Daiwa Securities

Iwashita's Economic & Market Watch

BOJ decides to further raise interest rates without delay

- BOJ opted to hike again at July MPM, in line with prior media reports; consistent with *Outlook Report*, reflects BOJ's call that time was right to scale back easing; plans to cut JGB purchases to around Y3tn per month in Jan-Mar 2026 as expected
- July *Outlook Report* forecasts sustained trend inflation of around 2%; BOJ to monitor service prices, consumer spending trends in gauging need for next rate hike; explanation of policy conduct, hawkish tone signal intent to continue normalizing

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Early-morning press reports indicated BOJ considering rate hike

NHK, Jiji Press, and the Nikkei reported in the early hours of 31 July Japan time that the Bank of Japan (BOJ) was considering another rate hike. Past examples indicate that when media outlets use the term "considering" ("kento" in Japanese), it should be taken to mean that a rate hike is virtually a done deal. We note this for future reference. Jiji Press reported on 25 July, ahead of the media blackout that begins two trading days prior to BOJ monetary policy meetings (MPMs), that a rate hike was on the agenda for the upcoming MPM, and the presumption was therefore that the BOJ would finalize the details of the hike at the July meeting. However, the BOJ's advance explanations were not enough by themselves to justify reporting that it was definitively set to raise the policy rate. The new information in today's *Nikkei* article was that the Ministry of Finance (MOF) and Cabinet Office did not intend to exercise their right to request that the BOJ delay its decision, indicating their acceptance. We surmise that with the blackout underway, information obtained from outside the BOJ enabled the media to write today's headlines about the Bank "considering" a rate hike.

We had argued in previous reports that the BOJ was clearly preparing to recalibrate monetary easing to align with economic, financial, and inflation trends, independent of any planned reduction in its JGB purchases, and that a decision was only a matter of time[1]. The main changes since the start of July were the growing expectations for a US rate cut in September (and a concurrent pause in JPY's slide versus USD), and growing calls from within Japan's ruling Liberal Democratic Party (LDP) for the BOJ to normalize monetary policy from the second half of the month[2]. Political support makes it easier for the BOJ to act. Expectations for another BOJ rate hike caused USD/JPY to correct toward 151 on 25 July, with the Nikkei Stock Average also falling more than Y1,000 on the day to below 38,000. Despite some volatility, USD/JPY trended between 152.0-152.5 on the day of the MPM, with US factors also instrumental in capping its recovery high. The Nikkei Stock Average has also rebounded to above Y38,000, which permits the conclusion that a major sustained market selloff is unlikely and that today's rate hike will have little impact. Overnight index swaps (OIS) factored in a 72% probability of a rate hike as of the morning close ahead of today's MPM decision. They currently factor in a hike to 0.50% some way ahead, in Jun-Jul 2025. The main focus points at BOJ Governor Kazuo Ueda's press conference were likely his stance toward normalizing policy in future and his views on consumer prices.

BOJ hikes again, as per prior media reports

Against this backdrop, the BOJ announced the results of its 30-31 July MPM just after 13:00 JST. The majority of Policy Board members voted in favor of raising the uncollateralized overnight call rate from 0.0-0.1% to 0.25% (with two, Toyoaki Nakamura and Asahi Noguchi, voting against).

[1] Refer to *Iwashita's Economic & Market Watch: Only matter of time before BOJ recalibrates easing (8 Jul 2024).*
[2] Refer to *Iwashita's Economic & Market Watch: BOJ to wait until last minute before making July rate hike decision (26 Jul 2024).*

