

Daiwa's View

FICC Research Dept.

Implications of Iran War for BOJ's monetary policy— Emergency responses during a time of yen depreciation and a test of its strategy of continuing with rate hikes

- Iran war occurring during yen depreciation heightens rationale for postponing rate hikes in the short term and increases risk of falling behind the curve in the medium to long term



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Emergency during a period of yen depreciation: Forex rates no longer serve as “shock absorber”

During periods of yen appreciation, the currency's strength partially functioned as a buffer against rising import prices when Japan faced supply shocks, like an oil crisis. Furthermore, with mechanical risk-off yen buying tending to occur during emergency situations, forex rates were expected to partially absorb the shock.

However, the current Iran war is an issue that is playing out during a time of yen depreciation, and forex rates are not necessarily functioning as a safety valve. In fact, the yen itself has been sold openly, once again highlighting the vulnerabilities presented when emergencies occur during periods of yen depreciation.

Actually, risk-off yen buying was temporarily observed during the plunge in the Nikkei Stock Average. However, looking at the financial markets as a whole since last week, we get the strong impression that markets tilted towards a “triple sell-off” in which equities, bonds, and the yen all fell simultaneously amid a deteriorating situation. It is noteworthy that the yen's depreciation was relatively contained during that time, but this can be interpreted naturally as a result of the temporary success of government warnings and messages to the market, rather than conventional factors related to yen appreciation.

If crude oil prices were to remain high or rise further going forward, the concern would be that this would result in a vicious cycle in which expectations of a deteriorating trade balance would lead to a weaker yen, which would in turn push up import prices further. While it has only been about a week since the crisis began, we cannot rule out the possibility that selling pressure on the yen could intensify as markets price in a worsening balance of payments during this time when the market is sensing that high oil prices could persist. The shock-absorbing function that forex rates had during periods when the yen was strong has weakened, and forex rates are actually becoming a channel that amplifies shocks.

Timing of rate hikes: March is off the table, April is the base case, but with reduced certainty

The outbreak of the Iran war has virtually eliminated the possibility of a rate hike in March. However, we still see a rate hike in April as the base case, based on the assessment that (1) the wage-price interaction remains intact, and (2) underlying inflation and inflation expectations are gradually converging towards 2%.

That said, it would be reasonable to judge that the probability of a rate hike in April has decreased compared to before in response to the heightened geopolitical uncertainty and increased financial market volatility. The view that more time will be needed in order to assess the impact of this exogenous shock is beginning to carry greater weight in the BOJ's policy operations, as well.

Nevertheless, whether the BOJ can actually implement a rate hike in April will continue to be a test of the credibility of its strategy of continuing with rate hikes. The BOJ, for its part, is maintaining a fighting posture, with one of those in the know saying that, even with uncertainty over domestic and overseas economies rising due to heightened tensions in the Middle East, the BOJ was maintaining its rate-hike path and was not ruling out the possibility that conditions requiring a rate hike in April could materialize. Whether or not the BOJ will be able to implement a rate hike in April, as well as the rationale for its decision and the message it sends, will have a major influence on market assessments in the period ahead.

The financial environment remains accommodative based on current fundamentals such as the price outlook, structural labor shortages (labor supply constraints), spring wage negotiations (wage hike trends), and the growth rate. Ideally, it would be desirable to avoid missing this opportunity, and proceed with early and gradual rate hikes. There is a shared awareness within the BOJ that it should not spend too much time verifying the effects of rate hikes, and that a pace of once every few months would be appropriate. This is backed by an understanding that the risk of falling “behind the curve” would increase if policy actions were delayed.

The “must act” argument vs. reality: Political constraints to early and gradual rate hikes

Of course, the BOJ's policy operations are not determined by fundamentals alone. Monetary policy is not divorced from communication with the government and the political environment, and when an exogenous shock has occurred, there is a particular tendency for people to become aware of the structural inclination to fall “behind the curve” due to the relationship with the administration. This is even more the case given the current Takaichi administration’s stance on monetary policy following its historic landslide election victory.

Given that forex rates are under the jurisdiction of the government (Ministry of Finance), the BOJ tends to adopt a cautious explanatory framework in situations in which the impact of forex rates has to play a central part in the explanation. Consequently, the pace of rate hikes is likely to be more constrained compared to what fundamentals would suggest they would be.

