

Two considerations that matter more in a “new phase”

The Bank of Japan (BoJ) raised its policy rate to around 1.25% at its September 17–18 Monetary Policy Meeting. Its next meeting will take place on October 29–30. On October 30, the BoJ is scheduled to release its latest assessment of current economic and price conditions and its outlook as “The Bank’s View” in the Outlook for Economic Activity and Prices (Outlook Report; the full report will be published on the following business day).

At the press conference following the September meeting, the Governor’s statement that monetary policy had entered a “new phase” attracted particular attention (1). He explained that the objective of policy had shifted from raising underlying inflation when it was thought to be below 2%, to stabilizing it at around 2% as it approaches that level.

If this is interpreted as a message that the price stability target has broadly been achieved, the implication, in theory, is that the policy rate should be kept at the neutral interest rate — the level that neither stimulates nor restrains economic activity and inflation. The estimated range for the neutral rate is around 1.1% to 2.5%, and September’s increase brought the policy rate close to the lower bound. The question now is how quickly, and how far, the BoJ will continue to raise rates under its stated policy of further tightening.

Two considerations will be particularly important: the outlook and risks for underlying inflation, and the current state of financial conditions. Upside risks to underlying inflation will be a key determinant of the eventual destination for rate hikes — the terminal rate— while the extent to which financial conditions remain accommodative will help determine their pace.

This article first assesses the current state of underlying inflation. It then considers the discussions that may unfold at the October meeting on inflation risks and financial conditions, drawing on the Governor’s September press conference, the meeting’s Summary of Opinions (2), remarks by Policy Board members in September and October, and recent economic data.

How should current underlying inflation be assessed?

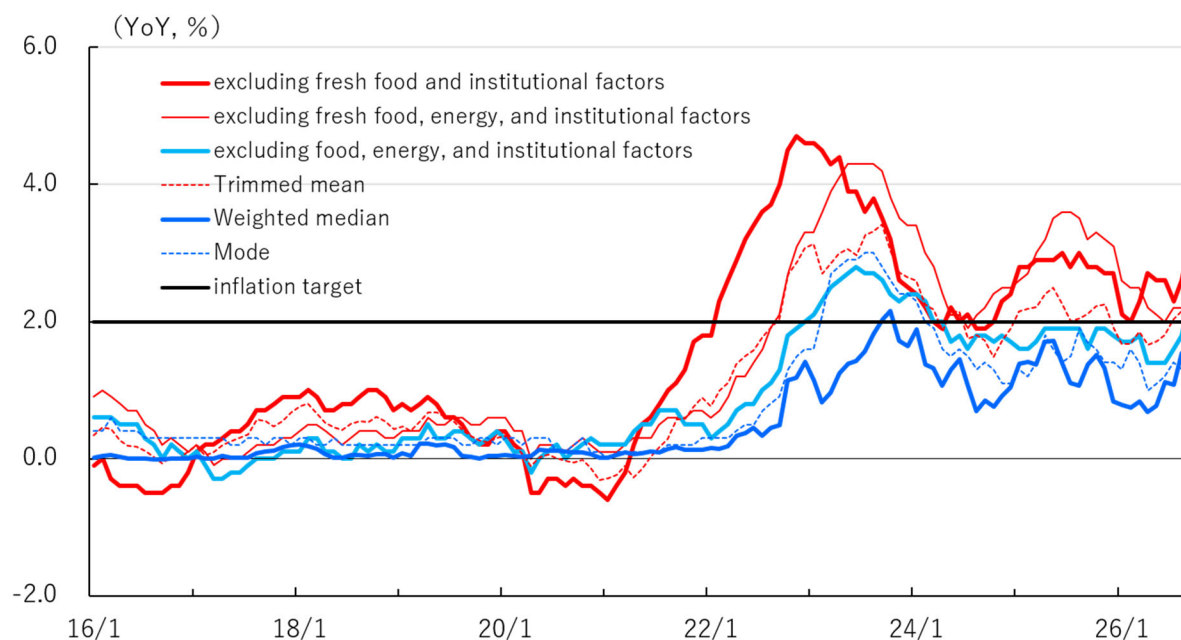
At the September meeting, BoJ used the same wording in the statement as before: “underlying CPI inflation has been approaching 2 percent.” The Summary of Opinions from the September meeting also included some views, such as “underlying CPI inflation has generally reached 2 percent” and “underlying CPI inflation is expected to reach 2 percent before long” that were somewhat stronger than the BoJ’s official assessment.