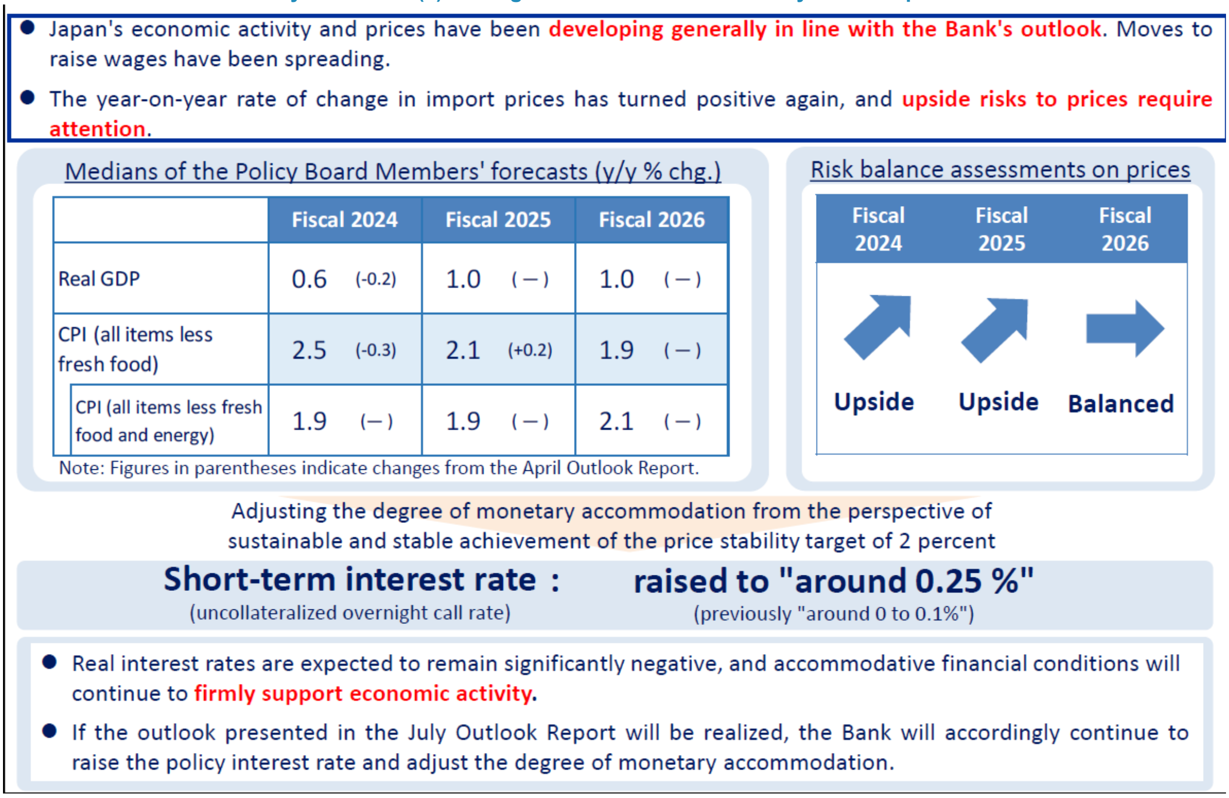
Moves to normalize often decided at July MPMs

The July MPM underscored our impression based on past experience that the BOJ often discusses normalizing policy at its July meetings (the July 2024 MPM followed similar discussions in July 2006, July 2018, and July 2023). When asked at his 26 April press conference following the release of the April *Outlook Report* whether conditions were in place for an additional rate hike (move to scale back easing), Mr. Ueda noted that the inflation outlook for the second half of the BOJ's forecast period was already around 2%, and if this came to pass it would be enough by itself to justify recalibrating monetary policy. The BOJ followed through on this today, proving that those who trusted in Mr. Ueda's statements were right to do so. Given our painful experience in 2023, since the start of July we had noted that the BOJ was growing more receptive to raising rates based on the June Tankan and branch manager's meeting report. With today's hike, it has avoided falling behind the curve.

Action in line with *Outlook Report*; reflects BOJ's call that time was right to scale back easing

The BOJ's July meeting statement (bold indicates quotes from original text) contains a string of positive observations: **"Japan's economic activity and prices have been developing generally in line with the outlook presented in the previous *Outlook for Economic Activity and Prices* (*Outlook Report*)," "private consumption has been resilient," "moves to raise wages have been spreading," "upside risks to prices require attention"**. In view of these circumstances, **"the Bank judged it appropriate to adjust the degree of monetary accommodation,"** and stated that **"real interest rates are expected to remain significantly negative after the change in the policy interest rate, and accommodative financial conditions will continue to firmly support economic activity."** Regarding the outlook, it stated that **"given that real interest rates are at significantly low levels, if the outlook for economic activity and prices presented in the July *Outlook Report* will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation."**

Chart 1: Decisions at the July 2024 MPM (1): Change in the Guideline for Money Market Operations



- Japan's economic activity and prices have been developing generally in line with the Bank's outlook. Moves to raise wages have been spreading.
- The year-on-year rate of change in import prices has turned positive again, and upside risks to prices require attention.

