Daiwa Securities

Daiwa's Economic View

BOJ carefully charting its own path amid Japan's political confusion

- BOJ stands pat amid Japan's political confusion, US presidential election
- BOJ maintains status quo at Oct meeting, removes upside price risk wording for FY24
  Growth rate, core-core CPI largely unchanged in Oct *Outlook Report*
  New wording added to explanation of conduct of monetary policy; cautiously raising interest rates as basic stance
- Key points going forward include US economy, wages/service prices, and private consumption
  Important for BOJ to carefully provide information after US presidential election

FICC Research Dept.

Mari Iwashita
81-3-5555-8852
mari.iwashita@daiwa.co.jp

Kento Minami
81-3-5555-8789
kento.minami@daiwa.co.jp

Daiwa Securities Co. Ltd.

BOJ stands pat amid Japan's political confusion, US presidential election

Japan's ruling coalition (Liberal Democratic Party (LDP) + Komeito) lost its majority in the 27 October Lower House election, suffering its worst defeat since 2009. In preparation for the special 11 November Diet session, Prime Minister Shigeru Ishiba is working to gain a majority of votes for his re-nomination. Specifically, he wants to (1) reinstate LDP lawmakers who were previously stripped of their party endorsement and forced to run as independents due to their involvement in a slush fund scandal and (2) see if the Democratic Party for the People (DPFP) would be willing to form a "partial coalition" in which the two parties agree to work together on issues such as the budget and important bills on a case-by-case basis. Of note, the DPFP has pledged to raise the basic income tax exemption, reduce consumption taxes, and lift the freeze on trigger clauses. So, if the DPFP and LDP can reach a compromise, there is a good chance that they could implement more aggressive fiscal stimulus measures. Meanwhile, the strength of the US economy after the start of interest rate cuts in September was confirmed. At this juncture, with a Trump victory ("triple red") being factored in, government bond yields are rising and the dollar is strengthening, reflecting concerns about fiscal risk. With the US employment statistics for October due out on 1 November and with the US presidential election on the 5 November, the BOJ will now use this time to monitor unstable markets.

BOJ maintains status quo at Oct meeting, removes upside price risk wording for FY24

The BOJ's Monetary Policy Meeting (MPM) on 30-31 October landed right between Japan's Lower House election and the US presidential election. As such, the Policy Board voted unanimously to maintain the status quo for now, as expected. Its statement on monetary policy was very short, consisting of only four lines. Discussions were apparently not heated, as the meeting wrapped up before noon. Forecasts in the October *Outlook Report* were largely unchanged from those in the July report, which confirms that the current economic and price conditions are on track with the Bank's outlooks. However, for now the BOJ does not need to rush to raise interest rates, as it continues to closely monitor the uncertain state of the US economy, as well as unstable markets, with a sense of nervousness. The explanation for its conduct of monetary policy was updated to include a new phrase about paying close attention to the future development of overseas economic activity and market trends. However, its basic policy of raising interest rates remains unchanged. While the BOJ is proceeding cautiously, it has not given up on its own path forward. Specifics are provided below (in bold).

Oct *Outlook Report* (page 8)
As for the conduct of monetary policy, while it will depend on developments in economic activity and prices as well as financial conditions going forward, given that real interest rates are at significantly low levels, if the aforementioned outlook for economic activity and prices will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation. On this basis, the Bank needs to pay due attention to the future course of overseas economies, particularly the U.S. economy, and developments in financial and capital markets. It also needs to examine how these factors will affect the outlook for Japan's economic activity and prices, the risks surrounding them, and the likelihood of realizing the outlook.

One focus of attention this time was the wording for the risk balance within the Bank's price outlook. Specifically, the wording was changed from "Risks to prices are skewed to the upside for fiscal 2024 and 2025" in the July *Outlook Report* to "Risks to prices are skewed to the upside for fiscal 2025" in the October report. In other words, the BOJ deleted the wording for upside price risks for fiscal 2024. This change seems to reflect the pause for accelerated yen depreciation over the past three months, as well as the expected resumption of the government's measures to address high prices. The core CPI outlook for FY25 was revised downward in light of the recent decline in resource prices, but upward price risks remain.