Other opinions, however, noted that Within the CPI, “the year-on-year rate of increase in services prices has been rising gradually thus far, but it appears that the pace of increase has been more or less unchanged recently” and “the rates of increase in both the CPI (all items less fresh food) and the CPI (all items less fresh food and energy) have remained in the range of 1.5–2.0 percent recently,” which implicated there was no sign of accelerating the underlying CPI inflation and had not reached 2%.

Among the BoJ’s published measures of underlying inflation, the three series that tend to register higher readings have remained above 2%, while the three that tend to register lower readings have

generally remained below 2% (Figure 1). In recent months, however, all six measures have risen, with the latter three approaching or edging slightly above 2%.

Chart 1: Indicators of underlying inflation

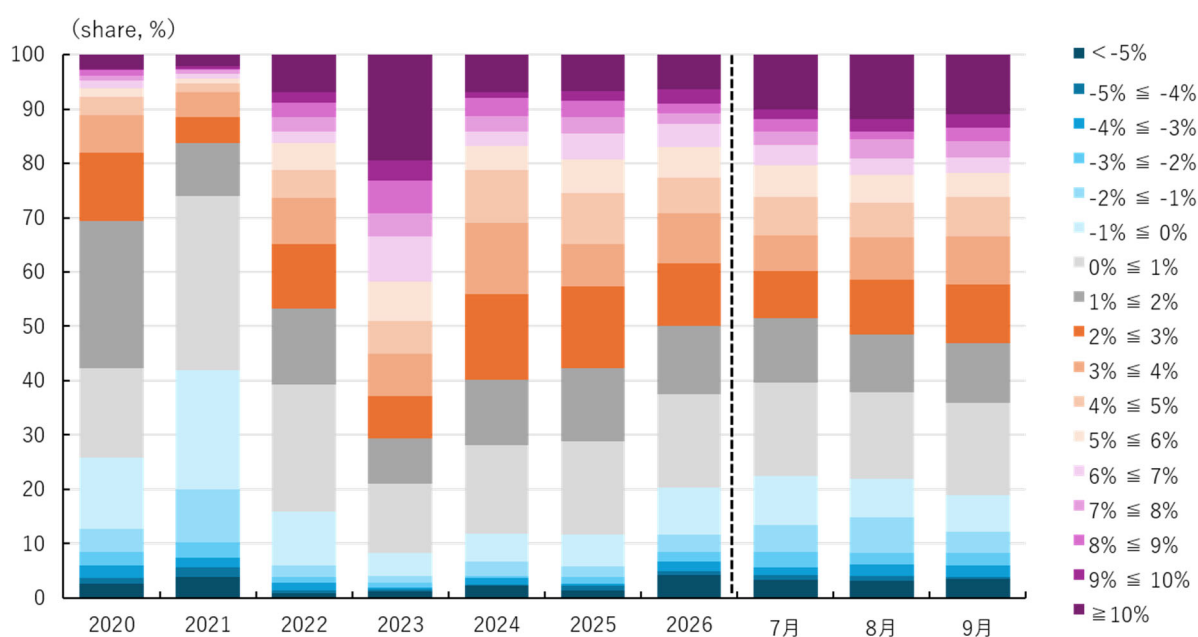


Source: Nomura Research Institute, based on Bank of Japan data.

At the September meeting, board members also shared the view that increases in prices charged in business-to-business transactions were being passed through to consumer prices, and that, as anticipated before the summer, some degree of pass-through was occurring across a broad range of items.

The distribution of price increases across CPI items supports this assessment: since July, the share of items with year-on-year price increases exceeding 2% has gradually risen and now exceeds 50% (Chart 2).

Chart 2: Distribution of price increases across CPI items



Sources: Bank of Japan “Tankan” and “Opinion Survey on the General Public’s Views and Behavior,” Statistics Bureau “Consumer Price Index (CPI).” Compiled by Nomura Research Institute

Taken together, the gradual changes in these indicators over the past several months suggest a meaningful possibility that the BoJ’s updated assessment on October 30 will describe underlying inflation as having “broadly reached 2%.”

Upside inflation risks and the terminal rate

How should upside risks to inflation be assessed? At the September meeting, developments in the Middle East, global demand related to artificial intelligence (AI), and exchange-rate movements were cited as potential sources of upward pressure. At his press conference, the Governor also referred to enterprises’ increasingly proactive wage- and price-setting behavior and a rise in medium- to long-term inflation expectations. The Summary of Opinions additionally cited the risk of higher import prices and persistently elevated oil prices. More specifically, it noted that rising costs for packaging materials, food trays and distribution costs could make it easier for enterprises to pass on costs, supporting further increases in final consumer goods’ prices.

