Mizuho Economic Outlook & Analysis

3 Scenarios of the Bank of Japan's Monetary Policy

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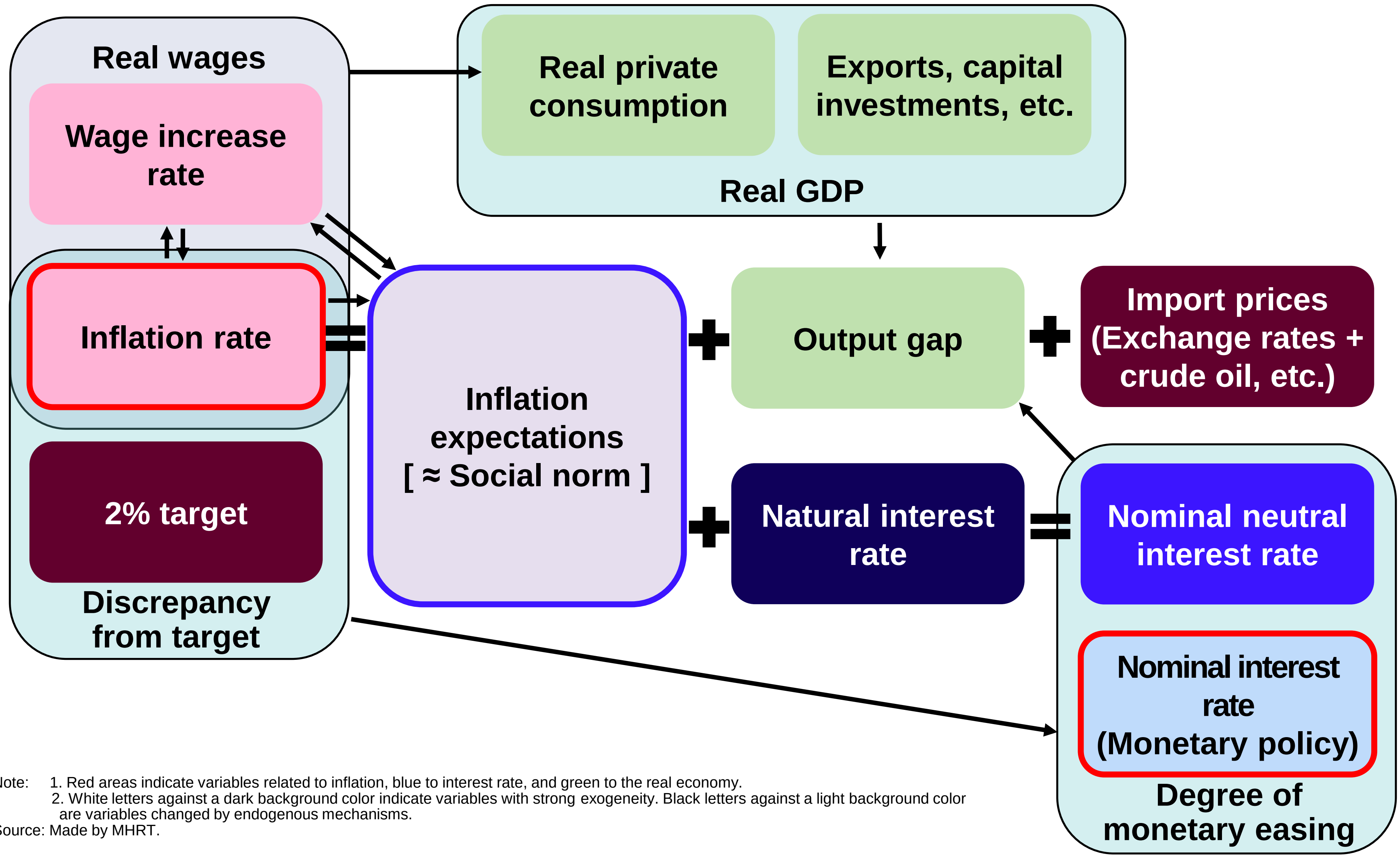
Summary

