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Bank of Japan hikes again and, while mindful of risks, will keep normalizing

Key takeaways

- The Bank of Japan (BOJ) announced another interest rate hike on Friday, 24 January, bringing short-term rates to their highest level since 2008.
- While the BOJ is sensitive to potential shocks from overseas, the bank is relatively optimistic about Japan's economic fundamentals and sees room for additional rate hikes, with real interest rates still negative.

As widely expected, the Bank of Japan (BOJ) announced a 0.25% policy rate hike following its 23-24 January policy board meeting, bringing short-term rates to 0.50% for the first time since 2008. BOJ Governor Ueda Kazuo, in his remarks following the announcement, was non-committal about the timing and pace of subsequent hikes. However, he left little doubt that he views rates as still far below Japan's neutral rate and, with real interest rates still negative, monetary policy remains broadly accommodative.

As such, the BOJ continues to see room for additional hikes but will be careful to monitor the impact of Friday's rate hike on households and businesses, the direction of inflation and the outcome of wage negotiations, the movement of the yen against the dollar and other major currencies, and the impact of Trump administration policies on Japan and the global economy.

Shortly before the BOJ's decision was announced, the Ministry of Internal Affairs and Communications released December inflation data showing that the core consumer price index (CPI), which excludes fresh food, rose 3%, the largest increase in sixteen months. Core CPI averaged 2.5% in 2024, the third straight year of average inflation above 2%, the longest such stretch since a four-year stretch from 1989 to 1992. The

inflation data suggests that the confidence of Ueda and other BOJ officials that, as Ueda said in December, “the sustainable and stable achievement of the 2 percent price stability target is now within sight” is not misplaced. Indeed, in the BOJ’s Outlook for Economic Activity and Prices (the so-called *tenbō*), released on Friday, the bank raised its expectations for inflation for the remainder of FY2024, FY2025, and FY2026 in light of higher rice prices and the impact of the weaker yen. The bank’s outlook may receive further vindication in this year’s *shuntō* wage negotiations, which began on Wednesday, 22 January with both Keidanren and RENGO officials affirming the need for further pay increases to deliver real wage gains.

To the extent that the BOJ is reluctant to move faster – and that the Ishiba government is reluctant to declare an end to deflation formally – it may have less to do with domestic economic indicators and more to do with uneasiness about the possibility of geopolitical shocks, particularly shocks arising from US macroeconomic and trade policies. In the *tenbō*, all three of the risks the bank cited related to overseas economic activities, starting in the near term with uncertainty surrounding the US policies but also including the longer-term impact of geopolitics and climate change on resource-dependent Japan’s commodity imports and macro trends in globalization, digitalization, and demographics on Japan’s growth potential. In short, the BOJ, while not complacent about the risks of potential shocks to growth and prices, is confident that Japan’s economic fundamentals are basically sound, giving the bank space to continue normalizing monetary policy on a steady timetable, affording the economy time to adjust.

The upshot is that Friday’s decision will give further impetus to the Ishiba government’s indications that the Japanese government should shift to a post-Abenomics framework, starting with reducing the dependence on macroeconomic stimulus for growth. Rising interest rates will lend greater credence to Prime Minister Ishiba Shigeru’s calls for fiscal sustainability – which he repeated in his policy speech to the Diet on Friday – as will a new Ministry of Finance (MOF) estimate, delivered to ruling party lawmakers on 22 January, which shows that debt servicing costs could rise by more than 25% through FY2027 if long-term Japanese government bond yields rise to 2.4%. At the same time, Ishiba’s efforts to prioritize fiscal sustainability could bolster the BOJ’s independence, effectively unwinding the Abenomics consensus that subordinated the bank’s independence to the government’s priorities.

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