Daiwa's Economic View

BOJ's final answer in 2024 and broad-perspective review of monetary policy

- BOJ decides to stand pat at Dec 2024 meeting, but board member Tamura proposes rate hike
  In 2025, US rate cutting to slow, while BOJ rate hiking policy continues
  Decision on additional interest rate hike likely in Jan-Mar, depending on wages, US economy
- Historic broad-perspective review of monetary policy
  Suggests unconventional monetary policy will remain an exceptional measure
  Implications for conduct of future monetary policy include ensuring of some room to maneuver

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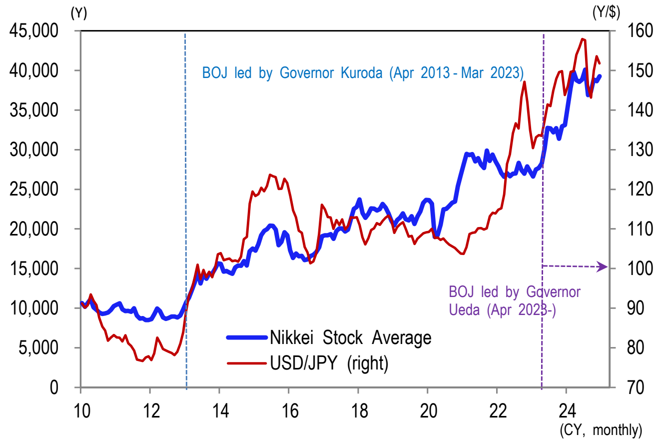
BOJ decides to postpone rate hike at last BOJ meeting of 2024

At its 18-19 December Monetary Policy Meeting (MPM), the BOJ decided by majority vote to maintain the status quo. Board member Naoki Tamura, however, proposed hiking the policy interest rate to 0.50% (paving way for such a hike from next meeting onward?). A key event this time was the release of the Bank's "Review of Monetary Policy from a Broad Perspective (explained below)." Various media reports just before this meeting did not refute the 4 December Jiji Press article that said the BOJ would "postpone year-end rate hike." Those media reports used such phrases as "no rush to hike rates" and "postponing a rate hike" to convey that the Bank was unlikely to make a big move at the December meeting.

A decision to lower interest rates by 25bp was made at the December FOMC meeting. The Fed also announced on the morning of 19 December an upward revision for its inflation forecast for 2025 onwards, reducing the number of expected rate cuts to two (from four previously) and raising the neutral interest rate to 3.0%. The market interpreted the rate cut as a hawkish move and the 10-year UST yield rose to 4.5%. Meanwhile, the yen weakened and has hovered just above USD/JPY155 after the BOJ's meeting (Chart 1). In 2024, the US economy was resilient and the inflation rate remained persistently high. Amid such conditions, the start of the new year will also likely entail some difficulties reading the "Trump 2.0" impacts.

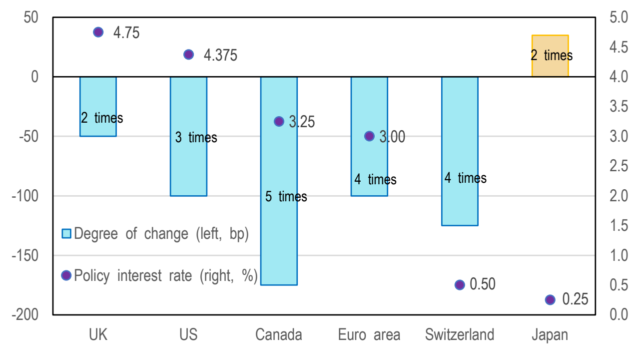
In 2024, while most major central banks were cutting interest rates (Chart 2), the BOJ decided in March to eliminate negative interest rates (lifting its policy interest rate to 0.0%) and end its yield curve control (YCC) policy. Then in July, it again raised rates and announced plans to reduce its JGB purchases. 2024 was a year in which the vector for Japan's policy interest rate differed from that of other countries and regions. Still, the BOJ managed to adjust the degree of monetary easing in response to economic and price conditions (with two interest rate hikes). We believe that these hikes were made possible mainly due to changes in the wage- and price-setting behavior among Japanese companies and because fears of a hard landing for the US economy, which the market was concerned about at the start of 2024, proved to be unfounded. That said, the market turmoil in August was traumatic. We will need to carefully monitor conditions in the US in 2025 to avoid misreading the situation.

