Mizuho Market Comment

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MIZUHO

Governor Kuroda to go out quietly in final BoJ meeting

- **We expect Governor Kuroda will go out quietly, leaving BoJ policy unchanged this week**
- **In the wake of Ueda's testimony, we see a slightly later move to tighten policy…**
- **…but still expect moves on YCC and the policy rate in summer…**
- **…which we expect will push JGB yields higher and lift JPY.**

Expectations of policy change have eased in recent weeks

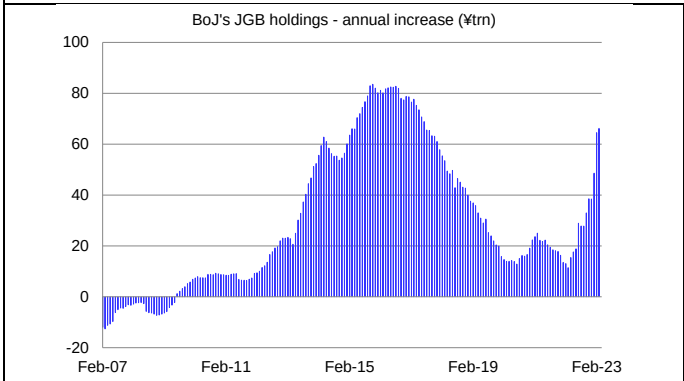
Expectations of a near-term change in BoJ policy have been dialled back in the wake of the BoJ's decision to boost its Fund Supply Operations against Pooled Collateral (18-Jan) at the previous BoJ meeting and the nomination and subsequent Diet confirmation hearings of the new leaders of the BoJ. We see the new BoJ leadership as somewhat more hawkish – which is almost inevitable given how dovish Kuroda and his two Deputy Governors were. Kazuo Ueda's testimony was somewhat dovish, giving the impression that he is in no hurry to alter the BoJ's policy settings.

The argument for a change in policy at the March meeting is for Kuroda to take the difficult decision on abandoning YCC leaving a clean(er) slate for his successor. Generally, central banks spring a surprise to get a bigger bang for the buck. A surprise on YCC at the March meeting would imply the BoJ wants much higher rates – which we see as unlikely. Two other factors also argue for action. These are unrelated to the end of Kuroda's leadership and will remain in play for much of H1. 1) JGB market functioning. The BoJ noted that JGB market functioning drove the December surprise. JGB market is functioning worse now. So market functioning would provide a pretext for action. We see this as the tail wagging the dog, but that is what seemed to happen in December and so this cannot be completely ruled out; also 2) Political pressure. With USD/JPY back above 135, it is possible that the government may be seeking steps that will limit further yen weakness. Another surprise would make it look as if the government is increasingly in control of monetary policy, which would be a bad look, given the huge volume of issuance that needs funding. We see the injection of political pressure into the policy mix as adding volatility this year.

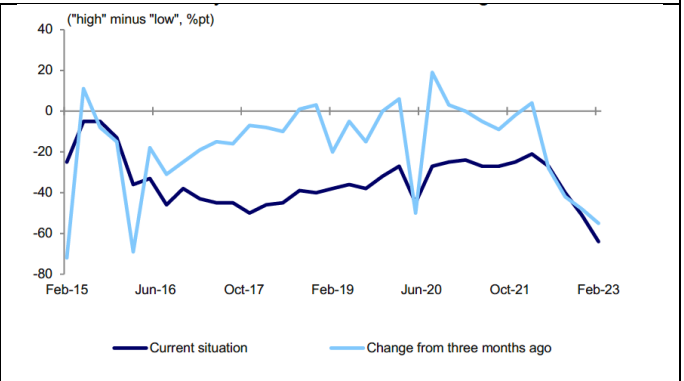
BoJ to stand pat in Kuroda's last meeting

We expect policy will be left unchanged at the 10 March meeting. This puts us squarely in the pack. 46 out of 49 Bloomberg survey participants saw no change in policy in the latest poll taken between 24 February and 1 March. Furthermore, a number of Board members have recently noted that they want to see the impact of the December tweaks before taking further action, including Takata and Nakagawa, which also argues for no action. Finally, there will be very little in the way of data on the spring wage round by Friday. It is said be a key part of the puzzle on the inflation outlook. All we know for now is that unions are seeking the biggest rise in 25 years. Bloomberg reports that union requests submitted to date are looking for an average rise of 4.49%.

