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Daiwa's View

FICC Research Dept

What will BOJ do at the last meeting in 2023?

- Focal points of BOJ's Dec meeting ahead of likely policy exit in 2024; Will BOJ signal plans to end negative rates in January 2024? Bright spots include sense of labor shortage, better corporate earnings, and medium/long-term inflation outlooks; Dec economic assessment may include downward revision for private consumption
- Expect politically-influenced decisions in 2024 amid elections in US and Japan
- BOJ should not miss golden opportunity for policy change

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Focal points of BOJ's Dec meeting ahead of likely policy exit in 2024

With only fourteen days left in 2023, the year end is fast approaching. Since the beginning of December, the BOJ has been sending out a series of messages. On the 4th, it held the first workshop covering its broad-perspective policy review (with BOJ materials being released on the 6th). On the 6th, BOJ Deputy Governor Ryozo Himino made a debut speech in which he gave an explanation assuming an exit and encouraged the market to be prepared for it. Another topic of discussion was what Governor Kazuo Ueda said in the Diet on the 7th when he stated that operations for monetary easing measures would face an even more challenging situation at the year-end and beginning of next year. Prime Minister Fumio Kishida and Governor Ueda had a meeting on the same day. Given these developments, I have changed my outlook for BOJ policy revisions. I now see the BOJ eliminating negative interest rates at the Monetary Policy Meeting (MPM) in January 2024 as the main scenario. The series of remarks by the Governor and Deputy Governor paving the way for an exit are an important signal. I had thought that the BOJ Governor would need to have a meeting with Prime Minister Kishida to obtain the understanding of the administration, and the necessary conditions for policy revisions are now in place.

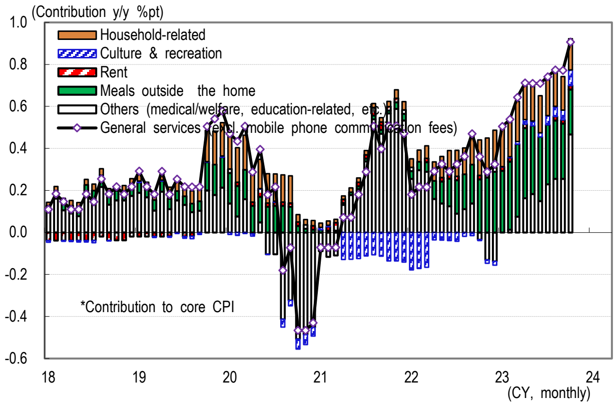
Starting with the 11 December Bloomberg article with the headline "BOJ sees little need to end negative interest rate in December," various reports prior to the BOJ's pre-meeting blackout period have stated that the Bank will make no major policy changes at the December Monetary Policy Meeting (MPM), but will instead simply ascertain conditions and take a wait-and-see approach. Also, while I took the statements by the governor and deputy governor as important messages, from the very start I have not expected any major policy changes at the December meeting. Ending negative interest rates is different from making yield curve control (YCC) operations more flexible. This is because ending negative rates involves changes to the BOJ's current accounts system, for which market participants will need time to prepare in advance. Furthermore, if, as Governor Ueda said, the time for making key assessments regarding the situation will be the period from the end of this year to the beginning of 2024, it is hard to imagine the Bank taking any action before then. If the BOJ were to take action, it would be desirable for it to do so in January after letting the market factor in possible revisions that could be made at the December meeting. For example, the chairman (Governor) might give instructions in the December statement that the BOJ should assess or consider elimination of negative interest rates by the next meeting. Or, Governor Ueda might send a similar message at the post-meeting press conference in December. Either could be said to be a more predictable kind of policy operations.

On 17 December, the online version of the *Nikkei* ran an article indicating that the BOJ is laying the groundwork for exiting monetary easing, while assessing the virtuous cycle of higher prices leading to higher wages. In this article, the *Nikkei* listed five key points pertaining to the likely discussions and conclusions at the BOJ's December Monetary Policy Board meeting. Specifically, these points are (1) likelihood of Bank ending negative interest rates, (2) likelihood of Bank mentioning its monetary policy outlooks, (3) assessment of "virtuous cycle of higher wages and higher prices," (4) overseas risks and forex, and (5) impacts of political turmoil. In this report we will share our opinions for these five points. Regarding points (1) and (2), it is our view that the BOJ will not end negative interest rates at the December meeting. Rather, we believe that it will use the December meeting to lay the groundwork for some action at the January 2024 meeting.