- **Q1. What are the possible scenarios of the Bank of Japan's monetary policy?**
  - The following 3 scenarios are considered possible:
    - (1) Raise the policy rate to 0.5% with no further increase. [Probability: 55%]
    - (2)-(A) Raise the policy rate to around 1% with no further increase. [Probability: 30%]
    - (2)-(B) Raise the policy rate to the nominal neutral interest rate level. [Probability: 10%]
  - The possibility of the policy rate not reaching 0.5% is low. [Probability: 5%]

- **Q2. What are the prospects of sustained inflation and wage growth?**
  - Thanks partly to "5% wage hikes," there is now a consensus that the inflation rate (core CPI) will exceed 2% in FY2024, but as wage growth slows in FY2025, core CPI is projected to fall below 2%. There is a high probability of the eventual situation not making it possible to declare the "sustained achievement of the 2% inflation target."
  - Meanwhile, with inflation expectations already rising to the mid-1% range, the likelihood of "a situation where achievement is in sight" falling apart quickly has significantly decreased. The scenario of the policy rate rising to just below the neutral interest rate (around 1%) ((2)-(A) in Q1) is considered plausible.

- **Q3. What is the outlook for the "neutral interest rate," which indicates the end point of rate hikes?**
  - The rate is estimated to be around 1%. Under the scenarios with continued rate increases ((2)-(A)(B) in Q1), the rate is expected to climb to the mid-1% range or around 2% from FY2026 to FY2027, creating room for a rate hike with considerable uncertainty remaining.

What does the BOJ watch for in managing its monetary policy?
(Relationship between macroeconomic variables and monetary policy)



Note: 1. Red areas indicate variables related to inflation, blue to interest rate, and green to the real economy.
2. White letters against a dark background color indicate variables with strong exogeneity. Black letters against a light background color are variables changed by endogenous mechanisms.

Source: Made by MHRT.

What is the neutral interest rate? What does it mean for monetary policy?

Inflation expectations

Forecasts about future inflation rates

+

Natural interest rate (Neutral real interest rate)

<u>Real</u> interest rate corresponding to the economic status of "neither expanding nor weakening"
(Real interest rate = interest rate - inflation expectations)

=

Nominal neutral interest rate

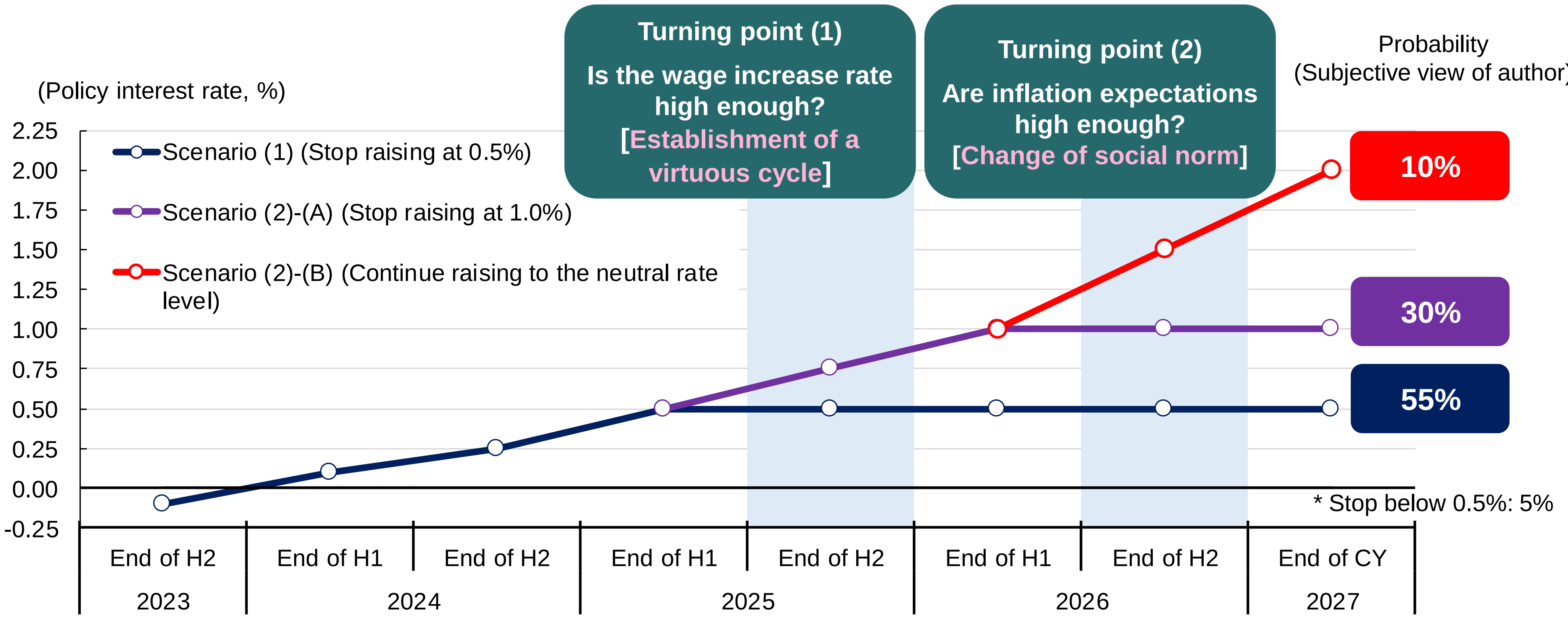
Interest rate corresponding to the economic status of "neither expanding nor weakening"
The actual rate below this level indicates a "accommodative monetary policy."

