Asset Management One

Registration No.: Director of Kanto Local Finance Bureau
(Financial Instruments Firms) No.324
Commodity Trading Advisor License #(1) No.24, the Minister of Agriculture,
Forestry and Fishery & the Minister of Economy, Trade and Industry
Member of Japan Investment Advisers Association
Member of The Investment Trusts Association, Japan

Why the Bank of Japan sticks to accommodative monetary policy

8 July 2022

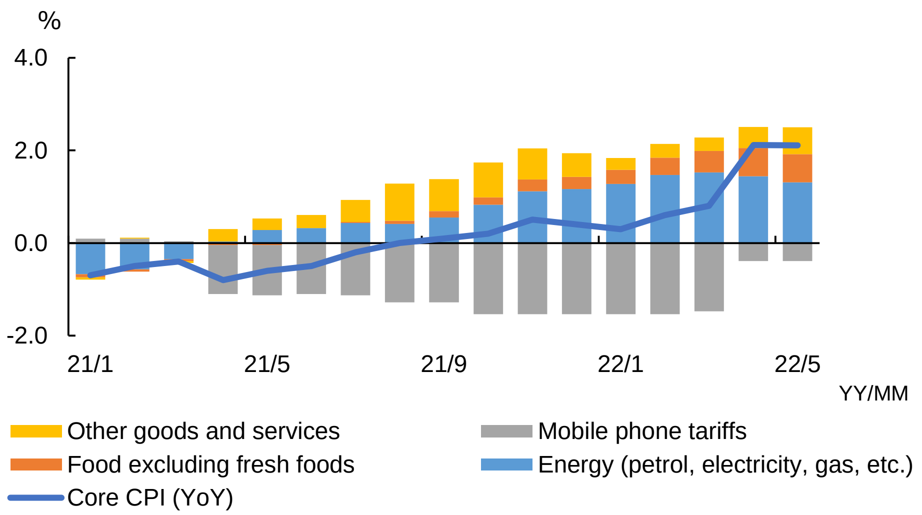
- The price stability target of 2% looks unsustainable even with improving price momentum, which the central bank places emphasis on, in 2023.
- An improvement in the output gap, inflation expectations and wage growth, which form price momentum, could lead to a shift in Japan's stubborn deflationary mindset.
- Faced with a glimpse of a change in the deflationary mindset that has prevailed for over 20 years on the horizon, Bank of Japan (BOJ) governor Haruhiko Kuroda's strong determination to finally turn things around could be a key reason behind his continued commitment to the accommodative policy stance.

The consumer price index excluding fresh food (Core CPI) surged to 2.1% year-on-year in April and May from +0.8% in March. This is the first time since 2008 that the core CPI has exceeded the BOJ's 'price stability target' of 2%, except for when the consumption tax rate was raised. This surge is mainly attributable to two factors, the rise in import prices, crude oil in particular, and falling out of the base effect from mobile phone tariff cuts last April. However, unlike before, this time price rises have been observed across a broad range of items. While the contribution of petrol, electricity and gas to price increases is significant, the contribution of food and other goods and services is gradually expanding against the backdrop of rising raw material prices. (Figure 1).

Yuko Iizuka, Economist

"BOJ monetary policy in the spotlight as the yen weakens"

