Daiwa Securities

Daiwa's Economic View

What's next for Japan? How will BOJ respond?

- 10th anniversary of "Halloween Easing"; expect BOJ to assess uncertainties
  Oct meeting focus on wording for outlook risks, Ueda's press conference
- Viewing Japan in context of the world; IMF's *World Economic Outlook*
  Current economic, price conditions in line with BOJ's forecast
- Political situation fluid, hard to read after ruling party loses its Lower House majority
  With US presidential election nearing, period for monitoring conditions to continue

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10th anniversary of "Halloween Easing"; BOJ to monitor market instability

Almost three months have passed since the BOJ decided to raise interest rates again on 31 July[1]. Also, the 10th anniversary of the BOJ's 31 October 2014 "Halloween Easing" (also known as then-BOJ Governor Haruhiko Kuroda's second round of "bazooka" stimulus) is almost here. At that time, consumption slumped after the sales tax rate was raised in April 2014 and crude oil prices fell sharply from the summer of that year. So, the BOJ responded with surprise market measures to prevent the risk of a delay in breaking from a deflationary mind-set. Looking back on the past, it is clear that consumer trends and crude oil prices are important factors, regardless of the economic situation. The main differences now compared to then are (1) nationwide core CPI growth has remained above 2% y/y for 30 consecutive months as of September and (2) corporate wage and price setting behaviors have clearly changed. Since this summer, one-sided forex market positions were unwound, the US started cutting rates in September, and the strength of the US economy was confirmed. In the US, where a Trump victory ("Triple Red") is now being factored in, there has been a stronger move towards higher interest rates and a stronger US dollar, reflecting awareness of fiscal risk (on 23 Oct, 10-year US Treasury yield briefly reached the 4.3% level and the yen briefly depreciated beyond the USD/JPY153 level). With the US presidential election set for 5 November, now is the time to monitor market instability over the short term.

Oct meeting focus on wording for outlook risks, Ueda's press conference

Under these conditions, BOJ Governor Kazuo Ueda spoke at an event in Washington D.C. on 23 October, where he said, "We are considering what the appropriate scale of normalization will be overall, and how to distribute the overall increase in interest rates over time." He added, "I am thinking about this day and night, even in my sleep." These words convey Ueda's serious nature, as well as his intention to carefully assess the US economy. At his press conference following the G20 Finance Ministers and Central Bank Governors Meeting on 24 October, Ueda touched on how the Bank will go about determining its next interest rate hike. He said, "We have enough time (to make a decision)," which was the same expression he used at his press conference following the Bank's September meeting. However, his real intention is probably to carefully look for the right time to raise interest rates. The forecast figures in the October *Outlook for Economic Activity and Prices* report *(Outlook Report)* are expected to be largely in line with those from July. The economic and financial situations are on track with Bank's outlook. However, we think the BOJ will maintain the status quo at its October meeting in order to assess the uncertainty of the US economy and the instability of financial markets.

There are two points for the October *Outlook Report* that warrant attention. First, is whether or not the Bank revises its wording for the price risk balance included in the July Outlook report, specifically, "Risks to prices are skewed to the upside for fiscal 2024 and 2025." We believe that the upside risk wording for FY24 could be removed due to a pause in the acceleration of yen depreciation and the expected extension of the government's measures to address high prices. A more important point is how Ueda will explain his process for determining when to raise interest rates at his press conference. Even if Ueda himself is cautious about the US economy, we think he will make an effort to convey that the interest rate hike path will not change in order to prevent the yen from weakening further.

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[1] Iwashita's Economic & Market Watch: BOJ decides to further raise interest rates without delay (31 Jul 2024).

Thinking of Japan in the global market—The IMF's World Economic Outlook

The IMF announced its *World Economic Outlook* on 22 October (Chart 1). The outlook indicated that the growth rate for world output in 2025 would continue at 3.2%, as in 2024, maintaining the scenario of a soft landing for the US economy. Among advanced economies, downward revisions in the Euro area continued, while upward revisions were made to US projections for 2024-2025, widening the difference in growth between the US and Europe (with the US the only winner). The economic weakness of Germany was particularly conspicuous. Going forward, the strength or weakness of the economy is likely to cause the pace at which rates are cut in the US and Europe to diverge, and serve as a factor in the market. Currently, the solid US economy is once again leading to a strengthening of the dollar and weakening of the yen. Provided the US economy does not suddenly stall, we think it will be able to take its time with corrective rate cuts for the time being. While the US is making corrective cuts for its policy interest rate, which is too high, Japan can probably adjust the degree of its monetary easing, for which the real interest rate is too low.

