Daiwa's Economic View

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Outlook for Japan's economy, policy rate (Aug 2024)

- Apr-Jun 2024 real GDP improves, but weak underlying trend for private consumption
- Economy expected to grow only moderately in FY24 as consumers remain thrifty, but inflation likely to hold near BOJ's 2% price stability target
- Next rate hike expected in Mar 2025, after assessing domestic/international economic conditions and results of 2025 spring labor-management wage negotiations

We recently revised our outlooks for monetary policy and policy rates in both Japan and the US to better reflect the abrupt market changes since the start of August. This report summarizes the current status for Japan's economy and its outlook (P1~4) and considers how the BOJ will likely conduct monetary policy into the next fiscal year (P4~5).

As for Apr-Jun 2024 real GDP, domestic demand improved, but the underlying trend for private consumption remained weak.

First, we want to confirm the GDP statistics released on 15 August.

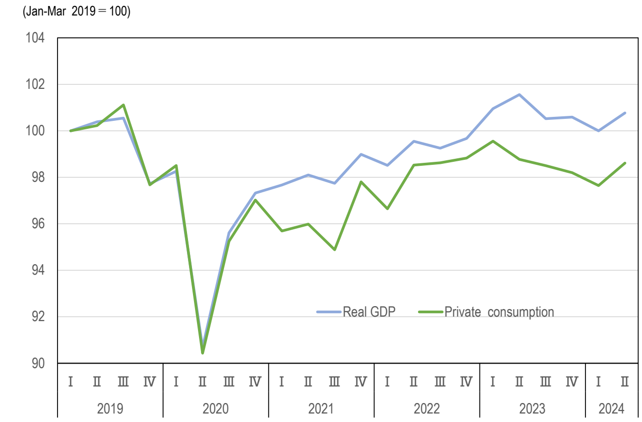
Apr-Jun 2024 real GDP grew 0.8% q/q (3.1% annualized) after contracting during the previous quarter. Domestic demand, mainly private consumption and capital investment, contributed to this growth. Nominal GDP grew to an annualized Y607.9tn. This means that the "Y600tn nominal GDP" target set by the Abe administration in 2015 as one component of the "New Three Arrows" of Abenomics was finally achieved nine years later. One item that particularly contributed to the higher GDP was private consumption, which apparently grew at a high rate due in part to the rebound for automobile sales (following suspended production due to a safety testing scandal), along with higher incomes due to substantial wage hikes.

However, even with this GDP recovery for the Apr-Jun quarter, private consumption is still not close to the pre-coronavirus level or the recent peak (Jan-Mar 2023). Deep-rooted thriftiness among consumers is one factor behind the tepid recovery for consumer spending.

Looking at consumption expenditures by type, durable goods rose on the back of better passenger car sales, while non-durable goods, which had deteriorated recently due to consumer thriftiness, showed signs of bottoming out. Meanwhile, the non-durable goods consumption level is still low and the consumption of services, which accounts for about 60% of all consumption, has started to decline. In light of these points, we think consumer spending has remained weak overall.

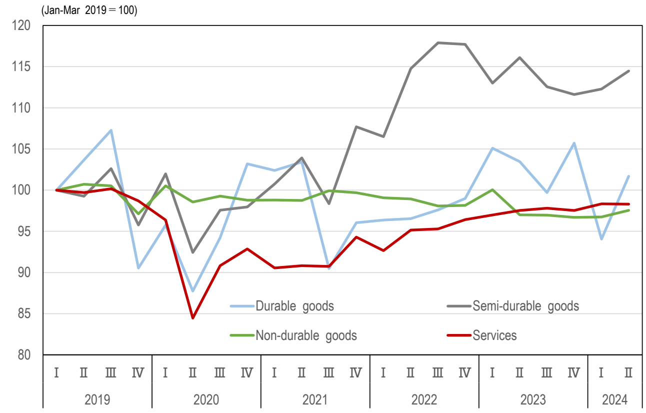
Capex also grew 0.9% q/q in real terms, bouncing back from a 0.4% decline for the Jan-Mar quarter. While a rebound from the automobile safety testing scandal was a major factor, a strong appetite for capital investment backed by strong corporate earnings and structural labor shortages also likely contributed to this growth. That said, calculations for the capex first preliminary quarterly estimates are based on supply-side statistics published up to that point. We should note that depending on the results of the Financial Statements Statistics of Corporations by Industry (to be released on 2 Sep), there is a possibility of a downward revision in the second preliminary quarterly estimates.

Real GDP Growth Rate, Private Consumption



Source: Cabinet Office; compiled by Daiwa.

Domestic Final Consumption Expenditure of Households by Type



Source: Cabinet Office; compiled by Daiwa.

Economic outlook: Expect only moderate growth in FY24

As for Japan's real GDP growth rate outlook, we forecast growth of 0.3% y/y for FY24, 0.9% for FY25, and 1.0% for FY26, assuming a soft landing for the US economy.

In 2H FY24, we expect the economy to gradually pick up due to (1) a moderate recovery for private consumption due to further wage growth (as reflected in higher wage hikes from the annual spring labor-management wage negotiations) and (2) a continued strong appetite for capex backed by upbeat corporate earnings.

