Japan
Fixed Income
26 November 2024
Japanese report: 25 November 2024

Daiwa Securities

Daiwa's Economic View

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

- Japan's economy continues to gradually recover, due in large part to domestic demand
- Expect gradual passing on of wage hikes to goods prices
- BOJ's phase for assessing overseas economies continues; expect next rate hike in Jan-Mar 2025 provided US economy remains strong

FICC Research Dept.

Kento Minami
81-3-5555-8789
kento.minami@daiwa.co.jp

Kaori Ichikawa
Kenji Yamamoto
Mari Iwashita
Daiwa Securities Co. Ltd.

Summary

Our outlook for Japan's real economy calls for positive growth of +0.3% y/y in FY24, +1.0% in FY25, and +1.0% in FY26, provided that the US economy makes a soft landing.

Japan's GDP for Jul-Sep 2024 grew for the second straight quarter due in part to a boost from solid private consumption. However, consumer sentiment remains weak and the outlook is unchanged at "gradual recovery." The momentum for higher wages is expected to continue from FY25 as well and a gradual economic recovery driven in large part by domestic demand is expected to continue.

Looking ahead, the rate of increase for goods prices will gradually contract, but growth for service prices will continue due to rising labor costs brought about by structural labor shortages. Indeed, service price growth is expected to hold at levels near +2% y/y through FY26.

The BOJ's basic policy is to raise rates amid extremely low real interest rates, but its phase for paying close attention to risks in overseas economies will continue. If the BOJ wants to "carefully assesses future US economic developments and policy management," the accuracy of its forecasts will be higher if the Bank waits until its January 2025 meeting to hike rates.

If the US economy remains upbeat, Japan's economy will remain on track and the conditions for a rate hike in January are likely to be in place. Meanwhile, the BOJ could wait until the March 2025 meeting to make a decision if it wants to first confirm (1) the feasibility of the policies of the new US administration and (2) concrete aspects (stances) of the annual spring labor-management wage negotiations. As such, we expect the BOJ to make its next interest rate hike sometime between January and March 2025. After that, we expect rate hikes once every six months.

Under a hard landing scenario, in which the US economy suddenly stalls, the virtuous cycle of higher wages leading to higher prices would be interrupted and the interest rate hiking cycle would come to an end.

Chart 1: Forecasts for Major Economic Indicators (%)

					→Forecasts*														→Forecasts*		
	FY23		FY24				FY25				FY26				FY22	FY23	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	(actual)	(actual)			
Real GDP growth rate (q/q)	0.1	-0.6	0.5	0.2	0.4	0.3	0.2	0.3	0.3	0.2	0.3	0.2	0.2	0.3		-	-	-	-
(annualized)	0.4	-2.4	2.2	0.9	1.6	1.1	0.7	1.1	1.1	0.9	1.2	1.0	0.8	1.3	1.6	0.8	0.3	1.0	1.0
Domestic demand contribution (q/q)	0.0	-0.2	0.6	0.6	0.6	0.3	0.2	0.3	0.2	0.2	0.3	0.2	0.2	0.3	2.1	-0.5	1.1	1.2	1.0
Private consumption (q/q)	-0.3	-0.6	0.7	0.9	0.4	0.3	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2	2.7	-0.6	0.9	1.3	0.9
Private non-residential investment (q/q)	2.1	-0.4	0.9	-0.2	0.5	0.3	0.3	0.4	0.6	0.6	0.5	0.5	0.6	0.6	4.1	0.3	1.8	1.5	2.2
Foreign demand contribution (q/q)	0.1	-0.4	-0.1	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.4	1.2	-0.6	-0.1	0.0
Core CPI (y/y)	2.5	2.5	2.5	2.6	2.5	2.5	2.7	2.2	2.1	1.9	1.7	1.7	1.6	1.8	0.6	2.8	2.5	2.2	1.8
Core core CPI (y/y)	3.7	3.2	2.2	1.9	2.2	2.0	2.1	1.8	1.6	1.7	1.8	1.8	1.9	2.0	2.2	3.9	2.1	1.8	1.9
Uncollateralized overnight call rate**	-0.1	0.0～0.1	0.0～0.1	0.25	0.25	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	-0.1	0.0～0.1	0.50	1.00	1.00

Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC), BOJ, Bloomberg; compiled by Daiwa.
**Forecasts by FICC Research Department.*
***Interest rates under Complementary Deposit Facility used through Oct-Dec FY23.*

Japan's economic outlook: Gradual recovery led by domestic demand

Assuming the US economy remains strong, we forecast Japan's real GDP growth to be +0.3% y/y in FY24, +1.0% in FY25, and +1.0% in FY26.