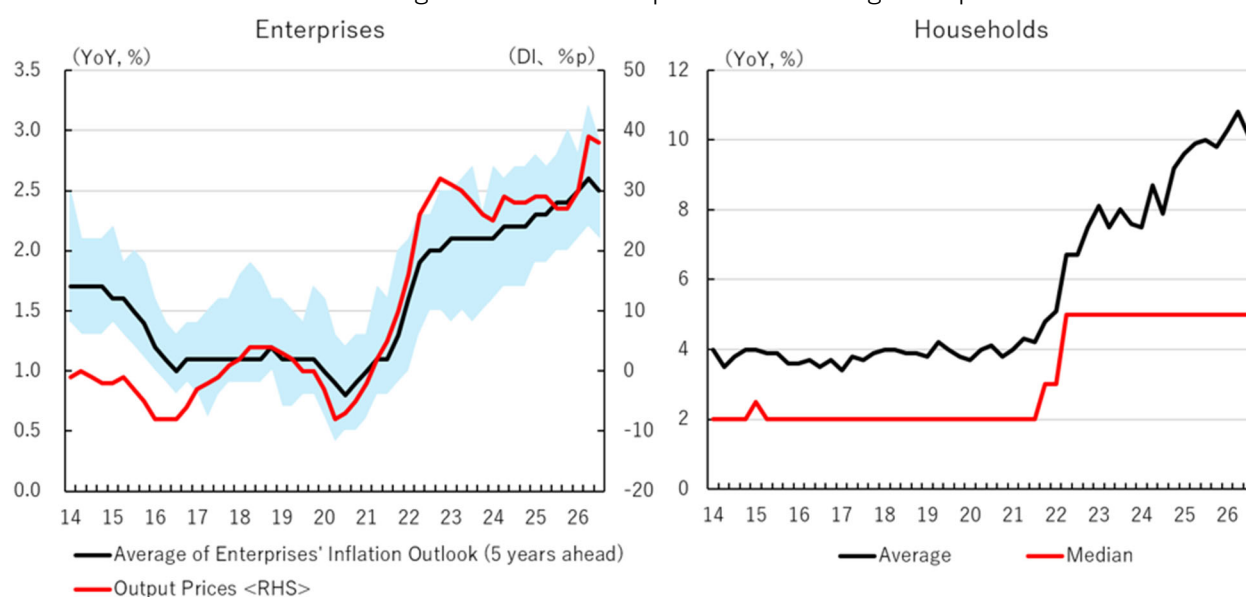
On global AI demand, Governor Ueda was reported to have said after attending the G20 finance ministers’ meeting that he said more policymakers saw global AI demand as somewhat stronger than what the BoJ had expected. (3) For Japan, AI demand could add to inflationary pressure by directly boosting exports and capital investment, widening the output gap. It may therefore be discussed as an additional upside risk relative to the previous meeting.

Developments in the Middle East and exchange-rate movements are, in themselves, sources of supply-driven price pressure. If that pressure becomes persistent through the interaction of wages and prices, however, it would pose an upside risk to underlying inflation. The key issue in the second

half of this fiscal year will therefore be second-round effects: changes in enterprises' price-setting behavior, developments in the spring wage negotiations ahead of the next fiscal year, and medium- to long-term inflation expectations among enterprises and households.

The October Tankan showed small declines in both enterprises' selling-price outlooks and their medium- to long-term inflation expectations. Households' medium- to long-term inflation expectations moved similarly. Nevertheless, all remain high by historical standards and warrant continued attention (Chart 3).

Chart 3: Medium- to long-term inflation expectations among enterprises and households



Source: Nomura Research Institute, based on the Bank of Japan's Tankan and Opinion Survey on the General Public's Views and Behavior.

The Tankan also indicated a further deepening of perceived labor shortages. Against this backdrop, the BoJ's latest Regional Economic Report included several accounts of enterprises planning wage increases next fiscal year comparable to those implemented this year, partly to secure staff. At the same time, particularly among small and medium-sized enterprises, some enterprises expected wage increases to be limited or remained uncertain about them, citing the need to respond to a higher minimum wage and difficulties passing on costs.

