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Daiwa's Economic View

Analysis of BOJ ahead of 2025

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BOJ in 2024: Implemented two interest rate hikes without delay

The year 2024 will come to an end in just 16 days. First, we would like to take a brief look back on the BOJ in 2024. At its December 2023 meeting, the BOJ provided no response to the growing speculation on the market (for a rate hike). Furthermore, a powerful earthquake hit the Noto Peninsula at the start of the new year. Still, despite those developments, the Bank stated in its January 2024 *Outlook Report* that the probability of achieving its price forecast has "continued to gradually rise." In this manner, it provided clear indications of a likely policy revision in the spring. Then, in his 8 February speech[1], BOJ Deputy Governor Shinichi Uchida summarized and conveyed the Bank's basic thinking on potential policy revisions. Apparently, data-oriented BOJ Governor Ueda decided to hike rates after confirming that, according to the first tally of wage negotiation responses by Japanese Trade Union Confederation (Rengo) as of 15 March, its member unions won an average wage hike of 5.28% (3.80% hike last year). This was the first hike of more than 5% in 33 years and much stronger than expected. The statement announcing the decision to end Japan's negative interest rate policy on 19 March clearly stated that the decision was made based on "recent data and anecdotal information (hearings)." This suggested that information from hearings is important material.

From April onwards, the market struggled to determine when the BOJ would reduce its purchases of JGBs and make another interest rate hike. Amid such conditions, the yen weakened following comments from BOJ Governor Ueda at his 26 April post-meeting press conference. At the June meeting, a decision was made only regarding the Bank's JGB purchase reduction policy. When foreign exchange market intervention was carried out in mid-July, the ball was tossed into the BOJ's court (Bank expected to play its role) and momentum for the normalization of monetary policy increased even within the ruling LDP. At the July meeting[2], decisions were made to again hike interest rates and reduce the Bank's JGB purchasing plan. This confirmed that the BOJ's policy reaction functions include exchange rates and that the Bank can more easily take action when it has political support. In its July statement, the BOJ clearly laid out its intention to gradually raise the policy interest rate to the neutral interest rate level against the backdrop of low real interest rates.

Trauma of summer 2024 market turmoil one reason why BOJ in no hurry to hike rates

The summer 2024 market turmoil that followed was due to the BOJ's hawkish stance, as well as concerns about a US economic downturn and strengthening expectations for a Fed rate cut in response to the weak July US jobs report released on 2 August. The sudden movement to close out the accumulated yen-selling positions led to a stronger yen and weaker stock prices. The market trauma of 2024 is probably one reason why the BOJ is not in a hurry to hike interest rates. Taking into account the US and Japanese elections set for the autumn, Ueda said at his 20 September post-meeting press conference[3] that "we have enough time" in determining the next interest rate hike. However, he did not use this expression during his 31 October post-meeting press conference[4], which can be seen as giving the Bank a free hand in its future policy decisions.

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[1] The BOJ's decision was in line with the content of this speech and the market began to place more importance on comments from Uchida.
[2] *Iwashita's Economic & Market Watch:* BOJ decides to further raise interest rates without delay (31 Jul 2024).
[3] *Daiwa's Economic View*: Ueda BOJ in no rush, assessing US economy (24 Sep 2024).
[4] *Daiwa's Economic View*: Ueda's Oct press conference: No longer using "enough time" phrase (1 Nov 2024).

Japan's political instability, hard for BOJ to act when budget priorities are high

The ruling coalition (LDP + Komeito) lost its majority of Lower House seats in the 27 October election. In order to reach a partial agreement to cooperate with the opposition Democratic Party for the People (DPFP), the government must address a decrease in tax revenue brought about by a revision of the annual income ceiling (amount of income exempt from income tax). As a result, preparations for the FY25 budget have been delayed. The three parties have agreed to review the income ceiling, but they have not yet agreed on how high to raise it. Normally, the outline of taxation would be announced by around 15 December, but there is no indication of when this will happen. It looks like a Cabinet decision on the FY25 budget will be made just before the end of this calendar year. With budget (fiscal policy) priorities at the forefront, the BOJ will probably struggle to take action until a resolution is reached. We think this could be one of the reasons why the BOJ did not want the market to factor in a December interest rate hike. Meanwhile, with the Upper House election set for July 2025, there is the view that the passage of the FY25 budget around the middle of March will be a milestone for Prime Minister Shigeru Ishiba. Such political instability is likely to continue for some time, but it seems like monetary policy will be left to the BOJ for now.

