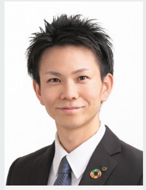
Daiwa Securities

Daiwa's Economic View

Outlook for Japan's economy, policy rate (Feb 2025)

- Japan's economy picking up, mainly due to domestic demand, but concerns about Trump impact
- Prices expected to remain high until mid-2025; on guard for higher-than-expected prices
- Expect next rate hike in July; 1% terminal rate?

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

We estimate Japan's real growth rate to be +0.8% y/y in FY24, +1.2% in FY25, and +1.1% in FY26. Due to delays in the positive turnaround for real wages, consumption is expected to remain in a gradual recovery for the time being. However, demand for capex is strong and steady growth is expected.

The biggest risk to the Japanese economy, however, is the impact of US economic policy. In particular, if a 25% tariff is imposed on Japanese cars, we estimate that would push down real GDP by around 0.2 to 0.3%. If the trade friction between the US and China intensifies and if tariffs are imposed on Mexico and Canada, the impact on the Japanese economy would be even greater.

The high cost of living due to the passing on of higher costs to prices is likely to continue until at least mid-2025. However, the risk balance for the price outlook is now skewed to the upside. We must remain mindful of risks such as soaring food prices continuing into 2H FY25, forex risks, and the risk of higher-than-expected service prices.

While the BOJ has set a basic interest rate hiking pace of around every six months, we expect it to raise interest rates earlier if data and information indicate that the probability of higher-than-expected prices is increasing. At this juncture, however, we expect the next interest rate hike to be in July of this year. In addition, we assume that the terminal point of the current interest rate hiking cycle will be a policy interest rate of 1%.

Chart 1: Forecasts for Major Economic Indicators (%)

	FY24			→Forecasts*	FY25				FY26				→Forecasts*		
	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	FY24	FY25	FY26
Real GDP growth rate (q/q)	0.7	0.4	0.7	0.2	0.2	0.2	0.3	0.3	0.3	0.2	0.2	0.3	-	-	-
(annualized)	3.0	1.7	2.8	0.7	0.8	1.0	1.0	1.2	1.2	0.9	0.7	1.2	0.8	1.2	1.1
Domestic demand contribution (q/q)	1.0	0.5	-0.1	0.4	0.2	0.2	0.3	0.3	0.3	0.2	0.2	0.3	1.1	1.0	1.0
Private consumption (q/q)	0.7	0.7	0.1	0.1	0.1	0.2	0.2	0.3	0.2	0.2	0.3	0.2	0.8	0.7	0.9
Private non-residential investment (q/q)	1.1	-0.1	0.5	0.2	0.4	0.4	0.5	0.4	0.5	0.3	0.3	0.4	1.9	1.4	1.6
Foreign demand contribution (q/q)	-0.3	-0.1	0.6	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	-0.2	0.2	0.1
Exports (q/q)	1.7	1.5	1.1	0.9	0.3	0.6	0.6	0.8	0.9	0.9	0.9	1.0	2.0	2.9	3.4
Imports (q/q)	3.0	2.0	-2.1	1.3	0.4	0.6	0.7	0.7	0.8	0.8	0.9	0.9	3.2	1.8	3.1
Core CPI (y/y)	2.5	2.7	2.6	3.0	3.0	2.6	2.3	1.9	1.8	1.7	1.8	2.0	2.7	2.4	1.8
Core core CPI (y/y)	2.2	2.0	2.2	2.5	2.6	2.3	1.7	1.7	1.9	1.9	2.0	2.1	2.3	2.0	1.9
Uncollateralized overnight call rate	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	0.50	1.00	1.00

Source: Cabinet Office, Ministry of Internal Affairs and Communications (MIC), BOJ, Bloomberg; compiled by Daiwa.
Note: Impact of free high school education program is not included in these forecasts.
**Forecasts by FICC Research Department.*

Japan's economic outlook: Recovery led by domestic demand, but concerns about Trump impact

For Japan's real economic growth rate, we expect positive growth of +0.8% y/y in FY24. Also, growth in FY25 and FY26 will be led by domestic demand and we expect growth of +1.2% for FY25 and +1.1% for FY26 (expected to exceed potential growth rate).