However, real wages have declined y/y for 26 straight months (Apr 2022 to May 2024) and rising prices have hurt consumer sentiment. It will likely take some time before consumer thriftiness starts to ease. For that reason, the uptick for private consumption is expected to be quite modest and we expect only a gradual recovery for Japan's economy. The real GDP growth rate will land below the potential growth rate, which is expected to be in the mid-range of the +0% level and the output gap (difference between real and potential growth rates) is likely to be negative.

Japan's economy will likely recover moderately in FY25. As for FY25 wage trends, we expect that wage increase momentum will remain intact, just like in 2024, due to the structural labor shortages and robust corporate earnings. Wage increases emerging from the spring labor-management wage negotiations will likely be around 3% (basic salary only). With wage growth continuing to outpace price growth, we expect private consumption to recover as consumers gradually become less thrifty. Under such conditions, we also expect the output gap to improve. Improvements for overseas economies, due to the effects of central bank interest rate cuts in various countries and other measures, should also underpin the Japanese economy.

Private consumption: Gradual upturn on higher real wages, but growth likely moderate

We expect private consumption to gradually improve as real disposable income growth rises due to the strong wage increases emerging from the 2024 spring labor-management wage negotiations along with the effects of the government's fixed-amount tax cuts and other policies. Also, even though the specific details and scale are unknown, benefits for low-income households planned for the fall economic stimulus package should also support consumption through an increase in disposable income.

That said, consumer sentiment is weakening as prices remain high. Even if real disposable income increases, there is the strong possibility that it will be channeled into savings accounts over the short term.

We should also pay attention to how rising interest rates and the sudden market changes since August could impact consumption. For example, there could be a risk that the recent significant stock price pullback might depress consumption through a reverse asset effect. The effects of higher interest rates may partially offset the effects of real disposable income increases/decreases depending on the generation. Specifically, for elderly households, higher interest rates are expected to provide a consumption tailwind through higher rates on bank savings deposits. However, pensions, which are a form of income, are expected to grow at a lower rate than price increases due to macroeconomic indexing, resulting in a decrease in real disposable income for elderly households. Meanwhile, while younger generations hold a higher proportion of mortgage loans relative to disposable income and, as such, are impacted more by increased interest rate burdens, real disposable income is expected to increase due to the high wage growth rates.

Taking all of these points into consideration, private consumption growth is likely to remain moderate.

Capex: Appetite remains strong amid upbeat corporate earnings

Going forward, we think a strong appetite for capex will continue due to (1) the outlook that robust corporate earnings are likely to be maintained owing to the yen's gradual appreciation relative to conservative foreign exchange assumptions in corporate business plans and (2) the structural labor shortages. Investments related to digital transformation and EVs, as well as investments to satisfy increasing demand related to more overseas tourists visiting Japan, should continue for now.

That said, the current concerns about a possible US recession and the impact of rising interest rates require caution. General economic theory suggests that companies will invest if the return on investment for their business is higher than the cost. Fears of a US recession and rising interest rates could alter investment costs and returns, potentially acting as capital investment disincentives.

Also, even if demand is strong, capital investment may not move forward due to supply factors caused by labor shortages. We want to see the extent to which the ambitious capex plans, which are expected to be confirmed by the BOJ's Tankan survey, will lead to actual capital investment going forward.

Price outlook: Remaining close to price stability target

We expect Japan's core CPI to rise 2.4% y/y in FY24, 2.2% in FY25, and 1.8% in FY26. As such, we expect core CPI to remain close to the BOJ's price stability target of 2% through FY26.

Energy prices are likely to turn volatile depending on whether the government ends or reinstates its price inflation measures. Core CPI will also be impacted by energy, oscillating back and forth in FY24, while the base effect of the previous year's measures to offset higher energy prices is likely to result in a high rate of increase in FY25. Also, lodging rates, which have recently been very high, are expected to decline as growth driven by the increase in overseas tourists visiting Japan stalls amid correction of the excessively weak yen. That said, in terms of overall service prices (excl. public services), we expect the wage growth trend to remain unchanged in FY25 against the backdrop of structural labor shortages. The high rate of increase is expected to continue as companies successfully pass on higher wages to their prices.

However, the status of wage increases depends not only on structural factors, but also on the economic cycle. If corporate earnings are squeezed by a US recession and the resulting rapid yen appreciation, companies may be unable to secure the financial resources needed for raising wages. In any case, we must monitor trends in overseas economies.

