Japan | Fixed Income

2 October 2024
Japanese report: 1 October 2024

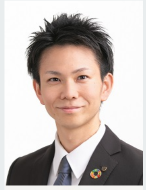
Daiwa Securities

Daiwa's Economic View

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

- Expect only modest growth for Japan's economy in FY24 as consumption recovery is delayed
- Forecast core CPI to remain above 2.0% y/y toward FY25; price outlook risks balanced to upside and downside
- BOJ's decision to hike rates heavily dependent on assessment of US economy; expect next hike in Jan-Mar 2025, assuming soft landing for US economy

FICC Research Dept.



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Summary

Assuming a soft landing for the US economy, we forecast positive real growth rates for Japan's economy of +0.4% y/y in FY24, +1.0% in FY25, and +1.0% in FY26.

While income conditions have improved in FY24, more time is needed for consumers to overcome their thriftiness. As such, the recovery for private consumption will be gradual. The economy is expected to pick up in FY25 as good momentum for higher wages should continue, with the 2025 spring labor-management wage negotiations resulting in big increases for basic salaries in the high 2% range.

Meanwhile, the BOJ's decision to raise interest rates is heavily dependent on its assessment of the state of the US economy. As such, a decision to hike rates before the end of this year seems out of reach. We expect the next interest rate hike to happen between January and March 2025.

The conditions for hiking interest rates could be in place as early as January 2025. That said, the Bank is adopting a cautious stance. There is a good chance that the Bank will make a decision to hike rates in March 2025, after the obtaining a clearer picture of the feasibility of policies implemented by the new US administration and the results of Japan's spring labor-management wage negotiations.

After that, we expect the BOJ to continue hiking interest rates once every six months, while carefully assessing conditions for overseas economies, particularly the US economy, and confirming a virtuous cycle of higher wages and higher prices.

Under a hard landing scenario, where the US economy suddenly slows, Japan's virtuous cycle of higher wages and higher prices would collapse and its interest rate-hiking phase would likely come to an end.

Japan's economic outlook: Expect only moderate recovery

Assuming a soft landing for the US economy (= no major impacts for Japan), we forecast positive real growth rates for Japan's economy of +0.4% y/y in FY24, +1.0% in FY25, and +1.0% in FY26.

From 2H FY24, consumer sentiment is expected to gradually improve, reflecting an increase in summer bonuses and high growth rates for scheduled cash earnings. Also, amid the growing demand for DX and GX, as well as efforts to address structural labor shortages, we expect a gradual economic recovery centered on domestic demand, with a strong desire to continue increasing capital investment on the back of strong corporate earnings.

However, private consumption for the Jul-Sep 2024 quarter is likely to weaken, particularly in terms of service consumption, due to the effects of warnings for the Nankai Trough earthquake, typhoons, and the summer heatwave. Also, due to the historical effect of 26 straight months of negative real wage growth, more time is probably needed before consumers overcome their thriftiness. Furthermore, in October 2024, many financial institutions plan to revise the interest rates they charge for variable-rate mortgages. We anticipate some negative effects due to higher interest rates, particularly among young people in their 20s and 30s who have large debts. As a result, we expect a fairly gradual recovery in private consumption due to improving income conditions with the economic recovery likewise remaining gradual.

The growing momentum for higher wages should continue in FY25 and beyond. With high wage growth expected and the rate of price increases slowing compared to 2024, real wages are expected to fluctuate but remain stable and positive in 2H FY25. As income conditions continue to improve, the private consumption recovery will also continue. Furthermore, as the effects of interest rate cuts by overseas central banks becomes more apparent, recoveries for overseas economies will also become a factor underpinning Japan's economy.