→ An important concept in predicting the pace of BOJ's interest rate increase.
(But an accurate reading is extremely difficult.)

Source: Made by MHRT.

3 scenarios of future monetary policy

- Roughly 2 patterns are considered possible for future monetary policy.
  - (1) Raise the policy rate to 0.5% with no further increase.
  - (2) Continue raising the policy rate thereafter.
- Case (2) leads to 2 further scenarios (total of 3 scenarios including (1)).
  - (2)-(A) Raise the policy rate to around 1% with no further increase.
  - (2)-(B) Raise the policy rate to the nominal neutral interest rate level.

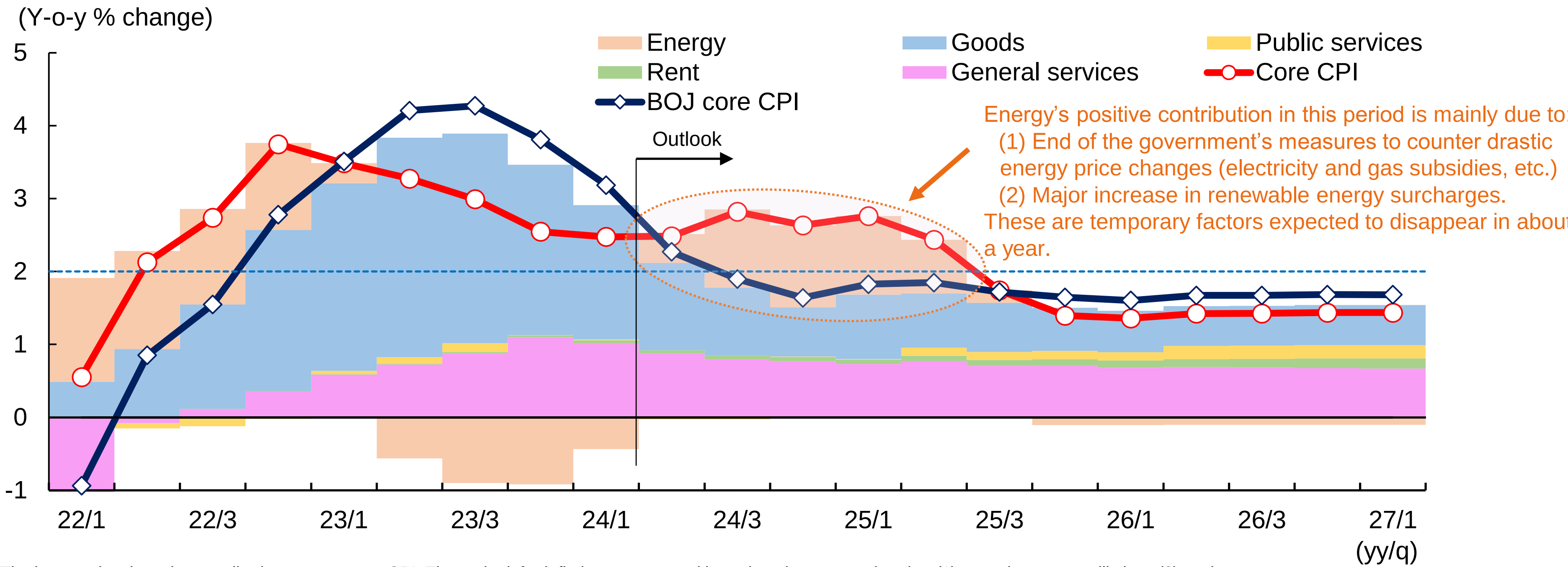


Source: Made by MHRT.