As for (3) assessment of "virtuous cycle of higher wages and higher prices," BOJ Governor Kazuo Ueda said during his October post-meeting press conference that "Accuracy for the 'second force' (= virtuous cycle of higher domestic wages leading to higher prices) is still insufficient." He added that, "Higher wages must boost prices, especially service prices and others." Ueda also cited labor market improvement, corporate earnings, wages, and information from hearings conducted by the Bank as factors to assess prior to the annual spring labor-management wage negotiations.

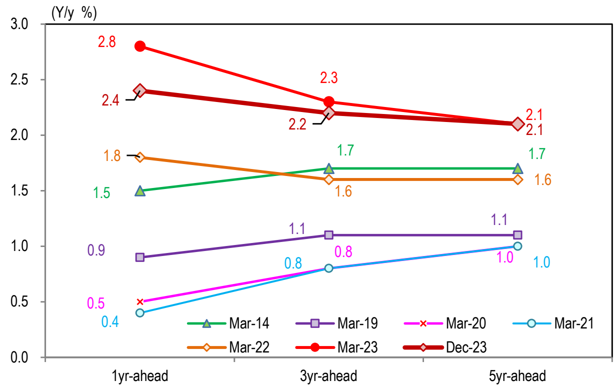
A broadening increase in service prices was seen in the October nationwide CPI released on 24 November (Chart 1). The Financial Statements Statistics of Corporations by Industry for the Jul-Sep quarter, released on 1 December, showed that ordinary profit for all industries (excluding finance and insurance) marked a record high for that quarter. Corporate earnings remain strong. The BOJ's December Tankan survey, released on 13 December, confirmed (1) a sense that labor is in short supply, (2) improving corporate earnings, (3) differences between small and large companies in terms of their abilities to pass on higher costs to their prices and (4) the medium/long-term inflation outlooks (Chart 2), which are now firmly above the 2% level. Compared to the October meeting, such catalysts point to progress for realizing the 2% price stability target.

Chart 1: Factor Breakdown of General Service Prices in Nationwide CPI



Source: Ministry of Internal Affairs and Communications (MIC); compiled by Daiwa.

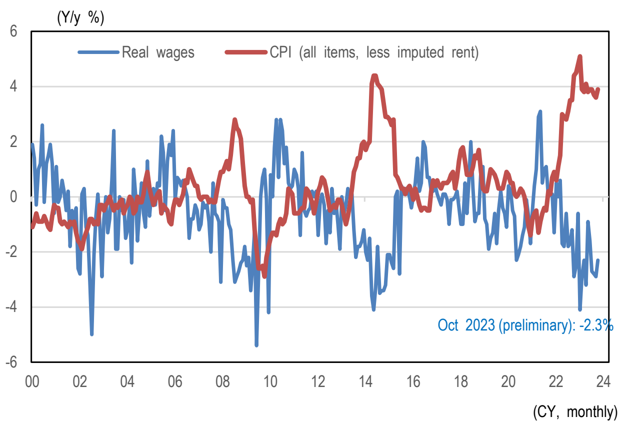
Chart 2: Inflation Outlook of Enterprises in BOJ Tankan (all sizes/all industries)



Source: BOJ; compiled by Daiwa.

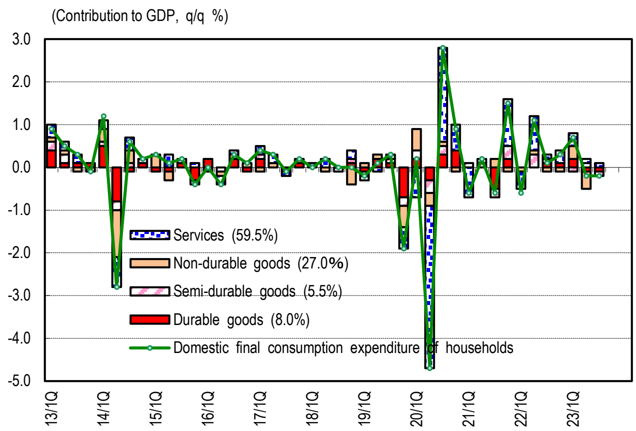
Conversely, preliminary monthly labor statistics for October (released on 8 Dec) showed that inflation-adjusted real wages fell 2.3% y/y, declining for the 19th straight month. There are variations by industry and we are waiting for wage increases to spread to a wider range of industries. Meanwhile, a Jiji Press article on 13 December reported that the BOJ was concerned about an increased tendency for households to save money due to inflation, and that it might make a downward revision to its assessment on consumption at the December meeting. In Jul-Sep real GDP data (second quarterly estimates released on the 8th), private consumption was revised downwards to -0.2% (Chart 4). The BOJ also appears to feel that there have been more markdowns for daily necessities mainly at supermarkets.

