Daiwa Securities

Economic Commentary

Bracing for 2025: Direction for the world and Japan

- “Trump 2.0” impacts as main theme for 2025
  How long can US remain sole winner (in terms of economy, strong dollar, high stock prices) continue?
  Major focus in Japan is how many more interest rate hikes are possible
- BOJ’s Ueda lacking sense of urgency (for rate hike) ahead of Jan meeting
  Summary of Opinions from Dec BOJ meeting lacks sense urgency for hiking rates

  BOJ can explore rate hikes in 2025 if US economy remains firm

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.

Greetings ~ Main theme for 2025 is “Trump 2.0” impacts

First, we would like to wish everyone a very Happy New Year. Fortunately, there were no major surprises during the year-end and New Year holidays in Japan. Indeed, the exchange rate returned to the USD/JPY157 level, while Nikkei 225 futures topped 39,500. In 2024 we keenly felt that, amid global divisions, the US holds relative advantages in the fields of energy, military, and AI, and that the US economy is resilient. As such, key themes for the world in 2025 will be the impact of “Trump 2.0” (including economy and geopolitical risks) and how long can the US remain the sole winner (in terms of the economy and capital flows: strong dollar and high stock prices). Meanwhile, in Japan, an ordinary Diet session is set to convene on 24 January. Here, passage of the FY25 budget is awaited ahead of the spring season. With an Upper House election slated for this summer (20 July seen as most likely date), markets and the economy could become harder to read if matters in Japan and the US are determined from political perspectives. In terms of monetary policy, the US is expected to decelerate the pace of interest rate cuts (turning point if cuts stop). Meanwhile, a major focus for Japan is on how many times interest rates can be raised (Chart 1). In 2025 we will continue to provide timely information that is useful for all our readers. We ask for your continued support and patronage.

BOJ’s Ueda lacking sense of urgency (for rate hike) ahead of Jan meeting

At his 19 December 2024 post-meeting press conference, BOJ Governor Kazuo Ueda was asked why the Bank had decided not to raise interest rates in December. He said, “We need a little more information, such as the degree of momentum from next spring’s labor-management wage negotiations. The future for overseas economies, including the US, is uncertain and there is a great deal of uncertainty about the policies of the next US administration. In light of these points, we have decided to maintain the status quo.” The governor added, “We would like one notch more of information in order to believe we can raise interest rates.” As was the case in his 30 November *Nikkei* interview, he repeatedly mentioned monitoring wages and the US economy. After the yen’s further depreciation, Ueda delivered a speech at the Japan Business Federation (Keidanren) on 25 December. Here, he continued to express his support for raising interest rates, but there was no sense of urgency in his comments ahead of the next meeting in January. Ueda left the impression that he would continue to make careful decisions without rushing to raise interest rates and that he would tolerate a weak yen as long as there was no significant risk of higher prices.

Chart 1: Schedule of Japanese and US Monetary Policy Meetings in 2025

	Jan	Feb	Mar	Apr	May	Jun
BOJ MPM	23-24*	-	18-19	30	1*	16-17
US FOMC	28-29		18-19**		6-7	17-18**

	Jul	Aug	Sep	Oct	Nov	Dec
BOJ MPM	30-31*	-	18-19	29-30*	-	18-19
US FOMC	29-30	-	16-17**	28-29	-	9-10**

Source: BOJ, Fed; compiled by Daiwa.
**BOJ announces Outlook for Economic Activity and Prices report.*
***Fed announces Summary of Economic Projections.*

Summary of Opinions from Dec BOJ meeting lacks sense urgency for hiking rates

The Summary of Opinions from the BOJ's December meeting was released on 27 December 2024. Here, we could confirm that, in addition to board member Naoki Tamura (who actually submitted a proposal to raise interest rates), there are other members who said that the degree of monetary easing should be adjusted. However, three new opinions favoring adjusting the degree of monetary accommodation (last three opinions in the "Opinions on Monetary Policy" section), provide a sense that the BOJ is currently not in a hurry to hike rates as it first wants assess the policy management of the new Trump administration. Six specific opinions are provided below (in bold, with underlining of important points provided by author). Based on these points, the probability of a rate hike in January factored in by the market has dropped to 40%.

