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The Bank of Japan will continue interest rates hikes with the aim of reaching 1%, which is thought to be the lower bound for the neutral interest rate

2 April 2025

- It has been one year since the Bank of Japan (BoJ) abandoned negative interest rate policy. Although the BoJ notes that the underlying rate of inflation is still below 2%, some indicators are increasingly pointing to momentum towards achieving the price stability target.
- Market seems to imply the minimal level of 1% for the neutral interest rate, which could be the final destination of the recent interest rate hikes. But as interest rates continue to rise, there is speculation that the neutral interest rate could increase.
- Based on our economic and price forecasts, we expect that the policy interest rate hikes will continue at intervals of around six months in 2025, with the aim of reaching 1% by the end of the year. This level is seen as the lower bound for the neutral interest rate. However, we need to keep an eye on the rising uncertainty in domestic and international politics and policies.

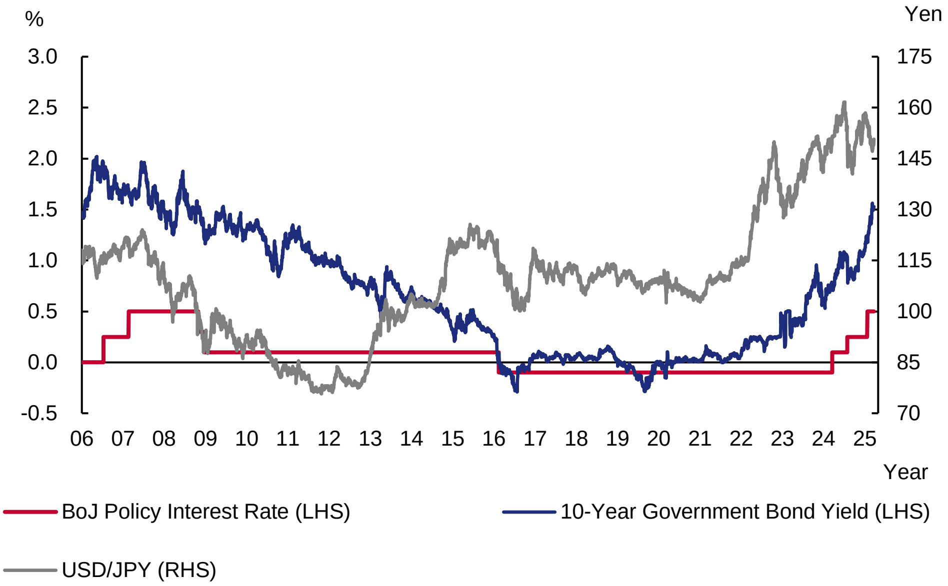
Yuko Iizuka, Economist

One year has passed since the end of negative interest rates

The BoJ's Monetary Policy Meeting on March 18-19, 2025, where the policy interest rate was left unchanged, took place exactly one year after the end of the negative interest rate policy in March 2024 (when the uncollateralized overnight call rate was set at around 0-0.1%). Since then, the policy interest rate was raised to 0.25% in July 2024, and a decision to reduce the amount of long-term government bond purchases was made. Furthermore, the policy interest rate was raised to 0.5% in January 2025. The BoJ has been gradually raising interest rates at intervals of around six months.

The USD/JPY exchange rate has weakened to 160 yen per dollar for the first time in 37.5 years in July 2024, but has since strengthened due to the BoJ's continued interest rate hikes. The 10-year government bond yield has risen to the 1.5% for the first time in 16.5 years in March 2025 (Figure 1, next page).