Chart 1: Forecasts for Major Economic Indicators (%)

	FY23			→Forecasts* FY24				FY25				FY26			FY23 (actual)	→Forecasts* FY24	FY25	FY26
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
Real GDP growth rate (q/q)	0.1	-0.6	0.7	0.4	0.3	0.3	0.2	0.2	0.3	0.2	0.2	0.2	0.3	0.3	-	-	-	-
(annualized)	0.2	-2.4	2.9	1.7	1.4	1.2	0.7	0.6	1.1	1.0	1.0	1.0	1.1	1.1	1.0	0.4	1.0	1.0
Domestic demand contribution (q/q)	-0.1	-0.1	0.8	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	-0.4	0.8	0.9	1.0
Private consumption (q/q)	-0.3	-0.6	0.9	0.3	0.3	0.3	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	-0.6	0.7	0.9	0.8
Private non-residential investment (q/q)	2.1	-0.5	0.8	0.6	0.4	0.3	0.4	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.4	2.1	1.7	2.1
Foreign demand contribution (q/q)	0.2	-0.5	0.0	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.2	-0.3	0.1	0.0
Core CPI (y/y)	2.5	2.5	2.5	2.6	2.3	2.7	2.4	2.3	2.5	1.8	1.8	1.8	1.6	1.6	2.8	2.5	2.2	1.7
Core core CPI (y/y)	3.7	3.2	2.1	1.9	1.8	1.6	1.7	1.7	1.6	1.6	1.8	1.8	1.9	1.9	3.9	1.9	1.7	1.8

Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC), BOJ, Bloomberg; compiled by Daiwa.
**Forecasts by FICC Research Department.*

Inflation outlook: Upside/downside risks in balance

September core CPI inflation (in the ward-area of Tokyo) slowed as the government reintroduced cost-of-living measures to curb rising prices. Despite recent evidence that incomes are improving, there are still no signs of broader-based moves to pass on higher labor costs, and growth in private service prices continues to slow. However, firms typically revise prices in October (the start of the second half of the fiscal year), and we expect rising labor costs to result in numerous price hikes that drive up service prices from the October CPI (Tokyo data announced 25 Oct).

The government's resumption of electricity and gas subsidies from September (for Sep-Nov bills) depressed the Japan-style core CPI by 0.5 points. We expect another 0.5-point negative impact in October, followed by roughly –0.3 points in November as subsidies are scaled back. The government is also discussing a further extension to cost-of-living measures. New LDP president Shigeru Ishiba has commented regarding rising prices that "we will look at what kind of policies are effective for addressing food and energy [inflation]". Assuming that energy subsidies remain at the level applied to November 2024 bills, we think a further extension would depress the core CPI by at least 0.3 points.

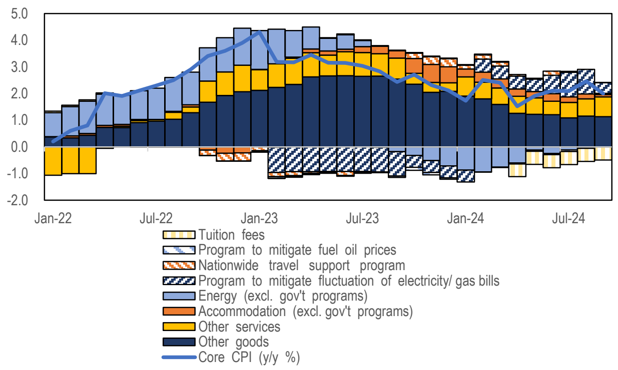
We expect structural labor shortages to drive sustained momentum for wage hikes in FY25 and beyond, and think companies will continue to pass on higher labor costs to consumers. We expect inflation to remain above 2% y/y in FY25, partly due to the base effect from past government cost-of-living measures.

We also see upside risks to this outlook. Specifically, we highlight the risks of (1) more drastic labor shortages that drive a greater-than-expected increase in wages, and (2) renewed US-driven inflation resulting from policies introduced after the presidential election (higher tariffs, tighter curbs on immigration).

Conversely, if the yen strengthens beyond current levels, this would curb the uptrend in import prices and put downward pressure mainly on goods prices. If China continues with cheaply priced "deflation exports," this could also affect consumer prices in Japan. Some steelmakers have already begun cutting prices in response to an increase in low-priced steel imports. Consumers' weariness with price hikes is also likely to impede the pass-through of higher costs.