One notable feature of the latest IMF report (Oct 2024) is its subtitle, "Policy Pivot, Rising Threats," clearly indicating an increased sense of uncertainty regarding the future. (In July, it was "The Global Economy in a Sticky Spot.") IMF Chief Economist Pierre-Olivier Gourinchas emphasized that the downside risks of growth were increasing. In addition to slowing growth in China and tensions with the Middle East situation, the greatest uncertainty in the near term lies with the Presidential election in the US. In a sub-scenario, the IMF estimated that the world growth rate would be lowered by 0.8% in 2025 and 1.3% through 2026 due to the overall impact of the introduction of an across-the board 10 percent tariff by the US (additional tariffs in Europe and China are also assumed), extension of Trump tax cuts (which run out at end-2025), immigration restrictions, and instability in the financial market. If this scenario were to become a reality, downward pressure on the Japanese economy would be unavoidable. Furthermore, in his press conference on 24 October, BOJ Governor Kazuo Ueda stated that optimism about the US economy was slightly on the rise, but that the bank had to do a deeper analysis regarding whether favorable US data would continue over the long term. The employment growth rate in the October US jobs report (to be released 1 Nov) is expected to slow substantially due to the US being hit by two hurricanes and the impact from the strike by union members at Boeing. It will likely still take some time in order to assess the situation.

Chart 1: IMF *World Economic Outlook* (real GDP, y/y %)

	2023 actual	2024	Revision	2025	Revision
World Output	**3.3**	**3.2**	0.0	**3.2**	-0.1
Advanced Economies	1.7	1.8	0.1	1.8	0.0
US	**2.9**	**2.8**	0.2	**2.2**	0.3
Japan	**1.7**	**0.3**	-0.4	**1.1**	0.1
Euro Area	**0.4**	**0.8**	-0.1	**1.2**	-0.3
Germany	-0.3	0.0	-0.2	0.8	-0.5
France	1.1	1.1	0.2	1.1	-0.2
Italy	0.7	0.7	0.0	0.8	-0.1
Spain	2.7	2.9	0.5	2.1	0.0
UK	0.3	1.1	0.4	1.5	0.0
Emerging Market and Developing Economies	**4.4**	**4.2**	0.0	**4.2**	-0.1
Brazil	2.9	3.0	0.9	2.2	-0.2
Russia	3.6	3.6	0.4	1.3	-0.2
India	8.2	7.0	0.0	6.5	0.0
China	**5.2**	**4.8**	-0.2	**4.5**	0.0
ASEAN-5	4.0	4.5	0.1	4.5	-0.1
Saudi Arabia	-0.8	1.5	-0.2	4.6	-0.1

Source: IMF WEO (released on 22 Oct 2024); compiled by Daiwa.
Notes: (1) Revision indicates difference from Jul 2024 WEO Update.
(2) For India, data and forecasts are presented on a fiscal year basis (starting in Apr).

Tokyo CPI in Oct: Slow progress in passing higher wages on to service prices

In his regular press conference on 20 September, BOJ Governor Ueda stated that the bank was very interested to see how favorable wage trends were reflected in service prices mainly in October, so there was much interest to see to what extent prices rose in Tokyo CPI data at the beginning of 2H.