- **In order to decide whether to raise the policy interest rate, the Bank should, on the domestic front, focus on developments in wages, services prices, and private consumption. On the external front, it should focus on <u>developments in the U.S. economy and the policy conduct, as well as developments in financial and capital markets reflecting these factors</u>. It is therefore appropriate for the Bank to examine developments in the run-up to next year's annual spring labor-management wage negotiations and the situation surrounding the new U.S. administration.**

- **There are high uncertainties over the course of discussions on tax and fiscal policy in Japan and over the policy stance of the new U.S. administration taking office at the beginning of 2025. Thus, from the perspective of <u>risk management</u>, it is appropriate for the Bank to maintain the current monetary policy at this meeting.**

- **At this stage, the upside risks to prices do not suggest a pressing need to raise the policy interest rate. Import prices have been stable and yen carry trade positions have not been built up. On the domestic front, the cumulative increase in wages over the past three years has not caught up with that in prices, and <u>it is therefore desirable that relatively high wage increases are achieved in 2025</u>.**

- **If economic activity remains on track, the timing of the adjustments of the policy interest rate should depend on two factors: <u>(1) the pace at which the rate hikes need to progress, calculated backward from the time the goal is expected to be reached</u>; and (2) the assessment of both upside and downside risks to prices observed at the time of each MPM. From this perspective, it is appropriate for the Bank to maintain the current monetary policy at this meeting.**

- **Underlying inflation has been increasing steadily, while the risk of the Bank falling behind the curve is limited. <u>The Bank will likely decide to raise the policy interest rate in the near future</u>, but at this point <u>it is necessary for the Bank to be patient</u> and monitor the uncertainties over the U.S. economy until those uncertainties subside.**

- **<u>The Bank is in a phase where it should slightly ease off the accelerator of monetary easing</u>, so that it can slow down when necessary while avoiding harsh braking.**

Since Trump's US presidential election victory on 5 November 2024, the idea that it would be better to wait and see how the new US administration manage its policies may have grown stronger within the BOJ. The reason for concern about market trends seems to be the traumatic market turmoil witnessed in August 2024. Also, the last three opinions in the "Opinions on Monetary Policy" section include such new expressions as "pace at which the rate hikes need to progress, calculated backward from the time the goal is expected to be reached," "necessary for the Bank to be patient," and "should slightly ease off the accelerator of monetary easing." We interpreted this to mean that there were several members who argued in favor of slowing down the rate hiking phase.

The new Trump administration has already vowed an additional 10% tariff on China along with 25% tariffs on Canada and Mexico, but we do not know when it will decide on tariffs for other countries. Over time, we should be able to gather a little more information, but it is unclear when that will lead to a one-notch improvement (for BOJ information gathering). It may be difficult to make a decision at the 23-24 January Monetary Policy Meeting, which will be held immediately after the inauguration of the new US President on 20 January.

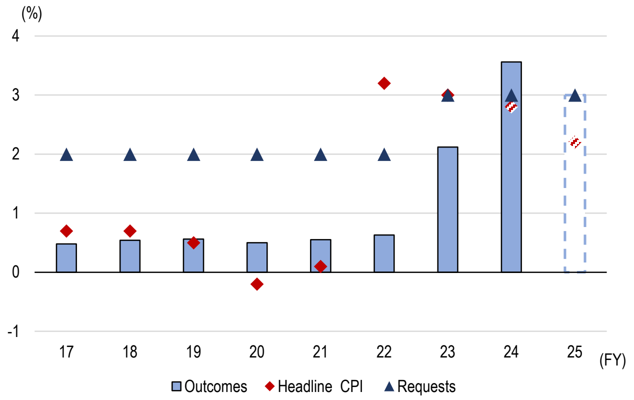
BOJ can explore rate hikes in 2025 if US economy remains firm