Developments outside of Japan in 2024: US economy remained resilient

Meanwhile, US economy has been resilient, proving again this year that "what happens twice, happens three times." In the US, the annual revision of GDP announced on 26 September pointed to high productivity after the aforementioned summer turmoil. This led to a change in the view that employment growth is slowing. Since October, it seems that there has been a shared recognition that the possibility of a soft landing for the US economy has increased, based on comments from Fed Chairman Jerome Powell and views about the US economy expressed at international conferences. In 2024, we keenly realized that, amid the global fragmentation, the US has some relative advantages in such areas as energy, military, and AI, which have allowed its economy to remain resilient. The US as the sole "economic winner" is also evident in the flow of funds (rising stock prices). Meanwhile, the much-watched 5 November US presidential election ended with a surprisingly easy victory for Trump. In both Japan and the US, we can assume that public dissatisfaction due to high prices has led to a decline in support for the current US and Japan administrations.

Even though markets are wary of "Trump 2.0" policies, it is important to remember that the US economy is solid and inflationary pressures remain sticky. The incoming Trump administration will accelerate the use of tariffs and measures against illegal immigration that are possible under presidential authority. However, Trump's administration surely recognizes that high tariffs increase inflationary pressures, which leads to public dissatisfaction. Also, the strength of the global IT cycle[5] (demand expected to remain strong until around 2026) means that a major expansion of US finances is probably not necessary. Still, it seems likely that the strength of the US economy will continue in 2025 due to tax cuts, deregulation, and support for the country's energy industry. It is important to analyze the US economy in 2025, while understanding the strengths that are unique to the US.

Beware market trend changes due to "Trump 2.0"

At this moment, markets are expecting that the second Trump administration will extend tax cuts, but not provide excessive government spending, while taking care not to increase inflationary pressures. As such, there is no upward pressure on long-term UST yields and pressure for a stronger dollar is not increasing. However, if the US economy stays strong, we should probably keep in mind that a pause for interest rate cuts (around 4.0% for FF rate) could come into view by the middle of 2025 with the dollar remaining at an elevated level. We need to be on guard for the possibility of changes for UST yields and exchange rate trends in the future. Meanwhile, our concern from this autumn and beyond is potential weakness for the European economy in the face of the America's unchallenged dominance. The German, which is particularly dependent on China, is not performing very well. At the 12 December ECB board meeting, a 50bp interest rate cut was reportedly discussed as an option. Also, the current collapse of the Assad regime in Syria and the passage of a resolution to impeach the South Korean president have led to instability in

[5] Box 1 in the BOJ's October 2024 *Outlook Report* explains the IT cycle trends.

the Middle East and on the Korean Peninsula, respectively. Inevitably, we will have to keep an eye on such geopolitical risks in 2025.

BOJ communicating carefully ahead of December MPM

On 30 November, the *Nikkei* carried an exclusive interview with BOJ Governor Kazuo Ueda[6]. (The interview itself was conducted on the 28th.) With only one official speaking engagement (a speech by Policy Board member Toyoaki Nakamura on 5 Dec) scheduled before the 18-19 December Monetary Policy Meeting (MPM), we feel it was good that the BOJ made an effort to communicate clearly. What can be gleaned from the interview is that, with domestic indicators determining the BOJ's thinking regarding rate hikes being in line with its forecasts, the BOJ is beginning to lay the groundwork for another hike. However, the bank is less confident regarding US factors.

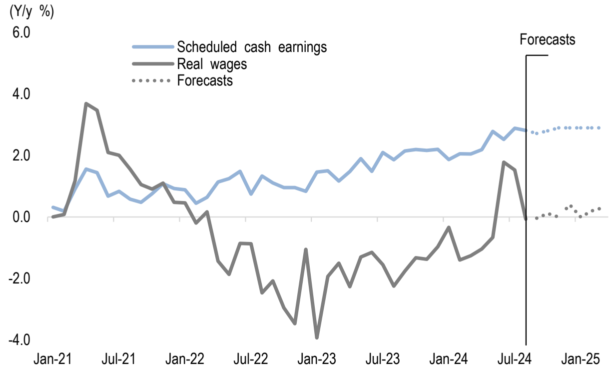
During BOJ Governor Kazuo Ueda's post-MPM regular press conference on 31 October, he said that "Even if the US economy remains strong for now, new risks may emerge depending on the next US president." In response to a question during the *Nikkei* interview regarding whether the BOJ is close to raising rates again, he noted that "we can say that [a rate hike] is approaching in the sense that economic data are on track to meet our forecasts, but the outlook for US economic policy is a major question mark." While tariffs are making headlines, it will take time to gauge their impact. The BOJ has yet to decide whether to wait until the major question marks about the outlook become smaller question marks, or opt for market stability before new risks emerge. It appeared that the BOJ is in no hurry to raise interest rates, and reluctant to create the impression that a December rate hike is a fait accompli.