On balance, domestically transmitted price pressure originating in supply shocks appears to have eased somewhat, but it remains an upside risk requiring vigilance. The risks identified by the BoJ at its previous meeting are therefore likely to remain a basis for the next rate increase.

Over a somewhat longer horizon, this raises another question: could the terminal rate itself move higher? There are two reasons it might—maintaining an appropriate real interest rate and anchoring inflation expectations.

First, as the Fisher equation implies, if inflation expectations rise faster than nominal interest rates, real interest rates fall. A higher nominal rate would then be needed to maintain the same degree of monetary restraint. Conversely, leaving the terminal rate unchanged as inflation expectations rise

would effectively reverse some of the reduction in monetary accommodation. If inflation expectations rise further while upside inflation risks persist, the terminal rate can therefore be expected to rise as well.

Second, a higher terminal rate could serve a risk-management purpose by reinforcing the anchor for inflation expectations. Setting an upper limit on interest rates in advance, at a time of mounting upside inflation risks, could send markets a signal of tolerance for higher inflation. Signaling a higher terminal rate, by contrast, would communicate that rate increases may continue. Although the policy rate remains some distance from the upper end of the estimated neutral-rate range, an indication that the terminal rate could rise as tightening proceeds might also help curb yen depreciation to some extent.

Financial conditions and the pace of rate increases

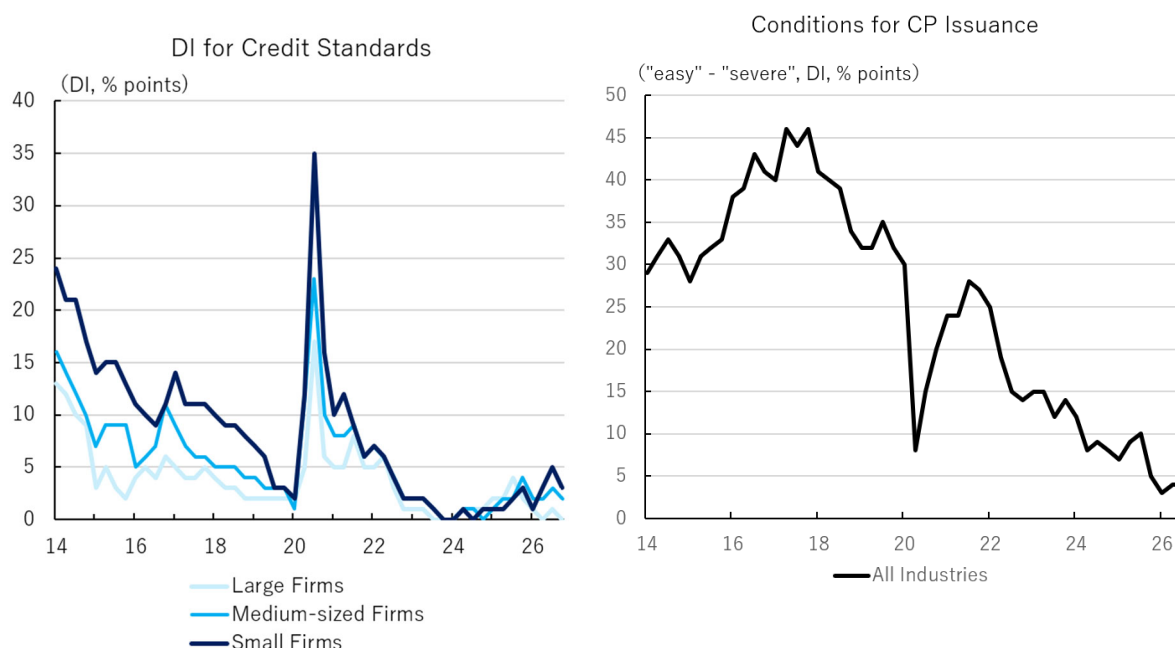
At the September meeting, the BoJ judged that financial conditions remained accommodative even after the policy-rate increase. One opinion held that further policy adjustment was appropriate because financial conditions had changed little following the preceding rate hike.

The Governor identified three perspectives for assessing financial conditions: interest rates; bank lending; and asset markets, including equity prices and exchange rates. He judged that long- and super-long-term interest rates had become considerably tighter, while bank lending and asset-market conditions remained somewhat accommodative.

As to how these perspectives should be assessed in practice, the Summary of Opinions emphasized the importance of listening to enterprises. Are changes in interest costs or funding conditions prompting enterprises to hold back capital investment? For households, are interest costs or access to bank credit constraining housing investment or purchases of durable goods? These are crucial channels through which monetary policy is transmitted from financial conditions to the real economy.

