Japan | Fixed Income | 24 January 2025
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Daiwa's Economic View

BOJ decides to hike rates at Jan meeting; see roughly six-month hiking pace

- No major market turmoil after Trump's inauguration speech, BOJ decides to again hike rates
  Examining the BOJ's communication efforts
- Jan statement clearly conveys intent to keep adjusting degree of monetary easing
- Jan *Outlook Report*: Expects to maintain around 2% inflation for second half of projection period
  Significant upward revision for prices; risk of higher-than-expected prices in US

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No major market turmoil after Trump's inauguration speech

As of the fourth week of January, the market had almost completely factored in a rate hike at the BOJ's January meeting. This was due to various media reports, as well as speeches by BOJ Deputy Governor Ryozo Himino (14 Jan) and BOJ Governor Kazuo Ueda (15 Jan) that repeatedly hinted at a January rate hike. In his 30-minute inauguration speech on 20 January, President Trump promised a "golden age" for the United States with "America First" as his watchword. When Trump started signing executive orders, the market temporarily reacted when he called for 25% tariffs on goods from Mexico and Canada (to take effect on 1 Feb). However, his comments were perceived as a less strict response with the same content as before. In his online speech at the Davos Forum on 23 January, Trump called for OPEC to reduce the price of crude oil and for the Fed to lower interest rates, but so far this has not unsettled markets. As such, the BOJ cleared its final assessment criteria allowing for this rate hike.

Examining the BOJ's communication efforts

In the period leading up to this meeting, based on our report dated the 20 January[1], many of our readers asked about our impressions of the BOJ's communication efforts this time. At his post-meeting press conference in December, Ueda said, "We need a little more information" and "We would like one notch more of information." As time passed, the Bank should have been able to gather a little more information, but it was unclear when that would lead to the desired "one-notch" increase. The annual spring labor-management wage negotiations are easy for the BOJ to understand. However, the Bank struggled to make concrete assessments at the end of 2024/start of 2025 because it was overly fixated on how conditions in the US might unfold. We viewed that as a poor point. That said, the speech by BOJ Deputy Governor Himino before the January meeting allowed the Bank to carefully communicate its intentions. This was soon followed by a speech from BOJ Governor Ueda. It felt like information was sent out on a daily basis and incorporated all at once. We think the BOJ took steps to mitigate any big surprise on the final day of its January meeting. It seems that the Bank's intention was to continue harmonizing board member speeches, while striving to carefully provide information. However, the slow pace of interest rate hikes and the overlapping timing of the twice-yearly speeches mean that one of the deputy governors' speeches will end up being used to deliver key messages before important meetings.

BOJ again hiked rates as speculated in pre-meeting media reports

Under these conditions, the BOJ held its first Monetary Policy Board meeting of 2025 on 23-24 January, with its decision announced just after 12:20 p.m. on the second day. The Policy Board decided by a majority 8-to-1 vote to raise rates (board member Toyoaki Nakamura, participating via conference call, voted against the action[2]). Specifically, the Policy Board voted to encourage the uncollateralized overnight call rate to remain at around 0.5% from 0.25% previously. As for the Funds-Provisioning Measure to Stimulate Bank Lending, which is determined at the January meeting every year, new loan disbursements will not be made after 30 June 2025, as scheduled, and transitional measures[3] were taken. This is a reasonable decision when interest rates are being raised.

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[1] *Daiwa's Economic View*: BOJ to consider hiking rate in Jan with PM Ishiba's consent (20 Jan 2025).
[2] He opposed this policy change, arguing that the Bank should decide on changing the guideline for money market operations after confirming a rise in firms' earning power from sources such as the Financial Statements Statistics of Corporations by Industry at the next MPM.
[3] Bank decided to allow counterparties to roll over up to 50% of the amount of loans maturing in 2025 into one-year loans from Jul 2025.