At 9:28 on the morning of 4 December, Jiji Press released an article titled "BOJ to carefully assess US economy, other factors = postponing year-end rate hike." The part of the article that said, "There is a sense of confusion about the prospect of a December interest rate hike" resonated with the author. This seems to suggest that policy management is influenced by the subtleties of human emotion. Information is not free (= result of accumulated effort). Meanwhile, one point of concern is that the wording, "A decision to raise interest rates will be made at the January meeting or later," suggests that there is still the possibility that the Bank will be unable to make a decision even in January. The BOJ likely wants to avoid making hasty decisions because it intends to proceed with rate hikes slowly and gradually.

Domestic focus is sustainability of wage hikes

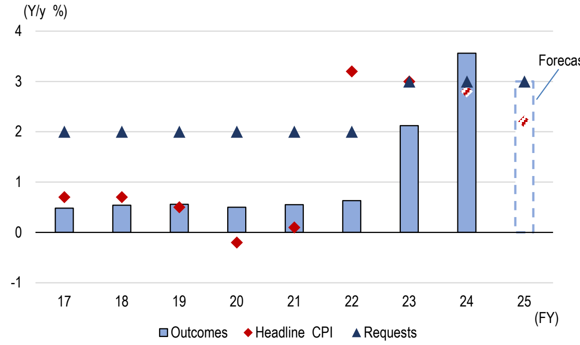
Mr. Ueda explained that "the results of the 2024 spring labor negotiations are feeding into the Monthly Labour Survey data as expected. Growth in scheduled cash earnings is between 2.5-3%, broadly consistent with long-term consumer price index (CPI) inflation of 2%. The key point will be whether this continues"; and "if goods inflation slows a little further, real wages should pick up slightly, supporting consumer spending". Scheduled cash earnings (Chart 1) remain a key monthly metric.

Chart 1: Nominal Wages, Real Wages



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

Chart 2: Outcomes of Spring Wage Negotiations (base pay hikes, forecast)



Source: Japanese Trade Union Confederation, Ministry of Internal Affairs and Communications, Cabinet Office; compiled by Daiwa.
Note: FY24 and FY25 headline CPI figures based on mid-FY24 Cabinet Office simulation.

[6] *Economic Commentary: Analyzing Governor Ueda's interview* (2 Dec 2024).

On the subject of the 2025 spring labor negotiations, Mr. Ueda also noted that "we want to see how much momentum comes out of them, and we will not be able to confirm that for a while, but it is not as if monetary policy decisions are on hold until then". Targets for the FY25 negotiations are "at least 5% (incl. regular pay increases) and at least 3% base pay hikes, in line with 2024", suggesting that wages are likely to continue rising (Chart 2).

Dec Tankan serves as factor supporting view that Japan's economy is on track

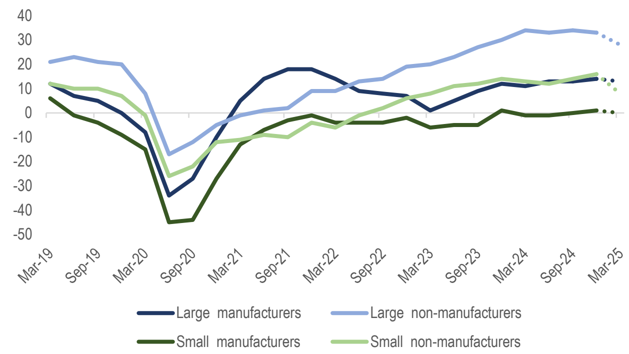
On 13 December, the BOJ released its December Tankan survey, which confirmed that the Japanese economy is on track[7]. Large companies and small non-manufacturers have steadily continued passing on higher prices (excl. small manufacturers). The business conditions DI worsened for large non-manufacturers but improved for large manufacturers and small firms, a favorable result overall.

The employment conditions DI (for companies of all sizes and all industries) came in at -36, suggesting that there continues to be a strong sense that there is a labor shortage. Forecast DIs confirmed that this feeling is intensifying at many firms targeted by the survey, regardless of company size or industry. Considering that employment conditions are tight, particularly at SMEs, we can say that it is highly likely that the continuation of wage hikes during 2025 spring wage negotiations, mainly at large firms, will spread to many companies (incl. SMEs).

That said, it is very likely that the December survey has not yet factored in uncertainties that will stem from the policies of Trump 2.0. The business conditions DI at large automakers, which are seen as susceptible to high tariffs, improved to +8 (from +7 in the previous survey), and the forecast DI improved to +11. We need to keep in mind that the policies of Trump 2.0 could have an impact on corporate trends that are currently favorable.

