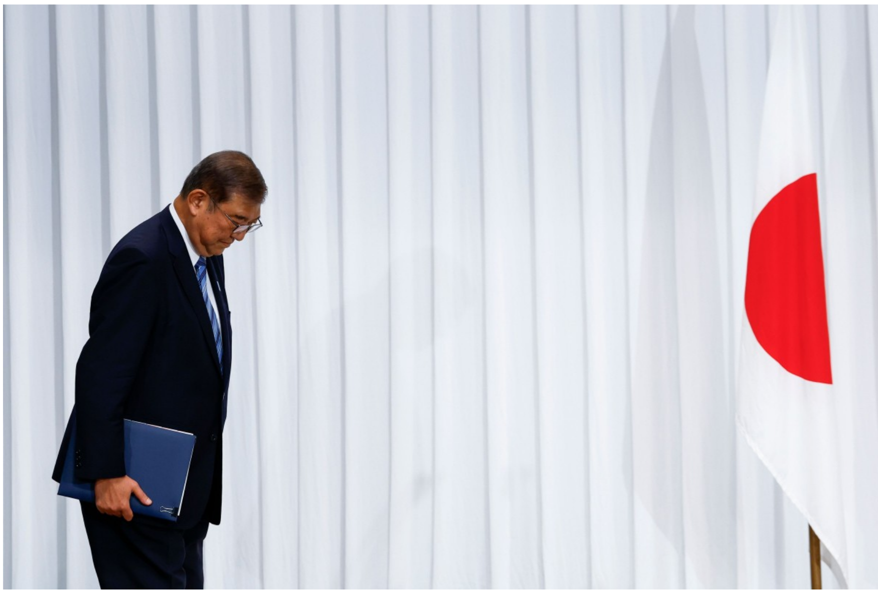
Stable inflation supports Bank of Japan's policy normalisation

The Bank of Japan will continue on its path of policy normalisation, supported by sustained inflationary pressures and a recovery in economic activity



Japan is experiencing a period of political uncertainty and new prime minister Shigeru Ishiba's approval ratings have fallen sharply recently

GDP is expected to moderate in the third quarter

Japan's automobile production disruptions in July and August started to normalise in September, but the mega-earthquake warning and typhoon in early September may have hindered a full recovery in economic activity. We foresee a solid recovery in manufacturing output from October onwards.

In the services sector, which makes up more than 60% of GDP, retail sales, tourism, and dining out have shown the most improvement. Consequently, services will continue to drive overall growth, bolstered by strong wage increases.

Meanwhile, the trade deficit is expected to narrow, contributing positively to growth, driven by weaker commodity prices and a gradual increase in exports. We expect GDP to decelerate from 2.9% (quarter-on-quarter seasonally adjusted annualised rate in the second quarter of 2024) to 1.2% in the third quarter, and then to grow at a faster pace of 2.4% in the fourth.

Inflation will remain above 2% until mid-2025

The latest headline inflation logged 2.5% year-on-year in September and is expected to stay above 2% until mid-2025. Early Tokyo inflation in October confirmed that services prices rose firmly. This indicates that Japanese firms are passing on input cost increases to output prices more than before as households, supported by higher wage growth, can better afford these price hikes.

With the end of the summer energy subsidy programme in October, headline inflation is expected to reaccelerate in the near term, and service-led price increases are likely to continue.

Japan is going through an unusual period of political uncertainty

The ruling Liberal Democratic Party coalition failed to secure a majority in the lower house for the first time since 2009, and new Prime Minister Shigeru Ishiba's approval ratings have fallen sharply recently. A special Parliament session is expected on 11 November, when parliaments convene to elect a prime minister seat. We believe Shigeru is likely to receive the most votes. His party has the largest presence, and the opposition parties' wide political spectrum makes it difficult for them to collaborate effectively.

Given that the LDP still lacks a majority in parliament, the new government will likely need to collaborate with minority parties in policymaking. We believe this local political uncertainty will not significantly impact the BoJ's policy decisions in the near future.

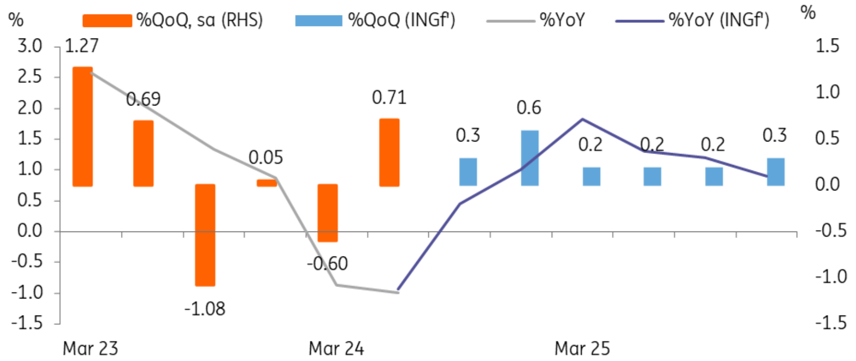
BoJ: rate hikes will come in 2025

Looking back at the October BoJ meeting, we believe Governor Ueda's comments were hawkish. He didn't indicate when the next rate hike would be, but he also didn't completely rule out a hike in December, instead stating that every policy meeting from now on will be a live event.

Ueda reiterated that the economy is following the BoJ's projected path, and if this continues, the central bank will implement another rate hike. His overall tone on growth and inflation was more positive compared to the previous meeting.

Between now and the BoJ's December meeting, US data, Tokyo's November inflation, and labour cash earnings will be closely watched. But, the most dominant factor in the BoJ's December move is likely to be FX. Even if the BoJ decides to extend its pause in December, we continue to believe that the BoJ will hike rates by 25bp each quarter until it reaches 1.0%.

The market is quite dovish about the BoJ's rate path



Source: CEIC, ING estimates

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