Forecasts for Major Economic Indicators (%)

	FY23 Oct-Dec	FY23 Jan-Mar	FY24 Apr-Jun	→Daiwa's forecasts FY24 Jul-Sep	FY24 Oct-Dec	FY24 Jan-Mar	FY25 Apr-Jun	FY25 Jul-Sep	FY25 Oct-Dec	FY25 Jan-Mar	FY23 (actual)	→Daiwa's forecasts FY24	FY25	FY26
Real GDP growth rate (q/q)	0.1	-0.6	0.8	0.4	0.2	0.2	0.2	0.2	0.2	0.3	-	-	-	-
(annualized)	0.3	-2.3	3.1	1.7	0.8	0.7	0.8	1.0	0.9	1.1	1.0	0.3	0.9	1.0
Core CPI (y/y)	2.5	2.5	2.5	2.4	2.1	2.8	2.4	2.2	2.4	1.8	2.8	2.4	2.2	1.8
Core core CPI (y/y)	3.7	3.2	2.1	1.8	1.8	1.7	1.8	1.8	1.8	1.8	3.9	1.9	1.8	1.8

Source: Cabinet Office, Ministry of Internal Affairs and Communications, BOJ, Bloomberg; compiled by Daiwa.

BOJ policy rate outlook: Assessing the economy; Will next rate hike be in Mar 2025?

In his 7 August speech, BOJ Deputy Governor Shinichi Uchida touched on a risk that significant changes in financial markets could also impact the economic and price outlooks, saying "The Bank needs to maintain monetary easing with the current policy interest rate for the time being, with developments in financial and capital markets at home and abroad being extremely volatile." Abrupt market changes since August, as well as the US recession fears that triggered those changes, increase the risk of Japan's economic and price outlooks not unfolding as the BOJ expects. That probably means there is an increased need to carefully assess economic conditions.

However, the traditional policy reaction function defined as "If the BOJ's economic and price outlooks are successfully realized, interest rates will be raised accordingly" has not been changed. In that regard, we believe that the following are the key points when examining the steady progress for the economic and price outlooks going forward.

US economy and political situation

During his 7 August speech, Uchida said, "There has been global market volatility triggered by fears of a slowdown for the US economy" and "There is no such thing as raising interest rates when financial markets are unstable." So, we probably first need to assess the economic situation in the US and how it impacts markets.

Also, the sudden market changes since August have temporarily resulted in yen appreciation to the USD/JPY141 level. Such rapid exchange rate fluctuations could worsen corporate earnings and suppress wage hikes during the 2025 spring labor-management wage negotiations. In the event of a hard landing for the US economy, we think the yen could easily appreciate. However, even if a hard landing is avoided, we could still assume a rapid weakening of the dollar and appreciation of the yen depending on the political situation, including the US presidential election later this year. The political situation in the US will also be an important consideration for examining steady economic and price outlook progress going forward.

Japan economic trends

The BOJ explained its outlook for prices as, "The underlying consumer price increase rate is expected to gradually increase due to a better output gap, as well as the continued strengthening of the virtuous cycle between wages and prices and an increase in the medium/long-term inflation expectations." The three variables listed here are the output gap, the strengthening of the virtuous cycle between wages and prices, and inflation expectations.

Among these three variables, we believe that the output gap is likely to remain negative in 2024, as mentioned earlier. Meanwhile, the real GDP growth rate forecast in the BOJ's July 2024 *Outlook Report* is +0.6% y/y in 2024. Assuming a potential growth rate in the mid-0% range, the BOJ's projected output gap for 2024 is expected to be positive near 0%.

In the first place, improvement in the output gap applies upward pressure on prices through an increase in demand. This will be essential in fostering the second force, which is the "mechanism whereby wages increase on the back of economic improvement, leading to moderate inflation."

We see a strong possibility that the BOJ's outlook could be weaker than expected due to a slow recovery for private consumption. We expect the output gap to improve more slowly than the BOJ's assumption. Also, signs of upward pressure on prices due to increased demand will not be confirmed in FY24. In that case, we will need to clearly monitor whether the virtuous cycle between wages and prices will continue in FY25 in order to confirm sustained price increases.

In light of these factors, we believe that hiking interest rates will be difficult, at least by the end of this year, as time is needed to assess impacts of the US economy and the US presidential election in November. Furthermore, if the risk of a slow recovery for Japan's economy increases, we believe that a rate hike would be more likely in March 2025, after conditions up until the spring 2025 labor-management wage negotiations are confirmed.

The 2025 wage increases should then be reflected over the summer with service price increases expected to spread with the passing on of labor costs to prices. Also, as wage increases are reflected, consumers will be less inclined to remain thrifty through the fall. We should see a recovery in private consumption and an improvement in the output gap. In that case, we would expect another rate hike in October 2025, when such conditions can be confirmed. In addition, if a virtuous cycle between wages and prices can still be confirmed in 2026, we believe that the BOJ would raise interest rates to 1.0%, which is assumed to be the terminal rate.

Under a hard landing scenario in which the US economy rapidly stalls, we would expect the Japanese economy to likewise deteriorate rapidly with an interruption for the virtuous cycle between wages and prices. Here, the policy rate would remain at its current level, likely ending the Bank's rate-hiking cycle.

Projections for BOJ's Policy Interest Rate (%)

	FY24			FY25			
IOER	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Lower limit	0.25	0.25	0.25	0.50	0.50	0.50	0.50
Upper limit	0.25	0.50	0.50	0.75	0.75	1.00	1.00
Term-end	0.25	0.25	0.50	0.50	0.50	0.75	0.75

Source: Compiled by Daiwa.

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