Jan statement clearly conveys intent to keep adjusting degree of monetary easing

The BOJ's January statement is full of many positive expressions such as, "Japan's economic activity and prices have been developing generally in line with the outlook presented in the previous *Outlook Report*," "The likelihood of realizing the outlook has been rising," and "There have been many views expressed by firms stating that they will continue to raise wages steadily in this year's annual spring labor-management wage negotiations, following the solid wage increases last year." The Bank also noted such points as "Higher import prices stemming from factors such as the recent depreciation of the yen" and "Global financial and capital markets have been stable on the whole." In view of these circumstances, the Bank judged it appropriate to "adjust the degree of monetary accommodation" and added, "Real interest rates are expected to remain significantly negative after the change in policy interest rate, and accommodative financial conditions will continue to firmly support the economic activity." Looking ahead, the Bank said, "Given that real interest rates are at significantly low levels, if the outlook for economic activity and prices presented in the January *Outlook Report* will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation." The policy decisions are expressed in exactly the same way as they were at the last interest rate hike in July 2024 and the Bank has clearly stated that it intends to make further adjustments, provided the outlook remains on track. The message is that the BOJ is still working towards policy normalization. Markets are reacting to the strong yen, rising interest rates, and falling stock prices, according to the Bank's hawkish explanation.

At this juncture, import prices have turned positive and, if the yen depreciation continues to take hold, the risk of prices rising again will increase over time. The dollar-yen exchange rate has already held above USD/JPY155 for a month already. While it is reasonable to interpret the dollar's strength as being due to US-specific factors, even if "Trump 2.0" gets off to a mild start, many of its policies will, first of all, lead to inflation. There is a high possibility that the US inflation rate will rise from this spring. If the strong-dollar trend does not change significantly, the impact of elevated import prices on consumer prices in Japan will gradually become apparent from the middle of this year. We believe that US/Japan data from the middle of this year will be particularly important.

Chart 1: Change in Guideline for Money Market Operations (Decision at Jan 2025 MPM)

Japan's economic activity and prices have been **developing generally in line with the Bank's outlook**, and **the likelihood of realizing the outlook has been rising**.

Medians of the Policy Board Members' Forecasts (y/y % chg.)

	Fiscal 2024	Fiscal 2025	Fiscal 2026
Real GDP	0.5 (-0.1)	1.1 (—)	1.0 (—)
CPI (all items less fresh food)	2.7 (+0.2)	2.4 (+0.5)	2.0 (+0.1)
CPI (all items less fresh food and energy)	2.2 (+0.2)	2.1 (+0.2)	2.1 (—)

Note: Figures in parentheses indicate changes from the October 2024 Outlook Report.

Wages
- Firms have expressed the view that they will **continue to raise wages steadily**, following the solid wage increases last year.

Prices
- With wages continuing to rise, **underlying CPI inflation has been increasing gradually toward 2 percent**.
- CPI inflation is likely to be at around 2.5 percent for fiscal 2025, due to the higher import prices stemming from the yen's depreciation etc.

Overseas economies
- Global financial and capital markets have been **stable on the whole**, while attention has been drawn to various uncertainties.

Adjusting the degree of monetary accommodation from the perspective of sustainable and stable achievement of the price stability target of 2 percent

Short-term interest rate : (uncollateralized overnight call rate) **raised to "around 0.5%"** (previously "around 0.25%")

- Real interest rates are expected to remain significantly negative, and accommodative financial conditions will continue to **firmly support economic activity**.
- If the outlook presented in the January Outlook Report will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation.

Source: Reprinted from BOJ materials.

BOJ's Jan *Outlook Report*: Inflation to remain around 2% during projection period

Turning next to the BOJ's key checkpoint for economic and price trends, the January *Outlook Report*, it lowered its FY24 GDP growth forecast (median of majority of Policy Board members' forecasts) to +0.5% but maintained its forecast for FY25 onward at around +1.1% (Chart 2). Its forecasts are largely the same as its previous *Outlook Report*, indicating that its view of the economy has not changed appreciably. It expects moderate GDP growth (of around 1%) to continue in FY25 onward, exceeding the potential growth rate[4].