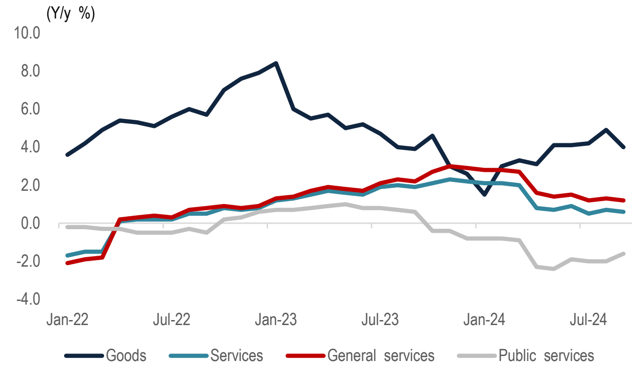
We therefore see both upside and downside risks to the inflation outlook, which we think are balanced at this point.

Chart 2: Breakdown of Contributions to Core CPI (in ward-area of Tokyo, y/y ppt)



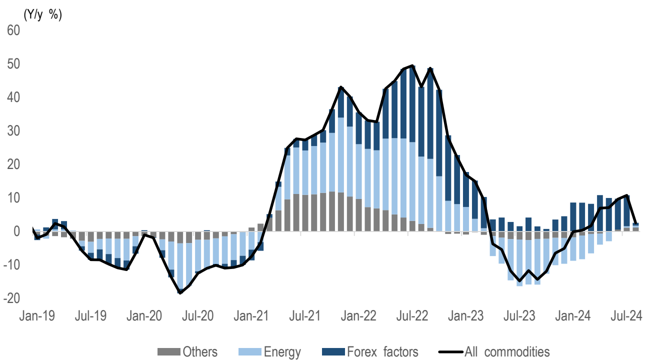
Source: MIC; compiled by Daiwa.

Chart 3: Goods/Services CPI (in ward-area of Tokyo)



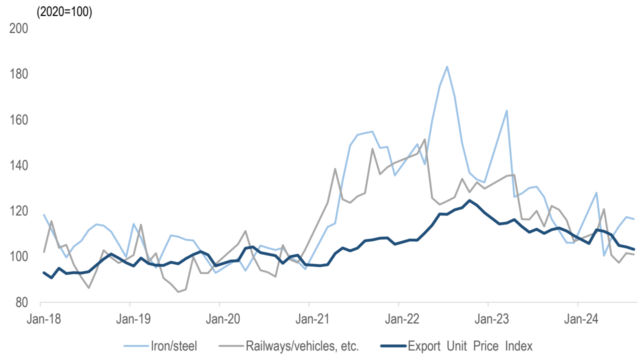
Source: MIC; compiled by Daiwa.

Chart 4: Import Price Index (yen basis)



Source: BOJ; compiled by Daiwa.

Chart 5: China's Export Unit Price



Source: Haver; compiled by Daiwa.

Wages: 2025 wage negotiations to sustain momentum for pay hikes

The Jun-Jul Monthly Labour Survey showed a marked pickup in special cash earnings driven by an increase in summer bonuses, causing growth in real wages to turn positive. Growth in scheduled cash earnings for full-time workers at continuously surveyed firms also accelerated to +3.0% y/y in July. This undoubtedly reflects the considerable pay increases agreed in the 2024 spring wage negotiations feeding into actual earnings.

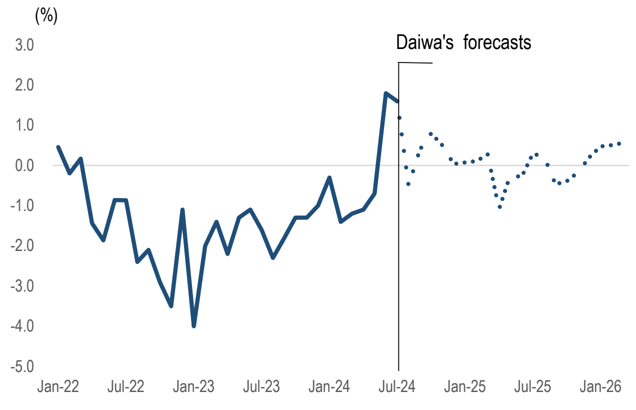
However, the switch to positive real wage growth largely reflected higher summer bonuses, and we think real wages in the August Monthly Labour Survey will likely fall again as the impact of bonuses fades. We subsequently expect positive growth in real wages to take hold in 2H FY25, despite some fluctuations until then caused by consumer price factors, due to the government reintroducing cost-of-living measures and the associated base effect.