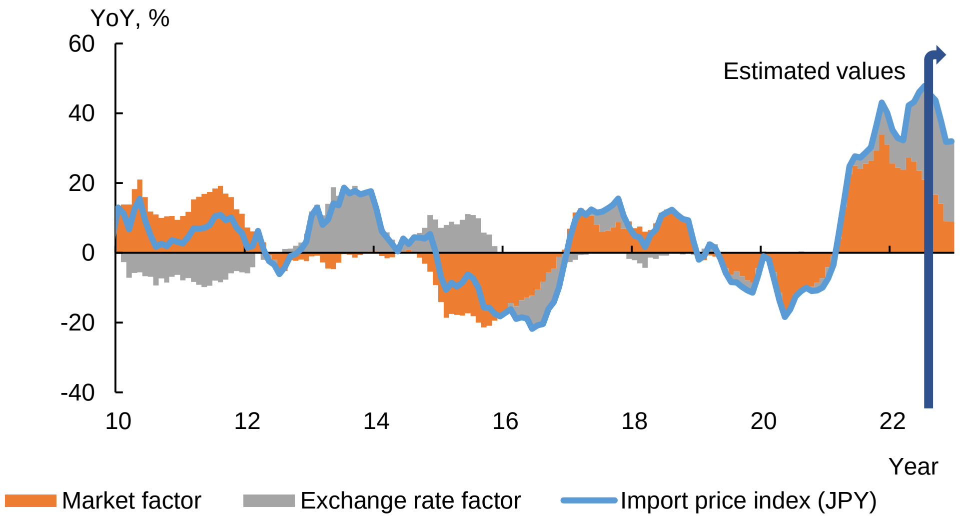
Figure 1: Contribution Decomposition of Consumer prices



Source: Ministry of Internal Affairs and Communications
Period: Monthly data from Jan. 2021 to May. 2022

In the meantime, in June the Japanese yen depreciated to 135 yen against the U.S. dollar for the first time in 24 years. This is partly attributable to the difference in the direction of monetary policy between the United States, which is in tightening mode, and Japan, which maintains an accommodative stance. A weak yen is considered beneficial for export companies by improving profitability of exports, but it also increases input costs due to the rising cost of imports. If the current level of exchange rate persists, import prices will likely remain at an elevated level even if rising in commodity prices have levelled off. (Figure 2). Speculation continues to swirl that the BOJ may also pivot its monetary policy, given that weaker yen may increase costs for businesses and households.

Figure 2: Impact of Exchange rate on Import prices



Source: BOJ
Period: Monthly data from Jan. 2010 to Dec. 2022
Note: Market factor is based on the import price index in contract currency.
The two factors after June 2022 are estimated values assuming that, market factor: the index in contract currency remains at the May 2022 level, and exchange rate factor: the exchange rate remains at 140 yen/dollar from July 2022.

"BOJ's focus on price momentum"

The BOJ governor Haruhiko Kuroda said in his speech at Columbia University "given the developments in Japan's economy, it is necessary and appropriate for the Bank to continue with monetary easing and thereby firmly support the economy. Japan's economy is on its way to recovery from a significant downturn caused by COVID-19. The output gap is still negative, and economic overheating has not been of concern. Moreover, the rise in commodity prices is projected to result in trading losses for the time being, and this will push down domestic demand through a decline in income. The role of the Bank's monetary policy should thus be to provide accommodative financial conditions and thereby support the achievement of a full-fledged economic recovery."

The BOJ has consistently emphasised "momentum towards the price stability target" in the past. Momentum, in the context used by the BOJ , specifically refers to (i) the output gap, (ii) inflation expectations and (iii) wage growth. It has pointed to the weakness of these items as a reason for maintaining monetary easing in recent monetary policy meetings. It refers to Japan's negative output gap and the risk that inflation expectations and wage growth will not rise sufficiently.

"Prospects for BOJ's price momentum"

