Daiwa Securities

Daiwa's View

Will global turmoil make BOJ more cautious about hiking rates?

- Political conditions becoming more chaotic worldwide; wave of change ahead of next Trump administration strengthening
- Confusion involving externals is reason for BOJ to be cautious, but not hiking rates entails some costs
- Overly cautious stance on hiking rates at stage far removed from neutral not necessarily appropriate safety measure

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At around 8:00 p.m. Japan time on 6 January, the *Washington Post* ran a report titled, "US President-elect Trump aides considering universal tariffs on critical imports." Markets reacted to this report with the 10-year UST yield dropping from 4.63% to 4.58% and the dollar slipping from USD/JPY157.95 to 156.23. Trump later denied the content of the *Washington Post* report, saying, "The story in the *Washington Post*, quoting so-called anonymous sources, which don't exist, incorrectly states that my tariff policy will be pared back. That is wrong." Following that statement, the 10-year UST yield briefly rose to 4.64% (closed at around 4.61%) and the dollar rebounded to USD/JPY157.2. These moves may have reminded many people of the period around 2016-2019, resulting in a sense of deja vu. These developments, which seemed like a "slapstick comedy," raise concerns for markets once Trump returns to the White House.

Then, on 6 January, both Canadian Prime Minister Justin Trudeau and Fed vice chairman Michael Barr announced early resignations. There was no great sense of surprise about Trudeau's resignation, as his approval ratings have been in a slump for some time and there were also concerns about his poor relationship with Trump. Following the recent political turmoil in Germany and France, this resignation is another reminder of the confusion now surrounding global politics. However, Barr's resignation was somewhat of a surprise as he had previously expressed his intention to serve out his term, which ends in July 2026. It is noteworthy that Barr mentioned in his letter to President Biden that "The risk of a dispute over the position could be a distraction from our mission."

Political situations around the world are becoming increasingly chaotic and we can sense a strengthening wave of change ahead of the next Trump administration.

Two risks lurking behind potential BOJ rate hikes

Even in Japan, where Prime Minister Shigeru Ishiba is already facing a decline in his approval rating, there is room for discussion regarding his compatibility with Trump. A key event in Japan will be the Upper House elections in July. In light of these externals, there is some truth in the current market's interpretation that the BOJ is likely to be more cautious when making decisions. That said, as Mohamed A. El-Erian indicated in the 7 January morning edition of the *Nikkei*, BOJ rate hikes entail two risks. The first risk is "hasty normalization of interest rates" and the second is "being overly cautious about raising interest rates." El-Erian said in this *Nikkei* report that, "Of the two, the more likely risk is that the BOJ will be too cautious and so delay raising interest rates." The latter could also include the risk of excessive yen depreciation.

To begin with, when central banks adjust policy interest rates, the proper course of action is to move more quickly when the policy interest rate is far from neutral and to make adjustments more gradually as it approaches neutral. In the case of Japan, if the current policy interest rate of 0.25% is clearly lower than the neutral interest rate, then being overly cautious about raising interest rates at a stage far from neutral is not necessarily an appropriate safety measure. Of course, the BOJ also must be careful about the uncertainty of externals. This is because, if there are no expectations for dispelling the uncertainties about externals for some time, the Bank could restrict its options to an inappropriate extent.

Costs of raising rates and not raising rates

Ultimately, there are costs to raising interest rates, as well costs to not raising interest rates. Looking at only the current expectations held by JGB market participants[1], the market seems to recognize that the BOJ is estimating the cost of not raising interest rates to be relatively small. However, BOJ Governor Kazuo Ueda said during his December post-meeting press conference, "There is naturally a risk that we could fall behind the curve by waiting too long. We will of course take that risk into account. So, for example, if we decide not to raise interest rates, we will make our decision based on whether it is appropriate to not raise interest rates."

Even when examining the above comments from Ueda, we think the BOJ is fully aware of the existence of potential risks, specifically the risk of "being overly cautious about hiking interest rates" (= falling behind the curve) that El-Erian indicated.

In any event, it is unlikely that the BOJ will finalize its stance for the January Monetary Policy Meeting before confirming the December US employment statistics, which will be released on the 10 January. Our focus will be on what kind of message the BOJ provides after the release of the US employment statistics, including the speech by BOJ Deputy Governor Ryozo Himino on 14 January.

◆ Fed vice chairman Michael Barr (6 Jan 2025)

・The position of vice chair for supervision was created after the Global Financial Crisis to create greater responsibility, transparency, and accountability for the Federal Reserve's supervision and regulation of the financial system. The risk of a dispute over the position could be a distraction from our mission. In the current environment, I've determined that I would be more effective in serving the American people from my role as governor.

[1] 46% of respondents expect a rate hike in January, 74% by March, and 99% by May (based on OIS market, as of 5:00 a.m. 7 Jan).

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