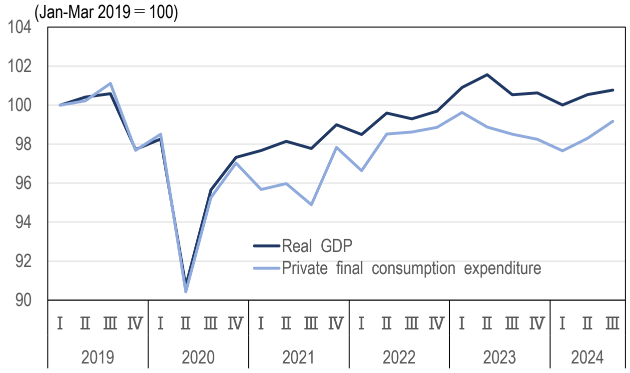
Jul-Sep 2024 real GDP, released on 15 November, came in at +0.2% q/q growth (+0.9% annualized), marking the second consecutive quarter of growth, helped by strong growth in personal consumption. A decline in service exports and the strong increase in imports contributed negatively to external demand, however, keeping overall growth modest.

Based on Jul-Sep GDP, we revise our current outlook, including an upward revision for domestic demand and downward revision for external demand through FY25. Note that the Jul-Sep increase in personal consumption was driven by one-off factors, including demand spikes on heatwaves and earthquakes, as well as a recovery in auto production, and note also that consumption levels have yet to reach pre-COVID levels. Consumer sentiment remains weak as consumers still have a frugality bias. Despite inflation, from Oct-Dec 2024 we still expect the economy to gradually recover on pent-up demand for automobiles and improvement in incomes helped by rising scheduled cash earnings and increases in the minimum wage.

We expect wage hikes to maintain momentum beyond FY2025 and sustain a gradual recovery led by domestic demand. The 2025 spring wage negotiations look set to usher in higher wages, with RENGO (Japanese Trade Union Confederation) demanding wage hikes of over +5% including regular pay raises, like last year, and Keidanren (Japan Business Federation)'s draft basic policy, which serves as a guideline for management, stating that spreading and establishing strong wage increase momentum across society is a social responsibility. We expect the 2025 spring wage negotiations to again result in high base pay increases of around 3%.

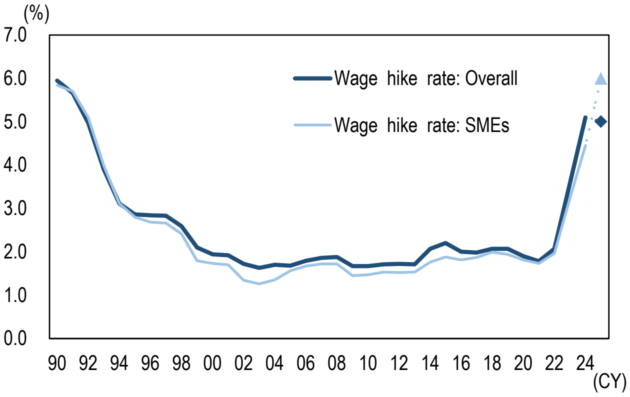
However, uncertainties surrounding the policies of US President-elect Trump and their impact on corporate earnings, particularly in manufacturing, merit close attention. Additionally, SMEs will have to raise wages defensively to avoid labor shortages amid hikes to the minimum wage and increases in labor's relative share, and their costs are rising. Be aware of the risk of these factors altering corporate behavior in Japan.

Chart 2: Real GDP, Private Final Consumption Expenditure



Source: Cabinet Office; compiled by Daiwa.

Chart 3: Spring Wage Negotiation Results, Basic Plans for 2025



Source: Japanese Trade Union Confederation; compiled by Daiwa.
Note: Results through 2024 (solid line) are based on reported responses, while 2025 (dotted line) reflects the 2025 spring labor negotiation demands. Figures for SMEs include adjustments to correct disparities.