For enterprises, funding conditions are likely to continue to be judged accommodative. In the latest survey, the net balance of financial institutions reporting easier lending attitudes widened for small and medium-sized enterprises, for which bank borrowing is a particularly important source of finance. The Tankan's measure of conditions for issuing commercial paper also remained in "easy" territory, although its longer-term trend points to a gradual decline in the degree of accommodation (Chart 4).

Chart 4: Corporate funding conditions

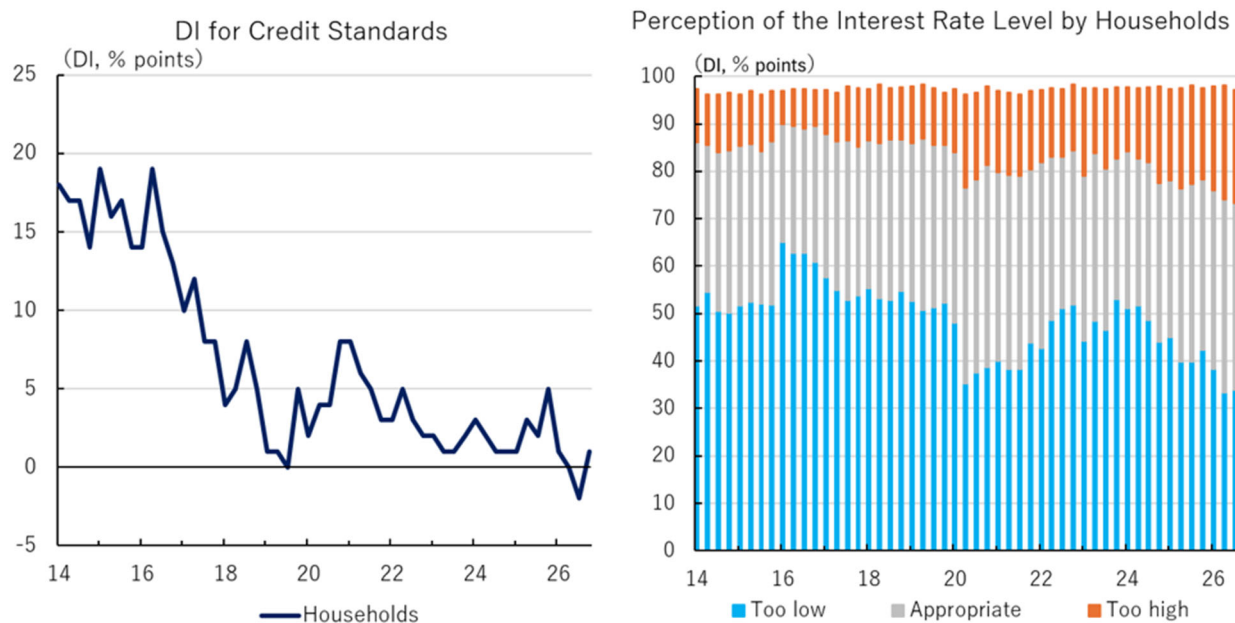


Source: Nomura Research Institute, based on the Bank of Japan's Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks and Tankan.

Household borrowing conditions appear less accommodative than those facing enterprises, but probably not to an extent that would lead the BoJ to judge them restrictive. Financial institutions' lending attitudes toward households have been trending from easier conditions toward neutrality. After moving into net-tightening territory in the previous survey, however, the latest reading rebounded slightly into net-easing territory.

Meanwhile, a gradually increasing share of households view interest rates as "too high" given economic conditions, while the share viewing them as "too low" has declined. Borrowers thus appear increasingly conscious of higher rates (Chart 5). New housing loans have fallen year on year, and higher interest rates may be contributing to that decline.