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

	Fiscal 2024	Fiscal 2025	Fiscal 2026
Real GDP	0.6 (-0.2)	1.0 (－)	1.0 (－)
CPI (all items less fresh food)	2.5 (-0.3)	2.1 (+0.2)	1.9 (－)
CPI (all items less fresh food and energy)	1.9 (－)	1.9 (－)	2.1 (－)

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

Risk balance assessments on prices

Fiscal 2024	Fiscal 2025	Fiscal 2026
Upside	Upside	Balanced

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 : raised to "around 0.25 %"
(uncollateralized overnight call rate) (previously "around 0 to 0.1%")

- 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 July 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 "Decisions at the July 2024 MPM (1): Change in the Guideline for Money Market Operations."

Regarding the weak consumer spending that has prompted concern, the BOJ likely expects the boost to household incomes from wage hikes and government income tax cuts to support firm consumption and avert an economic downturn. However, it will take at least six months for a weaker yen to affect trend inflation. That said, USD/JPY has now remained above 150 for more than four months since the BOJ scrapped its negative interest rate policy (NIRP) in late March. We expect rising import prices to gradually begin affecting consumer prices this autumn. With the BOJ following through with today's rate hike on the promises it made in April, it has explicitly signaled its intention to further adjust monetary policy if trends continue to align with its outlook. Its message is that it will continue to normalize. We think data from autumn onward will be the next focus.

Planned cuts to JGB purchases: To fall to Y3tn per month in Jan-Mar 2026 as expected

The BOJ telegraphed today's planned reduction in JGB purchases at the June MPM and confirmed market participants' views at its Bond Market Group meetings, indicating its effort to ensure proper communication with the market. The minutes of the meetings, which the BOJ released somewhat earlier than usual, also explicitly state that (1) it will allow long-term interest rates to be determined by the market, and (2) it will reduce purchases in a flexible and predictable manner (Chart 2).

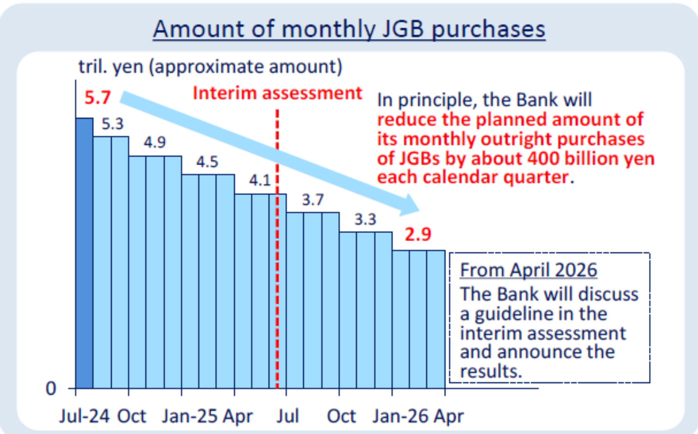
This also supports the view that the following opinion, which appeared for the first time in the minutes of the 9-10 July Bond Market Group meetings (published on 19 July), was a message from the BOJ itself: "If the Bank reduces the amount of its monthly purchases to about three trillion yen, that will be a clear message that it is committed to significant reduction. Besides, the share of the Bank's JGB purchases in the issuance amount is likely to decline considerably and bond market functioning is expected to improve."