Inflation will fall below 2% within FY2025 and trend around the mid-1% range thereafter

- Inflation is predicted to hover far above 2% in FY2024, but the rate is expected to fall significantly to the mid-1% range in the first half of FY2025 due to (1) slowdown in wage growth and (2) loss of energy contributions.
- Thanks to high levels of wage increases and other factors, general services prices are likely to maintain high growth for the time being, but increases in goods prices will show a marked decline.

Outlook for inflation

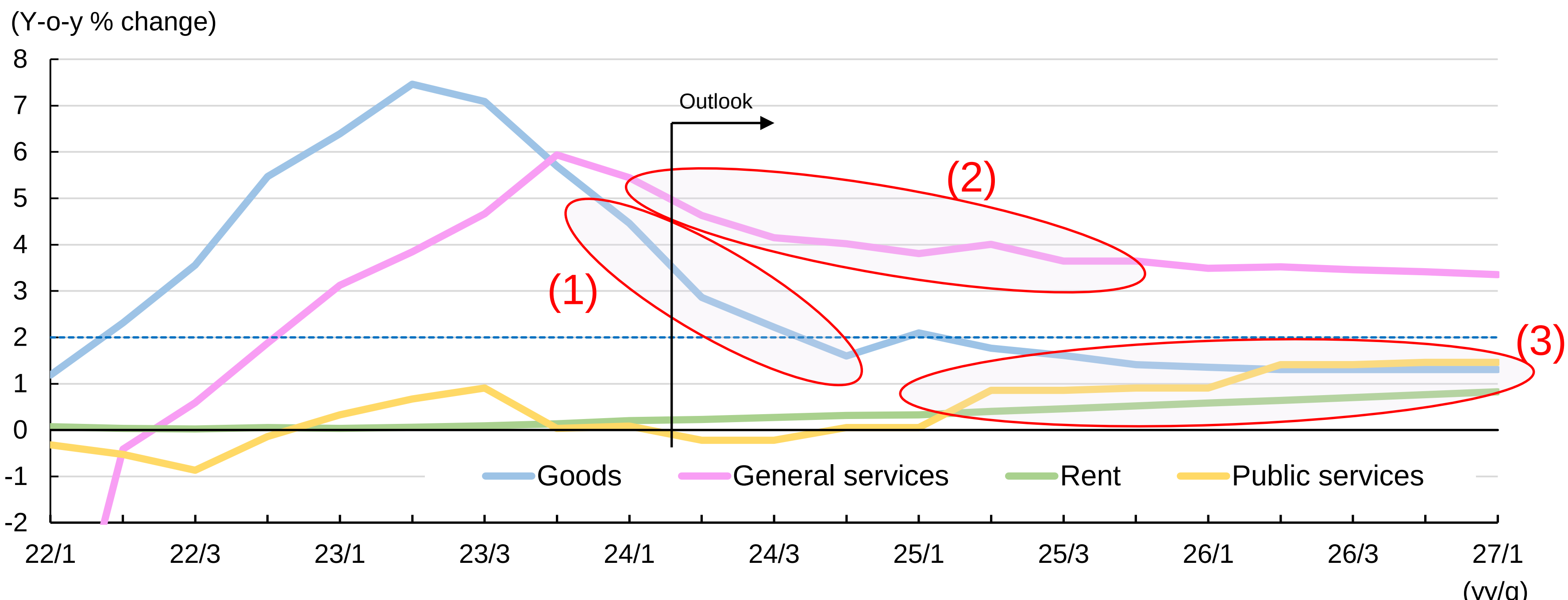


Note: The bar graphs show the contribution rates to core CPI. The outlook for inflation was created based on the assumption that (1) wage increases will slow; (2) exchange rates will gradually move toward a higher yen; and (3) oil prices will gradually decline. Goods exclude energy, and general services exclude rent.
Source: Made by MHRT based upon the Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Key points in predicting the underlying inflation rate

- There are 3 key points in predicting the underlying inflation rate.
  - (1) How much goods inflation slows when the so-called “first-round effects” weaken.
  - (2) To what degree large wage hikes are reflected in general services prices (= emergence of “second-round effects”).
  - (3) Whether rents and public utility charges, which have mostly remained flat, will rise faster.

