Daiwa Securities

Daiwa's Economic View

Paths Japan should take, BOJ to put rate hike on hold this autumn

- Japan weakened by heat waves, earthquakes, and typhoons in summer of 2024
  Japan's weaknesses: Low energy/food self-sufficiency, changing demographics
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  Calls for "wise spending" ahead of LDP presidential election on 27 Sep
  Ishiba, Kono reviewing Abenomics, calling for monetary policy normalization
- BOJ to put rate hike on hold this autumn; eyes on Governor Ueda's press conference

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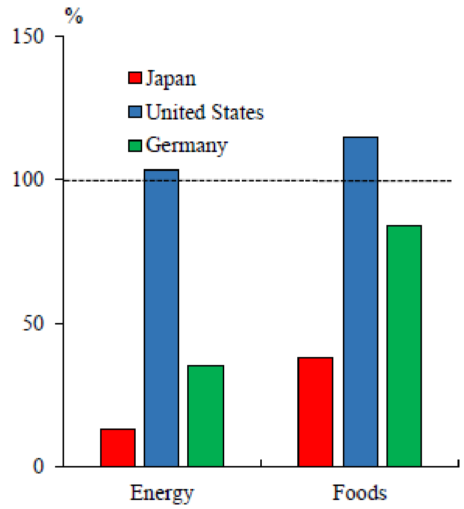
Summer heat, earthquakes, typhoons sapping Japan's national power

As of mid-September, Japan is seeing no respite from high summer temperatures. August featured concerns about a Nankai Trough earthquake and damage from frequent typhoon landfalls and sudden torrential rain. We therefore expect Jul-Sep consumer spending to be dominated by negative factors. If these conditions recur in successive years, climate and natural disasters could become weaknesses that depress Japan's national power (potential growth rate) over the long term. We think the central government needs to focus more on addressing climate change and building national resilience.

An accurate grasp of short-term changes is crucial in economic forecasting. The ability to identify long-term shifts in global trends is also required. Japan's global positioning is another key factor in considering the country's outlook. In a 28 August speech, BOJ Deputy Governor Ryozo Himino cited Japan's low energy and food self-sufficiency ratios in explaining the difference in inflation rates between Japan, the US, and Germany (Chart 1). His analysis shows that while rising import prices had a greater impact on Japan than other countries, the overall effect was smaller than in the US and Germany due to Japanese companies' caution about passing on higher costs and government measures to counter inflation. However, the fact remains that Japan is a net importer of resources that is vulnerable to rising global resource prices. In our view, the government needs to urgently take proper steps to address its energy policy.

Chart 1: Energy and Self-Sufficiency Rates in Japan, US, and Germany



Source: Partially excerpted from materials for speech by BOJ Deputy Governor Ryozo Himino on 28 Aug 2024 (Chart 3).
Note: Figures for energy are as of 2021, while figures for foods are as of fiscal 2022 for Japan and as of 2020 for US and Germany.

Japan's weaknesses: Low energy self-sufficiency, demographic changes

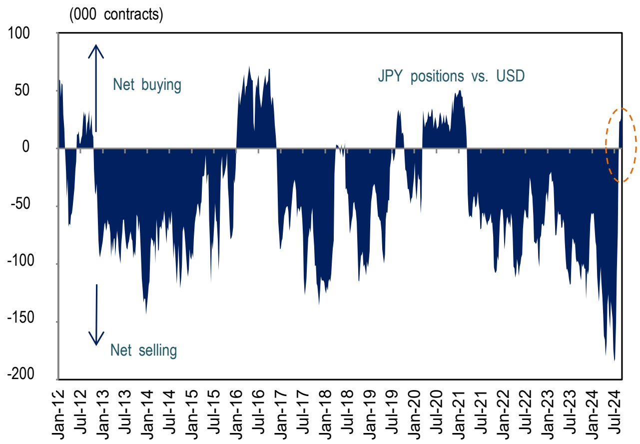
In an 11 September speech on employment and income conditions, BoJ policy board member Junko Nakagawa argued that Japan's additional labor supply (gap between working-age population/number of employed) is set to narrow. Her view is that a tighter labor market will tend to create upward pressure on wages. It is desirable for supply constraints created by labor shortages to increase upward pressure on wages across all enterprises and industries. However, measures such as deregulation to create a more liquid job market will be needed to resolve labor shortages. At the same time, Japan's falling population will limit overall consumer spending. While concerns tend to focus on weakness in real consumption caused by inflation, we would bear in mind the lack of prospects for Japan's consumer spending to gain momentum in the first place. We think spending will inevitably rise only slightly despite government subsidies (cash transfers) and tax cuts targeting low-income households, and would describe consumer spending as having downside resilience. Incidentally, we would also caution that the changing climate we discuss above could result in a shorter spring and autumn (effectively two rather than four seasons). This would in turn mean that seasonally adjusted values, which are intended to even out distortions in historical patterns, could cease to give an accurate picture of underlying conditions.