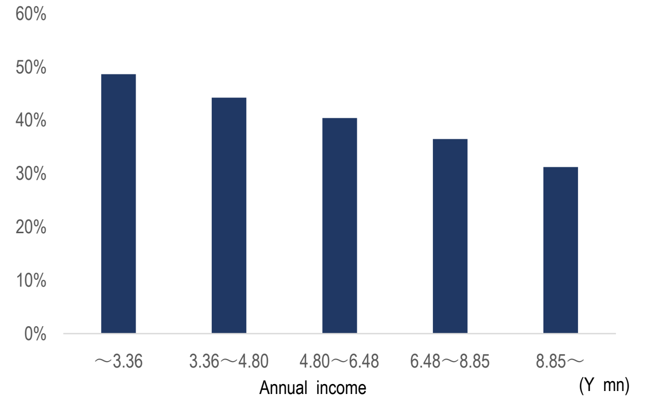
However, we expect that the recovery for consumption will remain gradual. The annual spring labor-management wage negotiations for 2025 are expected to result in wage increases similar to 2024, reflecting the current high price levels, and a clear positive turnaround in real wages is expected to occur from the second half of FY25. In particular, the current high prices for goods are led by necessities. Indeed, household consumption is expected to stagnate among low-income earners, who tend to spend a large proportion of their income on necessities (charts 2 and 3).

Meanwhile, due to structural labor shortages and an increase in demand for DX (digital transformation), we expect the appetite for capex to remain high. There are currently supply-side issues such as construction delays due to labor shortages, but demand remains strong and the machinery orders balance remains high. The number of months on hand for the machinery orders balance is 14.8 months. A considerable amount of time will be needed just to process the current outstanding orders (Chart 4). Furthermore, given that there is still room for investment in intellectual properties in Japan, including DX, as compared to the US, capex growth is likely to remain strong for the time being (Chart 5).

That said, the biggest risk to the Japanese economy from here is the impact of US economic policy. On the 18 February, US President Trump said that the tariff rate on cars imported to the US would be around 25%. With Japan's vehicle inspection system, safety standards, and environmental regulations being pointed out as "non-tariff barriers," the possibility of tariffs being imposed on Japanese automobiles is increasing. The automobile industry has a wide base in Japan and the impact on the Japanese economy from a decrease in automobile exports due to the introduction of tariffs would be significant.

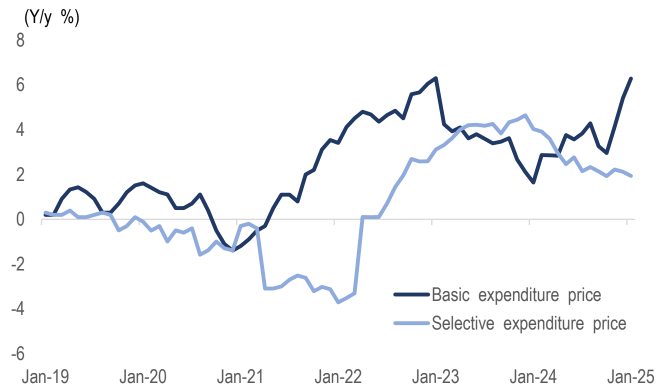
Actually, if a uniform 25% tariff is imposed on cars (passenger cars and trucks) exported from Japan, and assuming a price elasticity of demand of 1, an analysis of the impact on Japan's real GDP based on the inter-industry relations table would show a downward effect of around 0.2 to 0.3%. In that case, Japan's economic outlook figures would be lower than expected. In addition, if the US tariff policy leads to a decrease in Japanese exports to China due to a decrease in Chinese domestic demand caused by the US-China trade friction, or if there is a negative impact on overseas production bases due to tariffs on Mexico and Canada, the impact on the Japanese economy would be even greater.

Chart 2: Percentage of Necessities in Consumption Expenditure by Annual Income Group



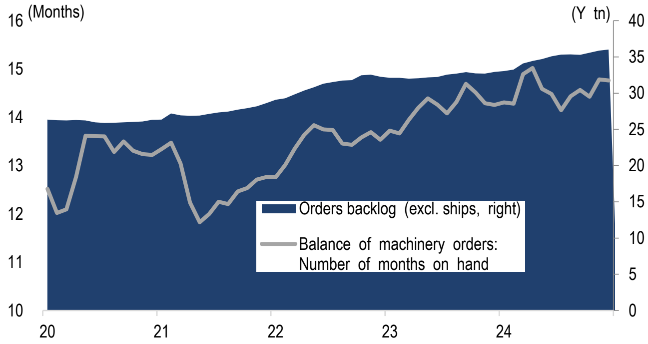
Source: MIC; compiled by Daiwa.
Note: We have made a rough estimate of the items that are considered necessities, assuming that they are food (excluding food eaten outside of the home), housing, utilities, medicine, and others.