Figure 1: Policy Interest Rates, Long-term Yields and Exchange Rates



Source: LSEG Data & Analytics, Asset Management One Co. Ltd.
Note: 1. Daily data from 2 January 2006 to 24 March 2025
2. The uncollateralized overnight call rate for BoJ Policy Rate
3. Includes the period of quantitative easing and the period during which negative interest rates were applied to a portion of the balance of current account deposits at the BoJ

Momentum toward achieving the "Price Stability Target" is accelerating

Consumer prices excluding fresh food (Core CPI) have exceeded 2% year-on-year for three consecutive years since 2022, but the BoJ Governor Ueda's view is that the underlying rate of price growth is still below 2%. The service prices (excluding the rent of owner-occupied houses) that the BoJ focuses on when looking at the underlying rate of price growth increased 1.9% year-on-year in February 2025, approaching 2%.

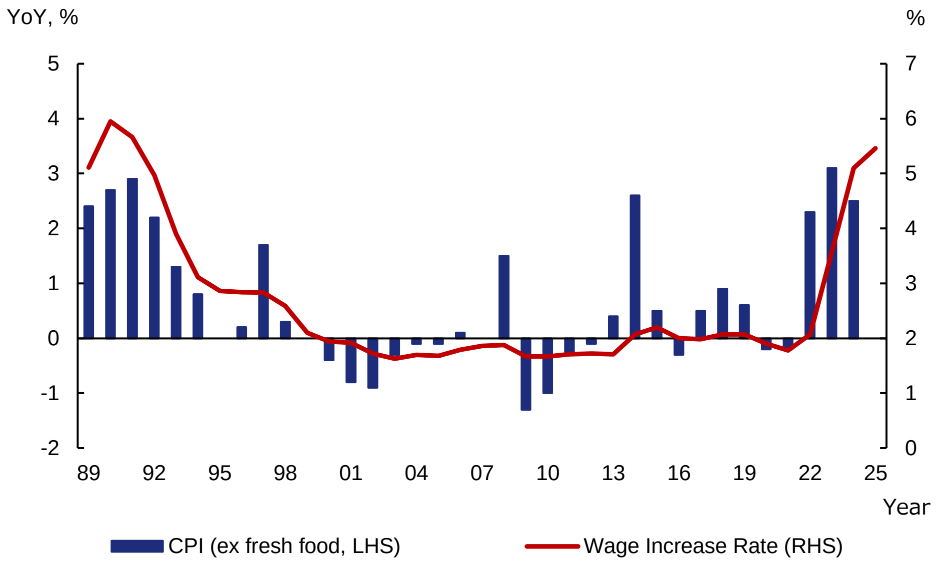
In addition, BoJ looks at a range of factors, including (1) output gap, (2) inflation expectations, and (3) wage growth.

Looking at the expected price growth in the Tankan survey's corporate price outlook (all industries and enterprises), it exceeds 2% for all time frames: 1 year, 3 years, and 5 years. This suggests that companies are becoming more proactive in their pricing.

According to the Japanese Trade Union Confederation (Rengo) survey, wage growth was 5.1% in 2024, first time it has exceeded the 5% since 1991, and first survey results for 2025 were also high at 5.46% (Figure 2, next page). At a press conference, Governor Ueda stated that while prices and wages were within expectations, the results of the spring labor negotiations (Shunto) were slightly stronger than expected.

