Japan: BoJ justifying rate hikes with reasons for rate cuts

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- **The BoJ has been maintaining its policy that "if its 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". In the Outlook Report and in Deputy Governor Shinichi Uchida's speech, he pointed to the severe labour shortage and the inability of facilities to operate as the reasons why strong inflation continues and interest rates need to be raised despite the small supply-demand gap. The interpretation is that there is a surplus of capital that cannot be operated due to labour shortages, and although the supply-demand gap is estimated to be small, strong inflation will continue.**
- **To strengthen the substitutability of capital and labour, the predictability of firms with sustained nominal GDP expansion must be increased. Increasing that predictability will require a continued commitment by policymakers to an accommodative policy mix. It is the exact opposite of hiking rates because the substitutability of capital and labour is weak, and because labour shortages will cause inflation to rise strongly. Stronger commitment by policymakers to continue an accommodative policy mix is likely to lead to stronger substitutability. Since demand would not be strongly stimulated by a rate cut, if the BoJ's analysis is correct, the monetary policy needed to stabilise the rate of inflation is not a rate hike, but a rate cut to promote capital investment. Excessive rate hikes that further weaken the rate of substitution would only lead to stagflation.**
- **The BoJ is making the mistake of thinking that the substitutability of capital and labour is a micro outcome and not a macro outcome such as interest rates and expectations for nominal GDP. It is making the mistake of trying to justify rate hikes by the stereotype that higher inflation = higher interest rates, and as a result, it is making the mistake of explaining rate hikes with reasons for rate cuts. In fact, just as the "stock effect" of lowering long-term interest rates that the BoJ had claimed did not actually exist, we would know that another BoJ theory is wrong, as the structural deflationary pressures of a weak supply-demand gap and a positive corporate savings rate is likely to begin outweighing the impact of rising import prices, and from H225, the rate of inflation begins to slow rapidly. We continue to expect the BoJ to hike its policy rate only once in FY25 (through Q126). With the Trump administration's policies and the growing uncertainty about the US economic outlook, the BoJ's judgment is likely to shift more weight to the "continued high level of uncertainty surrounding the economy and prices" than to the increased certainty of achieving the price stability target, and the pace of rate hikes is likely to slow. The BoJ added "the evolving situation regarding trade and other polices in each jurisdiction" to the list of uncertainties.**

At its March monetary policy meeting, the BoJ left its policy rate (overnight unsecured call rate) unchanged at 0.5%. Having just decided to raise rates in January, the BoJ decided that there was no need for consecutive rate hikes. The BoJ maintained its judgment that "Japan's economy is likely to keep growing at a pace above its potential growth rate, with overseas economies continuing to grow moderately and as a virtuous cycle from income to spending gradually intensifies against the background of factors such as accommodative financial conditions". However, the real GDP in 2024 was almost zero percent (+0.1%) from the previous year, well below the potential growth rate (+0.6%)

estimated by the Cabinet Office. With the supply-demand gap also at almost zero percent, the risk that economic overheating to accelerate the rate of inflation is small. Political criticism is mounting against the BoJ's monetary policy management, which has been responsible for zero growth by twice backfiring rate hikes while the government has supported economic activity with massive economic stimulus and flat-amount tax cuts. We expect the real GDP growth to be negative in Q125 due to a prematurely executed additional rate hike in January and a rebound from the rush of exports before the Trump tariffs. Fears of future rise in mortgage rates have considerably weakened consumer activity at the end of last year and the beginning of this year. With the Trump administration's policies and the growing uncertainty about the US economic outlook, the BoJ's judgment is likely to shift more weight to the "continued high level of uncertainty surrounding the economy and prices" than to the increased certainty of achieving the price stability target, and the pace of rate hikes is likely to slow. The BoJ added "the evolving situation regarding trade and other polices in each jurisdiction" to the list of uncertainties.