The three main risks the BOJ cites for the Japanese economy are (1) overseas economic and inflation trends and global financial and capital market trends, (2) import price trends, mainly for commodities and grain, and (3) the impact on companies' and households' longer-term growth expectations and the potential growth rate from changes in the external environment that affect Japan. On point (1), the BOJ added a mention of uncertainty regarding US policy conduct to the details of "overseas economic and inflation trends". It maintained its view from the October 2024 report that upside and downside risks to the economy are generally balanced.

The BOJ also raised its forecasts for core-core inflation (which it views as the key indicator of underlying inflation) from 2.0% to 2.2% for FY24 and from 1.9% to 2.1% for FY25, though it maintained its FY26 forecast. It also raised its core CPI forecasts for FY24 and FY25 by more than we expected. This reflects the above-forecast increase in rice prices, weaker yen, and stubbornly high oil prices over the past three months, and may also signal that the BOJ is taking a more serious view that we expected of the weaker yen and high oil prices. However, it likely sees these as one-time factors given that its 2026 forecasts assume that it will achieve its 2% inflation target. 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 projection period.

Chart 2: FY24-26 Forecasts of Majority of Policy Board Members (y/y %)

	Real GDP	CPI (all items less fresh food)	(Ref) CPI (all items less fresh food and energy)
FY24	+0.4 ～ +0.6 [+0.5]	+2.6 ～ +2.8 [+2.7]	+2.1 ～ +2.3 [+2.2]
As of Oct	+0.5 ～ +0.7 [+0.6]	+2.4 ～ +2.5 [+2.5]	+1.9 ～ +2.1 [+2.0]
FY25	+0.9 ～ +1.1 [+1.1]	+2.2 ～ +2.6 [+2.4]	+2.0 ～ +2.3 [+2.1]
As of Oct	+1.0 ～ +1.2 [+1.1]	+1.7 ～ +2.1 [+1.9]	+1.8 ～ +2.0 [+1.9]
FY26	+0.8 ～ +1.0 <+1.0>	+1.8 ～ +2.1 [+2.0]	+1.9 ～ +2.2 [+2.1]
As of Oct	+0.8 ～ +1.1 [+1.0]	+1.8 ～ +2.0 [+1.9]	+1.9 ～ +2.2 [+2.1]

Source: BOJ; compiled by Daiwa.
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.

[4] In Jan report, footnote says that "Under a specific methodology, Japan's recent potential growth rate is estimated to be around 0.5 percent (downward revision from the range of 0.5-1.0 percent in Oct 2024 report). This reflects the estimated potential growth rate of +0.58% for 1H FY24. The rate should be interpreted with considerable latitude.

However, it stuck with the October report's language regarding the macro output gap, stating that it "has followed an improving trend, albeit with fluctuations" and that "the gap is likely to widen moderately within positive territory toward the end of the projection period." The BOJ's estimate of the Jul-Sep 2024 output gap, announced on 8 January, was –0.53% (–0.58% in Apr-Jun); the gap has remained negative since Apr-Jun 2020. It will likely take time for it to become consistently positive.

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 stuck with the language from its October report stating that risks are "skewed to the upside for fiscal 2025," despite this apparently presaging the upward revision to inflation forecasts that it made in the January report. We note that it kept in the language regarding upside risks despite the substantial upward revision to its core CPI forecast. This suggests that it continues to view US economic and political trends, and the resulting forex trends, as the key risks to inflation (particularly on the upside).

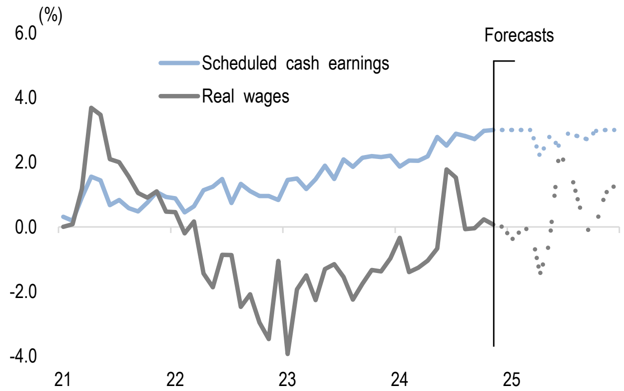
Real wages still negative despite virtuous wage-price cycle

The BOJ is growing more confident about the outcome of the 2025 spring labor negotiations, and media reports since early this year suggest that wage hikes are indeed likely to remain at high levels. SMEs' labor share also suggests that substantial wage hikes are likely in FY25 even at smaller firms[5]. However, while real wage growth has recently risen out of negative territory, it has yet to definitively turn positive, and consumer sentiment remains weak (Charts 3 and 4).