Chart 3: CPI by Expenditure Type



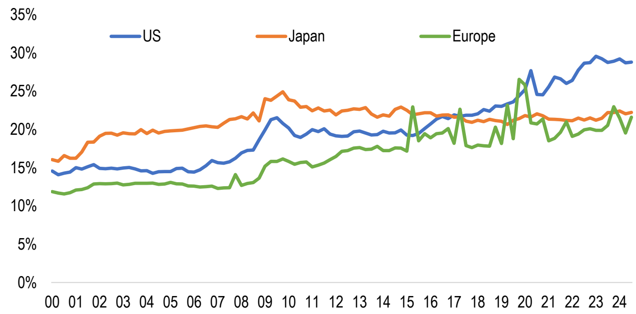
Source: MIC; compiled by Daiwa.
Note: Elasticity of expenditures for the price of each index item of less than 1 is classified as basic expenditure items, while those 1 or more are classified as selective expenditure items.

Chart 4: Balance of Machinery Orders and Number of Months on Hand



Source: Cabinet Office; compiled by Daiwa.

Chart 5: Intellectual Property Investment in Japan, US, and Europe



Source: US Department of Commerce, Eurostat, Cabinet Office; compiled by Daiwa.
Note: Ratio of intellectual property investment to total capital formation.

Price and wage outlook: Prices to remain high until mid-2025; on guard for higher-than-expected prices

In January, the y/y change in the CPI (nationwide) for food further accelerated to +5.1% (Dec: +4.4%). Meanwhile, against the backdrop of special factors related to overseas package tours, general services growth slowed to +1.4% (Dec: +1.8%). The overall price of goods also rose 6.3% (Dec: +5.4%) and currently the passing on of higher costs to prices has strengthened (charts 6 and 7).

Due to strengthening of this passing on of higher costs to prices, it is highly likely that core CPI will remain at around +3% y/y until mid-2025. According to a Teikoku Databank survey, the number of food items with higher prices is expected to exceed last year's figure toward the first half of 2025, highlighting the strong desire to pass on higher costs to prices (Chart 8). Also, the high price of rice, which has made a large contribution to current CPI growth (contribution to overall CPI in Jan was +0.41%), is expected to be brought under control by the release of government-held rice stocks. However, the factors behind the price increase are not only the tight supply/demand conditions, but also the increase in production input costs. So, it is highly likely that the government's price suppression effects will be limited. Under these conditions, the y/y price increase rate for rice is likely to remain high until around the summer of 2025 (Chart 9).

However, even though the international commodity prices for agricultural products are currently rising, their levels are low compared to the past. At the very least, we expect the pressure to pass on higher costs to prices, due to overseas factors, will gradually decline (Chart 10). From mid-2025, core CPI growth is expected to gradually slow, amid some fluctuations due to the base effect of measures taken in the previous year to counter high electricity and gas prices. Core CPI should settle at around 2% y/y growth around the end of 2025. That said, the risk balance of this price forecast is skewed to the upside. The main reasons are (1) risk that the previously mentioned rise in food prices will continue into the second half of FY25, (2) forex risks, and (3) risk of higher-than-expected service prices.

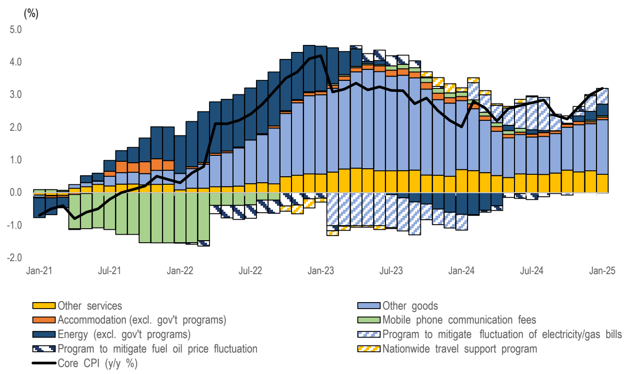
With regard to forex, the yen has been strengthening recently and, even though the risk of higher-than-expected prices has decreased at the moment, there is a possibility that the pressure of the strong dollar due to US tariffs will remain for the next few months. At the same time, Japan's real yield is unlikely to rise substantially into positive territory. As such, there is little room for the yen to strengthen or for the real interest rate differential to shrink due to the BOJ factors. If the yen were to weaken against the backdrop of a strengthening US economy, that would create further pressure to pass on higher costs to prices. In that case, there is a high probability that prices will remain high through the second half of FY25.