Chart 1: Nikkei Stock Average, USD/JPY Rate (from 2010)



Source: Bloomberg; compiled by Daiwa.
Note: Dec 2024 data uses average through the 18th.

Chart 2: Number of Policy Interest Rates Changes, Degree of Change for Six Major Central Banks (2024)



Source: Central banks' data; compiled by Daiwa.
Note: Policy interest rates as of 14:00 on 19 Dec 2024 (JST).

BOJ to continue hiking in 2025; Jan-Mar will be key

The December MPM statement contained no new hints, as expected. Based on the BOJ's assessment of the current state of the economy and outlook, it looks to have made only minor tweaks to its view, suggesting that the economy is on track with its forecasts (Chart 3). Given policy board member Naoki Tamura's suggestion that the BOJ should raise interest rates to address the risk of an inflation overshoot, we will be watching Governor Kazuo Ueda's comments at the press conference about its reasons for foregoing a hike at the December meeting. This will be a key opportunity to confirm whether his views on the potential for further rate hikes have changed in the three weeks since his *Nikkei* interview (interview conducted on 28 Nov, article published 30 Nov).

The BOJ has more opportunities to communicate with the market ahead of the next MPM (23-24 Jan 2025), including Mr. Ueda's 25 December speech to Keidanren, the 27 December Summary of Opinions from the December MPM (which will tell us if board members other than Mr. Tamura favored a rate hike), the 9 January report from the BOJ branch managers' meeting, and Deputy Governor Ryozo Himino's 14 January speech in Yokohama. The year-end holidays also typically feature more messaging from corporate leaders about the spring labor negotiations. The market will likely pick up on any changes in their conviction. Given the possibility that the BOJ's focus on careful communication could prolong conditions conducive to a weaker yen, we see the most likely outcome as a rate hike in January, when the BOJ will release its *Outlook for Economic Activity and Prices* report (*Outlook Report*) that factors in the upcoming government stimulus package.

However, the BOJ is also undoubtedly concerned about the impact of Trump administration policies and the risk from Trump 2.0. If it opts to wait for the major question mark about the outlook to become a smaller question mark, it will need to confirm the specifics of President Trump's policies via his State of the Union and budget speeches after he takes office on 20 January. If the BOJ opts to avoid a hasty judgement and proceed cautiously as far as possible (within FY24), we think it could wait until the March 18-19 MPM to raise rates again.

Chart 3: Changes in BOJ's Assessment of Current Economic Conditions, Outlook, and Risk Factors

		Dec 2024
Current conditions		Red lettering indicates corrections and additions. ⇒ indicates status of revisions from Oct to Dec.
	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 have been on an improving trend ⇒ Previous "improving" downgraded to "improving trend."
	Private consumption	Has been on a moderate increasing trend despite the impact of price rises and other factors. ⇒Unchanged
	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 2.0-2.5 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 downwards from "around 2.5 percent" in Oct to "range of 2.0-2.5 percent" in Dec. 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, 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 October 2024 *Outlook for Economic Activity and Prices*, underlying CPI inflation is likely to be at a level that is generally consistent with the price stability target. Through fiscal 2025, it is also expected that a dissipation of the effects of the government's measures pushing down inflation will make a positive contribution to the y/y rate of increase in the CPI (all items less fresh food), whereas factors such as the past decline in crude oil and other resource prices will make a negative contribution.
Risk factors		There remain high uncertainties surrounding Japan's economic activity and prices, including developments in overseas economic activity and prices, developments in commodity prices, and domestic firms' wage- and price-setting behavior. Under these circumstances, it is necessary to pay due attention to developments in financial and foreign exchange markets and their impact on Japan's economic activity and prices. In particular, with firms' behavior shifting more toward raising wages and prices recently, exchange rate developments are, compared to the past, more likely to affect prices.

Source: BOJ; compiled by Daiwa.

Implications of BOJ's historic policy review include ensuring of some room to maneuver

Alongside the December MPM, the BOJ released its Review of Monetary Policy from a Broad Perspective, which analyzed the impact of unconventional monetary policy tools over the past 25 years, including their side effects. Mr. Ueda commented at his regular press conference following the October MPM that the review would not include anything that would immediately affect its near-term policy conduct, and that it would offer useful information in considering future monetary policy. The key points of the review conclude with the strongly worded heading "Implications for the Future Conduct of Monetary Policy".