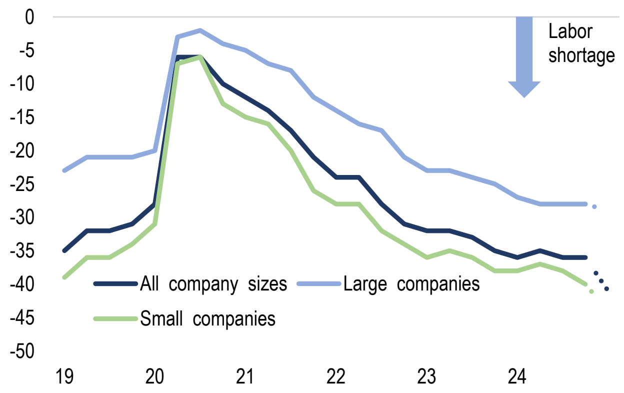
The supply-demand balance for products and services at large manufacturers showed a deterioration of -2 in both domestic and external demand, while small manufacturers had a -1 deterioration in external demand. This was probably due to weakness in the European and Chinese economies. Although supply-demand should improve going forward and corporate sentiment is not presently weak, be aware that continued weakness in external demand could deteriorate business conditions.

Chart 3: Business Conditions DI (by company size, industry)



Source: BOJ; compiled by Daiwa.
Note: Dotted lines indicate forecast DI in Dec survey.

Chart 4: Employment Conditions DI



Source: BOJ; compiled by Daiwa.
Note: Dotted lines indicate forecast DI in Dec survey.

BOJ to forego rate hike at last MPM in 2024

Before the 13th, prior to the blackout period for the BOJ's December policy meeting, the BOJ held a briefing for the press, and the media reported on that briefing with quotes from BOJ officials. On the evening of the 11th, Bloomberg reported, "The BOJ is in no rush to hike rates, and sees low risk of inflation accelerating even if there is no rate hike this month, according to sources," and on the 12th at 2:30 PM, Reuters reported, "The BOJ will assess the situation until just before

[7] *Economic Commentary*: Context before the BOJ's Dec policy meeting, analysis of Tankan (13 Dec 2024).

December meeting as the argument for postponing a rate hike has strengthened, according to sources." Neither story repudiated the Jiji Press article on the 4th suggesting the possibility of no more rate hikes this year, an indication that bank staff is not in a hurry to hike. However, there was new information indicating there are board members leaning toward a December rate hike. They are likely considering early action out of concern that waiting to assess Trump risks could make it hard to act. That said, it is unlikely they would oppose the chairman's proposal to maintain the status quo. If the purpose of Governor Ueda's interview in the *Nikkei* on 30 November was to reduce market expectations for a December rate hike, the BOJ got what it wanted. It is hard to imagine the BOJ making a decision that would change this trend.

On the morning of the 19th, the second day of the Monetary Policy Meeting in December, a press conference will be held by Fed Chair Jerome Powell (with a hawkish outlook anticipated regarding rate cuts), together with the announcement of the results of the December FOMC meeting (at which a 25bp rate cut is anticipated), as well as economic/price projections and the dot plot (regarding which a slowdown in the pace of rate cuts in 2025 and an upward revision to the neutral interest rate are anticipated). This will provide an important opportunity for the market and the BOJ to confirm the rate cut path the Fed will take in the future. The BOJ is likely to forego a rate hike at the December meeting, but the USD/JPY rate is at the upper half of the Y153.0 level. The strong dollar/weak yen sentiment continues, driven by expectations that the US will slow the pace of rate cuts next year and the BOJ will put off hiking rates as it assesses risks from the Trump presidency. Attention is likely warranted regarding further appreciation of the dollar (depreciation of the yen), including after the Christmas holiday.

Additional rate hike by BOJ expected during Jan-Mar 2025, after situation in US has been confirmed

If the BOJ waits until its next meeting on 23-24 January 2025, it will have opportunities to disseminate more information to the market. Such information includes Governor Ueda's 25 December speech before the Japan Business Federation (Keidanren), the January BOJ branch managers' meeting report, and the 14 January speech by BOJ Deputy Governor Ryozo Himino (in Yokohama). During the year-end and New Year period, an increasing number of comments are made by corporate managers ahead of spring wage negotiations. Any changes in the likelihood of BOJ rate hikes would be conveyed via such information. If the Bank insists on a cautious approach, a rate hike in January, when the BOJ releases its *Outlook Report* (accounting for economic measures), would become the likely choice.

That said, even though the BOJ is on track with its outlook for Japan's economic and price trends, and even though the current situation in the US is within expectations, the Bank is also concerned about the impact of the policies of the incoming Trump administration (= Trump risk). If the BOJ waits to determine whether this large question mark hanging over the future will become smaller question mark, it will need to confirm various policy measures in Trump's State of the Union Address, budget messaging, and other communications after his 20 January inauguration. If the BOJ chooses to avoid hasty decisions and proceed slowly within the scope of what it can do (within current fiscal year), there is the possibility that it could potentially wait until the 18-19 March 2025 meeting to hike rates. With Japan's economy on track, the BOJ is exploring the possibility of a rate hike by the end of FY24. We think the timing has not been decided yet. All we can do is keep a close eye on information from the BOJ, while monitoring upcoming data.

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