Also, the risk of higher-than-expected service prices is mainly due to the risk of higher-than-expected prices originating from Japan's supply constraints (caused by labor shortages). For example, the passing on of higher wage costs to service prices after wage hikes resulting from the 2025 annual spring labor-management wage negotiations are much higher than that for the previous year.

Meanwhile, as for the 2025 annual spring labor-management wage negotiations, the outlook is higher than previously expected due to the strength of the momentum for pay increases among companies since the beginning of the year. Nevertheless, if we take into account that the CPI for 2024 was lower than the previous year, we expect the rate of increase in wages, including regular pay increases, to remain at around the same level as the previous year, at 5%. If wage increases are similar to the previous year, the risk of higher-than-expected service prices would not be that great over the short term. However, as BOJ Governor Kazuo Ueda indicated at his 24 January post-meeting press conference, if inflation increases in 2025 due to the passing on of higher costs to prices, there could be upward pressure on wage hikes at the annual spring labor-management wage negotiations, even in 2026. There is the need to stay on guard for the possibility that increasing pressures to pass on higher costs to prices will impact service prices after a certain lag.

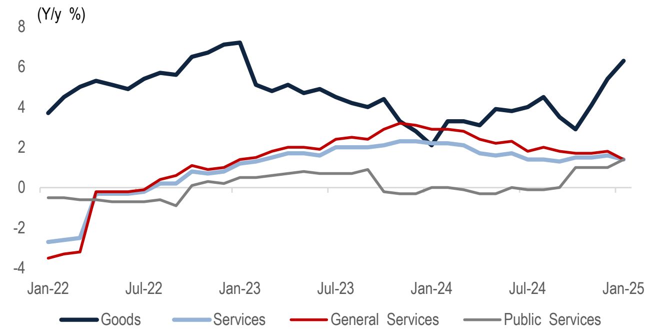
Nominal wages (scheduled cash earnings) as seen in the Monthly Labour Survey for FY25 are expected to remain stable at around +3% y/y from the summer to autumn, reflecting the pay increases from the 2025 annual spring labor-management wage negotiations. Meanwhile, we think that a clear upturn for real wages will not occur in the second half of FY25 due to price factors (passing on of higher costs to prices) (Chart 11).

Chart 6: Breakdown of Contributions to Core CPI



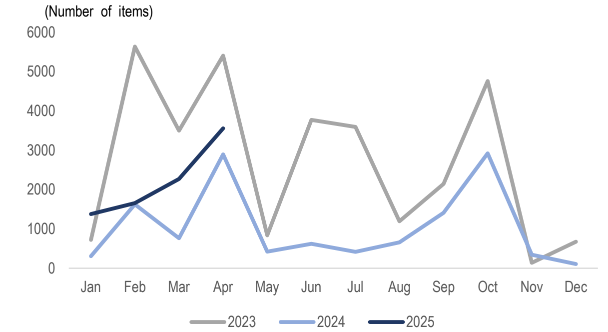
Source: MIC; compiled by Daiwa.

Chart 7: Goods and Services CPI by Type



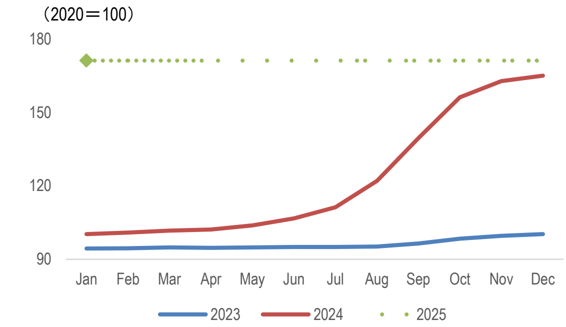
Source: MIC; compiled by Daiwa.

Chart 8: Number of Food Items with Higher Prices



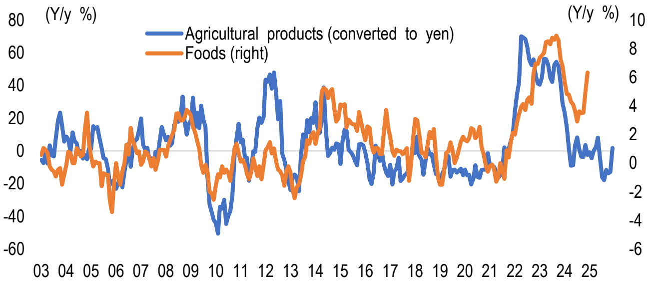
Source: Teikoku Databank; compiled by Daiwa.