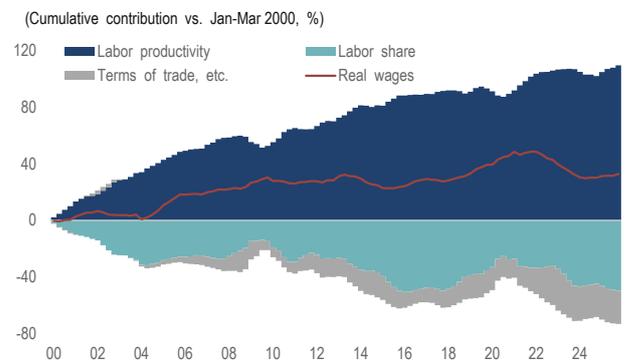
Furthermore, while the current Iran war brings the risk of upside price pressure through import inflation and a weaker yen, it also entails downside risks to growth, such as a deterioration in the terms of trade, downward pressure on real income, and a tightening of financial conditions. The BOJ needs to determine whether this will remain a temporary cost-push phenomenon or if it will have second-round effects on expectations, wages, and price-setting behavior, making both policy operations and communication more difficult.

Japan's Terms of Trade, WTI Crude Oil Price



Source: BOJ, EIA; compiled by Daiwa.

Factor Decomposition of Real Wages (cumulative contribution)



Source: Cabinet Office, BOJ, Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by Daiwa.

April will be a turning point: Negative supply shock and the buildup of "magma" when falling behind the curve

[The current Iran war has very much the nature of a typical negative supply shock \(terms-of-trade shock\) for Japan.](#) The rise in crude oil and natural gas prices is a complex shock that, while potentially pushing up headline inflation, also carries the possibility of depressing growth through deterioration in the terms of trade and tightening of financial conditions. The latter, in particular, creates an environment in which postponing rate hikes can be more easily justified politically.

At the same time, however, import inflation during a period of yen depreciation tends to accumulate upward pressure on prices over time, and it actually increases the risk of falling "behind the curve" in the medium to long term—resulting in a buildup of "magma." This is a situation in which a cautious stance that seems rational in the short term forces more abrupt and difficult policy responses over time. This is also the lesson we learned from the inflation surge that occurred under fiscal expansion during the post-COVID economic expansion (reopening) in Europe and the US and the Ukraine shock.

The policy phases of major central banks are not symmetrical, even when facing the same exogenous shock. The Fed is in a waiting phase, assessing the timing for resuming rate cuts, while the ECB is also basically on hold (or facing the risk of rate hikes), monitoring the persistence of energy prices and their spillover to expectations. On the other hand, the BOJ is in a phase in which it equates normalization with continuing rate hikes, and the current Iran war is viewed as a shock that will make it more difficult to decide how to continue rate hikes, but not stop them.

In other words, what is important for the BOJ is not that this shock negates the direction of rate hikes themselves, but that it increases the uncertainty of its policy path—at what pace and to what extent rate hikes can be continued.

In short, given Japan's current fundamentals, early and gradual rate hikes are desirable. However, in an environment in which an emergency is occurring during a period of yen depreciation, political constraints tend to lead to falling "behind the curve." In this context, whether or not the BOJ can implement a rate hike in April will likely become a fork in the road that will affect the market's confidence in the BOJ's strategy of continuing with rate hikes.

Risk scenario: Market path (for yen, JGBs, stocks) if April rate hike is postponed

While a postponement of a rate hike in April would not, in itself, necessarily mean an immediate change in the monetary policy stance, the market is likely to have a greater reaction to the reasoning and messaging given for it, than to the postponement itself. The starting point will be the forex rate (yen), and pressure for a weaker yen is likely to become more pronounced, while the monetary policy asymmetry between the BOJ and other major central banks temporarily widens. However, this is more likely to manifest as a rise in volatility rather than a linear depreciation of the yen, depending on the explanation provided.

In the JGB market, a rise in the uncertainty premium is likely to occur in the short- to medium-term zone, reflecting the opacity of the policy path, as the market senses an extension about to be made to the BOJ's short-term timeline. On the other hand, in the long-term (and superlong) zone, steepening of the yield curve could become a point of discussion against the backdrop of concerns about the risk of falling "behind the curve" due to political constraints and the continuation of fiscal expansion (incl. measures to address high prices), despite expectations of a slower pace of rate hikes.

For the stock market, the focus will be on the consistency of policy and the ability to see the path forward, rather than the postponement of the rate hike itself. If the explanation were insufficient, there would be a risk of the market developing a sense of uncertainty surrounding the yen, yields, and prices at the same time, increasing stock market volatility. (Although, over the long term, it would likely tilt towards higher stock prices through the probability of inflation.) In short, the biggest risk for the Japanese market would be a decline in the credibility of its strategy of continuing with rate hikes, rather than insufficient tightening itself. If such a decline were to occur, the yen, JGBs, and stocks would all likely experience instability before a clear direction emerged.

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