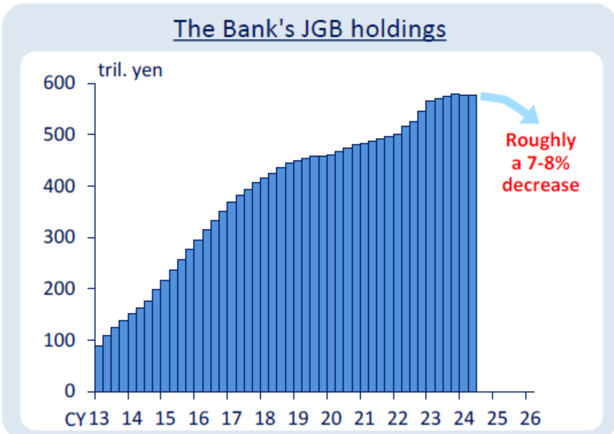
Chart 2: Decisions at the July 2024 MPM (2): Plan for the Reduction of the Purchase Amount of JGBs

The concept of the plan for the reduction until March 2026

1. Long-term interest rates: to be formed in financial markets in principle
2. JGB purchases: appropriate for the Bank to reduce its purchase amount of JGBs in a predictable manner, while allowing enough flexibility to support stability in the JGB markets

Reduction in a Predictable Manner





Allowing Enough Flexibility

1. The Bank will conduct an interim assessment of the plan at the June 2025 MPM.
2. In the case of a rapid rise in long-term interest rates, the Bank will make nimble responses by, for example, increasing the amount of JGB purchases.
3. The Bank is prepared to amend the plan at the MPMs, if deemed necessary.

Source: Reprinted from BOJ' materials "Decisions at the July 2024 MPM (2): Plan for the Reduction of the Purchase Amount of JGBs."

Today's plans also indicate that the BOJ will reduce JGB purchases over the coming quarters rather than making drastic cuts, in line with the growing number of opinions on the pace of reductions in the Bond Market Group meeting minutes stating that "It is desirable for the Bank to reduce the amount of its purchases of JGBs in a stepwise manner." As a result, it will in principle reduce its holdings by around Y400bn per quarter, to roughly Y3tn in Jan-Mar 2026. The BOJ's announced plans for its outright purchase (*Rinban*) operations now state specific values for its offers per auction for each remaining maturity. Going forward, we think it plans to mechanically reduce its purchases in line with the planned amounts disclosed for each quarter. It also indicated that it stands ready to expeditiously deploy unscheduled or fixed-rate purchase operations in the event of a spike in yields. The BOJ's plans therefore align with the message it sought to convey in the Bond Market Group meeting minutes. We think this was why the market accepted today's announcement with no surprise despite the numerous materials about the BOJ's planned cuts.

BOJ lowers growth rate projection for FY24 in July *Outlook Report*

Next, in the July *Outlook Report*, the important check of Japan's economic and price situations, the growth outlook (median of policy board members' forecasts) was revised downward to +0.6% for FY24 and unchanged at +1.0% for both FY25 and FY26 (Chart 3). The BOJ explained that the GDP revisions announced on 1 July (retroactive revision of MLIT data) resulted in a downward revision for FY23 and a lower carry-over effect, which was a factor in the downward revision for FY24. Industrial production statistics released on 31 July showed that the Apr-Jun quarter picked up to +2.9% q/q (-5.2% in Jan-Mar). Real GDP growth turned negative in the Jan-Mar quarter of this year, but the BOJ probably expects a pick up in the Apr-Jun quarter due to the robust US economy, resumption of automobile production in Japan, and resilient consumption. Japan's moderate growth (around 1%) is expected to persist from FY25, continuing to grow above the potential growth rate.[3]

Chart 3: FY24-26 Forecasts of Majority of Policy Board Members (y/y % chg)

	Real GDP	CPI (all items less fresh food)	(Ref) CPI (all items less fresh food and energy)
FY24	+0.5 ～ +0.7 [+0.6]	+2.5 ～ +2.6 [+2.5]	+1.8 ～ +2.0 [+1.9]
As of Apr	+0.7 ～ +1.0 [+0.8]	+2.6 ～ +3.0 [+2.8]	+1.7 ～ +2.1 [+1.9]
FY25	+0.9 ～ +1.1 [+1.0]	+2.0 ～ +2.3 [+2.1]	+1.8 ～ +2.0 [+1.9]
As of Apr	+0.8 ～ +1.1 [+1.0]	+1.7 ～ +2.1 [+1.9]	+1.8 ～ +2.0 [+1.9]
FY26	+0.8 ～ +1.0 [+1.0]	+1.8 ～ +2.0 [+1.9]	+1.9 ～ +2.2 [+2.1]
As of Apr	+0.8 ～ +1.0 [+1.0]	+1.6 ～ +2.0 [+1.9]	+1.9 ～ +2.1 [+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.

