Daiwa Securities

Daiwa's Economic View

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Vector differences, but also similarities for US/Japan monetary policy

- Japan/US monetary policy diverge, forex trends change
  Fed begins rate cuts, judgement difficult around inflection points
  BOJ/Fed both in no hurry, both adjusting from extremes
- BOJ's rate hike is foregone conclusion, mental exercise suggests 25bp hike once every six months
  Past experience suggests overseas factors could prevent hike; depends on US economy this time
- BOJ to put rate hike on hold this autumn; Oct warrants attention

Japan/US monetary policy diverge, forex trends change

More than 50 days have passed since the BOJ's 31 July decision to raise interest rates again. The sharply below-forecast US July employment data announced on 2 August heightened both concerns about a US recession and expectations for rate cuts, and the dollar weakened due to the contrasting trajectory of US and Japanese monetary policy. USD/JPY neared 139 at one point on 16 September. This represents a roughly Y20 correction from the level of above Y160 that prevailed between 26 June and 11 July in just over two months. Forex trends clearly became part of the BOJ's policy reaction function when it introduced more flexibility to its yield-curve control (YCC) policy in July 2023. A year on, the start of US rate cuts is at last driving an inflection in the dollar's rise against the yen. The BOJ's move to normalize policy would not have been enough by itself to achieve this. At the same time, we note that market trends could remain volatile depending on developments in the US, which could create anxiety for the BOJ.

Fed begins rate cuts; judgement difficult around inflection points

On 18 September, the majority of the Fed board voted in favor of a 50bp rate cut (only Michelle Bowman dissented, advocating a 25bp cut). As with media reports ahead of BOJ MPMs[1], the Wall Street Journal report prior to the FOMC appears to have caused the market to price in a 50bp rate cut. However, after indicating the Fed's commitment to protecting the economy with this substantial rate cut, Chair Jerome Powell definitively stated that 50bp should not be assumed to be the new pace. Board members' policy rate forecasts are split, and indicate a far slower pace of rate cuts than the market expects. This implies that Mr. Powell persuaded hawkish FOMC members to agree to the substantial recent cut. The shift in the focus of risk management from inflation to employment suggests that the Fed (which is in no hurry to cut rates) and the market (which is demanding for rate cuts) could change their stances depending on incoming payroll data. We expect the Fed to do everything it can to achieve a soft landing for the US economy. However, based on past experience, economic data around inflection points is frequently a mixed bag and difficult to definitively judge unless a major shock occurs. The structure of the global economy has changed considerably due to the "compound inflation" caused by the COVID-19 pandemic, climate change, and military conflicts, and extrapolating based on past trends will likely lead to the wrong conclusion. We would keep this firmly in mind going forward. The recent pause in the downtrend in oil prices should provide some reassurance about global economic trends.

[1]Several leading BOJ officials typically give presentations to a group of journalists ahead of the pre-MPM blackout. The media reports we refer to here represent a summary of these presentations. While the rule is that the speaker is not named, the reports cite first-hand rather than leaked information.

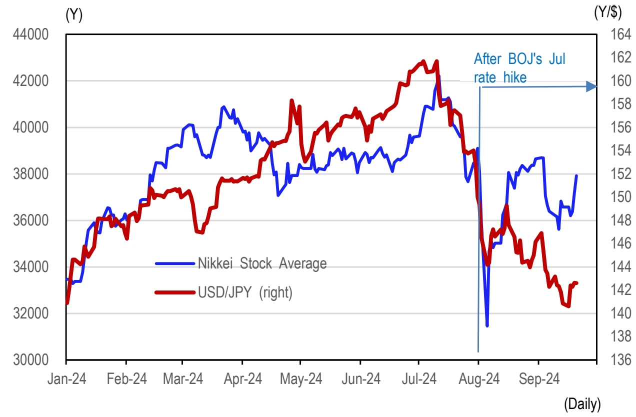
BOJ/Fed both in no hurry, both adjusting from extremes

As expected, the BOJ unanimously decided to stand pat at its 19-20 September MPM. There was no heated debate during the meeting, which ended just before noon JST. The BOJ confirmed the impact of its July rate hike at the September meeting, positioning this as a preparatory phase ahead of the October *Outlook for Economic Activity and Prices* report (*Outlook Report*). It has kept a watchful eye on the volatile market since the July MPM, but has found nothing that materially affects economic/inflation trends or its view of risks to the outlook, and sees no need to rush to raise rates. Despite this, its base case is for rate hikes to continue given that short-term real interest rates in Japan remain very low, and it continues to think that adjusting the degree of monetary easing is appropriate assuming that the economy and inflation remain in line with its forecasts.

