

Daiwa's View

BOJ's neutral rate estimates: Separating the medium- to long-term guideline from the near-term policy path?

- BOJ will very likely indicate a guideline for neutral interest rate at next week's MPM
- If communication can make sharp distinction between near-term policy path and neutral rate, it could potentially have effect comparable to Fed's longer-run federal funds (FF) rate
- In anticipation of flattening pressure on the long-term to superlong zone as uncertainty recedes, we forecast that 10s30s flattener trade will be promising

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Will BOJ narrow the estimated range?

A strong signal was sent via media reports from sources last week indicating that there would be a rate hike (from 0.50% to 0.75%) at the next Monetary Policy Meeting (MPM). In response to this, the OIS market's pricing-in of a rate hike by year-end has risen to 89%. With BOJ Governor Kazuo Ueda having said that the BOJ would state the bank's opinion regarding the neutral rate more clearly at the time of the next rate hike, it is very likely that the BOJ's latest views on the neutral rate will be unveiled next week.

So far, the BOJ's estimated range for the neutral rate has been 1-2.5% (a natural rate of interest of -1% to 0.5% + underlying inflation of 2%). However, the latest consensus is that this estimated range will be narrowed somewhat. Some opinions have been voiced suggesting that raising the lower bound from 1.0% would likely further intensify upward pressure on yields.

Separating the medium-to-long-term guideline from the near-term policy path?

The author believes that the release of the latest views on the neutral rate would carry with it a new, qualitatively different implication. The author feels that it would imply that the BOJ was introducing a communication strategy that made a sharp distinction between the neutral rate and the near-term policy rate path.

As is well known, in its quarterly Summary of Economic Projections (SEP), the Fed uses a dot plot to show the expected path of the FF rate for the next one to three years, while also indicating its "longer run" estimates for the neutral rate. This constitutes a disclosure of information that distinguishes between the neutral rate and near-term policy changes.

US Longer-run FF Rate (median), 30yr US OIS Rate**Projected Appropriate Policy Path (%)**

FF rate	2025	2026	2027	2028	Longer run
Median	3.6	3.4	3.1	3.1	3.0
Central tendency	3.6-4.1	2.9-3.6	2.9-3.6	2.8-3.6	2.8-3.5
Range	2.9-4.4	2.6-3.9	2.4-3.9	2.6-3.9	2.6-3.9

Source: Fed; compiled by Daiwa.

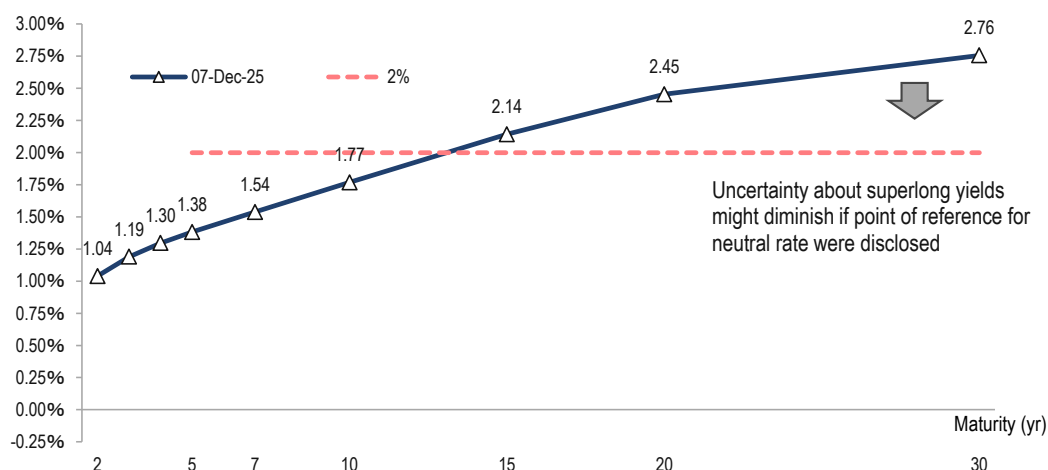
However, in recent discussions about rate hikes in Japan, there has been a tendency to conflate the terminal rate and the neutral rate, which should be distinct concepts. The author's understanding of the issue is that the time has come to adopt an approach to communication that makes a sharp distinction between discussion of the neutral rate and discussion of the near-term policy path.

According to a media report on 5 December based on sources in the know, the BOJ feels that the economic and price situation does not require that there be a continued rush to raise rates after the rate hike to 0.75%, and that, while the BOJ may indicate its latest views on the neutral rate, which neither stimulates nor restrains the economy, determining a specific level will be difficult, and that it has not changed its plans to estimate the rate while assessing the impact of rate hikes. Looking back on the past shows that the BOJ has a track record of successfully paving the way for the withdrawal of monetary easing by presenting a medium- to long-term vision for matters such as the reduction of its JGB holdings (QT) and ETF sales, while maintaining a cautious stance in the short term. By presenting its latest views regarding the policy rate this time around, the BOJ is likely going to indicate the eventual path forward, while implementing cautious rate hikes in the near term. If it were to do this, it would be a favorable move for the current JGB market, which is facing [fragmentation](#) due to uncertain factors.

Flattening

Currently, OIS rates are: 1.04% for the 2-year rate, 1.38% for the 5-year rate, 1.77% for the 10-year rate, 2.45% for the 20-year rate, and 2.76% for the 30-year rate. (See chart below.) If the BOJ were to indicate a base case estimate for the neutral rate of 2.0%, this would be roughly neutral with respect to the current 10-year OIS rate (with 5yr at 1.38% and 5yr5yr at 2.15%), but would potentially exert downward pressure on superlong yields. If the neutral rate were 2.5% or lower, it would exert upward pressure on the 10-year sector, and current superlong yields would be largely justified, which should leave buyers feeling more assured. Finally, if the rate were to be raised to 3.0% or higher, it would likely put upward pressure across the entire yield curve.

Japan's OIS Rates (JYSO), "2%" Line



Source: Bloomberg; compiled by Daiwa.

The neutral rate is 3.0% in the US, where the potential growth rate is more than 1.0% higher than in Japan. Therefore, the center of the neutral rate level indicated by the BOJ this time around is unlikely to be the same as that in the US. Based on a policy of continued rate hikes going forward, we think [the 10s/30s flattener trade would likely be a promising position heading into next year](#).

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