Aggressive BoJ purchases…



… have worsened bond market functioning



Source: Bloomberg, BoJ

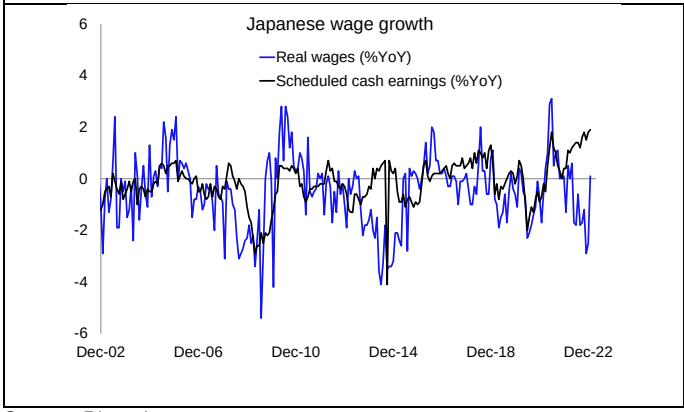
Wages a key driver of medium-term outlook

The Bloomberg survey also noted that 61% of respondents saw a BoJ policy change in April (20%) or June (41%). Our expectation is that the BoJ will make some adjustments to policy this year, most likely in the summer. That said, Ueda's testimony suggests no urgency and policy change in early summer now looks less likely than late summer, especially as we see overseas bond yields as more likely to be declining later in the year, which in turn lowers the risks of ending YCC.

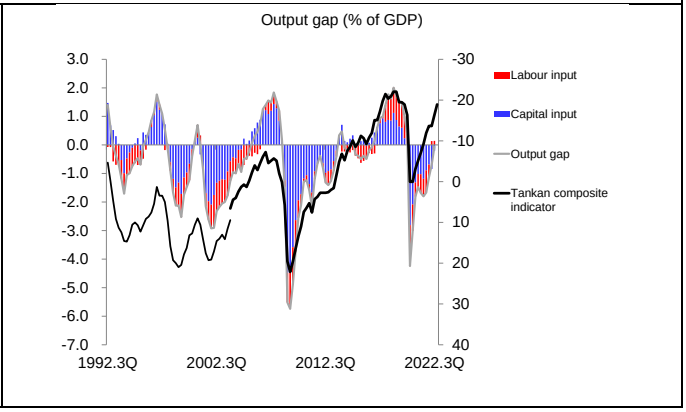
Despite the big drop in last Friday's Tokyo CPI, the ex fresh food and energy number nudged higher and the labour market tightened a little. We suspect that the inflation outlook will be in the grey zone by summer – meaning that the BoJ can play it either way. Anecdotal evidence on the wage front remains impressive, although these reports are generally from bigger companies. Smaller companies, where unionisation is much lower or non-existent are almost always more hesitant on wages. Furthermore, the proportion of unionised employees continue to decline and was just 16.5% in summer 2022. A Shinkin Bank survey of SMEs in the Tokyo area showed ~70% will not raise base wages as a result of difficult economic conditions.

The labour market is likely to remain tight. We expect that unemployment will decline in Japan in 2023 from already low levels. The chart below right suggests that the BoJ's estimate of the output gap is still negative but only marginally so. With the GDP expected to be well above Japan (very low) potential in FY23 and FY24, it will turn positive, which will buttress the BoJ's inflation view.

Nominal wages already elevated…



…output gap set to turn positive



Source: Bloomberg

From NIRP to ZIRP

We expect that the BoJ will shift policy in summer against the backdrop of an elevated inflation forecast, political pressure and JGB market dysfunction. For now we expect both some changes to YCC and an end to NIRP. However, we do not expect a string on interest rate hikes. We see the exit from NIRP getting stuck around zero – hence our strapline "From NIRP to ZIRP".

From an FX perspective, the Japan side of the equation is pricing a policy rate of around 5bp on a 12-month horizon. Much of the move in the policy rate we expect is priced in at the short end. Ending YCC would likely push longer-term yields higher and we assume it would also narrow swap spreads in the longer maturities as to some extent swaps are already pricing in some chance of an end to YCC so JGB yields would rise more.

Nonetheless, we see a policy move driving speculation of further changes and believe that policy change in Japan will lift JPY. In addition, we see short-dated UST yields as somewhat elevated at current levels and expect some easing by year end as markets look to policy easing in 2024. This will also help USD/JPY push lower. We continue to see USD/JPY around the 120 level on a 12-month horizon.