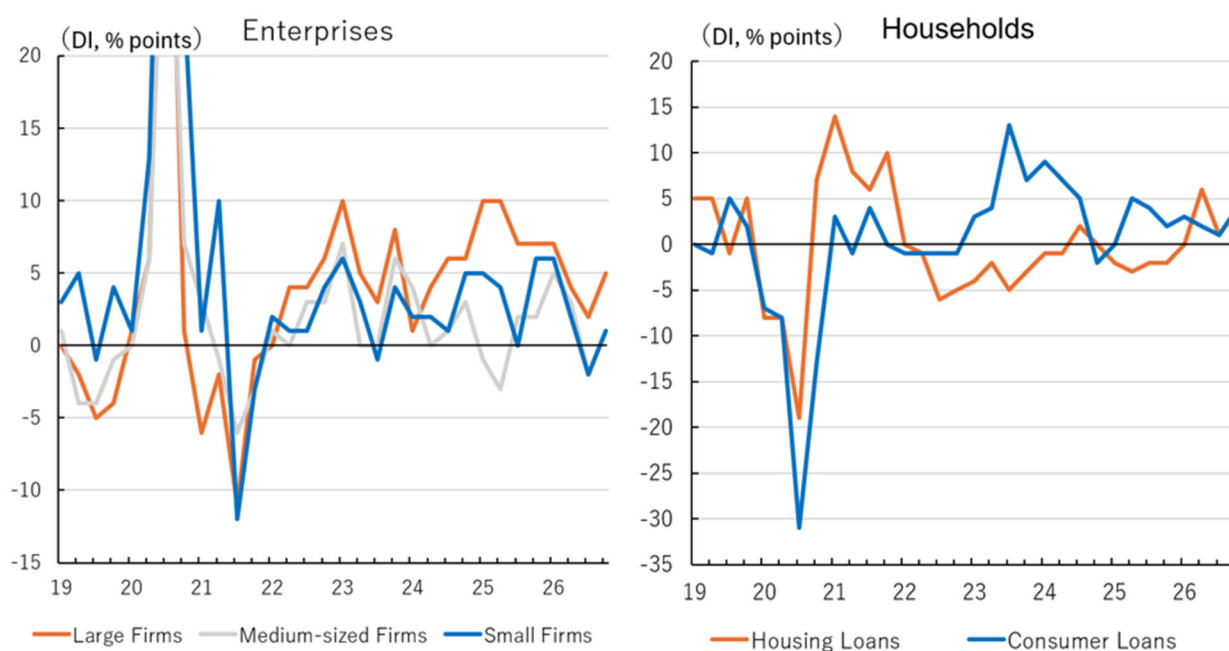
Chart 5: Household borrowing conditions



Source: Nomura Research Institute, based on the Bank of Japan's Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks and Opinion Survey on the General Public's Views and Behavior.

From lenders' perspective, however, there are no signs that demand for credit is declining among either enterprises or households (Chart 6).

Chart 6: Demand for Bank Lending



Source: Nomura Research Institute, based on the Bank of Japan's Senior Loan Officer Opinion Survey on Bank Lending Practices at Large Japanese Banks.

Taken together, these developments suggest that the BoJ will maintain its explanation at the October meeting that financial conditions remain accommodative and the policy rate is still some distance from a neutral level, making further rate increases necessary to reduce the degree of accommodation.

Nevertheless, it remains unclear when and to what extent past rate increases will affect banks' lending attitudes, enterprises' and households' funding conditions, and demand for credit. The BoJ will need to assess those effects even as it continues to raise rates. A further acceleration in the pace of tightening therefore seems unlikely.

Policy will need to account for weak domestic demand

The pace of rate increases will depend not only on the assessment of financial conditions but also on domestic demand—particularly weak household consumption, which in turn affects demand for credit. As the differing opinions at the previous meeting illustrated, the question is whether consumption weakness is temporary and likely to reverse, or reflects a more persistent shortfall in demand.

Recent consumption indicators remain soft. The BoJ's Consumption Activity Index, released on October 7, showed a month-on-month decline in real consumption activity in August. The Ministry of Internal Affairs and Communications' Family Income and Expenditure Survey, released on October 9, showed that real consumption expenditure by two-or-more-person households fell 3.1% year on year in August, its ninth consecutive monthly decline. Although expenditure rose 0.1% month on month, the increase was modest and below market expectations.

The BoJ's Regional Economic Report found that, across regions, middle-income households and older people who have not benefited from wage increases continued to economize. It also reported that price increases were causing some customers to turn away, particularly from lower-priced products. By contrast, spending on high-end goods remained robust among tourists, including inbound visitors, and affluent households benefiting from wealth effects; there was little evidence that price increases were deterring them. This suggests a divergence in consumption between groups benefiting from accommodative financial conditions and those that are not.

Monetary policy is a macroeconomic instrument charged with maintaining price stability. It cannot directly address such disparities, nor should doing so become its objective. What the BoJ can do in setting policy is calibrate the timing and pace of rate increases while assessing their effects on small and medium-sized enterprises and on lower- and middle-income and older households — the groups most closely associated with weakness in domestic demand.

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