Oct *Outlook Report*'s growth rate largely unchanged; revisions in next report?

In the October *Outlook Report*, which is an important review of economic and price conditions, the growth rate forecasts (median of majority of policy board members' forecasts) were +0.6% for FY24, +1.1% for FY25, and +1.0% for FY26, with only a slight revision for FY25. The forecasts were generally unchanged (Chart 1). Real GDP was stronger than expected for Apr-Jun FY24, but it apparently lacked the strength to accelerate in the Jul-Sep quarter due in part to weather-related factors. According to the industrial production statistics released on 31 October, the Jul-Sep quarter saw a y/y decrease of 0.4% (compared to a 2.7% increase in Apr-Jun). This figure turned negative due in part to the impact of typhoons. That said, the revised figure for the October Production Forecast Survey was +5.1% m/m and a recovery in the Oct-Dec quarter is expected. On the other hand, while the US economy is currently strong, there is also some uncertainty. The particulars of Japan's economic measures have not been determined, which makes changing the forecast figures difficult. There is the strong possibility that revisions will be made next time when there is a better grasp of economic measures along with the annual GDP figures due out from mid-December. From FY25 onwards, Japan's gradual economic growth (growth rate of around 1%) is expected to continue, even at a rate exceeding its potential growth rate[1].

In the October ESP Forecast survey of private-sector forecasts (Chart 2, 26 Sep ~ 3 Oct response period, 37 responses), the projected average real GDP was +0.55% for FY24, +1.05% for FY25, and +0.88% for FY26. For just FY26, the BOJ seems to be slightly more bullish than the private sector forecasts. Next time, based on economic measures, the Bank may become more optimistic about the future from FY25 onward.

In the October *Outlook Report*, the BOJ again cited the following three risks to economic activity and prices: (1) developments in overseas economic activity and prices and in global financial and capital markets, (2) developments in import prices, particularly those of commodities, including grains, and (3) the impact of various changes in the environment surrounding Japan on firms' and households' medium- to long-term growth expectations and on Japan's potential growth rate. In the case of (1), the Bank explained "US and European central banks have started to lower policy interest rates" and "US and European economies are likely to avoid significant slowdowns." The BOJ revised its economic activity risk balance from "skewed to the upside for fiscal 2025" in the July report to "generally balanced" in the October report.

[1] In Oct report, footnote says that "Under a specific methodology, Japan's recent potential growth rate is estimated to be in the range of 0.5-1.0 percent " (the same since Jan report). This reflects the estimated potential growth rate of +0.64% for 1H FY24 (only Apr-Jun). The rate should be interpreted with considerable latitude.

Chart 1: Forecasts of Majority of Policy Board Members

y/y % chg.

	Real GDP	CPI (all items less fresh food)	(Reference) CPI (all items less fresh food and energy)
Fiscal 2024	+0.5 to +0.7 [+0.6]	+2.4 to +2.5 [+2.5]	+1.9 to +2.1 [+2.0]
Forecasts made in July 2024	+0.5 to +0.7 [+0.6]	+2.5 to +2.6 [+2.5]	+1.8 to +2.0 [+1.9]
Fiscal 2025	+1.0 to +1.2 [+1.1]	+1.7 to +2.1 [+1.9]	+1.8 to +2.0 [+1.9]
Forecasts made in July 2024	+0.9 to +1.1 [+1.0]	+2.0 to +2.3 [+2.1]	+1.8 to +2.0 [+1.9]
Fiscal 2026	+0.8 to +1.1 [+1.0]	+1.8 to +2.0 [+1.9]	+1.9 to +2.2 [+2.1]
Forecasts made in July 2024	+0.8 to +1.0 [+1.0]	+1.8 to +2.0 [+1.9]	+1.9 to +2.2 [+2.1]

Notes: 1. Figures in brackets indicate the medians of the Policy Board members' forecasts (point estimates).

2. The forecasts of the majority of the Policy Board members are constructed as follows: each Policy Board member's forecast takes the form of a point estimate -- namely, the figure to which they attach the highest probability of realization. These forecasts are then shown as a range, with the highest figure and the lowest figure excluded. The range does not indicate the forecast errors.

