, which has once more pushed up the USD/JPY rate to the Y137 level. With policy meeting scheduled on 16 March at the ECB and on 21-22 March for the FOMC, it would probably not be wise for the BOJ to make a move without first observing what the market does following those other policy meetings.

Speculation on policy change persists in market, despite BOJ sending message of wait-and-see stance

Looking back on last year, BOJ was very resistant to pressures from market

BOJ is showing some ingenuity in terms of operations to contain higher yields and prevent short selling

Although the BOJ has been in active dialogue with the market, the market still has strong expectations of a policy change. There are also many observers who note that because BOJ Governor Kuroda has had the reputation of liking surprises over the past decade, it would not be unusual if an action were taken at the March meeting. Although it is true that the BOJ surprised at its December 2022 meeting, it is also true that it did not act immediately in response to the market disruptions that triggered circuit breakers in the bond futures market in June 2022 or to the rapid weakening of the yen to above Y151 against the dollar in October. The BOJ has already proven that it can be very resistant to pressures from the market to modify policy. Since the BOJ decided to enhance its supply of funds against pooled collateral at its January policy meeting, there have been no hiccups in its operations in the 5yr zone, which it conducted on four occasions supplying a total of Y4tn to combat upward pressures on interest rates. On the other hand, on 27 February, the BOJ revised the terms and conditions of its securities lending facility by raising the minimum fee rate for three on-the-run 10yr JGB issues and lowering the upper limit of the lending amount, in order to prevent short-selling by speculators. If Governor Kuroda is aiming to reduce the burden on his successor, there is no point in implementing such measures.

Even if the trading band were widened again, it would not fix yield curve distortions

BOJ has duty to provide explanation regarding revisions to YCC framework

Even if the BOJ did further widen the trading band for the 10yr yield, it would probably neither fix the yield curve distortions nor improve market functionality. Abandoning the long-term rate target is a change to the YCC framework that it would have to explain. Given that it argued in its March 2021 policy assessment that the framework was working, it would need to go through the process of reviewing or verifying the reasons why it is no longer working. If the BOJ were to just abolish the framework without such groundwork, it would be laying some potential landmines right before bringing in a new governor. For now, what the BOJ can probably do is to show some ingenuity in terms of market operations.

Correction in silicon cycle normally takes about a year

There are downside risks with overseas economies

Next, I would like to confirm the current fundamentals in Japan. With exports lacking momentum on concerns over economic slowdowns in the US and China and declining demand for semiconductors, we expect production to remain weak for now (Chart 1). The correction in the silicon cycle normally lags by about a year (the recent peak in production of SPE was in Sep 2022). The recent trend in shipments also shows weakness in capex. Although we expect the Japanese economy to follow a moderate recovery trajectory for now, the downside risks to overseas economies cannot be ignored. The market has been slightly more optimistic about the global economy since January, but it is predicated on positive impacts from the reopening of China's economy.

Since Feb, core CPI has been pushed down by government's measures to cope with inflation

Nationwide core CPI for Feb is expected to slow to +3% level; reading for Apr-Jun highly likely to be at upper 2% level

Meanwhile, since February, the y/y change in Japan's CPI has been pushed down by government measures to cope with inflation. On a nationwide basis, as well, the CPI for February is expected to slow to the +3% level y/y. However, as plans to raise prices (mainly for food) are continuing, the reading is very likely to stay at the upper 2% range in the Apr-Jun quarter. In addition, due to the artificial decline in energy-related prices, growth in core-core CPI is likely to exceed that in core CPI for about one year (Chart 2). While core-core CPI is one underlying indicator of inflation, an overall determination needs to be made together with other related indicators.

Upward pressure on prices could change depending on future direction of rising electricity charges and sustainability of companies passing higher costs onto product prices

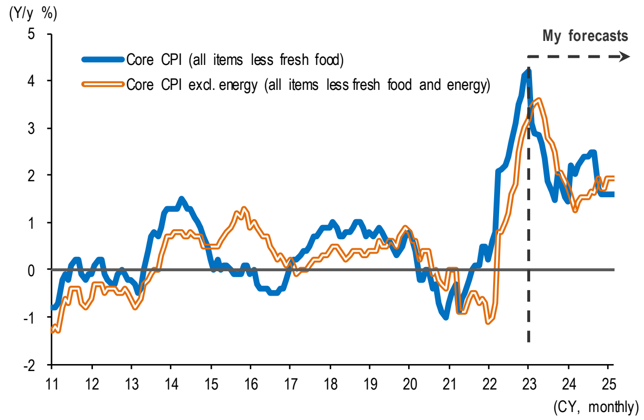
Moving forward, upward pressures on prices could change depending on the electric utilities' requests for rate increases (METI's detailed survey changed to the latest data for exchange rates and fuel prices, which means smaller rate hikes) and the persistence of higher prices being passed on. Either way, the median forecast in the BOJ's January *Outlook for Economic Activity and Prices* report (*Outlook Report*) is still for a core CPI in FY23 of +1.6%[1], but that is likely to be revised upward in the next *Outlook Report*, due out in April. Meanwhile, amid rising prices, there is a rising trend toward raising wages, with a priority on younger workers, at large enterprises. Even with a base salary increase of around 1%, an overall wage hike of nearly 3% is expected to result from the spring wage negotiations (the results of which will be released on 17 Mar at many companies). Because the BOJ's 2% price stability target requires sustained wage increases, this will take time to confirm.