Outlook for inflation by category

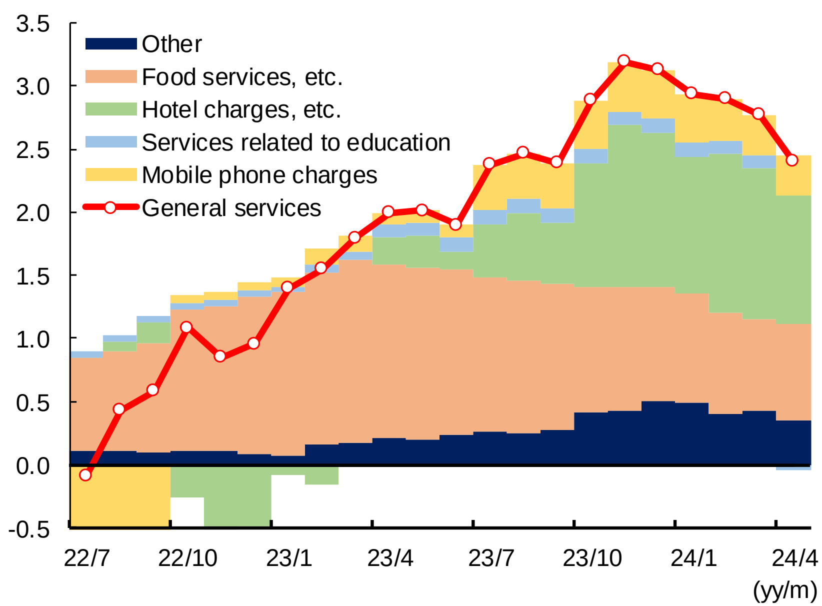


Note: The outlook was created based on the assumptions that (1) wage increases will slow; (2) exchange rates will gradually move toward a higher yen; and (3) oil prices will gradually decline. Goods exclude energy, and general services exclude rent.
Source: Made by MHRT based upon the Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Services price hikes are spreading across wider areas but remain insufficient

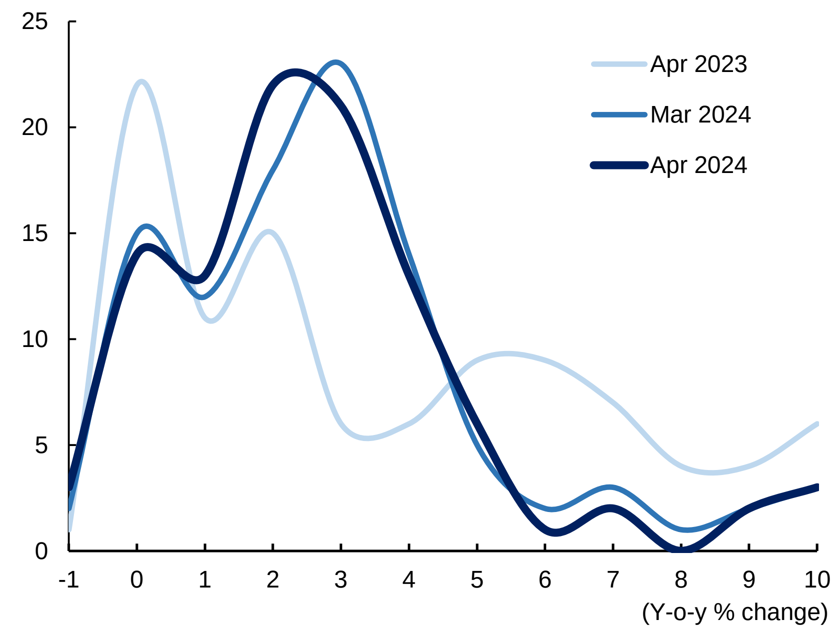
- Services prices rose higher than 2% in FY2023, but contributions were made mostly by limited items (food services, hotel charges, overseas package tour charges, etc.). Prices have yet to rise across the entire sector.
- The distribution of general services' price fluctuations shows the price-hike trend is spreading across wider areas to a certain extent, but many categories continue to remain at around 0%, indicating the insufficient pass-through of wage increases.
  - The peaks around 2-3% are due to 0-1% increases for some items and declines in the figures for food services, etc. from above 5%.

