Daiwa Securities

Economic Commentary

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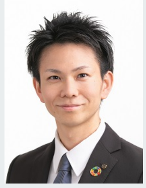

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10yr JGB yield has risen over two weeks since BOJ hike rate at Jan meeting

Two weeks have passed since the BOJ decided at its 23-24 January Monetary Policy Board meeting to raise interest rates[1]. In the policy assessment section of the January statement, the exact same wording as that used when interest rates were raised last July was used. The Bank also clarified that if its outlook remains on track, it will further adjust rates. If the perception is that the neutral interest rate is still far away (even with a policy interest rate of +0.5%) with the real interest rate significantly negative, then it is only natural for the Bank to maintain a hawkish stance.

Then on 30 January, BOJ Deputy Governor Ryozo Himino delivered a speech titled "A World with Interest rates." He spoke about the interest rate hiking path just like BOJ Governor Kazuo Ueda did earlier during his press conference following the January meeting[2]. Still, he used different expressions than Ueda such as "The 'world of real interest rates' is still far away" and "It was not normal for real interest rates to remain clearly negative for a prolonged period if shocks to the economy or factors that cause deflation are eliminated." These comments left the impression that the BOJ has a forward-looking stance in regards to raising interest rates. In addition, the Summary of Opinions from the January meeting (released on 3 Feb) included three opinions about the risk of rising prices. The strongest opinion among these was, "Prices could deviate upward from the baseline scenario due to further progress in the pass-through of cost increases to consumer prices toward fiscal 2025 and to the depreciation of the yen. In addition, investors' expectations have increased, following a rise in asset prices including real estate. It will be necessary for the Bank to adjust the degree of monetary accommodation from the viewpoint of avoiding the yen's depreciation and the overheating of financial activities, both of which appear to be due to excessively high expectations of continued monetary easing." In response to the BOJ's sustained hawkish stance in the information it released, the 10-year JGB yield did not move in line with the drop for the 10-year UST yield. Indeed, the 10-year JGB yield briefly rose to 1.295% on 5 February. From here, there will probably be movements that consider the potential for hiking interest rates ahead of schedule and raising the final target level.

Hawkish board member Tamura as pilot for interest rate hiking phase

BOJ board member Naoki Tamura delivered a speech and held a press conference on 6 February. This was his first such speech in roughly five months. His previous speech was on 12 September 2024[3], when the market was finally starting to calm down after the turmoil in August following the BOJ's July interest rate hike. The fact that he clearly expressed his own views on the neutral interest rate was a sign that he is more than just a hawk among the board members, but that he is also the pilot for the next interest rate hike. Then, considering that Ueda said during his 20 September post-meeting press conference that there was "enough time," we view Tamura as courageous in disseminating information and having foresight. At the meeting in December last year, Tamura submitted a proposal to hike interest rates, citing the risk of higher-than-expected inflation. His proposal (while defeated by majority vote) served to pave the way for a rate hike in January.

[1] *Daiwa's Economic View*: BOJ decides to hike rates at Jan meeting; see roughly six-month hiking pace (24 Jan 2025).
[2] *Daiwa's Economic View*: Ueda's BOJ to keep pursuing additional rate hikes (27 Jan 2025).
[3] *Economic Commentary*: Speech from BOJ Policy Board member Tamura: Desire for policy normalization unchanged (17 Sep 2024).

Neutral interest rate at least around 1%; not fully factored in by market

As he did in his speech five months ago, Tamura again said "My sense is that the neutral interest rate would be at least around 1%." However, he was more specific in terms of the time frame and said "Therefore, I think it is necessary for the Bank to raise the short-term interest rate to at least that level by the second half of fiscal 2025 to contain the upside risks to prices and achieve the price stability target in a sustainable and stable manner." At the press conference following his speech, Tamura explained that, due to the risk of higher prices and other factors, "The probability of this (realizing price stability target) happening has increased. The time frame in my mind (until the interest rate is hiked to 1%) has narrowed somewhat."