Our outlook for real wages assumes that the impetus for pay hikes remains intact in the 2025 spring wage negotiations. Unions' basic policy for spring wage negotiations indicates that their demands for base pay increases reflect a comprehensive assessment of pay levels, labor market pay trends, and the need for growth in disposable income to exceed inflation; we expect the 2025 negotiations to again reflect these criteria. A mid-FY24 Cabinet Office simulation puts FY25 headline CPI inflation at 2.2% (versus +2.8% in FY24), and we therefore expect unions to demand at least a 2.2% increase in base pay given the need for disposable income growth to outpace inflation.

We note that union demands tend to be in round numbers, suggesting that they could well request a 3% increase (the 2024 demand was for "at least 3%"). However, we expect the outcome of 2025 wage negotiations to be more muted than 2024 given prospects for FY25 inflation to slow y/y and the fact that employers tend not to raise wages more than unions demand. However, structural labor shortages are increasing the need to increase pay, as evidenced by Suntory's 26 September announcement that it will raise wages by around 7% (incl. regular-increase component) in 2025. We also think corporate earnings are likely to remain high if exchange rates stay at current levels, resulting in sustained momentum for wage hikes. We therefore expect the 2025 negotiations to result in a sizeable increase in base pay, of 2.5-2.9%.

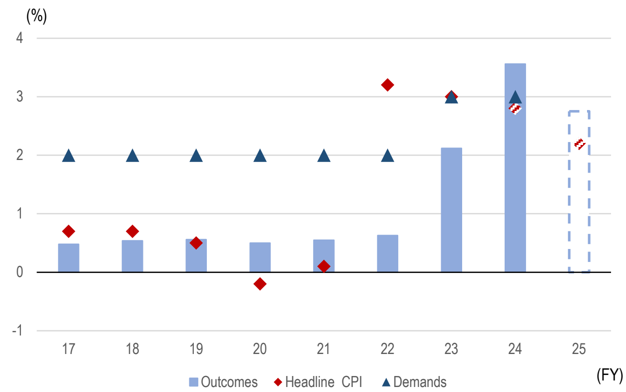
We would also bear in mind Shigeru Ishiba's election as LDP president on 27 September. Mr. Ishiba has noted the importance of wage hikes, stating on the subject of economic stimulus (incl. cost-of-living) measures that "wage hikes have the most immediate effect". As in 2024, we think greater pressure for wage hikes from the government will also support substantial pay increases in the 2025 negotiations.

Chart 6: Forecasts for Real Wages



Source: Actual data from MIC, Ministry of Health, Labour and Welfare; compiled by Daiwa.

Chart 7: Outcomes of Spring Wage Negotiations (base pay hikes, estimated)



Source: BOJ, Bloomberg; compiled by Daiwa.
Note: 2025 headline CPI based on mid-FY24 Cabinet Office simulation.

Consumer spending: Upturn as real wages rise, but growth remains gradual

The BOJ's real Consumption Activity Index shows a sharp recovery in durables spending from June; this reflected the resumption of operations at all Daihatsu Motor plants in May following the halt to auto production due to certification issues. Jun-Jul spending was up m/m. We also think service spending is gradually rebounding, but spending on non-durables remains weak due to consumers' continued thriftiness in the face of rising prices.

At its September Monetary Policy Meeting (MPM), the BOJ upwardly revised its language on consumer spending from "has been resilient despite the impact of price rises and other factors" to "has been on a moderate increasing trend despite the impact of price rises and other factors."

BOJ Governor Kazuo Ueda mentioned at his post-MPM press conference that the Consumption Activity Index turned upward in 2Q and continued to rise in July.