Summer 2024 upset: US recession concerns drive USD weakness/stock market pullback

A month and a half have passed since the BOJ's 31 July decision to raise interest rates again. The 2 August release of July US employment data prompted growing concerns about a US recession and drove the concerted unwinding of the yen carry trade (Chart 2). We refer to this as the "summer 2024 upset". The approach of a first Fed rate cut in September, signifying that US and Japanese monetary policy are set to diverge, caused USD to weaken. USD/JPY fell below 150 on the day of the BOJ's July monetary policy meeting (MPM) and neared 139 at one point on 16 September. This represents a roughly Y20 correction in the two months since mid-July, when USD/JPY was above Y160. Meanwhile, Japan and US stock markets corrected sharply on expectations for US rate cuts, and while they have rebounded for now, trends remain volatile (Chart 3).

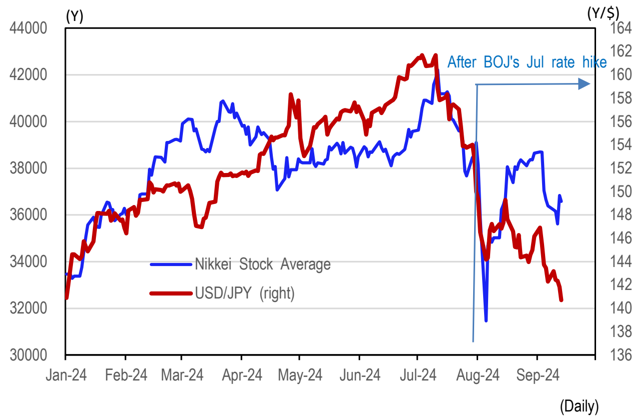
In our view, factors that could drive medium-term yen weakness include (1) Japan's low potential growth rate, (2) delays to fiscal consolidation, and (3) a persistent trade deficit. None of these can be resolved solely with monetary policy. As we have written previously, (1) and (3) require the government to signal its commitment to a growth strategy. On point (2), Japan's lack of fiscal space means a need for wise spending rather than preconceived notions about the size of the fiscal response.

Chart 2: IMM Speculators' USD/JPY Positions



Source: Bloomberg; compiled by Daiwa.

Chart 3: Nikkei Stock Average, USD/JPY Rate



Source: Bloomberg; compiled by Daiwa.

Paths Japan should take, importance of fiscal soundness, promotion of energy policy

Based on the above bullet points, we believe that the important paths for Japan to take are (1) fiscal soundness, (2) financial system normalization, and (3) promotion of energy policy. Just ahead of the appointment of Kazuo Ueda as BOJ Governor in the spring of 2023, there was heated debate about reworking the joint statement (regarding policy coordination between government and BOJ to overcome deflation and achieve sustainable economic growth) released on 22 January 2013. Core CPI has remained above 2% y/y growth since April 2022 and currently measures are being taken to combat rising prices. As such, it feels like the end-of-deflation declaration should have already been made. While the BOJ is making progress towards achieving its price stability target, it is hard to say that the government is making progress in its efforts to establish a sustainable fiscal structure.

Calls for "wise spending" in lead-up to LDP presidential election on 27 Sep

Under these circumstances, the ruling Liberal Democratic Party (LDP) presidential election was launched on 12 September and a record nine candidates ran for the position, the most since 1972. This time, many candidates have shown that they are committed to economic growth while also keeping an eye on finances (Chart 4). For example, former LDP secretary-general Shigeru Ishiba touched on "supporting the economy through flexible fiscal spending," but also talked about "conducting economic and fiscal management that also takes into account fiscal discipline." Also, digital transformation minister Taro Kono talked about the need to build up fiscal reserves for emergencies and to pursue a new normal for interest rates. We were left with the impression that he is more concerned about fiscal soundness than the other candidates.