Inflation outlook: Price pass-throughs proceeding, but slowly

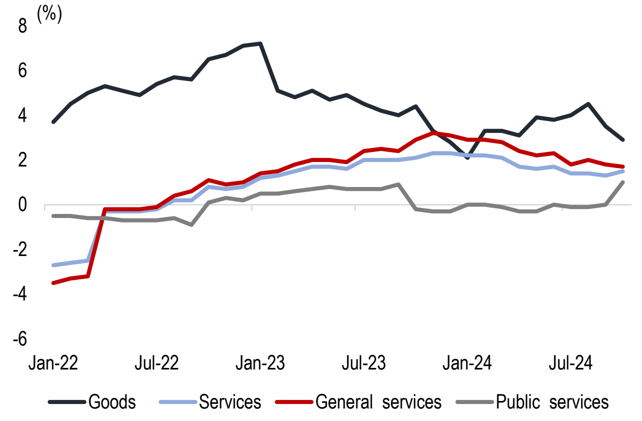
In October, consumer prices for general services did not accelerate nor did services prices reflect strong wages any more than they did last year. However, service prices are on an upward trend, evidence that higher wages are being passed through to prices, albeit slowly. We expect gradual price pass-throughs to continue as labor costs rise.

Meanwhile, increases in prices for food excluding fresh produce have accelerated, although much of this can be attributed to such temporary factors as adverse weather and surging raw material prices, and price increases have slowed for many other goods. Consumer fatigue with price hikes has created resistance to price pass-throughs, including de facto price increases implemented by reducing product quantities, and this resistance could exert downward pressure on goods prices going forward.

Core CPI should remain volatile because of government measures to combat high prices. The economic measures approved by the Cabinet on 22 November include the resumption of electricity and gas subsidies, which ended with October usage, from Jan-Mar 2025, and an extension of gasoline subsidies, albeit at a reduced scale, beyond their end-2024 expiration. We expect the resumption of electricity and gas subsidies to lower CPI by approximately 0.34% in Feb-Mar 2025 and by about 0.18% in April relative to a world without the subsidies, although the subsidies were larger in 2024, and base effects could create upward pressure on the y/y change in prices.

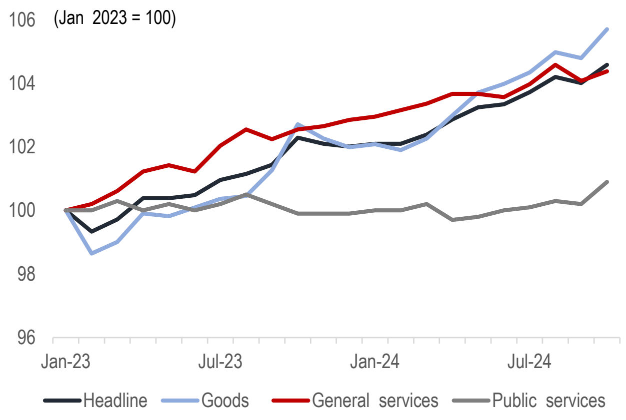
We think service prices are likely to continue rising from FY25 as structural labor shortages drive up labor costs. On the other hand, rising labor costs are a burden, especially for SMEs, making price pass-throughs essential for sustained wage and price increases. The government's priority is on facilitating labor cost pass-throughs by year-end, and we expect progress in this regard to result in earnings improvement, particularly at SMEs.

Chart 4: Y/y Changes in CPI for Goods and Services



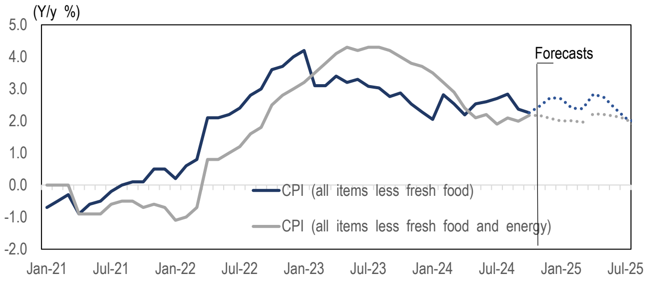
Source: MIC; compiled by Daiwa.