However, there are several caveats regarding Jul-Sep 2024 consumer spending. The August Economy Watchers Survey featured notable negative comments such as "numerous cancellations due to earthquakes and typhoons amid a decline in mobility caused by the intense heat severely depressed our income. The slow-moving Typhoon Shanshan in particular had a prolonged impact" (Shikoku, urban hotel) and "the overlap of major typhoons with the summer vacation season affected our sales" (Tohoku, travel agent). We need to consider the impact of extraordinary factors such as heatwaves and natural disasters, particularly in services, in assessing Jul-Sep consumer spending. We also expect only limited growth in Jul-Sep durables spending given Toyota Motor's decision to halt production for three models through end-August. This reflected further revelations since 6 June of issues with falsified certification test data.

We think early-August market volatility will have little impact on consumer spending given that the Nikkei 225 has rebounded to near its level prior to the shock.

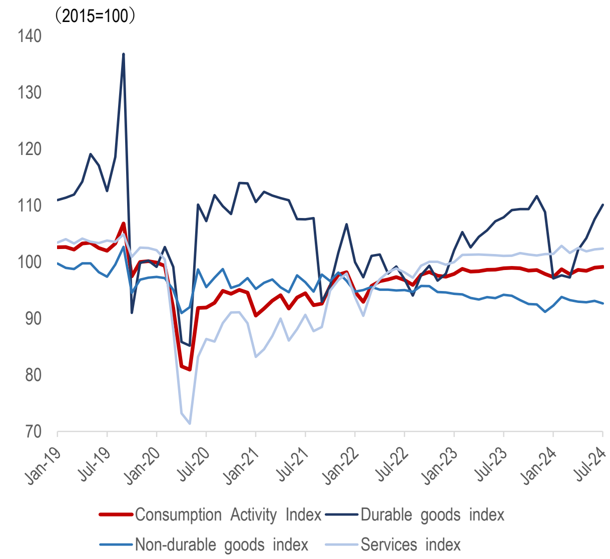
However, the fact that frequently purchased items such as food face greater inflationary pressure than the headline CPI is making consumers more aware of high prices. Behavioral economics argues that people prefer avoiding losses over receiving an equivalent gain (loss aversion), suggesting that they are likely to focus more on the negative effects of inflation than on growth in their income. While real income growth has turned positive, it will likely take time for consumers to gain a tangible sense that incomes have risen.

Improving income conditions also disproportionately benefit younger demographics, and we therefore need to look at data by age group to analyze current consumer spending in detail.

Data on savings and debt by age group shows that people in their 40s and below have more debt than savings, while over-50s have more savings than debt. The BOJ is focusing on the economic impact of rising interest rates, which we think are more negative for people in their 40s or below and more positive for the over-50s.

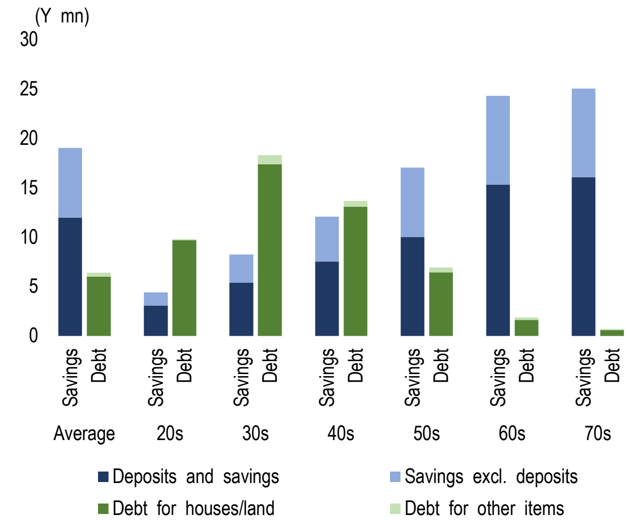
Many financial institutions plan to revise the interest rates they charge for variable-rate mortgages in October; we expect rising interest rates to have a negative impact mainly on younger demographics that have substantial debt. We also think it will take time for consumer sentiment to improve given that, after a prolonged downturn, growth in real wages looks set to remain near zero in the near term. We expect consumer spending to rebound as income conditions improve, but at a very gradual pace.

Chart 8: Consumption Activity Index (Real)



Source: BOJ; compiled by Daiwa.