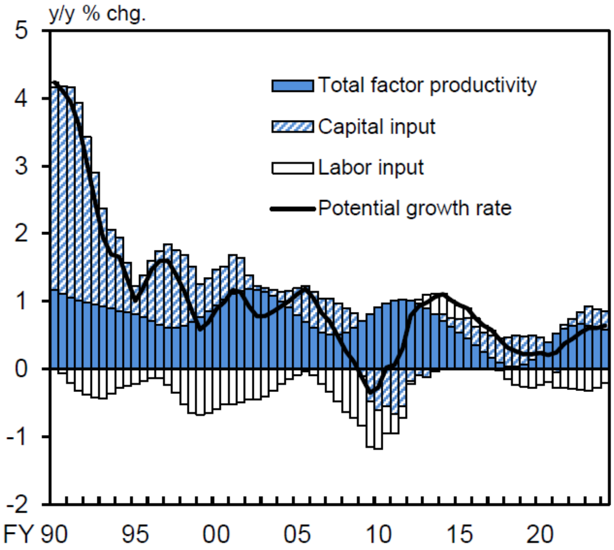
The review noted the overall positive impact on the Japanese economy from large-scale monetary easing despite some side effects, but noted that "the negative effects may become larger in the future". It also noted that while future monetary policy conduct will mainly focus on controlling short-term interest rates, it does not rule out the use of unconventional monetary policy tools if it judges that the benefits outweigh the costs.

This implies that it could deploy unconventional policy in the event of a global shock that occurs while it is unable to raise the policy rate. However, it also notes that "Given that unconventional monetary policy measures cannot fully substitute for conventional monetary policy measures (guiding short-term interest rates), it is desirable to conduct monetary policy so that the zero lower bound would not be reached." We surmise that this signals the BOJ's wish to use control of short-term rates as its main monetary policy tool, and to raise the policy rate while it can (while maintaining accommodative real interest rates) to ensure it has room to maneuver.

The review confirmed that while unconventional monetary policy tools boosted economic activity and prices, they had less of an impact than initially expected, and there were also side effects such as a decline in the functioning of the JGB market, narrower loan spreads, and distortions in resource allocation. The report notes the possibility that the negative effects may become larger—(1) the functioning of the JGB market may not fully recover and (2) substantial changes in external conditions could impede financial intermediation. It notes that "the Bank should not exclude at this point any specific measures when considering the future conduct of monetary policy. However...in considering the implementation of unconventional monetary policy measures, it will be necessary for the Bank to design policy measures that can exert positive effects while minimizing side effects as much as possible," suggesting that it will only deploy unconventional monetary policy tools in exceptional circumstances.

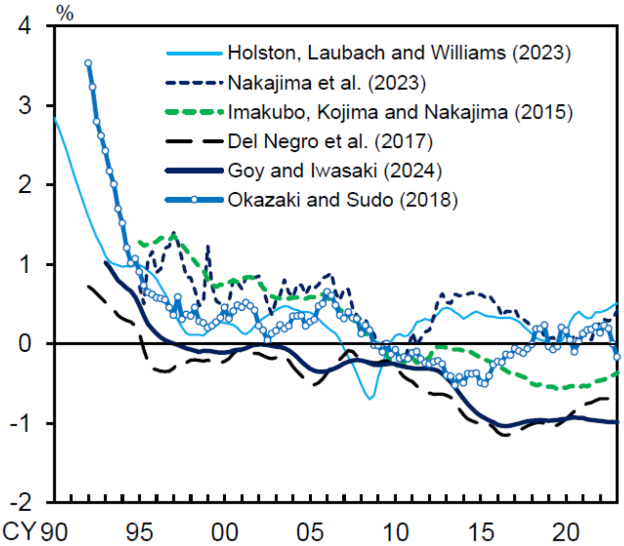
The review also noted that "the following issues are also important: whether efforts including the progress in addressing digital transformation (DX) and green transformation (GX) will raise productivity; whether the behavior of firms...will change with a more aggressive spending attitude; and whether the potential growth rate will increase along with these changes." It also noted the need to watch for factors such as "a changing trend of globalization". A long-term perspective on productivity and other factors will be needed in gauging the neutral policy rate, as well as the recent virtuous cycle of wages and prices.

Chart 4: Potential Growth Rate



Source: Reprinted from BOJ materials.

Chart 5: Natural Rate of Interest



Source: Reprinted from BOJ materials.

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