[3] In Jul report, footnote says that "Under a specific methodology, Japan's recent potential growth rate is estimated to be in the range of 0.5-1.0 percent" (the same as in previous Apr report). This reflects the estimated potential growth rate of +0.64% for 2H FY23. The rate should be interpreted with considerable latitude.

In the July "ESP Forecast" survey of private-sector forecasts (Chart 4, 26 June ~ 3 July response period, 38 responses), the projected average real GDP was +0.44% for FY24, +1.07% for FY25, and +0.89% for FY26. The BOJ's forecasts are slightly more bullish than the private-sector forecasts. There are likely to be different views on the strength of the US economy, the resurgence of the manufacturing cycle, and the effects of the government's economic stimulus measures.

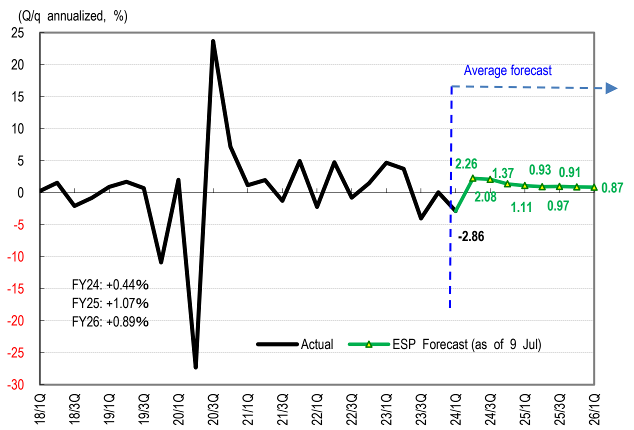
Among the three risks to economic activity and prices in the July *Outlook Report*, risk (1) developments in overseas economic activity and prices and in global financial and capital markets and (2) developments in import prices, particularly those of commodities, including grain were completely the same from the April *Outlook Report*. Risk (3) impact of various changes in the environment surrounding Japan on firms' and households' medium/long-term growth expectations and on Japan's potential growth rate was also unchanged. The economic risk balance was revised from "risks to economic activity are generally balanced for FY24 onward" in the April report to "risks to economic activity are skewed to the upside for FY25" in the July report. While the scenario for FY25 and beyond remains unchanged, it appears that a rebound from the downside in FY24 has been factored in.

Core-core CPI outlook unchanged, to remain around 2%

Meanwhile, the price (core CPI) forecast was revised slightly downward from +2.8% to +2.5% for FY24, due to the government's reinstatement of price inflation measures. The reading for FY25 is somewhat higher than that for FY24 due to the rebound from the downward pressure in FY24. During the past three months, the wage increase rate has been stronger than expected (5.10% in Japanese Trade Union Confederation's (Rengo) final tally of responses from spring wage negotiations), oil prices have trended lower (WTI futures have remained below $80/bbl since late July from $81~86/bbl range in late April), and the yen has appreciated slightly (yen depreciated from USD/JPY155 level in late April to nearly USD/JPY162 in early July, but is now at around USD/JPY152 level). The core-core CPI forecasts, which the BOJ emphasizes as the key underlying price trend, remains unchanged at +1.9% in FY24 and FY25, and will remain elevated at +2.1% in FY26. These figures are based on the assumption that the Bank's 2% price target will be realized. The BOJ is likely to continue to monitor whether prices are indeed moving along that trajectory.