Chart 9: Household Savings and Debt



Source: MIC; compiled by Daiwa.

BOJ policy rate outlook: Bank to assess US economy, determine if next rate hike possible in Jan-Mar

During his 20 September post-meeting press conference, BOJ Governor Kazuo Ueda suggested that the Bank needs to assess the US economy as a condition for steady progress toward the BOJ's economic activity and price outlooks. Specifically, he said, "Recent data for the Japanese economy is on track, but the global economic outlook is uncertain, mainly that of the US, and the resulting market movements are causing uncertainty for our outlooks." On top of that, he said, "The risk of higher-than-expected inflation due to yen depreciation since the beginning of the year has decreased to a reasonable extent. As such, we now have enough time to make policy decisions."

The BOJ's policy reaction functions are still ① whether or not the Japanese economy trends in line with its outlook and ② whether or not consumer prices are higher than expected. Even though the US economy and financial/capital market trends are adding some uncertainties to Japan's economic outlook (①), the risk of higher-than-expected prices due to yen appreciation (②) has been reduced. As such, there is no longer any reason to hastily raise interest rates, so there is probably enough time for the BOJ to carefully assess impacts on the Japanese economy."

However, it is clear that the BOJ's future interest rate hike decisions are heavily dependent on its assessment of the US economy. The key is to determine the best timing for hiking rates. In order to decide whether to again hike interest rates, the Bank will need to first confirm that future US employment data (such as unemployment rate) has stabilized. That said, the possibility of a significant Fed interest rate cut will increase even further if the actual unemployment rate, specifically the Fed's Summary of Economic Projections (SEP) in the US employment data for next month and beyond, approaches the projected end-2024 unemployment rate of 4.4% (median). The US employment statistics could potentially lead to a major decision by the BOJ.

In addition, from the perspective of financial and capital market instability, the BOJ will also need to assess the outcome of the US presidential election on 5 November. However, as the effects of monetary policy are delayed, it is hard to immediately assess the impact of the Fed's previous interest rate hikes or the impact of the interest rate cuts that began in September. Within this year, at the very least, determining whether the US economy can realize a soft landing will be difficult. We expect the BOJ to make its next interest rate hike between January and March 2025.

Ueda mentioned the following as points of interest for the domestic economy: ① wage trends from autumn onwards, ② impact of minimum wage hikes, ③ impact of passing on higher costs to service prices, ④ trends ahead of next year's spring labor-management wage negotiations, and ⑤ future form of consumption.

As for that point, we believe that wage increase momentum will continue and, even though the consumption recovery will be delayed, there is a high probability that consumption will steadily recover. Also, the BOJ's quarterly Tankan (September) survey released on 1 October contained no signs of any changes in corporate behavior at this time. The results of the 2024 spring labor-management wage negotiations were also reflected in the Monthly Labour Survey for July. Looking at only domestic factors, there is the strong likelihood that Japan's economy will remain on track.

More specifically, the continuity of wage increases can be confirmed in the spring labor-management wage negotiations basic plan (due out in mid-Oct) and policy (due out at beginning of Dec). The Tokyo CPI data (due out on 25 Oct) should confirm the spread of service price hikes. There is the possibility that consumption will not clearly recover. However, during his 24 September press conference, Ueda said, "The premise behind the scenario of gradual private consumption growth is that there will be continued, steady wage increases, and that household income will also increase." If income conditions improve, even if consumption does not strongly recover, consumption should still remain "steady" and in line with BOJ forecasts.

The above considerations, as well as our premise is that the US economy will make a soft landing, suggest the possibility that conditions for raising interest rates will be in place as early as January 2025. However, the BOJ is adopting a cautious stance. There is a good chance that the Bank will make a decision to hike rates in March 2025, after the obtaining a clearer picture of the feasibility of policies implemented by the new US administration, as well as the results of Japan's spring labor-management wage negotiations. After that, we would expect the BOJ to hike rates once every six months.

Meanwhile, under a hard landing scenario, where the US economy suddenly stalls, Japan's virtuous cycle of higher wages and higher prices would collapse and its interest rate-hiking phase would likely come to an end.

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