Chart 4: Economic, other Policies of LDP Presidency Candidates

Candidates	Age	Monetary/fiscal stance	Nuclear power policy	Major economic/fiscal policies
Shigeru Ishiba, 12* (Former Secretary General)	67	Economic growth and sound fiscal conditions	Passive	• Use regional revitalization as catalyst for Japan, shift to decentralized, domestic demand-led economy. • Improve potential growth rate, correct disparities, invest in growth areas (support AI research, promote digital technologies, others), invest in human resources. • Formulate (1) emergency measures to deal with rising prices of daily necessities, mortgage rates, others and (2) economic/price measures that include improving environment for wage hikes and strengthening measures to pass on higher costs to prices.
Shinjiro Koizumi, 5* (Former Environment Minister)	43	—	Positive	• Implement regulatory reforms to create new industries (support startups, others) and labor market reforms (review dismissal regulations, others). • Support low-income earners and SMEs impacted by high prices (basically wants to continue with policies of Kishida administration, such as raising wages and encouraging people to "switch from saving to investing").
Sanae Takaichi, 9* (Minister for Economic Security)	63	Monetary easing / Fiscal expansion	Pro	• Strategic fiscal spending for crisis management and growth investment through proactive fiscal policy (achieving strong economy through increased employment and income). • Strengthen food/energy resource security, national resilience, investment in growth areas, HR development, others. • Increase tax revenue without raising tax rates by promoting innovation and increasing employment/income.
Taro Kono, 9* (Minister for Digital Transformation)	61	Monetary normalization/ Fiscal soundness	Positive	• Reform labor market to boost wages and support corporate growth (fluidization of labor markets, equal pay for equal work, others). • Promote private-demand-led investment (automated driving, smart grids, GX) and human capital investment through regulatory reforms. • Create industries that lead to regional revitalization through open data of local service demand.
Takayuki Kobayashi, 4* (Former Minister for Economic Security)	49	Prioritizing economy	Pro	• Invest boldly in local areas for strategic fields such as chips, cars, and environment (correct excessive concentration of resources in Tokyo). • Make digital services profitable (programs to make Japan an "AI advanced nation"). • Thoroughly support recovery of earnings at SMEs through measures such as passing on higher costs to prices initiatives and support for labor-saving investment, as well as support for startups. • Formulate package of measures to deal with rising prices in 2024.
Yoko Kamikawa, 7* (Foreign Minister)	71	Fiscal soundness	Pro	• Formulate measures to combat high prices, such as increases in real wages and minimum wages. • Foster growth industries such as chips and AI. Expand content industry overseas. • Promote "switch from saving to investing" and support middle class through income redistribution. • Improve working environments through measures such as revitalizing local industries, SMEs, others and support for re-skilling.

Toshimitsu Motegi, 10* (Secretary General)	68	Monetary normalization/Economic growth and sound fiscal conditions	Pro	• Promote a "zero tax increase" policy through economic growth and use of Foreign Exchange Special Account. • Urgently formulate comprehensive economic package with highest priority on increasing citizens' income. • Use three key measures ((1) improve growth/productivity for SMEs, (2) fundamentally reform "Hello Work," (3) invest in growth areas) to improve productivity, allowing for end-of-deflation declaration within six months.
Yoshimasa Hayashi, 1*, 5** (Chief Cabinet Secretary)	63	Fiscal soundness	Pro	• Support SMEs that have high global market shares in specific fields (top global niches) and support startups. • Formulate growth strategies (promote GX investment, content industry, others) and reform labor environments (correct disparities, others). • Support household finances by maintaining energy measures and raising the minimum wage.
Katsunobu Kato, 7* (Former Chief Cabinet Secretary)	68	Monetary normalization/Economic growth and sound fiscal conditions	-	• Double incomes and promote domestic investment (income doubling via tax system promotion and regulatory reform as top priority). • Realize sustainable regional growth through thorough support for local companies' supply chains, export capacity building, others. • Promote work style reforms and active participation of women.

