Notes on Financial Markets Vol.107

Press conference by Governor Kuroda – Curse of gradual recovery

March 24, 2015

Introduction

Having observed a series of economic indicators that seem to be consistent with the gradual recovery scenario, it would be rational for the BOJ to revise their economic assessment upward at some margin. It is also interesting to note the focus of attention by domestic media and markets may be gradually shifting to the management of the QQE in FY2016.

Economic assessment

Upward revisions of the economic assessment are concerning two major components of domestic demand. First, the MPM of the BOJ deleted their previous reference to the remaining weakness of some parts of consumption demand. Second, they confirmed that housing investment has returned to its gradual recovery path.

In terms of private consumption, Governor Kuroda explained that continuous expansion of employment and gradual increase in earnings have been functioning as supporters. He also emphasized that increase in nominal wages in two consecutive years, although they are smaller than expected, have improved the sentiment of consumers. Nevertheless, in reply to a question by a reporter, Governor Kuroda admitted that recent deceleration in inflation has in fact contributed to the improvement in real income.

All in all, the MPM of the BOJ altered the description of our economy from “continue its moderate recovery trend” to “continue recovering moderately”. According to Governor Kuroda’s account, this modest revision is intended to indicate that the directions of economic indicators have become more consistent than before.

Effects of the QQE

The “official views” of the transmission mechanism and the effects of the QQE that were expressed by the BOJ review on May 1 have stimulated discussion in our markets. This is why some reporters raised this issue at the press conference this time. (Please refer to my previous Note (No. 106 on May 6) that discusses its details and some implications.)

While Governor Kuroda reiterated the line of thoughts of the BOJ review, he referred to a few factors that could have significance to understand the BOJ’s view on the dynamics of inflation expectation.

First, Governor Kuroda explained his view that inflation expectation have been diverted from deceleration of actual inflation largely due to the fall in crude oil price. Second, he expressed the expectation that decrease in GDP gap would drive up our underlying inflation, which would result in further improvement in inflation expectation.

First point of discussion above seems to confirm the reason of the additional stimulus in October last year. From the BOJ’s viewpoint, enhancing the commitment to achieve the inflation target by way of “showing the money” has successfully prevented our inflation expectation from falling.

Nevertheless, there still remain some issues. We again find two different kinds of mechanism for our inflation expectation in first and second points of discussion above. First point refers to expectation by communication policy by the BOJ, and second point is based on expectation resulting in actual inflation (ie. adaptive expectation).

As discussed in the BOJ review, the MPM of the BOJ may collectively understand that both two kinds of the mechanism have been effectively functioning. Then, it would be rational for the BOJ to maintain the QQE as far as our economic recovery supports the improvement of inflation expectation as second point above suggests. And if and when something undermining this mechanism happens, the BOJ would enhance the QQE by way of first point above suggests, in order to prevent a drop in inflation expectation.

While this line of understanding could be useful for projecting the future course of the QQE to some extent, there still remain further unknowns. For example, balance of views in the MPM between two kinds of mechanism is not certain to outsiders, possibly because it may be dynamic in nature. Moreover, it would not be certain whether improvements of inflation expectation based on actual inflation would be sufficient for achieving the target. At the same time, however, it might be the case that the mechanism according to second point above would show diminishing returns.

Management of the QQE in FY2016

Interestingly, several reporters raised the issue of management of the QQE in FY2016 at the press conference. One of the reason would be that they understand the topic of another round of stimulus may have become irrelevant for now after having observed the upward revision of economic assessment by the MPM of the BOJ as discussed above.

One apparent issue for FY2016 is the next round of consumption tax hike in April 2017. Whether another round of jump and drop of private consumption would occur or not would be uncertain, in light of the fact that some portion of durable goods was renewed ahead of the first round of consumption tax hike in last April. Nevertheless, we have a trauma from the previous experience, which results in bearish views on the QQE.

From fundamental point of view, it would be easier to raise reasons to expect that the QQE would be maintained. The BOJ commits itself to maintain monetary easing until 2% target is stably achieved. Any policy action in FY 2016 could add the downward pressures on economic activities in FY2017 with a lag of monetary policy effects. Moreover, the MPM of the BOJ expects only 0.2% growth in FY2017, according to their most recent outlook released last month.

From the technical point of view, however, there is a growing concerns in the market that the QQE could face difficulties due to less liquidity in the JGB market. This may be another important reason why press reporters would like to discuss the QQE in FY2016.

From the BOJ’s viewpoint, either stronger or weaker than expected economic recovery could lead to a straightforward policy decision. Gradual recovery of economy and inflation, which would be more probable, could rather pose a challenge.

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