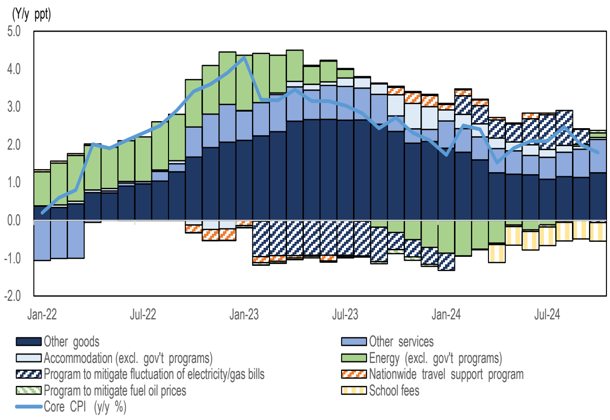
The CPI data for Tokyo's 23 wards (released on 25 Oct, Chart 2) showed that core CPI growth slowed due to policy factors, but the growth rate for food (excl. fresh food) increased substantially. Although this was probably caused by temporary factors, such as unstable weather and the rising price of raw materials, higher wages were passed on to prices to a greater degree than expected. That said, due to factors such as consumer fatigue in the face of rising price, the price of some food items was maintained via reductions in volume. Therefore, we may see downward pressure on prices in the future.

The growth rate for service prices increased due to the contribution from public services (Chart 3). However, the growth rate for general services slowed. With there being no signs of accelerated price growth in food categories other than dining out, which was impacted by rising food prices, we could not confirm that favorable wage conditions were being reflected in service prices to a greater extent than last year. On the other hand, while the level of general service prices rose higher than the previous month, the passing of higher wages on to prices is proceeding slower than we expected. However, we still expect labor costs to rise in the future due to structural labor shortages. Therefore, it is highly likely that service prices will continue to rise.

Current economic/price conditions are in line with projections

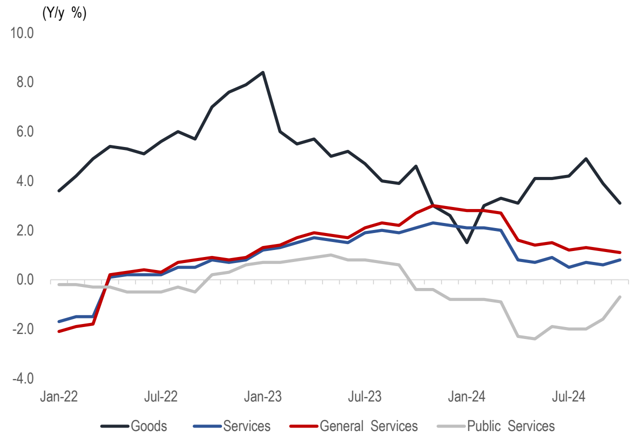
We expect projections in the October *Outlook Report* to be largely unchanged from those in the July report[2]. The BOJ will not change its view that prices will generally be at a level that is largely consistent with the price stability target in the second half of the projection period. The Bank is likely to indicate the view that current economic/price conditions are in line with its projections. The focus of attention this time will be whether there is a revision to the way the report described the risk balance regarding prices in July, when it stated that "Risks to prices are skewed to the upside for fiscal 2024 and 2025." We think upside risks for 2024 may be eliminated due to a pause in yen weakness and the anticipated extension of the government's inflation measures. While the price of services continue to rise, we may see downward pressure on the price of goods. However, the situation is still highly uncertain. It is difficult to say whether the risk balance will return to "neutral." As of July, the report stated that "risks to economic activity are skewed to the upside for fiscal 2025." We forecast that the wording will either be revised to "neutral" or remain unchanged, in order to be consistent with the assessment of the economy.

Chart 2: Breakdown of Contributions to Core CPI (Tokyo 23 wards)



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

Chart 3: Y/y Change in Goods and Service Prices (Tokyo 23 wards)



Source: MIC; compiled by Daiwa.

[2] Refer to Chart 3 (page 2) in our 17 Oct 2024 report: [Daiwa's Economic View—BOJ's future outlook (as of autumn 2024) ～ Signs BOJ monitoring conditions.]