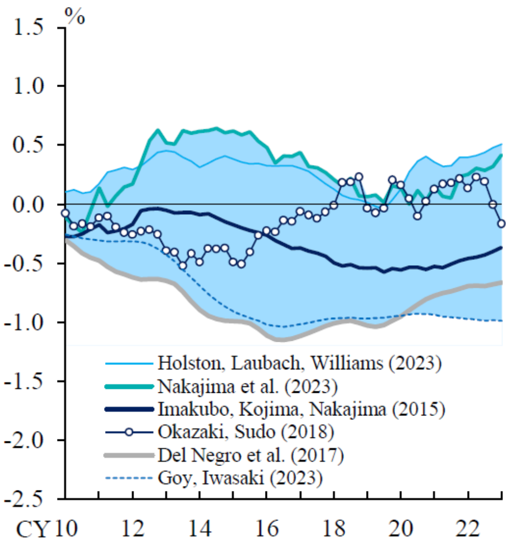
During his speech in September, it seemed like Tamura was the only hawk, but recently, there has been an increase in the number of board members who are leaning towards Tamura's point of view. In fact, the BOJ indicated in its official explanations that the natural interest rate is around -1.0% to +0.5% (Chart 1). Even though a broad view is required, if the 2% price stability target is achieved, we can calculate the neutral interest rate to fall between +1.0% and +2.5%. The lowest rate in this range is +1.0%, which means that the interest rate hiking phase does not necessarily end at +1.0%. From this perspective, it would be natural to think that a situation in which the market only factors in a final target for interest rate hikes of +1.0% is insufficient.

Assessing upside price risks; pursuing timely, gradual rate hikes

The January *Outlook Report* not only raised its price forecasts for FY25, but the assessment that there are significant upside price risks was also maintained. Furthermore, the BOX analysis in this report explained the strength of labor supply/demand conditions[4]. We feel that the analysis provided by the BOJ's Research and Statistics Department has been bullish on prices since the second half of last year and it is better to assume that this trend will continue. It is hard to imagine that the sense of labor shortage in the BOJ's Tankan survey's employment conditions DI will suddenly fade away. In his speech, Tamura referred to inflation expectations as, "I believe that inflation expectations of firms and households have risen steadily and have generally reached the 2% level." Unlike Europe and the US, Japan has no experience anchoring inflation expectations at 2% (Chart 2). The situation has now changed to the point that such anchoring is coming into view.

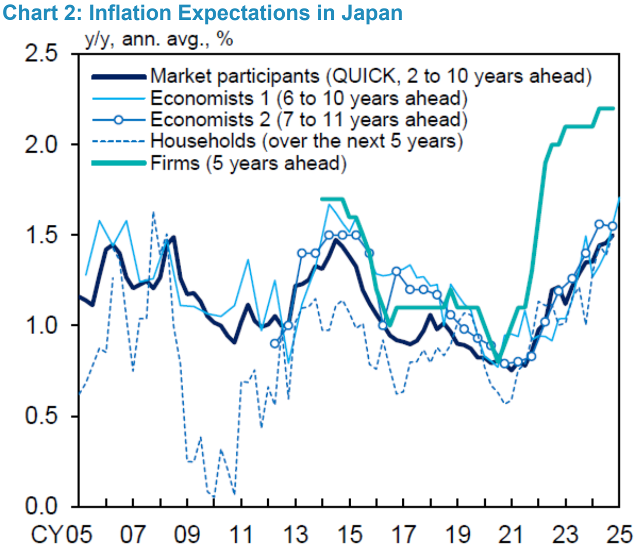
However, Tamura said, "How economic agents in Japan, which has long experienced a state without meaningful interest rates, react to higher interest rates is an issue that warrants careful attention without any preconceptions."

Chart 1: Estimates of Natural Rate of Interest in Japan



Source: Reprinted from BOJ materials.