Accordingly, even if the BOJ is on track with its outlooks for Japan's economic and price trends and the current situation in the US is within expectations, the Bank still remains concerned about the so-called "Trump risks," such as the impact of the new Trump administration's policy management and market trends based on those impacts. If the BOJ waits for this large question mark hanging over the future to become smaller, it will need to confirm the materialization of various measures in the Trump's State of the Union Address, the budget messages, and other details that will emerge after Trump's 20 January inauguration. If the Bank chooses to avoid hasty decisions and proceeds slowly within the scope of what it can control (within current fiscal year), the possibility of waiting until the 18-19 March meeting to hike rates will increase.

According to various reports at the end of 2024 and start of 2025, it seems that the momentum for wage hikes among major companies is spreading. Based on the lessons of 2024, we believe that a 3% basic salary increase is possible in 2025. Even so, the 9 January BOJ's branch managers meeting report (surveyed during Dec 2024) will likely include the view that small and medium-sized enterprises (SMEs) are still struggling to significantly hike wages, as was the case last year. If the BOJ is overly cautious when making decisions, the situation in which one more notch of information is desired will remain unchanged. Ultimately, it seems as if the Bank will wait for high-3% range wage hikes at the 14 March first tally of wage negotiation responses by Japanese Trade Union Confederation (Rengo, which is targeting wage hikes of more than 5%; Chart 2). The Bank can possibly make an early decision regarding SMEs at that point based on the earnings situations and information from hearings. Meanwhile, the rise in service prices has become entrenched (Chart 3). The BOJ will check whether this trend continues by looking at the monthly CPI to determine whether the underlying inflation rate can be sustained at around 2%.

The vectors for Japan and the US monetary policies remained different as of the start of 2025 and neither country is in a hurry to change their policies. For now, there remains some uncertainty about the US and market trends. In Japan, this will be a period for monitoring passage of the FY25 budget. The BOJ's January *Outlook Report*, which factors in economic measures, will only confirm the "on track" situation, while the "Trump risks" remain in place. If the new Trump administration quickly moves forward with tariff and immigration measures, the risk of waiting too long would increase for the BOJ and the possibility of the Bank becoming unable to quickly move would persist (decision to hike rates could be pushed back until May or later). Still, if the US economy remains steady and if the FF rate is lowered to around 4%, at which point rate cuts are temporarily halted, it is possible that the BOJ will consider hiking rates (twice in 2025). Also, when the June intermediate assessment of the plan to reduce the amount of JGB purchases is carried out, there is a possibility that the pace of such reductions will be re-examined depending on the state of the long-term JGB yield. 2025 will be a year in which the BOJ's policy normalization is expected to progress due to wage hikes taking hold.

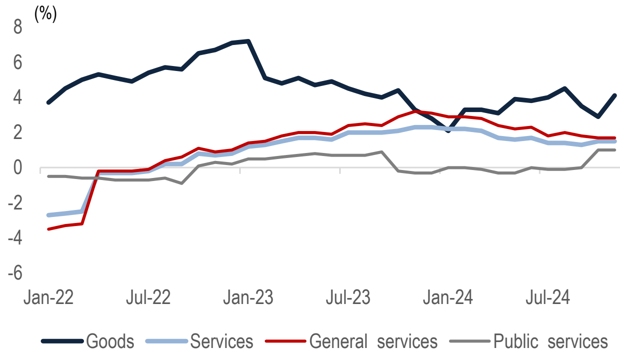
Chart 2: Outcomes of Spring Wage Negotiations (base pay hikes, estimated)



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

Note: FY24 and FY25 headline CPI based on mid-FY24 Cabinet Office simulation.

Chart 3: Nationwide CPI in Japan



Source: MIC; compiled by Daiwa.