Chart 3: Real Wages, CPI



Source: Ministry of Health, Labour and Welfare, MIC; compiled by Daiwa.

Chart 4: Domestic Household Consumption of Goods and Services in Japan



Source: Cabinet Office; compiled by Daiwa.
Note: Weightings of services and goods are based on CY2019 data.

The cautious factions within the BOJ are concerned about the impact of inflation on consumption and the difficulty of implementing wage hikes at SMEs. The road to normalization may likely become more difficult for the BOJ if (1) consumption continues to be weaker than expected due to inflation and (2) action by SMEs to raise wages and pass on higher costs to prices does not move forward as expected.

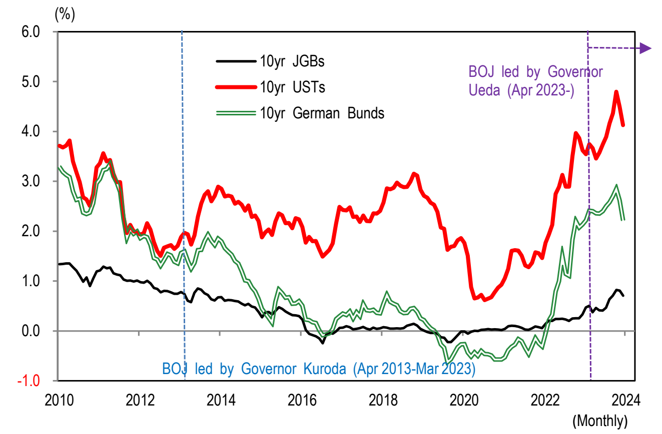
Under such conditions, Japan's Fair Trade Commission and Small and Medium Enterprise Agency on 29 November published a set of guidelines calling on large companies to accommodate the efforts of SMEs to pass on their higher labor costs in the form of higher prices for the goods and services that they provide to the large companies. The guidelines clearly state that a failure to negotiate could be a violation of the antitrust law and added that there should be regular opportunities for discussions. Around this time last year, as well, there were measures to encourage the passing on of higher raw material costs to prices as part of the SME support measures included in the economic stimulus package and the names of the parent companies that did not allow subcontractors (SMEs) to raise their prices were published. I remember being surprised that the government went that far. These efforts have had significant impacts and we recognize that results had been achieved in the form of progress passing on higher costs to prices since spring 2023. Rising labor costs this time seem inevitable considering Japan's labor shortage. If wage hikes are accompanied by a certain increase in productivity, a virtuous cycle of higher wages and prices would work. Many SMEs hold wage negotiations later than large companies, often from the spring or later. It will take some time to confirm that higher costs are being passed on to higher prices. As more attention is given to SMEs, delays making decisions will likely become longer.

Expect politically based decisions with elections in both the US and Japan in 2024

The fourth point for the December meeting pertains to "overseas risks and forex." In the US, when Fed Chairman Jerome Powell talked about having rate cut discussions at the December FOMC meeting on 13 December (combined with downward revisions for the policy rate and price outlook), the market perceived it as a policy shift. In response, the 10-year UST yield suddenly fell below 4.0% and the USD/JPY temporarily moved into a USD/JPY140-141 range (charts 5-6). I believe that the US economy is still stubbornly solid and inflation persists, but the current market continues to look for weakness. With 2.5% inflation still not within range in the US, factoring in 150bp in rate cuts next year seems excessive. On 16 December, Federal Reserve Bank of New York President John Williams said that it is premature to be thinking about a rate cut in March 2024. Furthermore, Atlanta

