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BOJ needs to do another comprehensive assessment

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Executive Summary

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With market participants' monetary policy outlook increasingly diverging from the BOJ's guidance, the BOJ needs to get back to basics. It should comprehensively assess how prices are set to broadly enlist private economic actors in pursuit of its inflation target.

Market participants expect BOJ to tighten despite low inflation

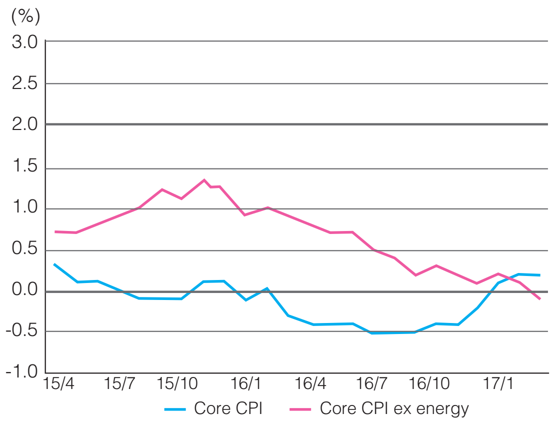
Market participants anticipate BOJ monetary tightening. Thirty-three of 39 market participants surveyed by Bloomberg in April expect the BOJ to tighten policy as its next move. Additionally, the Japan Center for Economic Research's April ESP Forecast Survey reported that 34 of 40 surveyed economists expect the BOJ's next move to be tightening or a revision of its policy framework.

Meanwhile, the March core CPI (headline CPI ex fresh food) came in at +0.2% YoY, far below the BOJ's +2% target. The March core CPI ex energy, a measure of trend inflation, was even lower at -0.1% YoY (see graph).

Given such low inflation data, market participants would normally be expecting the BOJ to prolong, not scale down, its existing monetary accommodation (or to even ease further under certain circumstances). Yet a majority of them expect the BOJ to do the opposite by tightening policy as already mentioned. This apparent paradox may be attributable to several factors.

First, overseas interest rates have been experiencing upward pressure. US interest

Year-over-year CPI readings



Source: NRI, based on Ministry of Internal Affairs and Communications data rates' upside drivers include the Fed's rate hikes, its plans to start downsizing its balance sheet (by reducing or halting reinvestment of runoff from its UST and MBS holdings) and the Trump Administration's expansionary fiscal policy. Even in the eurozone, markets are starting to price in monetary tightening in anticipation of an early withdrawal of ECB monetary accommodation. When overseas interest rates rise, they tend to drag Japanese interest rates along with them. Many market participants believe that keeping the 10-year JGB yield pegged at 0% will become increasingly challenging for the BOJ.

Second, the Japanese economy is expanding. While its negative output gap has recently been nearly eliminated or has even turned positive, multiple economic indicators, including the Indexes of Business Conditions and BOJ Tankan, are signaling economic expansion. Economic expansion naturally leads to expectations of inflation and, in turn, monetary tightening. With market participants expecting sub-2% inflation[1], however, their expectations of monetary tightening are puzzling. I address this conundrum later.

Third, market participants may personally hope the BOJ abandons its negative interest rate policy and/or raises its 10-year JGB yield peg. Since its September 2016 comprehensive policy assessment, the BOJ has been emphasizing a monetary policy stance that strikes a healthy balance among economic growth, inflation and finance. Its inclusion of finance in addition to economic growth and inflation implies that the BOJ will take financial institutions' earnings into consideration in conducting monetary policy, but market participants' expectations in this regard are likely overly optimistic.

The bane of low inflation amid economic expansion

Of these three points, the first can be ruled out as justification for monetary tightening. BOJ Governor Haruhiko Kuroda and other BOJ officials have repeatedly denied any possibility of the BOJ tightening policy in response to rising overseas interest rates. The third point also is unlikely to influence BOJ policy, given that market expectations not infrequently reflect market participants' personal hopes. The second point, however, is likely distressing the BOJ.

While market participants expect the BOJ to tighten policy as mentioned previously, they are anticipating a future inflation rate of only around +1%. Their expectations are at odds with the BOJ's repeated assertion that monetary accommodation will continue until the +2% inflation target has been attained,

NOTE

1) In the Japan Center for Economic Research's April ESP Forecast Survey, the 40 surveyed forecasters' mean forecast of the FY18 core-CPI inflation rate was 1.00%. The breakeven inflation rate implied by inflation-linked bond yields averaged about 0.4% in April.

perhaps because they are skeptical of monetary policy that hinges on an inflation target. If so, the only realistic way for the BOJ to restore confidence in its monetary policy, aside from drastic measures such as abandoning its inflation target, is to show results in the form of a steady rise in the actual inflation rate toward the +2% target.

The fact that inflation is essentially nonexistent even as the economy expands and the output gap shrinks is arguably a worst-case scenario for the BOJ because it casts doubt on the validity of the inflation transmission mechanism the BOJ is counting on to achieve its inflation target through quantitative and qualitative easing (QQE). The BOJ claimed that by driving down real interest rates, QQE would reduce the output gap and prompt upward revision of inflationary expectations, the latter of which would ultimately lead to realization of +2% inflation.

BOJ should take a hard look at how prices are set

Although elementary, the question of how prices are set is crucially important. The BOJ's assumption that a pickup in inflation should ensue from upward revision of inflationary expectations in response to output gap shrinkage driven by negative real interest rates is more or less correct in theory. In actuality, however, other factors also influence retail pricing, including changes in both businesses' pricing behavior and consumer preferences. Given the difficulty of modeling such factors, the BOJ's understanding of how prices are set likely differs from that of businesses and consumers. This point was in fact raised more than once at Governor Kuroda's press conference following the BOJ's April 27 Monetary Policy Meeting. Moreover, retail pricing is also affected by structural factors such as the Japanese economy's declining potential growth rate and demographic changes such as societal aging. When such structural factors are taken into account, the question of how prices are set is multifaceted and complex.

The BOJ's September 2016 comprehensive assessment did not include reassessment of the BOJ's assumptions regarding monetary policy transmission channels and their underlying pricing mechanisms. These assumptions' credibility would be in jeopardy if the inflation rate remains low amid continued economic expansion. The BOJ needs to comprehensively assess how prices are set so it can map out a path to its inflation target's attainment with broad involvement of private economic actors, including market participants, business executives and consumers.

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