Chart 2: Inflation Expectations in Japan



Source: Reprinted from BOJ materials.

[4] *Economic Commentary*: BOJ's Summary of Opinions points to focus on upside price risks (4 Feb 2025).

Tamura also said, "Bearing in mind that the short-term interest rate should be at the 1% level by the second half of fiscal 2025, I think the Bank needs to raise this rate in a timely and gradual manner, in response to the increase in the likelihood of achieving the price stability target. While doing so, it also needs to determine the appropriate level of the short-term interest rate by carefully assessing how the economy and prices respond to the rate hikes." Here, the wording "timely" was used for the first time. It will take some time to assess the response to the interest rate hike. In explaining the appropriate timing of the next policy rate hike (to +0.75%), Tamura said, "Now is the time for the Bank to ease off slightly from pressing hard on the accelerator of monetary easing, so that it can slow down when necessary while avoiding harsh braking." This has clarified that the similar opinion in the Summary of Opinions from the December 2024 meeting was his opinion.

Also, during his post-speech press conference, Tamura said that the BOJ has not necessarily set "every six months" as its pace for future rate hikes (no such preconceived notions). He said that depending on the data and information available at the time of meeting, there is a possibility that the pace of future interest rate hikes "may be faster or slower," as the BOJ has said in the past. Indeed, it has also demonstrated its stance of placing importance on the data and information available at the time. As we can see from the word "timely," it is better to accept that the exact timing cannot be predetermined.

Tamura's thoughts on "Review of Monetary Policy from a Broad Perspective"

In his speech, Tamura also touched on the "Review of Monetary Policy from a Broad Perspective," which was released at the December meeting last year. This review concluded that, "Although there have been certain side effects, the overall effect on the Japanese economy so far appears to have been positive." In response to that conclusion, Tamura pointed out that there were significant side effects on the supply side, such as the stagnation of business turnover and the resulting decline in productivity. Specifically, he said, "In my view, it is a stretch to say that the overall effect of large-scale monetary easing has been positive." He went on to note that the "Review of Monetary Policy from a Broad Perspective" did not analyze each individual policy and he stated that, "In my opinion, large-scale monetary easing had a positive effect on economic activity and prices for two years or so from 2013, by way of the repricing of assets, including in terms of foreign exchange rates, stock prices, and real estate. However, I feel that the marginal effects of subsequent additional measures, such as further increases in Japanese government bond (JGB) purchases and the introduction of the negative interest rate policy, were considerably limited."

In this manner, Tamura has expressed a negative stance on the effects of unconventional monetary policy measures such as the introduction of a negative interest rate policy and large-scale purchases of JGBs. Even if some kind of shock hits the Japanese economy in the future, it is highly likely that Tamura himself would oppose a return to the kind of unconventional monetary policy measures adopted in the mid-2010s. However, the content of the "Review of Monetary Policy from a Broad Perspective" also acknowledges the many side effects of unconventional monetary policy measures. Indeed, even the BOJ's own consensus is that unconventional monetary policy measures should be viewed exceptional measures.

Tamura also touched on the 2% price stability target during his speech. Here, he said, "It is important not to focus on the inflation rate at each point in time, but rather to capture the underlying trend of inflation by analyzing a variety of factors affecting the price changes." He added, "Rather than being particular about the numerical value of 2.0%, I believe that, as long as prices are increasing moderately, the Bank should examine whether the mechanism behind the increase is consistent with the price stability target." It seems that Tamura's view is that, for example, even if the rate of inflation falls below 2% due to a future external decline for the price of goods, as long as the overall inflation increase is gradual and the mechanisms behind it (such as underlying inflation rate, wages, and trends for the passing on of cost increases to consumer prices) are consistent with the 2% target, there is no major problem. However, if prices rise by more than 2%, this would fall outside the scope of prices "increasing moderately," and thus he would propose appropriate actions.

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