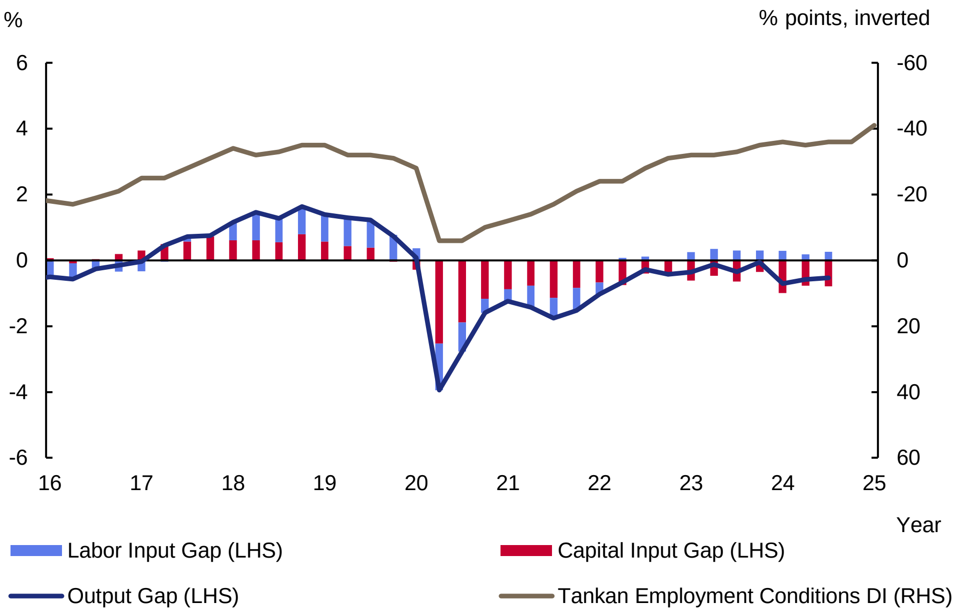
In this context, the BoJ's estimate of the output gap is still negative at -0.5% as of the July-September quarter of 2024 (Figure 3, next page). The output gap indicates the deviation from the average level of labor and capital utilization. In its recent announcements, the BoJ has indicated that the output gap is actually positive, considering that capacity is not being fully utilized due to labor shortage. Given that companies experience serious worker shortage, the Bank pointed out that there may be more upward pressure on wages and prices than the output gap suggests.

Figure 2: Price and Wage Growth Rates



Source: Japanese Trade Union Confederation (Rengo),
Ministry of Internal Affairs and Communications, Asset Management One Co. Ltd.
Note: 1. Annual data from 1989 to 2025, and to 2024 for CPI
2. The final results for the period 1989-2024 as of the end of June, and the first round of responses for 2025 as of March 14 for the wage increase rate

Figure 3: The BoJ Estimate of Output Gap



Source: BoJ, Asset Management One Co. Ltd.
Note: 1. Quarterly data from Q1 2016 to Q3 2024
2. Actual data up to Q4 2024 and forecast data for Q1 2025 for Tankan employment conditions DI
3. Tankan employment conditions DI ="excessive"－"insufficient"
for all industries and enterprises

The possibility of the neutral interest rate increase comes into focus

Market participants are paying attention to the neutral interest rate, which could be the final destination of the recent interest rate hikes.

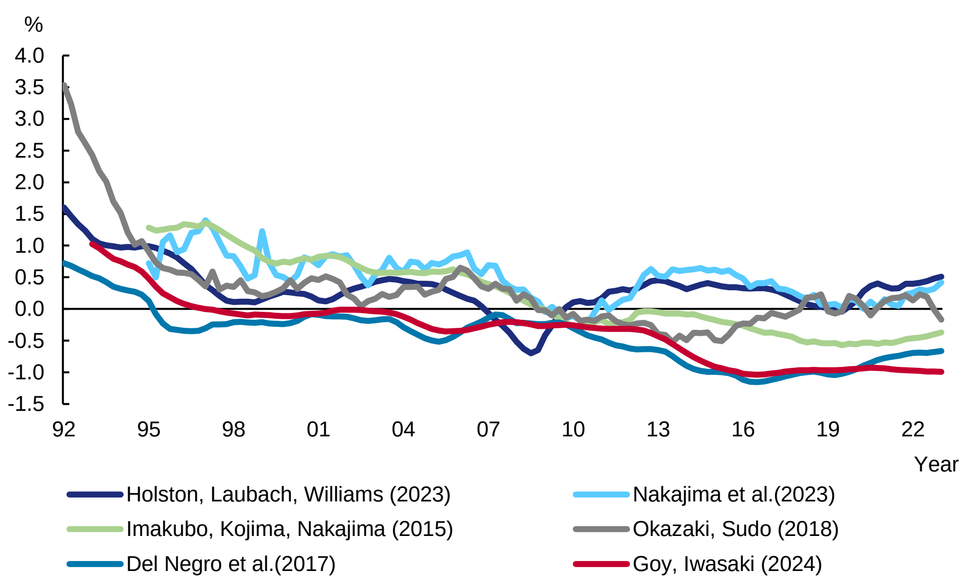
In his speech, the BoJ Deputy Governor Uchida stated that (1) the Bank might be achieving the price stability target of 2% in the second half of the projection period (somewhere between the second half of FY2025 and FY2026), (2) the policy interest rate at that point in time is expected to be close to the neutral interest rate, and (3) theoretically, this target is “2% (price stability target) + natural rate of interest”.