3. Each Policy Board member makes their forecasts taking into account the effects of past policy decisions and with reference to views incorporated in financial markets regarding the future conduct of policy.

Source: Reprinted from BOJ materials.

Core-core CPI forecast of around 2% unchanged

However, the environment for inflation over the past three months has featured the start of 2025 wage hike announcements from some large companies, a downtrend in oil prices (WTI crude fell below $80/bbl in late Jul and is now below $70), and a moderate slide in the yen (USD/JPY rose from Y152.0-152.9/$ in late Jul to around Y153). The BOJ maintained its FY24 core CPI forecast of +2.5%, but we expect the resumption of government measures to combat inflation to result in a slight downward revision in the next *Outlook Report*. The BOJ trimmed its FY25 forecasts only for the core CPI to reflect the recent decline in resource prices. It fine-tuned its FY24 forecast for core-core inflation (a key focus for the BOJ) to +2.0%, but maintained its forecasts of +1.9% in FY25 and +2.1% in FY26. These assume that inflation clears the BOJ's 2% target, and it will need to continue monitoring whether prices align with its forecast trajectory.

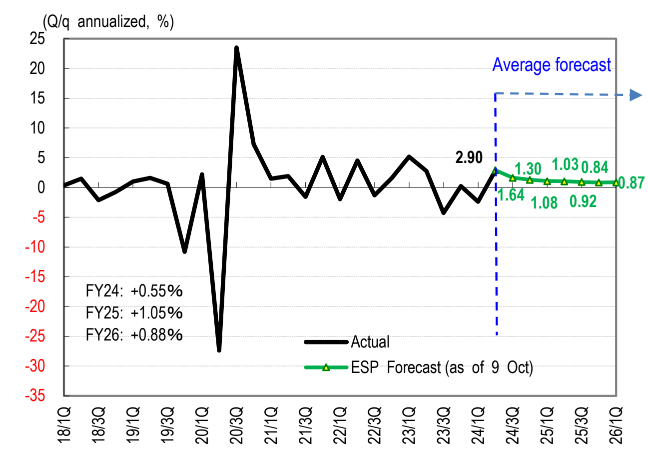
The BOJ continues to expect a gradual uptrend in underlying inflation given its expectation that "the output gap will improve and that medium- to long-term inflation expectations will rise", and it expects inflation to remain "generally consistent with the price stability target" in the second half of its forecast period. As with its economic forecasts, the BOJ's FY26 inflation estimate is higher than the average core forecast in the October ESP Forecast survey (Chart 3; +2.45% in FY24, +1.87% in FY25, +1.67% in FY26).

The BOJ continues to see two risks to inflation: (1) companies' price and wage-setting behavior, and (2) future forex movements and international commodity price trends, and their impact on import prices and domestic prices. On the balance of risks to prices, the BOJ deleted the reference to "fiscal 2024" in its July report ("risks to prices are skewed to the upside for fiscal 2024 and 2025"), and now sees risks as "skewed to the upside for fiscal 2025."

Future focus points: US economy, wages, service prices, consumer spending

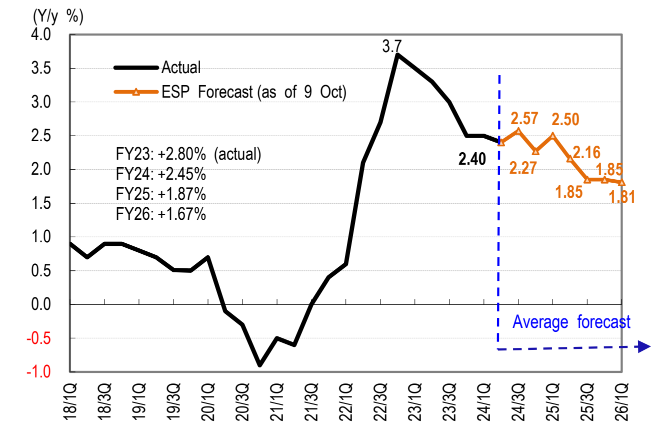
Overseas, the BOJ is watching whether the US economy can achieve a soft landing following the presidential election. We view the Christmas shopping season as a key factor in assessing this. In Japan, the BOJ is monitoring whether rising wages continue to drive up service prices. On the wage front, this year's spring labor negotiations resulted in the largest wage hikes in 33 years (+5.10%, as per the Japanese Trade Union Confederation's (Rengo) final-round tabulation of employers' responses). The Monthly Labour Survey shows that scheduled cash earnings (full-time workers) at continuously surveyed firms rose 2.7% in June, 3.0% in July, and 2.9% in August. The BOJ's discussion of the outlook for prices notes that "nominal wages have increased clearly."