Source: Candidates' websites and news reports; compiled by Daiwa.
**Shows the number of victories in Lower House elections.*
***Shows the number of victories in Upper House elections.*

Meanwhile, economic security minister Sanae Takaichi, who is in favor of continuing Abenomics, shared her opinion that "Growth through fiscal spending will increase tax revenue without raising tax rates, and a surplus in the primary balance will be achieved naturally." Even though Takaichi is known for favoring aggressive fiscal policy, she used the expression "strategic fiscal stimulus." However, there are differences in terms of the timeframe for increasing tax revenue due to fiscal stimulus (even though an increase in stimulus is immediately reflected, longer perspectives are needed for many economic growth aspects) and there is also the possibility that external shocks may make it difficult to achieve economic growth. In this regard, LDP secretary-general Toshimitsu Motegi is the only candidate advocating a policy of no tax increases. He wants to halt the one trillion yen tax increase to cover increased spending on national defense and the one trillion yen tax increase to cover increased insurance premiums for child-rearing support, and find other ways to cover these increased expenses. There are some harsh voices within the LDP, but a more robust debate over funding sources is needed. The new LDP president and new finance minister will probably need to thoroughly practice "wise spending."

Next, there are a few candidates who have clearly stated their stances on monetary policy. At the policy announcement press conference on 9 September, Takai took a cautious stance regarding financial normalization. Specifically, she said, "From the core-core CPI perspective, inflation is still weak and it is hard to state that the stable price target has been achieved." Also, just before the BOJ's July Monetary Policy Board meeting, both Kono and Motegi attracted some attention when they called for addressing excessive yen depreciation and promoting the normalization of monetary policy. Furthermore, Motegi also said that he would "declare the end of deflation within six months." Meanwhile, in his book, Ishiba pointed out that the financial strength of Japanese banks has declined due to QQE. On top of that, Ishiba and Kono should probably be commended for wanting to review Abenomics.

From the perspective of energy policy, we also want to monitor the restarting of nuclear power plants. On this point, most candidates are promoting the restarting of nuclear power plants with safety as a precondition. Even Kono and former environment minister Shinjiro Koizumi, who had both advocated phasing out nuclear power in the past, are now making positive comments about restarting nuclear power plants. Meanwhile, Ishiba said on 24 August, "I will make every effort to get closer to zero (nuclear power generation)", making it clear that he is cautious about restarting nuclear power plants. However, on 10 September he revised his stance to say that, "The result could be that the weighting of nuclear power plants decreases." However, it is clear that he is being more cautious with this issue compared to the other candidates. In order to increase Japan's international competitiveness, it is important to promote a long-term energy policy.

BOJ monitoring market trends, but unlikely to add new wording to its statement

If someone other than Takai wins the LDP presidential election, the new administration and the BOJ should be largely on the same page in terms of monetary policy normalization. In that case, we expect that the BOJ will continue to be entrusted with that task. After the decision to again raise interest rates in July, and the subsequent turmoil for the forex and stock markets, a three-way meeting (BOJ, MOF, and FSA) was held on the evening of 6 August. Here, the three parties confirmed that the government and the BOJ will assess trends for domestic and overseas economies, as well as financial markets. They also pledged to work together while maintaining close communication. In response to this, the speech given by BOJ Deputy Governor Shinichi Uchida on 7 August included the phrase "The Bank will not raise its policy interest rate when financial and capital markets are unstable" as a consideration. However, once the market has settled down, the BOJ will no longer be bound by that wording. The key chart included in his presentation materials was the one depicting how real short-term interest rates are at fairly low levels (Chart 5). If the economic activity and price forecasts are realized, adjusting the degree of monetary easing would be appropriate. Hiking rates is the basic policy.

The phrase "Need to monitor unstable financial and capital markets with the utmost vigilance" was also repeated by Ueda during his testimony before the Diet during an out-of-session meeting on 23 August, as well as in the speech given by BOJ Deputy Governor Ryozo Himino on 28 August. However, we assume that future statements will not include any new wording that could limit the BOJ's discretion in terms of how it conducts monetary policy.

