Daiwa Securities

Economic Commentary

BOJ's Ueda speaks at Keidanren, key trends to take root in 2025

- Steady progress toward achieving "price stability target" in 2024
  Now monitoring economic policies of next US administration, spring 2025 labor-management wage talks
  Wage hikes to take hold, BOJ to continue raising interest rates in 2025
- Corp behavior/productivity and neutral policy rate level as key points
  Suppression of forward-looking investments negatively impacted Japan's growth
  Positive corporate behavior and realization of 2% price target will lead to increase in Japan's growth potential

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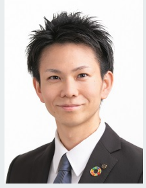

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BOJ Ueda's speaks at Keidanren (any Christmas presents?)

Every year, the BOJ governor delivers a speech at the Japan Business Federation (Keidanren), Japan's largest business lobby, during the final week of the year. That speech usually explains the medium- to long-term outlook for the Japanese economy. The title for the 2024 speech was "Achievement of the 2% Price Stability Target and Japan's Economy," which left the impression that Bank is now closer to realizing that objective as compared to the time of the December 2023 speech (titled "Wages and Prices: Past, Present, and Future"). Ueda said at the beginning of his speech, "I believe that 2024 has been a year of steady progress toward achieving the price stability target in a sustainable and stable manner, with a virtuous cycle between wages and prices gradually intensifying." He added that Japan's economy is expected to move even closer to sustainable and stable 2% inflation in 2025. These trends suggest that the BOJ's interest rate hiking policy will continue.

With Ueda's speech falling on 25 December, some people were hoping that he would deliver a "Christmas present." However, less than a week had passed since the December Monetary Policy Meeting (19 Dec vote). So, in the absence of any new important materials, it was natural for Ueda to repeat the content of his December post-meeting press conference[1]. Still, the yen extended its decline to a USD/JPY157.0-157.5 range after the BOJ maintained its policy stance and did not clarify when it would hike interest rates. The yen is likely to remain week as long as the BOJ continues to make cautious decisions without rushing to raise interest rates. While the exchange rate is certainly one of the BOJ's policy reaction functions, there is a certain time lag in terms of the impact on prices. When the Bank decided to again raise interest rates in July 2024, the import price index (yen-based) for June was up 9.6% y/y, but the most recent figure for November was down 1.2%, indicating a very different situation. This is another good reason for the Bank to proceed cautiously. Even so, the risk of prices rising more due to the further yen depreciation (or prolonged depreciation) must be taken into account.

As the final topic of his speech, Ueda raised two points regarding the future conduct of monetary policy. The first point is, "The Bank will maintain accommodative financial conditions by keeping the policy interest rate lower than the neutral interest rate (level that is neutral to economic activity and prices) and will thereby firmly support the economy." The second point is, "If economic activity and prices continue to improve, the Bank will accordingly need to raise the policy interest rate and adjust the degree of monetary accommodation." These two points are not new as, at the time of the July 2024 interest rate hike, the BOJ explained that the real interest rate was significantly negative and considerably lower than the neutral interest rate. The timing and pace of adjustments to the degree of easing will depend on future economic and price conditions. For now, the economic policies of the incoming Trump administration and Japan's spring 2025 labor-management wage negotiations are the major points. Regarding these negotiations, Ueda said, "Chairman Tokura of Keidanren noted at a recent press conference that strong momentum for wage hikes began in 2023, and this momentum accelerated significantly in 2024. He continued that, in 2025, he hopes to see this development take hold and achieve structural wage hikes. I fully share his aspiration." 2025 is expected to be a year in which BOJ policy normalization will progress due to wage hikes taking hold. At the January 2025 BOJ branch managers' meeting, information on wages from company hearings will be an important resource.

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[1] *Daiwa's Economic View*: Ueda's Dec press conference: BOJ needs a little more data (20 Dec 2024).

