

What is the BOJ's focus for their monetary policy decision?

At January Monetary Policy Meeting (hereafter MPM) held over January 20 and 21, the BOJ conducted an interim assessment of the Outlook for Economic Activity and Prices Report (Outlook Report) published on October end 2014. The impression of MPM this time was that the outlook presented by Governor Kuroda and the policy decided was not consistent. This time, the monetary policy was kept unchanged despite the huge downward revision of inflation outlook of 2015, and Governor Kuroda commented quote “the inflation will reach 2% y-o-y sometime in FY2015 with high probability” unquote, while expressed at the same time quote “(timing of reaching 2%) could possibly be changed a little” unquote. I would now try to find out the BOJ's real intention through my own interim assessment of Outlook Report and by analysing Governor Kuroda's speech to find out what is the real focus of BOJ when making their decision on monetary policy.

The change of inflation and GDP outlook somewhat seem to be consistent

First, let me go over the interim assessment of the Outlook Report. As shown in Diagram 1, the BOJ revised downward the inflation of FY2015 to 1.0% from 1.7% by just deducting attribution of energy cost hike of 0.7 to 0.8% points they had reflected in inflation forecast for FY2015. However, as the BOJ considers lowering energy cost is positive to the Japanese economy, they have revised upward their forecast of FY2015 and FY2016 real GDP growth rate from 1.5% to 2.1% and from 1.2% to 1.6%, respectively. As the BOJ assumed the crude oil price (Dubai) to rise from US\$55/barel to US\$70/barel towards the end of 2016 which would push up the inflation by 0.1% to 0.2%, they have revised upward their FY2016 inflation forecast from 2.1% to 2.2%. The change of inflation and GDP outlook somewhat seems to be consistent as the BOJ's analysis is such that “the fall in crude oil price is a factor to push down inflation in the short term, however, in the long run it will be a factor to improve the economic activities which will push up inflation”.

“Diagram 1 : Forecast of FY2014 to FY2016 by the BOJ's policy committee members”

	FY2014	FY2015	FY2016
CPI (excluding fresh food) * adjusted by excluding impact of the consumption tax hike	Revised down 0.9% (1.2%)	Revised down 1.0% (1.7%)	Revised up 2.2% (2.1%)
Real GDP	Revised down -0.5% (0.5%)	Revised up 2.1% (1.5%)	Revised up 1.6% (1.2%)

(Note) y-o-y. %. Median of the BOJ policy committee members' forecast. As of January 21, 2015. Numbers in parenthesis are as of October 31, 2014.

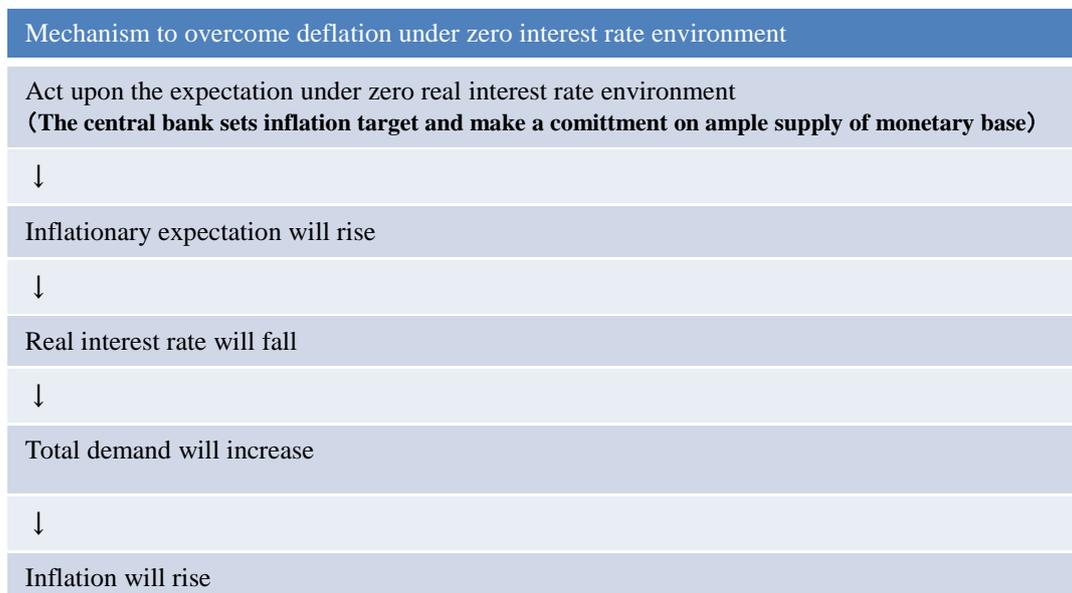
(Source) SMAM, based on the BOJ data.

However it is quite natural to feel that “the outlook of crude oil price by the BOJ is too optimistic” and “the achievement of 2% inflation sometime in FY2015 would be difficult” as the crude oil price continues to weaken. Many questions were casted to Governor Kuroda on the possible delay of achieving 2% inflation target at the press conference as he maintained his harder stance on “ the inflation to reach 2% y-o-y sometime in FY2015 with high probability”. Interestingly, the BOJ revised inflation forecast for FY2015 downward despite it could have maintained the forecast unchanged following the policy decision. If the BOJ had clearly stated the timing of achievement to be delayed into FY2016 following their downward revision of inflation, they would have been questioned on the reason of not implementing additional monetary easing at this time. Governor Kuroda could have had a difficult time answering questions at the press conference, as he had made answers such as quote “(timing of reaching 2%) could possibly be changed a little” unquote and quote “I am not saying that the inflation target will be achieved in 2016” unquote.

Change in inflationary expectation is important than the outlook of crude oil and inflation

It is not necessary to be too sensitive to the outlook of crude oil price and inflation. The BOJ focuses on the trend of inflationary expectation (financial market data and medium to long term inflation rate forecast by economists and result of survey to corporates and households). The BOJ’s monetary policy is based on the theory of reflationalist which is illustrated in Diagram 2 below.

“Diagram 2 : The basic framework of the theory of reflationalist”



(Note) The above diagram is intended to illustrate the basic framework of the theory of reflationalist, therefore does not cover every detail of the theory.

(Source) SMAM, based on the BOJ and publicly available data

Reason why Governor Kuroda always maintains his harder stance is to act upon the expectation, if his message changes to weaker tone it will be taken negative to the inflationary expectation.

Therefore, the BOJ is not necessarily inclined to take an additional monetary easing measure even if crude oil price weakens or the inflation outlook is revised downward except when the risk of weaker inflation expectation comes into picture. The reason of BOJ keeping their monetary policy unchanged was based on this logic which unfortunately was not communicated well to the market. Therefore, we should not judge that the possibility of monetary easing had receded based on the latest MPM policy decision and the announcement of Governor Kuroda. The upcoming focus will be on annual spring wage negotiation in midst of March when large sized companies will announce their wage raising for FY2015. I think the BOJ's additional monetary easing in April is possible if the risk of slow down in the change of deflationary sentiment by corporations and households becomes eminent due to insufficient wage increase.

Lastly, I think that the BOJ should not stick too much on the timing of achieving their inflation target. In the first place, majority of the central banks who adopts the inflation target do not set the timing of achievement. Their objective is to achieve the stability of inflation and the sustainable growth of economy in a medium term by the flexible operation of monetary policy even if the inflation target deviates in a short run. Since the BOJ has set the target of timing to show its strong commitment to the monetary easing policy, it is not easy to change their target, however, I find some difficulty in the BOJ's policy to be achieved as they have set the timing of achieving target closed ended while their monetary easing stance is open ended.

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