Hot topic: IMF's projection for Japan's neutral interest rate

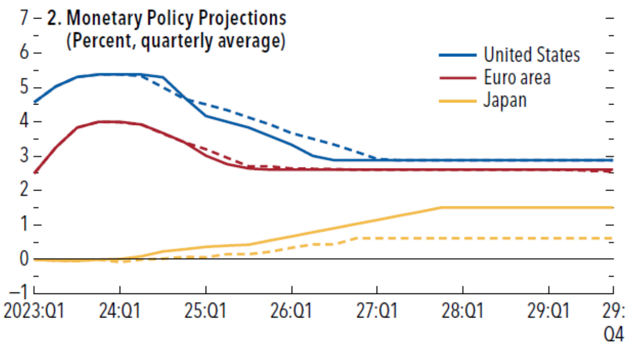
One hot topic right now is the IMF's *World Economic Outlook*. The IMF revised its forecast to reflect the BOJ's additional interest rate hike in July, estimating Japan's neutral interest rate at around 1.5% (Chart 4). If inflation expectations in Japan can be anchored at 2%, then theoretically, the neutral interest rate could be calculated as 2% based on the Taylor Rule. The IMF projections are not the only ones that are high. When looking at this graph, we were left with the impression that Japan's neutral interest rate is relatively high compared to the level of just below 3.0% for the US, which is essentially the only economy performing well right now. In other words, we think the US neutral interest rate level is probably a little bit higher. In the markets, the main focus is on the pace of interest rate cuts in the US, but if the goal of the rate cuts is higher than current market expectations, the period for US rate cuts will be short-lived. If Japan proceeds slowly, a 1~2% level seems possible.

In an interview in Washington on 22 October, the IMF's Japan mission chief Nada Choueiri cited the upward trend in personal consumption and wage increases (function of virtuous cycle of higher wages and higher prices) as reasons for his growing confidence in the sustainability of Japan's inflation. Also, regarding the BOJ's interest rate hike, she said, "It is necessary to proceed in a gradual and careful manner, taking into account the risks." In that respect, the BOJ is not in a hurry to raise interest rates and we expect that it will get back on track and continue to raise interest rates by 25bp about once every six months, while assessing the external environment.

Political situation fluid, hard to read after ruling party loses its Lower House majority

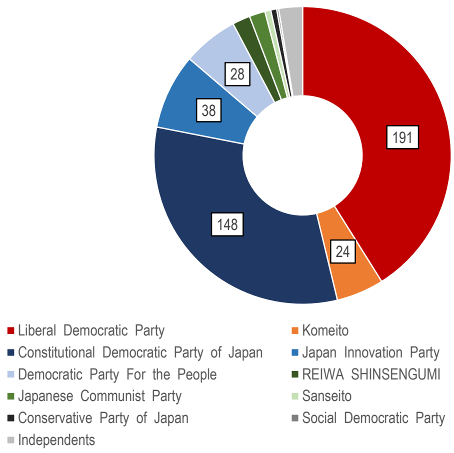
The Lower House election, held on 27 October, resulted in the ruling coalition failing to maintain a majority of seats (LDP: 191 seats, Komeito: 24 seats = 215 seats, missing the minimum of 233 of 465 seats overall needed for a majority). Indeed, the ruling coalition suffered its worst defeat since 2009 (Chart 5). The *Asahi Shimbun*'s 20 October report to some extent prepared the market for the likelihood of the ruling coalition losing its majority. Still, there will probably be a brief sell-off for Japanese equities, bonds, and the yen. After that, conditions will depend on negotiations to form a new coalition. The emboldened Constitutional Democratic Party of Japan will probably aim to form an opposition coalition to push for political reform. With Prime Minister Shigeru Ishiba intending to stay in office, there is a strong likelihood that he will seek the cooperation of new coalition partners. However, the Democratic Party for the People and the Japan Innovation Party are both aiming for expansionary fiscal policy and accommodative monetary policy, so the hurdle for the BOJ to raise interest rates could become higher. There are also concerns that the weakening of the Ishiba administration may delay the formulation of economic measures and the compilation of a supplementary budget. If the ruling party is unable to reach agreements with other parties, further "Japan selling" could be possible. The political situation is fluid and conditions are hard to read due to market instability. That said, the yen could weaken further and the possibility of the BOJ adjusting its degree of monetary easing will probably remain in place. At this point, our main scenario calls for an additional rate hike in Jan-Mar 2025.

Chart 4: Neutral Interest Rates in Japan, US, Europe (IMF projections)



Source: Reprinted from IMF materials.

Chart 5: Results of Lower House Election (No. of seats)



Source: Various media reports; compiled by Daiwa.

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