Breakdown of general services' contribution rates



Note: Hotel charges, etc. include lodging and overseas package tour charges; food services, etc. include meals outside the home and services related to domestic duties; and services related to education include private school tuition and supplementary education fees.
Source: Made by MHRT based upon the Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Distribution of general services' price fluctuation rates by items



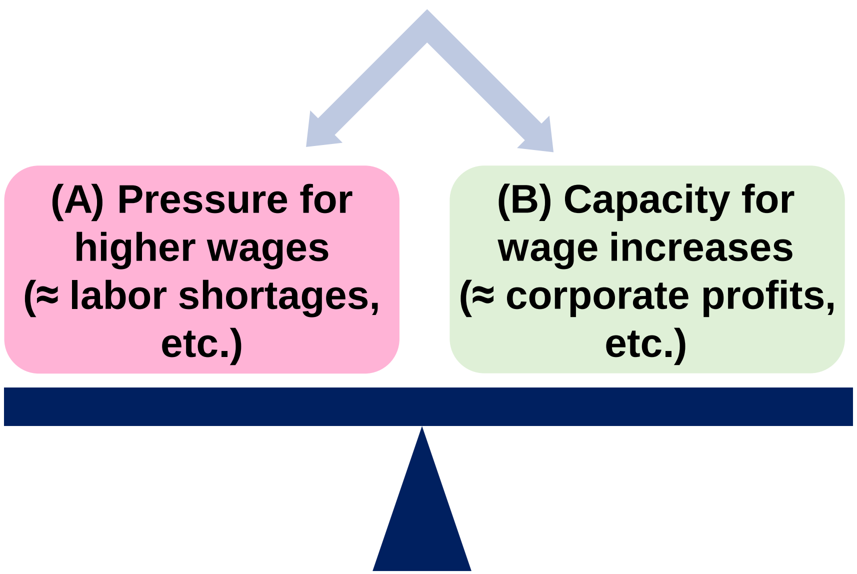
Source: Made by MHRT based upon the Ministry of Internal Affairs and Communications, *Consumer Price Index*.

Wage inflation is projected to slow from 2025 as firms' capacity to raise wages diminishes

- The wage increase rate is determined by the balance between "pressure for higher wages" (≈ labor shortages, etc.) and "capacity for wage increases" (≈ corporate profits, etc.).
- Since the "capacity for wage increases" is insufficient to sustain "5% pay hikes," wage growth is highly likely to lose momentum from 2025.
  - This year's pay hikes are expected to weigh heavily on the profits of small and midsized firms.
- In predicting the rate of slowdown, the most important point is the degree of pass-through of increased labor costs to prices.