Chart 2: Japan's Real GDP Growth Rate Forecasts



Source: Cabinet Office, Japan Center for Economic Research; compiled by Daiwa.

Chart 3: Japan's Core CPI Forecasts



Source: Ministry of Internal Affairs and Communications, Japan Center for Economic Research; compiled by Daiwa.

We expect scheduled cash earnings to continue rising by around 3% in September and beyond. The resumption of government measures to counter inflation will likely result in slight growth in real wages in Sep-Nov, although the rate is expected to be near to zero. The October BOJ branch managers' report[2] confirmed that wage increases are spreading to small and medium-sized enterprises (SMEs). It is clear that the BOJ not only waits for data to be released, but also proactively uses information from its own hearings to grasp (emphasize) changing situations. As for the 2025 wage increase rate target, it was reported on 16 October that "The policy is to increase wages by at least 5% including regular wage increases, and at least 3% for basic salary, the same level as that from the 2024 spring labor-management wage talks." So, it is highly likely that wage hikes will continue ahead of the 2025 spring labor-management wage negotiations.

The BOJ's September Tankan survey confirmed that the sense of labor shortages driving higher wages has persisted, with the employment conditions DI pointing to increasingly "insufficient employment." Meanwhile, the output prices DI for small companies continues to rise, and the outlook is particularly bullish, with the passing of higher costs to prices. In addition, the corporate price outlook in the Bank's Tankan survey remains above 2%. That is a desirable state for the BOJ, which wants to anchor inflation expectations at 2%, as in the US and Europe. The CPI data for Tokyo's 23 wards (released on 25 Oct) showed that 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. That said, 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. 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.

[2] *Economic Commentary*: BOJ branch managers report / Further yen weakening ahead of US/Japan elections (8 Oct 2024).

We will be looking for evidence of broader-based wage growth ahead of next year's spring labor negotiations, and look to confirm whether the move to pass on rising costs driven by labor shortages spreads to service prices. However, weak consumer spending caused by rising prices is a concern in terms of the balance between the economy and inflation. Our base case would be for consumer spending to remain firm over the long term as income conditions improve. Inflation and consumer spending remain key checkpoints for the BOJ in assessing whether its 2% price stability target is being achieved a sustainable and stable manner.

Governor Ueda's closely-watched press conference: No more mentions of "enough time"?

Finally, the market will again be watching BOJ Governor Kazuo Ueda's comments at the post-meeting press conference. BOJ governors' comments at these regular press conferences have in the past spurred a slide in the yen on numerous occasions. Since the September MPM, Mr. Ueda has repeatedly argued that the BOJ has "enough time" to decide whether to raise interest rates. It is unclear whether he had only the October MPM and the outlook for Japan and US elections in mind. The market tended to view his statement as meaning that there would be no rate hike at the next MPM. We will be watching to see if the BOJ revises its wording to prevent this interpretation from taking hold. We think it would be better to do so.

The last four opinions on monetary policy conduct in the Summary of Opinions from the September MPM noted the need to "carefully" communicate information about the BOJ's policy stance, changes in its view of the economy in response to developments in economic conditions, the underlying inflation picture, the outlook for economic activity and prices, the risks surrounding them, and the likelihood of realizing the outlook. Given that forex rates are part of the BOJ's policy reaction functions, it is entirely possible that a slide in the yen to above Y155/$ could trigger renewed expectations for another rate hike. We think the BOJ's communication skills will remain under the microscope. We hope to see it communicate carefully during the key period between the US presidential election result and the December MPM.

Corporate Name: Daiwa Securities Co. Ltd.
Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108
Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association