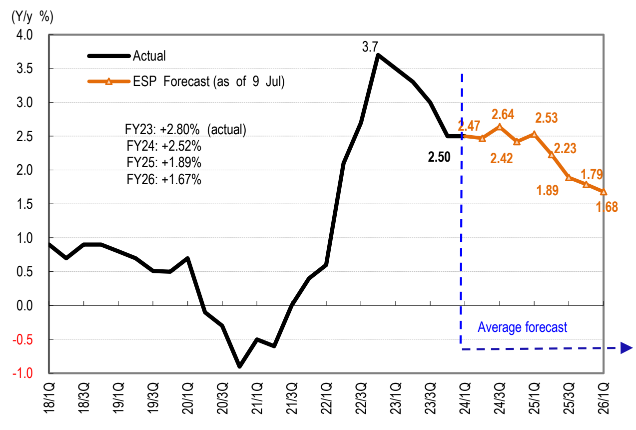
The BOJ maintained its view that "underlying CPI inflation is expected to increase gradually, mainly reflecting the improvement in the macro-output gap and the rise in medium/long-term inflation expectations," while remaining generally consistent with "price stability target" in the second half of the projection period.

Chart 4: Japan's Real GDP Growth Rate Forecasts



Source: Cabinet Office, Japan Center for Economic Research; compiled by Daiwa.

Chart 5: Japan's Core CPI Forecasts



Source: Ministry of Internal Affairs and Communications (MIC), Japan Center for Economic Research; compiled by Daiwa.

Note that since July 2023, after the BOJ increased the accuracy of its price forecasts, the Bank's figures for FY25-26 have been higher compared to the core-CPI forecast averages in the July ESP Forecast survey (Chart 5; +2.52% in FY24, +1.89% in FY25, +1.67% in FY26).

Meanwhile, the Bank's macro-output gap explanation this time was unchanged from April at "gap has followed an improving trend, albeit with fluctuation" and "gap is likely to widen moderately within positive territory toward the end of the projection period." The BOJ's estimate of the output gap announced on 3 July was -0.66% for the Jan-Mar 2024 quarter (-0.03% for previous quarter), remaining stuck in negative since the Jan-Mar 2020 quarter (Chart 7). That said, the weak Jan-Mar quarter result was due to a supply factor in the form of the temporary downturn in auto production, as opposed to weakness in demand. Still, it will take some time before this becomes a securely positive reading.

There were no changes for the two risk factors for prices, specifically (1) firms' wage- and price-setting behavior and (2) future developments in foreign exchange rates and international commodity prices, as well as the extent to which such developments will spread to import prices and domestic prices.

Virtuous cycle of wages and prices starting to turn

Regarding price trends, more and more data is pointing to strength in line with the outlook as of April. As for wages, the wage increase rate in the spring labor-management negotiations reached the highest level in 33 years (+5.10% in Rengo final tally). Also, the Monthly Labour Survey for May showed a +2.5% y/y increase for scheduled cash earnings, the highest level in 31 years, which should lead to expectations for growth in the June report and beyond. The BOJ's July branch managers' meeting report confirmed that wage increases are spreading to small and medium-sized enterprises (SMEs). A separate edition of the Sakura Report explained this situation in greater detail. Along with waiting for the release of pertinent data, the BOJ also had a steady stream of circumstantial evidence about such changing developments from its hearings.

The June Tankan survey was characterized by a strong price DIs, not only for large firms but also for SMEs. The output price DI for SMEs continued to rise and the outlook is particularly bullish, suggesting the possibility of further passing on higher costs to their prices. This has raised expectation that under the Japan FTC's guidelines, SMEs can make progress passing on higher labor costs to their prices. Also, the overall corporate outlook for prices in three years and five years has improved, albeit slightly (Chart 6). These are desirable figures for the BOJ, which wants to anchor inflation expectations at 2%, like the US and Europe.

Ascertaining service prices and consumption trends ahead of next rate hike

The price risk balance was revised to "skewed to the upside for FY24 and FY25" from "skewed to the upside for fiscal 2024 but are generally balanced thereafter" in April.

The focal point going forward is whether wage growth will continue to translate into higher service prices. After confirming that wage increases are spreading, it will be interesting to see if the data for October and beyond will be as expected, specifically progress shifting cost to prices in response to the impact of the yen's prolonged depreciation. We want to confirm that over time this will extend to service prices as well. Meanwhile, considering the balance between the economy and prices, weakness in consumption due to high prices has become concern. Prices and consumption will remain the key items to monitor for the sustained and stable realization of the 2% price target.