However, we have no convincing answer to the question of how long the BOJ can continue raising rates despite US and European central banks beginning to cut given the lack of precedent. BOJ policy board member Hajime Takata also noted in a 5 September speech the potential for an unprecedented decoupling of domestic and overseas economic cycles and monetary policy stances to depress the Japanese economy and create financial and capital market volatility. With the Fed in no hurry to cut rates and the US neutral rate of interest edging up from quarter to quarter amid a lack of adequate debate on the subject, we think it is fair to say that the time is right for the Fed to adjust interest rates downward provided the US economy does not suddenly stall. While the US is adjusting its policy rate down from unduly high levels, Japan should be able to adjust the degree of easing to redress current unduly low real interest rates. The trajectory of US and Japanese monetary policy differs, but neither the Fed or BOJ is in a hurry, and both are adjusting from extremes.

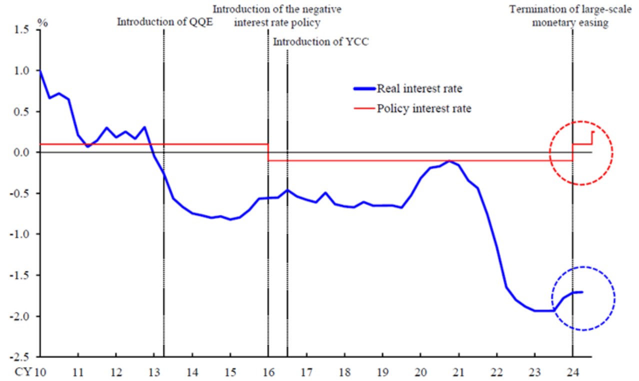
BOJ policy board member Naoki Tamura stated in a 12 September speech that his personal view is also that the neutral rate of interest is at least 1% or so, signaling his desire to continue with 25bp rate hikes through the second half of the BOJ's forecast period (which runs through FY26). A roughly 1% interest rate within FY25 would imply one 25bp hike every six months. While the BOJ was quick to raise rates again in July after ending its negative interest rate policy (NIRP) in March, this is consistent with the increase of only around 15bp in the uncollateralized overnight call rate. Assuming one hike every six months, attention will tend to focus on Jan-Mar and Jul-Sep 2025, followed by Jan-Mar 2026. Past experience suggests that overseas factors would be the likely obstacle to the BOJ's rate-hiking cycle; this time around, we think it could be forced to change course depending on whether the US economy manages a soft landing.

Chart 1: Nikkei Stock Average, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Chart 2: Real Short-Term Interest Rate (1-Year)



Source: Excerpted from materials for speech by BOJ Deputy Governor Shinichi Uchida on 7 Aug 2024 (Chart 13).

BOJ to put rate hike on hold this autumn while examining price trends

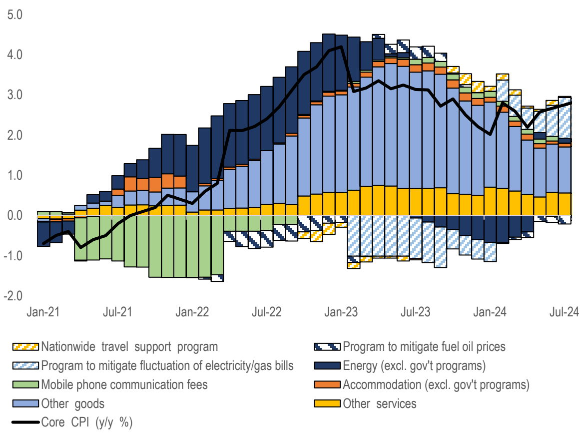
Looking at the BOJ's economic assessment for September, the overall reading for current conditions was revised upward for private consumption and prices (Chart 5). The Bank confirmed that private consumption recovered based on GDP for the Apr-Jun quarter. Spending on durable goods increased in July as well. Furthermore, the view that the underlying rate of increase in consumer prices will fall mostly in line with the "price stability target" in the second half of the projection period remains unchanged.