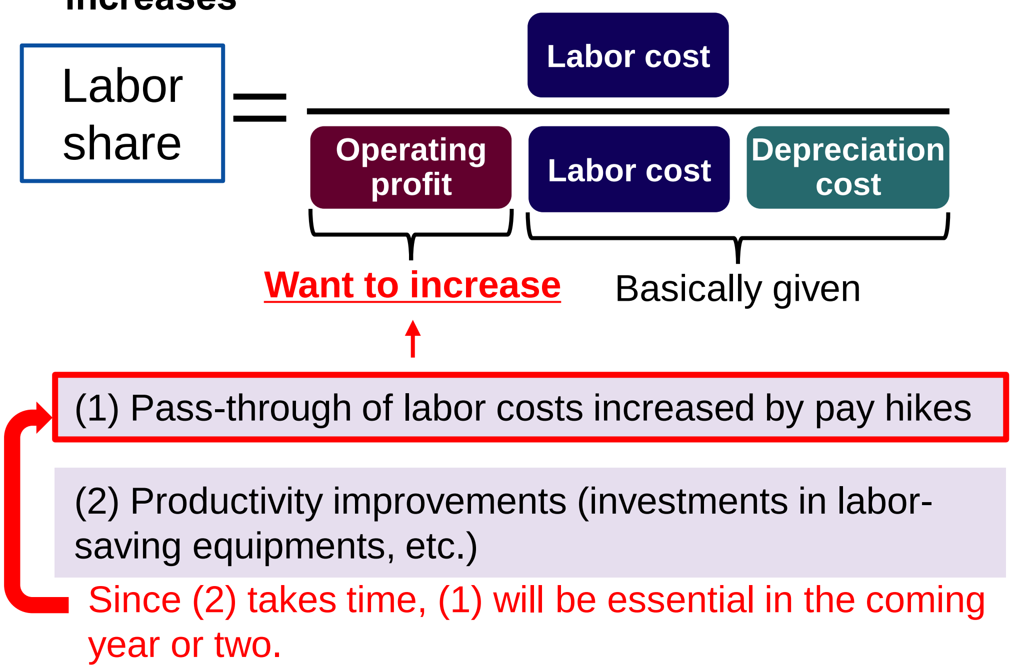
Environment surrounding wages

To which side the balance between (A) and (B) shifts will significantly affect wage growth in 2025.



Source: Made by MHRT.

Labor share as an index of "capacity for wage increases"



Source: Made by MHRT.

Raising wages to the mid-4% range is crucial to sustain 2% inflation

- Considering wage increases as a cost factor, mid-4% wage hikes (including regular raises) are required to sustain 2% inflation.
  - If wage growth fails to reach this level, cost-push pressure through labor cost increases will be insufficient, while declines in real wages will weaken personal spending, affecting companies' price-setting stance, and inflation is likely to slow.
- For this reason, if the rate of wage growth surpasses the mid-4% range in 2025, it will be easier for the BOJ to continue increasing rates.
  - On the other hand, if wage growth slows significantly, as businesses struggle to pass labor costs on to prices, it will be difficult to maintain a "virtuous cycle of wages and prices." (There is a higher probability for this case at present.)

Wage increase rate that aligns with 2% inflation

	3.5% wage increase	4.0% wage increase	4.5% wage increase
2% inflation rate	(Cost push is insufficient)	(Uncertain)	(Sufficient cost push)

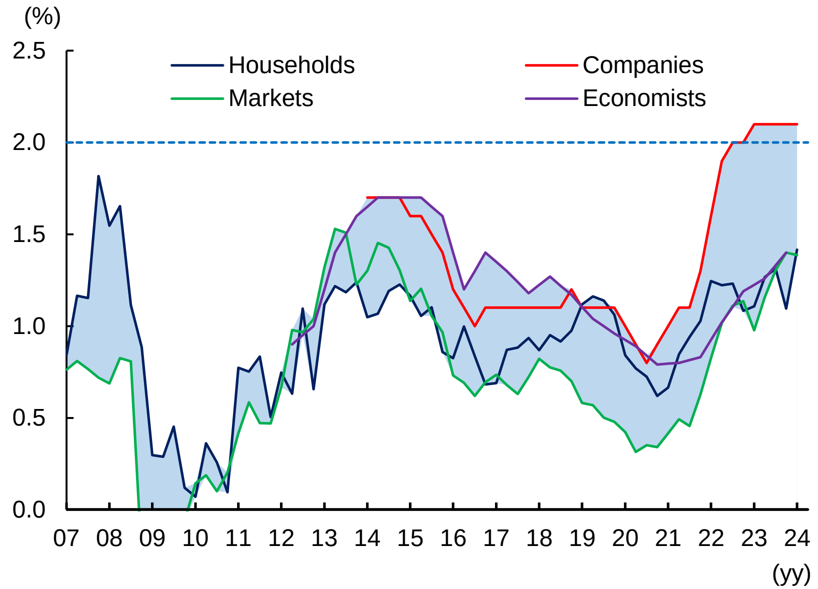
↑ At present, a rate around this level (upper 3% range) seems realistic.
(1) Pass-through of labor cost remains insufficient.
(2) As a result, mainly small and midsized firms will lose the capacity for wage increases.

Note: Wage increase rates include regular raises.
Source: Made by MHRT.