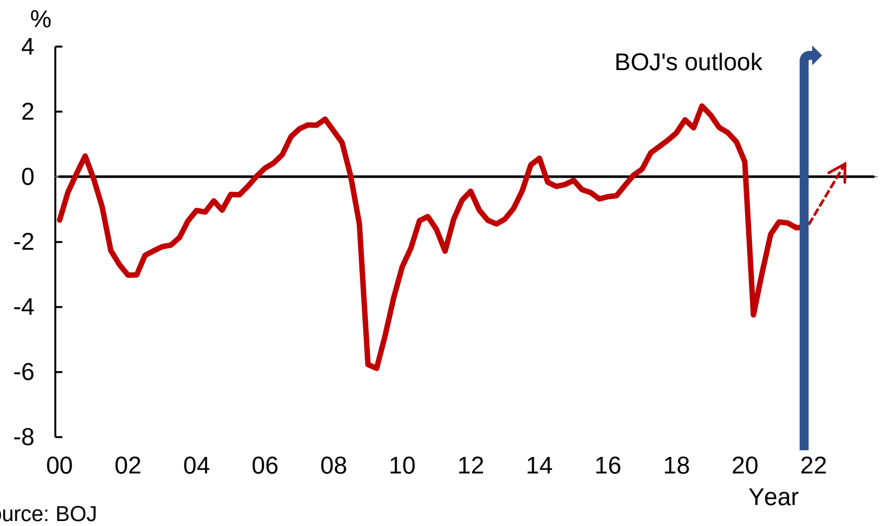
The BOJ is staying vigilant on these three aspects but remains optimistic on the prospects going forward.

Regarding the output gap, the BOJ expects it to turn clearly positive around the second half of FY2022 and that the positive gap will continue to expand moderately thereafter (Figure 3). Our GDP growth forecast using the methodology employed by the cabinet office indicates improvement in the output gap into FY2024.

The BOJ expects companies to become aggressive on pricing and pass on cost increases to customers, raising inflation expectations, particularly for goods. Such increases in the price of goods will lift medium- and long-term price inflation expectations of households and companies. This is known as 'adaptive formation of inflation expectations', and will further expand price increases to services and wage growth. 'Adaptive formation of inflation expectations' is a transmission mechanism that transposes past inflation into future inflation expectations. We believe that Japan, where spring wage negotiations are often influenced by the previous year's rate of price increases, provides fertile ground for this mechanism to work effectively

It should be noted, however, that there are a number of risks associated with this outlook that could cool the economy, such as the possibility of a significant deterioration in corporate earnings due to cost increases and the possibility of households becoming more cautious in their consumer confidence in the face of price increases.

Figure 3: Output gap in Japan



Source: BOJ
Period: Quarterly data from 1Q 2000 to 4Q 2021
Note: The red dotted line represents projections based on the BOJ's Outlook Report as of April 2022.

According to the BOJ's forecasts, we will see a certain degree of improvement in price momentum as we move into 2023. This could coincide with a slowdown of the U.S. economy following aggressive rate hikes by the Fed. Furthermore, in the absence of a further spike in crude oil prices, contribution of energy prices will have diminished by this time, posing a threat to maintaining the 2% inflation target. We therefore believe that the 2% price stability target, the achievement of which normalisation of monetary policy in Japan is predicated on, is hard to achieve.

"Difficulty to hold on to the price stability target of 2%"

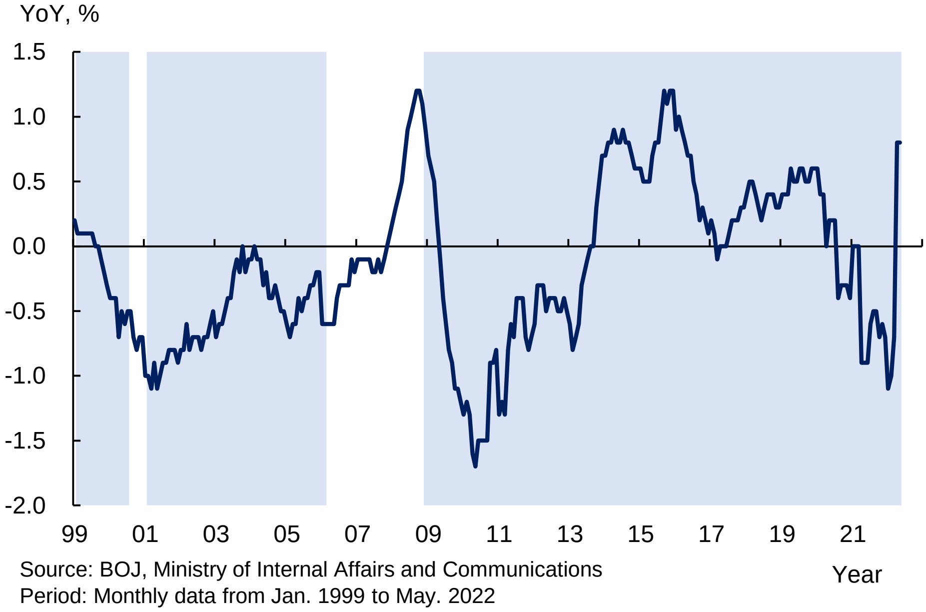
Prices are likely to find it difficult to maintain the 2% level, but we see this as an opportunity to change the way people in Japan view prices; the deep-rooted deflationary mindset. During the course of more than 20 years of monetary easing with an aim to end deflation, the BOJ has twice lifted monetary easing, but was forced to backtrack on both occasions.