Chart 5: CPI Levels for Goods and Services



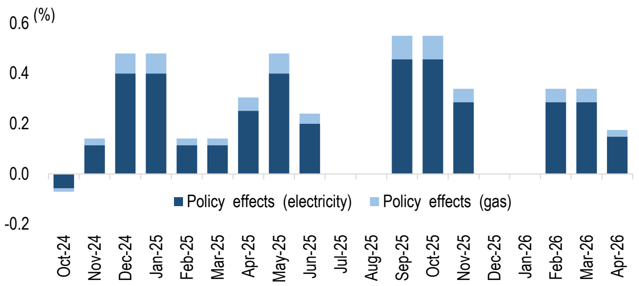
Source: MIC; compiled by Daiwa.

Chart 6: CPI Forecasts



Source: MIC; compiled by Daiwa.

Chart 7: Impact of Government's Electricity and Gas Subsidies (Contribution to headline CPI)



Source: MIC; compiled by Daiwa.
Note: Values include base effects.

BOJ policy rate outlook: Focus remains on overseas developments; next rate hike likely in Jan-Mar

At the press conference following his 18 November speech, BOJ Governor Kazuo Ueda stressed that the domestic economy and price conditions were “on track.” Specifically, he said there is a high probability that capital investment will continue to increase, while private consumption remains in a gradual upward trend. As for October core CPI inflation in Tokyo's 23 wards, Ueda indicated that there were efforts to revise prices for various items, including services, against the backdrop of rising wages and other factors. He also concluded that progress is being seen in the domestic environment.

Ueda also said that the key to predicting the future hinges on two points, specifically (1) whether overseas economies follow a path of gradual growth and (2) whether the virtuous cycle of higher wages leading to higher prices continues to strengthen. For the US economy in particular, he said that while concerns are receding, there is also a risk that the decline in excess savings that supported private consumption, as well as the impact of rapid interest rate hikes, could depress economic activity with a certain lag. He also said that there is a risk of inflation flaring up again in response to future economic developments and policy management (Trump administration's actions) and that the BOJ wants to carefully assess those situations.

In this manner, the BOJ's basic policy is to raise rates amid extremely low real interest rates, but the Bank's phase for paying close attention to risks for overseas economies will continue. Amid that phase, if the BOJ places importance on "carefully assessing" the situation, waiting until the January 2025 meeting to confirm the economic situation in the US and the policy management of the Trump administration after the start of 2025 would probably be preferable in terms of increasing the accuracy of its outlook. There is also the possibility that an additional rate hike by the BOJ before the budget for the next fiscal year is formulated in late December (following the October Lower House election) would be undesirable. Meanwhile, with the US presidential election now over, the impact of the policies of the incoming Trump administration are attracting attention. With the potential for both upside and downside risks for Japan's economy, the BOJ could opt for an early interest rate hike to provide the BOJ with more room to respond to situations involving its monetary policy.

Based on these considerations, we expect the BOJ to make its next interest rate hike sometime between January and March 2025. However, the possibility of a rate hike in January seems to be increasing considering such perspectives as (1) solid private consumption in Japan's GDP for the Jul-Sep quarter, (2) growing momentum for wage hikes in Japan, (3) increasing hopes for a soft landing in the US, and (4) ensuring increased leeway for monetary policy maneuvering. If the US economy continues to perform strongly, Japan's economy should remain on track. In that case, there is also the high likelihood that the conditions for a rate hike will be in place by the time of the BOJ's January *Outlook for Economic Activity and Prices* report. Meanwhile, if the BOJ wants more time to assess the feasibility of the new US administration's policies, as well as the concrete aspects (stances) of the annual spring labor-management wage negotiations, it could wait until March 2025 to make a rate hiking decision. After that, we expect the BOJ to hike interest rates once every six months, while ascertaining economic conditions in Japan and abroad, as well as the impacts of interest rate hikes.

However, the market is increasingly factoring in a December rate hike. As such, there could be the risk of a reaction (in the form of yen depreciation) if a rate hike is not made in December. If the yen weakens further due to factors such as waning market expectations for a December rate cut by the Fed, it is conceivable that the BOJ could indeed decide to make a rate hike at the December meeting. The BOJ has stated that "At each meeting, the Bank will make policy decisions based on its latest assessment of the current state and outlook for economic activity and prices with reference to, for example, the data and information available at the time of each meeting." Major actions or decisions seem possible at all BOJ meetings for the foreseeable future. The situation in which we cannot take our eyes off the December meeting will continue.

Meanwhile, under a hard landing scenario, in which the US economy suddenly stalls, the virtuous cycle of higher wages leading to higher prices would be interrupted and the interest rate hiking cycle would come to an end.

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