Chart 9: Price Level for Rice



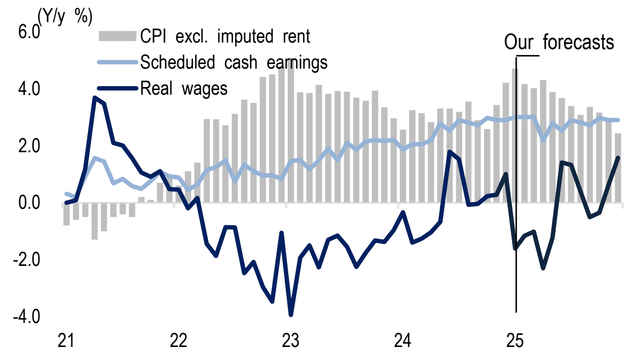
Source: MIC; compiled by Daiwa.
Note: Dotted line indicates value assuming index for Jan 2025 is left unchanged.

Chart 10: International Commodity Prices (agricultural products) and Food Prices



Source: Bloomberg, MIC; compiled by Daiwa.
Note: Data for one year in the future is used for "agricultural products (yen terms)" based on assumption that food prices are reflected with a certain lag.

Chart 11: Forecasts for Real Wages



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

Policy rate outlook: Expect next rate hike in July; 1% terminal rate?

In the January *Outlook Report*, the BOJ significantly revised upwards its price forecasts for FY24-25 and it also assessed that there is still a significant risk of higher-than-expected prices. So, the Bank is closely monitoring the likelihood of higher-than-expected prices as part of its risk weightings. Actually, speeches given by BOJ Deputy Governor Ryozo Himino (30 Jan), board member Naoki Tamura (6 Feb), and board member Hajime Takata (19 Feb) all presented a hawkish stance. Against the backdrop of the risk of higher-than-expected prices, there are indications that the BOJ could hasten the pace of interest rate hikes.

However, in terms of the pace and timing for adjusting its degree of monetary easing, Ueda said, "We will examine economic, price, and financial situations with no preconceived ideas." This suggests that the Bank will stress the importance of data and make comprehensive judgments. Board member Takata said that it is also important to gradually shift gears so that the risk of higher-than-expected prices does not become a reality. This suggests that interest rates should be raised earlier, if the probability of higher-than-expected prices increases.

Also, during his 6 February speech Tamura said that the rate-hiking pace is not set at once every six months and, depending on the data and information, the pace could be accelerated or decelerated. As such, we assume that the pace of rate hikes could change depending on the data, but the basic axis is expected to be around once every six months.

Accordingly, we think that the BOJ will continue to raise interest rates at a pace of around every six months as a basic guideline. However, if the probability of higher-than-expected prices increases based on data and information, we think the Bank could raise interest rates earlier.

Also, in concrete terms, in order to identify the specific risks, it will be important to see whether there have been any changes in price perceptions compared to that as of the January *Outlook Report* (price forecast for FY26 assumes a level consistent with price stability target).

At this juncture, the risk has not increased compared to when the January *Outlook Report* was released. In particular, with regard to forex, the risk of higher-than-expected prices is decreasing due to yen appreciation. Based on the current price situation, we expect the next interest rate hike to be in July, six months after the January hike. That said, as mentioned earlier, this pace could be accelerated if (1) inflation caused by the passing on of higher costs to prices remains high in 2H FY25 or if (2) the case of higher-than-expected service prices is anticipated.

Also, we assume the terminal of the current interest rate hike cycle to be 1.0%. The neutral interest rate is verified based on the impact of interest rate hikes on the economy, prices, and other factors. On top of that, the BOJ will also gradually raise interest rates while making comprehensive judgments based on data (as there is also the risk of higher-than-expected prices), up to the level of the "policy interest rate of 1%," which is viewed as the lower limit of the neutral interest rate. However, after that, we think the Bank will make careful judgments, while also considering the effects of its interest rate hikes. In this respect, when the policy interest rate is between 0.75% and 1.0%, there is a high possibility that the effects of the interest rate hike will be felt by some households and companies. In that case, the BOJ would likely turn cautious about hiking the policy interest rate beyond 1.0%.

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- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
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* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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