"A critical moment to shift the deflationary mindset"

The first time was in August 2000 when the BOJ lifted zero interest rates. Prior to this in February 1999, the BOJ introduced a zero-interest-rate policy to deal with the possibility of rising deflationary pressures in the future. In August of the following year, the Bank lifted the zero interest rate policy on the grounds that it had reached a point where deflationary fears could be dispelled, but about six months later, in February 2001, the Bank was forced to backtrack to easing again.

The second time was in two stages, with the lifting of the quantitative easing policy in March 2006 and then the lifting of zero interest rates in July 2006. The easing was lifted on the assumption that the year-on-year rate of the consumer price index would remain positive in the future, but monetary easing was reinstalled in October 2008 in response to the Global Financial Crisis and the fall of Lehman Brothers (Figure 4).

Figure 4: Consumer Prices and Monetary Policy



Source: BOJ, Ministry of Internal Affairs and Communications
Period: Monthly data from Jan. 1999 to May. 2022
Note: Shaded areas indicate the period of continued easing.
Consumer prices exclude i) fresh foods, ii) energy, and iii) the impact of the consumption tax rate hike.

In light of this history of the BOJ's monetary policy, in a speech in April 2013, shortly after assuming the governorship, BOJ Governor Kuroda stated that "the BOJ has conducted various monetary easing measures, including a zero-interest-rate policy, quantitative easing policy and even comprehensive easing policy, but the results have been slow and Japan has suffered deflation for nearly 15 years" and expressed his determination to "reverse deflationary pressures and achieve a return to vitality in the Japanese economy.“

Wage growth is the key to transforming the persistent deflationary mindset, and labour shortages and policy measures could act as tailwinds. Three years from now, in 2025, the baby-boomer will turn 75 years old, escalating labour shortages. Prime Minister Fumio Kishida is advocating for a policy of redistribution to people and small and medium-sized enterprises (SMEs).

With the deep-rooted deflationary sentiment that has persisted for more than two decades beginning to show signs of change, Governor Kuroda's firm stance on easing may be due to his strong intention to firmly seize the opportunity to build upon this sentiment and finally tackle the issue this time around.

Disclaimer

For this Presentation Material

- This documentation was prepared by Asset Management One Co., Ltd.
- This documentation is required to be used only by the investor to whom it is distributed.
- This documentation is only for the purpose of providing information and is not intended to be used to solicit investments.
- This documentation was prepared using data that Asset Management One Co., Ltd. has judged to be reliable including data from third-party sources. However, Asset Management One Co., Ltd. does not guarantee its completeness or accuracy. Additionally, the published data are only indicative of past performance and do not provide a guarantee of future performance.
- The contents included in this documentation are only current as of the date this documentation was prepared (July 8, 2022) and are subject to change without notice.
- The intellectual property and all other rights pertaining to the data published in this documentation including benchmark indices shall remain the property of the publisher and licensor.