Corp behavior/productivity and neutral policy rate level as key points

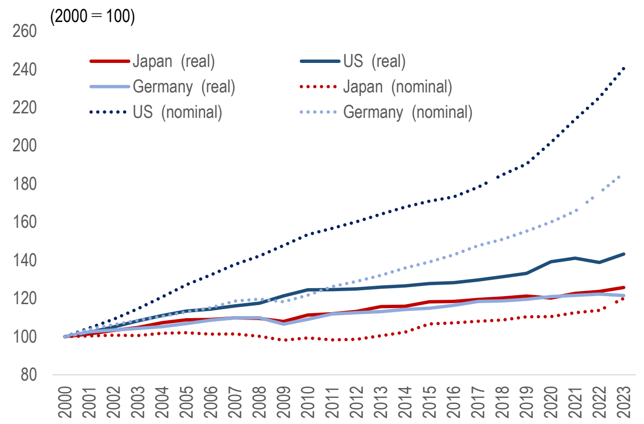
In his speech, Ueda first looked back on the economy during the past period of deflation and low inflation, and then mentioned the following as factors that contributed to the situation in which prices did not easily increase in Japan for a prolonged period: (1) Cautious corporate behavior due to factors such as declining expectations of growth (demand side), (2) Increase in cheap imports, technological innovation in IT and other fields, and downward pressure on prices caused by a strong yen (supply side), and (3) Establishment of practices and ways of thinking based on the premise that wages and prices are unlikely to rise. Furthermore, against this background, investment in facilities prioritizing cost-cutting became the main focus and, while labor productivity increased due to efficiency improvements, the suppression of forward-looking investment had a negative impact on terms of trade and Japan's growth.

The labor productivity mentioned above indicates real labor productivity. As the name suggests, this is labor productivity that takes into account the effects of price fluctuations. It is often calculated by dividing real GDP by the amount of labor input. This growth in real labor productivity is on a par with other countries, but it is important to note that the growth in Japan's nominal labor productivity, which is calculated by dividing nominal GDP by the amount of labor input, is significantly lower than that of other countries.

A situation in which nominal labor productivity does not increase despite increasing real labor productivity indicates that higher costs are not being passed on to prices to the same extent as that in other countries. As such, we can possibly assume that Japan's international superiority (competitiveness) is declining. Under these circumstances, the terms of trade are impacted by factors such as the price of energy and other imports. Here, as real wages are susceptible to external factors, this can have a negative impact on the stable growth of domestic demand, centered on private consumption.

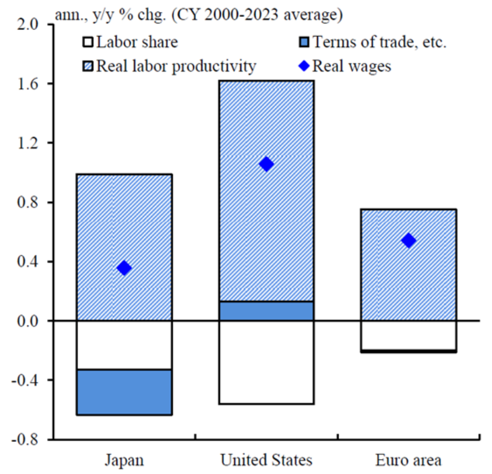
During his speech, Ueda said that realization of the 2% inflation target would lead to (1) greater room for monetary policy to stabilize the economy, (2) more positive corporate behavior, and (3) changes in household spending behavior and asset selection focused on cash and deposits. Of these, in particular, changes in corporate behavior could be a factor boosting Japan's growth potential by increasing international competitiveness through the promotion of investment in R&D and other areas, and by increasing labor productivity in both nominal and real terms. These possible changes can be viewed as background to the BOJ's goal of achieving its 2% price target under a virtuous cycle of higher wages leading to higher prices, without returning to an era of deflation and low inflation. This will be an important perspective when considering the neutral level of the Bank's policy interest rate toward the end of FY25.

Chart 1: Labor Productivity



Source: OECD. Stat; compiled by Daiwa.
Note: Calculated using the formula "GDP / (number of employees x hours worked per capita)".
Real labor productivity is compared using PPP rates.

Chart 2: Contributions to Changes in Real Wages



Source: Reprinted from BOJ materials.

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