The BoJ has been maintaining its policy that "if its 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". In the Outlook Report and in Deputy Governor Uchida's speech, he pointed to the severe labour shortage and the inability of facilities to operate as the reasons why strong inflation persists and interest rates need to be raised despite the small supply-demand gap. The interpretation is that there is a surplus of capital that cannot be operated due to labour shortages, and although the supply-demand gap is estimated to be small, strong inflation will continue. The substitutability of capital and labour is weaker in Japan than in the US and other countries. According to Yasuyuki Iida, Professor of Political Economy at Meiji University, a 1% increase in the capital/labour price ratio would result in a change in the capital/labour ratio of only 0.20-0.25 in Japan, but 0.7-1.0 in the US. This means that despite the growing labour shortage, substitution by machines and software is weak in Japan. Deputy Governor Uchida commented, "we need to address this issue of substitutability through, for example, the joint introduction of software or the consolidation of businesses to reach a larger scale. As you all know, raising productivity is a long and steady process. I believe we need to think concretely about measures to help micro level efforts in the workplace" and judged that it is a micro issue.

The weak substitutability of capital and labour in Japan is the result of rational corporate decisions. When the Japanese economy began to recover after the financial bubble burst, the government and the BoJ quickly resorted to austerity measures, and nominal GDP did not expand from an average of JPY525trn. If the business pie does not expand, it is rational for companies to not stop cutting costs and to continue to rely on surplus workers & low wages. This is because there was zero foreseeability of a sustained expansion of nominal GDP as a result of policymakers repeatedly crushing the economy when it began to grow. In order to increase the predictability of firms, there must be a strong commitment by policymakers to firmly expand the economy. Once that predictability is enhanced, investment in the substitution of labour for capital should quickly become stronger. Until that point, policymakers would need to continue with an accommodative policy mix. However, the BoJ has maintained its policy of reducing its accommodative monetary policy, and the government, led by Prime Minister Shigeru Ishiba, who has a pet theory of fiscal soundness, is beginning to show signs of being frightened by the "world with interest rates" and is moving in the direction of austerity, aiming to bring the primary balance into the black as soon as possible. It is another move to crush corporate predictability.

To strengthen the substitutability of capital and labour, the predictability of firms with sustained nominal GDP expansion must be increased. Increasing that predictability will require a continued commitment by policymakers to an accommodative policy mix. It is the exact opposite of hiking rates because the substitutability of capital and labour is weak, and because labour shortages will cause inflation to rise strongly. Stronger commitment by policymakers to continue an accommodative policy mix is likely to lead to stronger substitutability. Since demand would not be strongly stimulated by a rate cut, if the BoJ's analysis is correct, the monetary policy needed to stabilise the rate of inflation is not a rate hike but a rate cut to promote capital investment. Excessive rate hikes that further weaken the rate of substitution would only lead to stagflation. The BoJ is making the mistake of thinking that the substitutability of capital and labour is a micro outcome and not a macro outcome such as interest rates and expectations for nominal GDP. It is making the mistake of trying to justify rate hikes by the stereotype that higher inflation = higher interest rates, and as a result, it is making the mistake of explaining rate hikes with reasons for rate cuts. In fact, just as the "stock effect" of lowering long-term interest rates that the BoJ had claimed did not actually exist, we would know that another BoJ theory is wrong, as the structural deflationary pressures of a weak supply-demand gap and a positive corporate savings rate is likely to begin outweighing the impact of rising import prices, and from H225, the rate of inflation begins to slow rapidly. We continue to expect the BoJ to hike its policy rate only once in FY25 (through Q126).

BoJ's outlook on GDP growth rate and inflation

BoJ	Real GDP	CPI (ex fresh food)	CPI (ex fresh food and energy)
FY24	+0.5	+2.7	+2.2
FY25	+1.1	+2.4	+2.1
FY26	+1.0	+2.0	+2.1