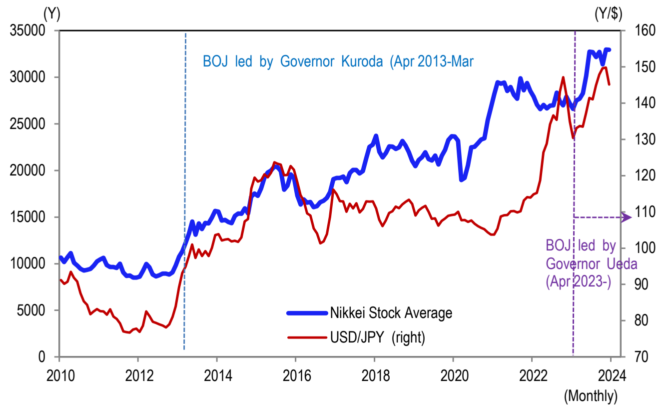
Federal Reserve President Raphael Bostic said he sees two rate cuts in 2024, but does not expect cuts to start until the third quarter. Even though these two key officials played down the likelihood of early rate cuts, the market seems to have largely ignored their comments. Over the past two years, both markets and analysts misread recessionary fears as more important than controlling inflation. The question for 2024 will be whether "third time's a charm" or "what happens twice happens three times."

Chart 5: Long-term Yields in Japan, US, Germany (from 2010)



Source: Bloomberg; compiled by Daiwa.
Note: Average during 1-15 Dec is used as Dec 2023 data.

Chart 6: Nikkei Stock Average, USD/JPY Rate (from 2010)



Source: Bloomberg; compiled by Daiwa.
Note: Average during 1-15 Dec is used as Dec 2023 data.

Inflation trends will remain a key factor in 2024 and we see global divisions and widening disparities as key themes next year. Global divisions are expected to lead to supply-constraints, which should ramp up inflationary pressures on goods. Meanwhile, public spending for national security will result in fiscal inflation and inflation factors will not disappear. 2024 will be an election year for both the US and Japan amid this time of widening disparities. As such, conditions may become difficult to read if decisions are influenced by politics.

If the US starts cutting interest rates earlier than expected, we would expect yen appreciation forces and dollar depreciation forces due to the narrowing Japan-US interest rate gap. However, over the medium/long-term, we believe that yen depreciation will persist due to Japan's inherent weaknesses such as (1) low potential growth rate, (2) fiscal reconstruction delays, and (3) entrenched trade deficits. Meanwhile, if the US economic slowdown continues, there is a strong possibility that downward pressure on the Japanese economy would increase. If the US starts cutting interest rates earlier or if the US economy slows, the window of opportunity for the BOJ to proceed with policy normalization will probably narrow. Even if the BOJ can explain that conditions will remain very accommodative even after ending negative interest rates, subsequent BOJ rate hikes could be more difficult.

The fifth and final point from the *Nikkei* article pertaining to the BOJ's December meeting is "impacts of political turmoil." Some believe that the political turmoil triggered by the ruling LDP's slush fund scandal will provide the BOJ with more policy freedom as the powerful Abe faction within the party loses some of its influence. We believe that the 7 December meeting between Prime Minister Fumio Kishida and Ueda resulted in the administration's understanding of the Bank's next policy revision. However, the next rate hike after ending negative rates should not be based solely on achieving the BOJ's 2% price stability target, but also on approval from the government in the form of a declaration that deflation has been overcome. This time, as shown by the title of "Comprehensive Economic Measures for Completely Break Free from Deflation," the expression "completely" suggests that it will take some time to confirm such conditions due to political considerations. Support for the Kishida administration has been declining recently and the earliest possible scenario for dissolving the Diet and holding a general election is likely March 2024 after the budget for the next fiscal year is passed. The BOJ will probably be hard pressed to take any action just before or after that election.

BOJ should not miss golden opportunity!

I believe that it is better for the BOJ to take action as soon as possible. However, the cautious factions within the BOJ may push more for a wait-and-see approach by pointing out worrisome factors in order to avoid a situation where people will say the BOJ failed because of a hasty response. That said, there is the sense that the market, to some extent, already assumes the ending of negative rates and many are in favor of such an action. The BOJ should not miss this golden opportunity. If it fails to take any action next January, at worst, the Bank be stuck until the end of the US interest rate cutting cycle.

During the press conference following his 6 December speech, BOJ Deputy Governor Ryozo Himino was asked about the timing for exit monetary easing. He explained that in the real economy "We don't have a green light for all conditions" and "With so many different signals being observed in the mix, we must make a decision somewhere." The first hurdle along that line could be the period between end-2023 and the start of 2024. After the December MPM, Governor Ueda's speech at the Japan Business Federation is slated for 25 December and the BOJ branch managers' meeting is scheduled for 11 January. I await Ueda's challenging and courageous decision.

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