The BoJ states that the natural rate of interest varies depending on the estimation method used, and that there is an estimation error for each result, so this rate cannot be used for actual policy decisions. However, the BoJ's policy board members mentioned a range of natural rate of interest estimates, from a minimum of around -1% to a maximum of 0.5% (Figure 4). The market views 1% (2% (price stability target + -1% minimum estimate of natural rate of interest) as the lower bound of the neutral interest rate in the second half of the forecast period.

Furthermore, the Taylor Rule, which is used as a benchmark when considering policy interest rate, is calculated based on the neutral interest rate, the output gap, and the inflation gap (the gap between the actual and target rate of price growth). An expansion of the output gap and the accompanying rise in inflation will push the appropriate policy interest rate up. The rising long-term yields were in part caused by the BoJ’s recognition that the output gap could exceed its estimate, and an interest rate hike above the lower bound of the neutral interest rate was a possibility.

The BoJ is cautious about suggesting a specific level for the neutral interest rate. However, with the policy interest rate expected to reach 1% with two more rate hikes (0.25% each), market participants are likely to assume that the interest rates will eventually exceed 1%, if inflationary pressure persists.

Figure 4: Trends in Estimated Natural Rate of Interest



Source: BoJ, Asset Management One Co. Ltd.
Note: 1. Quarterly data from Q1 1992 to Q1 2023
2. From Q1 1995 for Nakajima et al.(2023) and Imakubo, Kojima, Nakajima (2015)
3. From Q1 1993 for Goy, Iwasaki (2024)

Uncertainties abound, but the BoJ is expected to raise interest rates every six months

The BoJ has stated that, given how low the current real interest rates are, it will continue raising the policy interest rate and fine-tuned monetary easing, while cross-checking the economic and price projections against the actual readings.

We expect wage growth to remain high in 2025, real GDP growth to be in the mid- 1% range and core CPI in the mid- 2% range in FY2025. Based on this outlook, we expect the BoJ to raise interest rates twice, around the middle of the year and the end of the year, at intervals of around six months, and for the policy interest rate to reach 1%, which is thought to be the lower bound of the neutral interest rate.

However, there is a growing sense of uncertainty about both domestic and global politics and policies. In the statement from the Monetary Policy Meeting in March 2025, the uncertainty in “trade and other policies in each jurisdiction and developments” was included as a risk factor, with a nod to the Trump administration's tariff policy. In Japan, the distribution of gift certificates by Prime Minister Ishiba has caused political uncertainty in the run-up to the Upper House election in July. Furthermore, there is a possibility that the rising prices of essential goods such as rice will be passed on to consumers, particularly for food, and this may dampen consumer sentiment.

In this situation, the BoJ is expected to keep an eye on the highly uncertain domestic and overseas factors when proceeding with interest rate hikes. At the press conference following the March meeting, Governor Ueda gave the impression of leaving himself room for maneuver with regards to the timing of interest rates hikes, as he touched upon the uncertain trade policies, but also indicated that it shouldn’t take too long to assess their impact.

Some market participants also consider the possibility of an interest rate hike at the April 30-May 1 meeting, after the US implements its tariff hike.

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