Units: yoy%

Source: BoJ, Crédit Agricole CIB

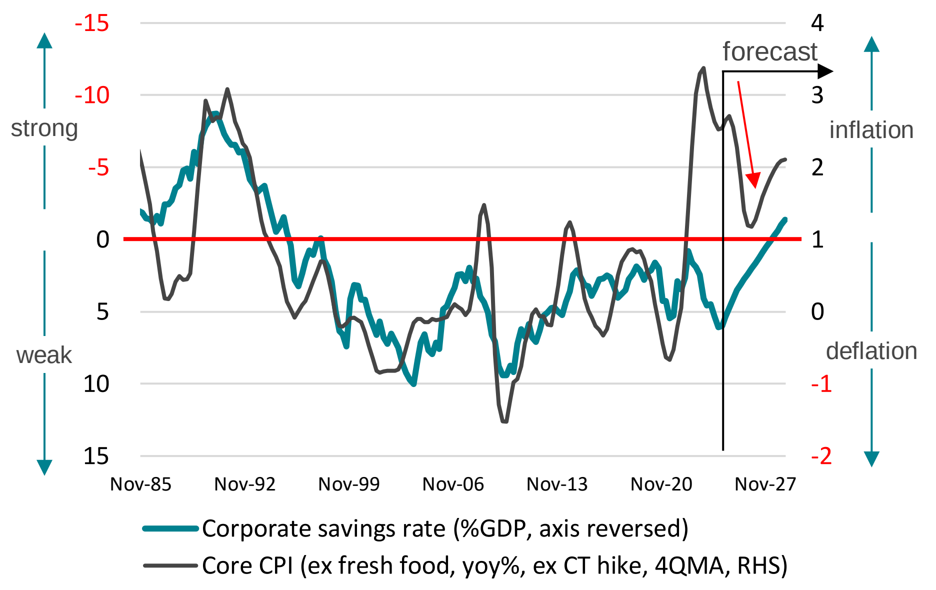
CACIB's outlook on GDP growth rate and inflation

CACIB	Real GDP	CPI (ex fresh food)	CPI (ex fresh food and energy)
FY24	+0.7 (+0.1)	+2.7(+2.5)	+2.3 (+2.4)
FY25	+0.6 (+0.9)	+2.1 (+2.5)	+2.0 (+2.4)
FY26	+1.3 (+1.0)	+1.3 (+1.2)	+1.3 (+1.2)
FY27	+1.6 (+1.6)	+1.9 (+1.7)	+1.9 (+1.7)

*parenthesis denote CY forecast; Units: yoy%

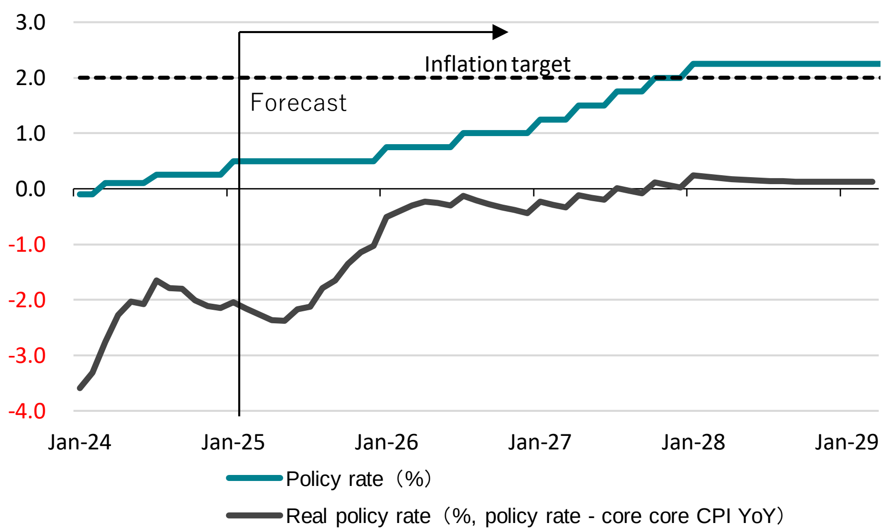
Source: Crédit Agricole CIB

Corporate savings rate and core CPI



Source: Cabinet Office, BoJ, MIAC, Crédit Agricole CIB

BoJ policy rate



Source: BoJ, MIAC, Crédit Agricole CIB

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