Inflation expectations currently stand at the mid-1% range and reaching 2% will take time

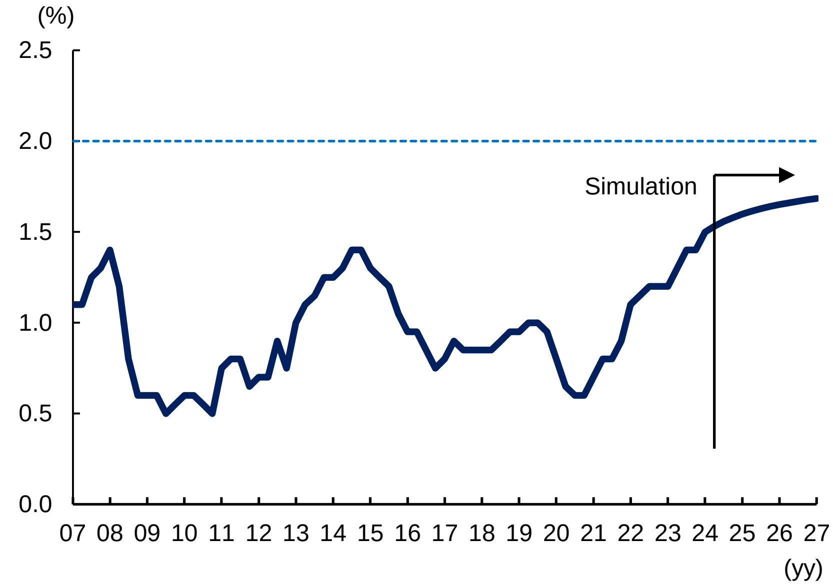
- “Inflation expectations” are important for the price outlook over the next two to three years.
  - “Inflation expectations” are largely synonymous with “underlying inflation,” a term frequently used by the BOJ recently.
- Multiple inflation expectation indices were combined to make one indicator for running a simulation on the future course. The result shows that inflation will gradually rise from the current mid-1% range to 1.7% by the end of FY2026 but will not reach 2%. If inflation expectations (≈ underlying inflation) fail to reach 2%, “sustainable achievement of the 2% target” cannot be declared.

Medium- to long-term inflation expectations by economic agents



Note: For “households” data, the modified Carlson-Parkin method was applied to qualitative answers (outlook five years from now) to the BOJ’s Opinion Survey on the General Public’s Views and Behavior. Data for “companies” are from the outlook of “General Prices” five years ahead of the Tankan Short-Term Economic Survey. Data on “markets” are the average of BEI 10 years and the QUICK survey (for the next ten years). “Economists” data are ESP Forecasts (7 to 11 years ahead.)
Source: Made by MHRT based upon the Bank of Japan, LSEG, QUICK, and others.

Simulation on medium- to long-term inflation expectations



Note: Medium- to long-term inflation expectations are “synthesized inflation expectation indicators” estimated by the BOJ. The BOJ’s analysis (2016) was used as a reference for the simulations. Specifically, simulations were run by providing paths of supply-demand gaps exogenously, based on the economic outlooks of private institutions, to establish a model where inflation history and inflation expectations mutually influence
Source: Made by MHRT based upon the Bank of Japan, LSEG, QUICK, and others.

Nominal neutral interest rate is projected to rise, but strong uncertainty remains

- Assessing the “neutral interest rate” level is an extremely difficult task that makes the BOJ generally cautious about the information it releases. According to recent releases, however, the BOJ is seen to estimate the current neutral rate of around 1% at the minimum.
- The future course of the neutral interest rate depends on the growth of inflation expectations (≈ underlying inflation). In the scenarios with continued rate increases, the neutral rate is expected to rise to the “mid-1% to 2% range.” If inflation expectations rise steadily, the possibility of rate hikes continuing to these levels cannot be ruled out.

Definition of “nominal neutral interest rate” (repeated)

Nominal neutral interest rate

= Natural interest rate

+ Inflation expectations

Source: Made by MHRT.

Levels of the nominal neutral interest rate (estimated based on information released by the BOJ, etc.)

Present

Around +1.0% to +1.5%

*** Calculated with the natural interest rate at -0.5% to ±0.0% and inflation expectations at +1.5%.**

Future (roughly FY2026 to FY2027)

Around +1.4% to +1.9% (Scenario (2)-(A))

Around +2.0% (Scenario (2)-(B))

*** Both scenarios are based on the assumption of an unchanged natural interest rate. Inflation expectations are assumed to increase by around +0.5%pt.**

Source: Made by MHRT based upon the Bank of Japan and others.