The nationwide CPI for August, released on 20 September, showed that core-CPI grew 2.8% y/y (2.7% in Jul), increasing for the fourth straight month. Core-core CPI (excludes energy) grew 2.0% y/y (1.9% in Jul). Core-core CPI fell below 2% in July for the first time in one year and ten months, indicating a continued slowdown in underlying inflation, but it rebounded in August.

Prices for goods (excl. fresh food) grew 4.2% y/y in August, (4.0% in Jul). Food prices have risen significantly due to factors such as unfavorable weather. Spending on consumer durables also increased against the backdrop of rising sales for electronic rice cookers, room air conditioners, and PCs. This could be a sign that prices are up due to the previous yen depreciation. Meanwhile, in addition to the recent downward trend for the price of crude oil, the exchange rate is also moving towards a stronger yen and there is a possibility of downward pressure on goods prices in the future. On the other hand, prices for general services, which had been slowing until now, rebounded in August, growing 2.0% y/y (1.8% in Jul). Spending on communication, education/entertainment (especially travel expenses for overseas package tours) and dining out have contributed to the rise. Meanwhile, we think there are some temporary factors at play such as higher costs for rice and other raw materials boosting the higher spending on dining out and higher costs for overseas package tours due to increased demand over the summer. So, it will be interesting to see whether this growth continues going forward.

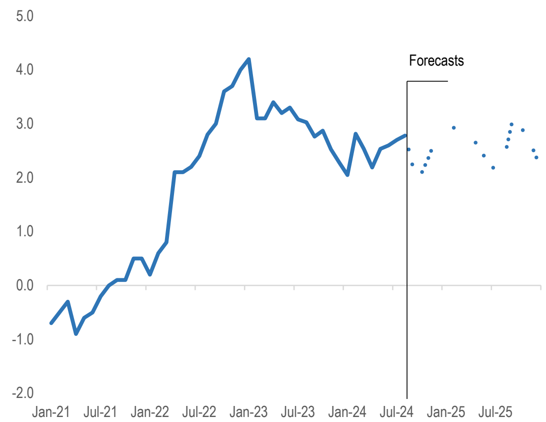
Going forward, core CPI is also likely to fluctuate significantly due to the government's measures to address high prices. From September to November, core CPI is expected to be pushed down by around 0.5% (around 0.3% in Nov) due to the revival of measures to counter high prices. That said, on 13 September, Reuters reported that "a proposal for a second extension of subsidies to offset high electricity and gas prices is being considered within the government." Even though such measures will likely to be discussed in earnest by the new administration, opinion polls conducted by various media organizations suggest that "measures to address high prices" is one of the top policies that people want addressed in the LDP presidential election in September. There is a high possibility that an extension will be made. Also, some in the ruling party have expressed opinions such as "I want these measures extended until March of 2025, at least." The scale of any new measures to address high prices by the government is unclear. Even if the scale of the measures is on par with that planned for November 2024 bills, that extension would at least push down core CPI by around 0.3%. We should keep that point in mind.

Chart 3: Breakdown of Contributions to Nationwide CPI (y/y ppt)



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

Chart 4: Forecasts for Japan's Core CPI (y/y %)



Source: Actual data from MIC; compiled by Daiwa.
Note: We are not assuming another extension of the measures to address high prices.

Catalysts to monitor ahead of Oct *Outlook Report*

In the July *Outlook Report*, the forecast for core-core CPI, which is a key indicator of underlying price trends that the BOJ stresses, was left unchanged at up 1.9% for both FY24 and FY25, and up 2.1% for FY26. These are the figures expected to make the 2% price target achievable and should be checking to see whether forecast accuracy increases. For now, we will continue to watch the unstable financial and capital market trends while waiting to ascertain whether a virtuous cycle of higher wages leading to higher prices can take hold.