Wage hikes in spring wage negotiations are expected to approach 3%, but it takes time to confirm sustained wage increases

Chart 1: Real Exports and Production in Japan

Source: BOJ, Ministry of Economy, Trade and Industry (METI); compiled by Daiwa Securities.
Note: For production, X indicates METI's mode (+1.3% m/m) as Feb forecast.

Chart 2: Nationwide Core CPI, Core-core CPI



Source: Ministry of Internal Affairs and Communications; compiled by Daiwa Securities.
Note: Excluding impact of consumption tax.

We need to continue carefully monitoring both downside risks to economy and upside risks to prices in Japan

The market appears to be focusing only on price trends. (There have, indeed, been many inquiries about price projections.) However, until we see sustained wage hikes, it would be difficult for the BOJ to revise its outlook that cost-push inflation is temporary. Meanwhile, growth of real GDP for Oct-Dec 2022 was sluggish, and the planned figures suggest that production in the current Jan-Mar quarter is weak. Therefore, it has become difficult for Japan's economy to return to pre-pandemic levels (the average levels in 2019) within FY22. One of the reasons for continued easing has not yet been resolved. In Japan, we need to continue to carefully monitor both downside risks to the economy and upside risks to prices.

New Ueda leadership likely to implement policy revisions to lessen side effects on assumption of continued easing

I forecast that the new Ueda leadership will consider policy revisions to lessen side effects on the assumption of continued easing. We interpret his remarks at the confirmation hearings in the Diet to indicate that he believes it will be difficult to normalize policy (by raising the short-term rate, i.e., removing negative interest rates) until stable inflation of 2% is confirmed. He also thinks policy decisions should be made separately for short-term interest rates and long-term interest rates. As he understands the side effects of the YCC, he will likely put the priority on revisions to the long-term interest rate (removal or shortening of guidance target), and this should be considered. Some of Ueda's distinctive qualities and strengths are that he demonstrates logical judgement and provides easy-to-understand explanations. He is likely to put the emphasis on the analysis of fundamentals and make measured judgments. The key test will be the April *Outlook Report*. We should note (1) how he explains the relationship between policy decisions and economic/price projections and (2) whether he can get communication with the market back on track.

Key is how he will explain relationship between policy decisions and economic/price projections in Apr *Outlook Report*

[1] Regarding February data in the ward-area of Tokyo, the Ministry of Internal Affairs and Communications (MIC) estimated that the government's inflation measures placed a 0.64ppt drag on electricity charges and a 0.30ppt drag on city gas charges (a 0.94ppt drag in total). There is a slight difference in contribution between nationwide CPI and CPI in the ward-area of Tokyo due to differences in the weighting of items. I expect Feb nationwide core CPI (due out 24 Mar) to rise 3.1% y/y.

Chart 3: Change in Description of BOJ's Assessment on Current Economic Situation

Current situation	Text in red shows revisions in Jan 2023 ⇒ shows expected revisions in Mar
Japan's economy	Despite being affected by factors such as high commodity prices, has picked up as the resumption of economic activity has progressed while public health has been protected from COVID-19 ⇒ Unchanged
Overseas economies	The pace of recovery has slowed ⇒ Unchanged
Exports	Have increased as a trend, with the effects of supply-side constraints waning ⇒ May be revised downward to "weak" on the back of decline in chip demand
Business fixed investment	Has increased moderately ⇒ Unchanged Business sentiment has been more or less unchanged ⇒ Unchanged Corporate profits have been at high levels on the whole ⇒ Unchanged
Private consumption	Has increased moderately, despite being affected by COVID-19 ⇒ Unchanged
Public investment	Has been more or less flat ⇒ Unchanged
Housing investment	Has been relatively weak ⇒ Unchanged
Industrial production	Have increased as a trend, with the effects of supply-side constraints waning ⇒ May be revised downward to "weak," similar to exports
Financial conditions	Have been accommodative on the whole, although weakness in firms' financial positions has remained in some segments ⇒ Unchanged
Prices	Y/y rate of change in the CPI (all items less fresh food) has been in the range of 3.5-4.0% due to rises in prices of such items as energy, food, and durable goods. Meanwhile, inflation expectations have risen. ⇒ Upward revision from "around 3.5-4.0%" to "4.0-4.5%," BOJ is expected to explain that CPI will slow down going forward due to government's measures to cope with inflation

Source: BOJ; compiled by Daiwa Securities.

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