Rising inflation since October 2024 has acted as a particular drag on real wages. Even if FY25 wage growth remains upbeat, there are no signs of a decline in prices of food and other items, which companies have increasingly raised since October 2024 to pass on higher costs; these tend to depress real wages via their contribution to y/y growth in the CPI. As a result, we think clearly positive growth in real wages excluding bonuses is unlikely until 2H CY25.

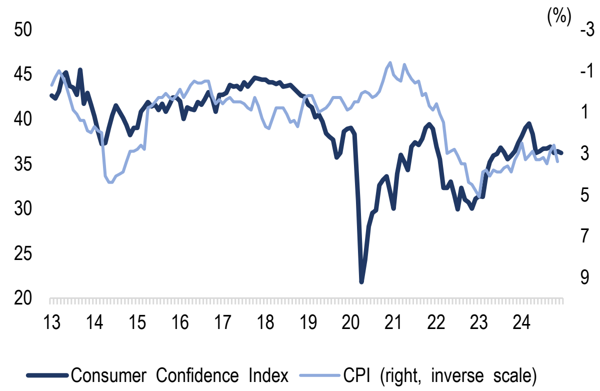
Consumer sentiment remains weak due to the sharp uptrend in prices of food and other essentials. We expect wage growth to remain high, inflation to gradually subside, and consumer spending to recover, but think the rebound in the latter will be slower and more gradual than we previously expected.

Chart 3: Forecasts for Real Wages, Scheduled Cash Earnings



Source: Ministry of Health, Labour and Welfare; compiled by Daiwa.
Note: Based on data continuously collected from same establishments.

Chart 4: Consumer Sentiment, CPI



Source: Cabinet Office, Ministry of Internal Affairs and Communications; compiled by Daiwa.

BOJ to watch service prices, consumer spending trends in gauging need for next rate hike

Overseas, the BOJ will be watching Trump 2.0's implications for the US economic outlook (initially, the impact on inflation and the potential for a pause in the Fed's rate-cutting cycle) and market trends. In Japan, it is monitoring whether rising wages continue to drive up service prices. It will be watching

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[5] *Economic Commentary*: 2024 wage hikes, checkpoints after spring 2025 wage talks (20 Jan 2025).

whether companies make progress with passing on higher costs amid prolonged yen weakness while seeking evidence of broader-based wage growth, and will be looking at whether future data aligns with its forecasts. It will be monitoring whether this spreads to service prices over time. However, weak consumer spending caused by rising prices is a concern in terms of the balance between the economy and inflation. Inflation and consumer spending remain key checkpoints for the BOJ in assessing whether its 2% price stability (inflation) target is being achieved in a sustainable and stable manner. The BOJ's next *Outlook Report* to be released on 1 May will include projections through FY27, extending the horizon for its forecast scenario. The messages it delivers will be crucial in gauging the terminal policy rate for the current cycle.

Governor Ueda's closely watched press conference: Any hints about next rate hike?

Finally, given that the market had largely priced in a January rate hike, the main focus will be BOJ Governor Kazuo Ueda's comments at the press conference. The BOJ's decision to hike rates in January, six months on from the previous hike in July 2024, will likely cause the market to assume that raising interest rates at a gradual pace means one hike every six months or so. This would imply that today's hike in the Jan-Mar quarter will be followed by another in Jul-Sep, but given the Upper House elections scheduled for July, at this point we think the BOJ is likely to raise rates again in September after reviewing cuts to its JGB purchases at the June meeting while monitoring where long-term yields settle. We will be watching for any new hints regarding the next rate hike and neutral rate of interest at Mr. Ueda's press conference.

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