BOJ board members differ on timeline for normalizing policy

Statements by BOJ policy board members Hajime Takata, Junko Nakagawa, and Naoki Tamura following the July MPM also signaled three differing views on the timing for normalizing monetary policy.

Mr. Takata[1] commented on 5 September that the BOJ should ensure that it devotes sufficient time to assessing the impact of individual rate hikes on the economy, prices, and financial conditions. We inferred from this that he is close to BOJ Governor Kazuo Ueda in wanting to properly assess the data. Mr. Takata's caution also reflects Japan's past experience of risks that originate overseas. On 11 September, Ms. Nakagawa then stated that the BOJ would carefully assess the impact of changes in financial market conditions on the economic and inflation outlook as it mulls further adjustments to its monetary easing regime. She appeared to be speaking for the BOJ's leadership. Finally, Mr. Tamura[2] noted on 12 September that while the BOJ envisages an interest rate of 1% in the second half of its forecast period (which runs through FY26), it will gradually raise short-term interest rates as it gains greater conviction on achieving its price stability target. He played up the presence of the BOJ's hawkish faction, which seeks to initially implement a series of 25bp rate hikes toward a 1% policy rate, with some conditions attached.

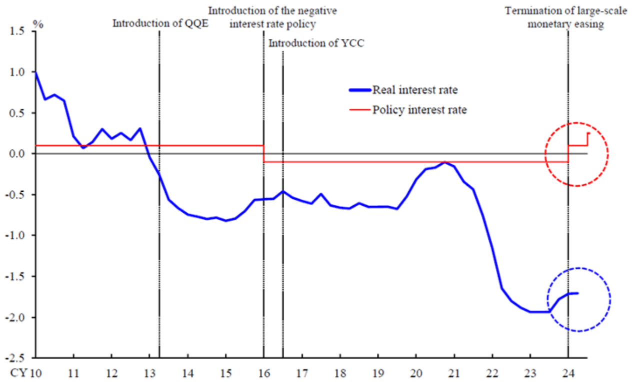
Autumn pause for BOJ rate hikes; focus on Governor Ueda's press conference

We expect the BOJ to limit itself to confirming the impact of its July rate hike at the September MPM, positioning this as a preparatory phase ahead of the October *Outlook for Economic Activity and Prices* report (*Outlook Report*). We expect the BOJ to hold off on further rate hikes this autumn given the LDP leadership race and the potential for a general election to follow soon after. In its July *Outlook Report*, the BOJ maintained its core-core inflation forecasts of +1.9% for FY24 and FY25 and +2.1% for FY26. It therefore assumes that its 2% price stability target is achievable, and will need to confirm that the target is indeed looking more plausible. In the near term, it will continue to monitor volatile financial and capital market trends while assessing whether a virtuous cycle of wage and price

[1] Economic Commentary-Speech by BOJ Policy Board member Takata: Is "true dawn" at hand? (6 Sep 2024).
[2] Economic Commentary-Speech from BOJ Policy Board member Tamura: Desire for policy normalization unchanged (17 Sep 2024).

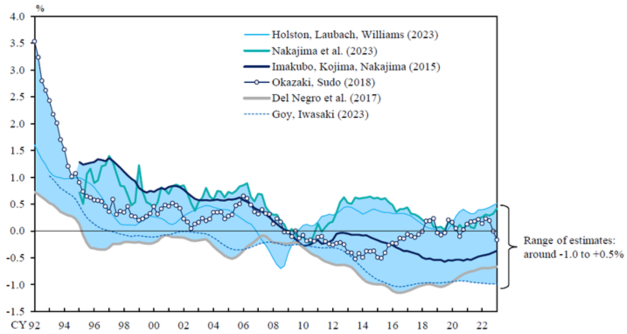
inflation is in place. The focus at the upcoming MPM will be Governor Ueda's regular 15:30 press conference, at which point the market's reaction to the September FOMC will be known. We expect the BOJ to maintain its basic stance on rate hikes, but will be looking for comments about the impact of the pause in JPY's downtrend and falling oil prices, and for any new explanations or keywords, for example regarding topics of focus.

Chart 5: 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).

Chart 6: Estimates for Natural Rate of Interest in Japan



Source: Excerpted from materials for speech by BOJ policy board member Hajime Takata on 5 Sep 2024 (Chart 10).

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