Monetary policy explanation suggests hawkish tone, normalization stance

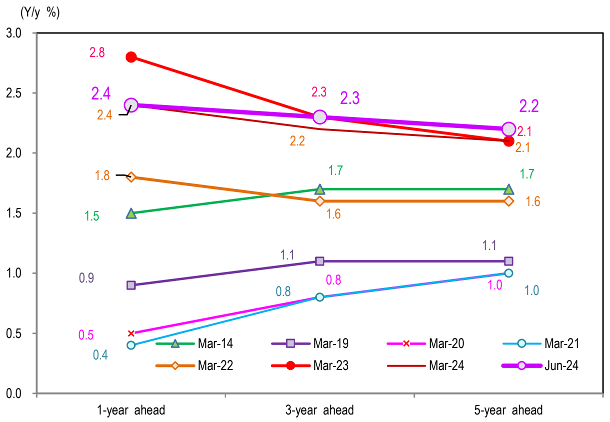
Finally, we note that the explanation of the conduct of monetary policy was heavily revised, including the word order, specifically the section below (shown in bold). Dovish statements in April such as "the Bank anticipates that accommodative financial conditions will be maintained for the time being" and "uncertainty remains high" were removed. In March, when the decision was made to review the framework, there was a shift from a somewhat dovish tone to an emphasis on adjusting the degree of easing in April. Three months later, the decision was actually made to raise interest rates further, in line with the economic and price outlook. The hawkish tone was reinforced with the Bank clearly communicating that if the economic and price outlook is realized, it will continue to normalize monetary policy going forward.

LDP Secretary-General Toshimitsu Motegi, speaking in Tokyo on 22 July, said that the BOJ needed to communicate clearly how it would normalize monetary policy, including considering gradual interest rate hikes. We can probably say that the July BOJ policy board meeting provided a response.

(from July *Outlook Report*, P8)
As for the conduct of monetary policy, ***while it will depend on developments in economic activity and prices as well as financial conditions going forward, given that real interest rates are at significantly low levels, if the aforementioned outlook for economic activity and prices will be realized, the Bank will accordingly continue to raise the policy interest rate and adjust the degree of monetary accommodation.***

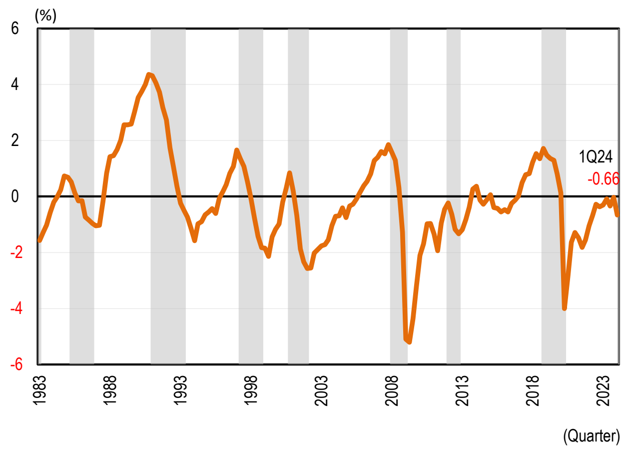
(from April *Outlook Report*, P8)
As for the conduct of monetary policy, it will depend on future developments in economic activity and prices as well as financial conditions. Uncertainties surrounding these economic and financial developments at home and abroad remain high. If the aforementioned outlook for economic activity and prices will be realized and underlying inflation will increase, the Bank will adjust the degree of monetary accommodation, while it anticipates that accommodative financial conditions will be maintained for the time being.

Chart 6: Inflation Outlook of Enterprises in BOJ Tankan (all-size enterprises/all industries)



Source: BOJ; compiled by Daiwa.

Chart 7: Output Gap Estimated by BOJ



Source: BOJ; compiled by Daiwa.
Note: Shaded areas indicate recessions.

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