In order to confirm whether the outlook for the Japanese economy and prices is on track, over the short term we will need to look at (1) BOJ's Tankan survey for September (due out on 1 Oct) to ascertain the state of corporate earnings, passing on higher costs to prices, and fundraising, (2) requested wage hike rate in the 2025 Spring Labor-Management Wage Negotiations Basic Plan (due out in mid Oct), and (3) degree to which high wage hikes are reflected in the Tokyo CPI, especially services prices (due out on 25 Oct). However, market instability is likely to continue for now with the LDP presidential election coming up on 27 September in Japan (as early as 27 Oct in case of dissolving Diet for snap general election) and the US presidential election set for 5 November. If the winner of the LDP presidential election is a candidate other than Sanae Takaichi, the new administration's approach to monetary policy normalization would be largely in step with the BOJ's current approach. As such, it is likely that the Bank would continue to be entrusted with the conduct on monetary policy. Also, as mentioned above, how the government's measures to combat rising prices will be extended is another important factor.

After the September FOMC meeting, the bond, equities, and currency markets fluctuated slightly, but did not experience any major turmoil. We can probably say that the Fed skillfully handled its communications with the market. In the case of the BOJ, Governor Kazuo Ueda's post-meeting press conference should attract attention. We believe that the BOJ's basic policy of raising interest rates will remain unchanged. Still, we want to confirm whether there are any new explanations or wording about the impacts of the pause for yen depreciation, falling crude oil prices, or any other points that warrant attention.

Chart 5: Changes in BOJ's Assessment of Economy and Current Conditions

		Sep 2024
Current conditions		Red lettering indicates corrections and additions. ⇒ indicates status of revisions from Jul to Sep.
	Japan's economy	Has recovered moderately, although some weakness has been seen in part. ⇒ Unchanged
	Overseas economies	Have grown moderately on the whole. ⇒ Unchanged
	Exports	Have been more or less flat. ⇒ Unchanged
	Industrial production	Have been more or less flat. ⇒ Unchanged
	Business fixed investment	Has been on a moderate increasing trend.⇒ Unchanged Corporate profits improving ⇒ Unchanged
	Private consumption	Has been on a moderate increasing trend despite the impact of price rises and other factors. ⇒Previous "resilient" wording was revised upward to "moderate increasing trend."
	Public investment	Has been more or less flat. ⇒ Unchanged
	Housing investment	Has been relatively weak. ⇒ Unchanged
	Financial conditions	Have been accommodative. ⇒ Unchanged
	Prices	The y/y rate of increase in the consumer price index (CPI, all items less fresh food) has been in the range of 2.5-3.0 percent recently, as services prices have continued to rise moderately, reflecting factors such as wage increases, although the effects of a passthrough to consumer prices of cost increases led by the past rise in import prices have waned. ⇒ Forecast revised upwards from "around 2.5 percent" in Jul to "range of 2.5-3.0 percent" in Sep. Descriptions about inflation expectations have been left unchanged.
Outlook	Japan's economy	Is likely to keep growing at a pace above its potential growth rate, with overseas economies continuing to grow moderately and as a virtuous cycle from income to spending gradually intensifies against the background of factors such as accommodative financial conditions.
	Prices	While the effects of the pass-through to consumer prices of cost increases led by the past rise in import prices are expected to wane, the y/y rate of increase in the CPI (all items less fresh food) is projected to be pushed up through fiscal 2025 by factors such as a dissipation of the effects of the government's measures pushing down CPI inflation. Meanwhile, underlying CPI inflation is expected to increase gradually, since it is projected that the output gap will improve and that medium- to long-term inflation expectations will rise with a virtuous cycle between wages and prices continuing to intensify. In the second half of the projection period of the July 2024 *Outlook for Economic Activity and Prices*, it is likely to be at a level that is generally consistent with the price stability target.

Source: BOJ; compiled by Daiwa.

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