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Japan's Economy: Monthly Outlook (Aug 2023)

Economic outlook revised; high growth seen in FY2023, but major slowdown expected in FY2024

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Summary

- In light of the announcement of the Apr-Jun 2023 GDP 1st preliminary results, we have revised our economic outlook. We now see growth in Japan's real GDP according to our main scenario at +2.1% in FY2023, and +0.8% in FY2024 (on a calendar year basis we expect +2.2% in 2023 and +0.9% in 2024).

- We expect Japan's economy to continue recovering despite price highs, with economic normalization and accelerated wage hikes, and accommodative fiscal and monetary policies providing support. Recently, recovery production of motor vehicles went into full gear. Inbound consumption, which has been rapidly recovering, has the full-fledged recovery in the number of visitors from China in its sights with the lifting of restrictions on group tours. Meanwhile, the weak yen of FY2022, which was labeled as "bad yen depreciation" due to the delay in normalization of economic activity, has turned into "good yen depreciation" in FY2023.

- On the other hand, positive factors are scarce in FY2024. The normalization of economic activity is expected to run its course and the reduction in trading losses is expected to settle down. The prospect of Europe and the US entering a phase of interest rate cuts and a pickup in the silicon cycle could be a boost to the economy, but caution is needed regarding downside risks in overseas economies. Also, a change in the direction of monetary policy in Japan and the US could cause the yen to strengthen.

- Our main scenario assumes that underlying inflation will not reach 2% during the forecast period and that the current framework of monetary easing measures will be maintained. However, if wage pressures increase further and the pace of underlying inflation increases faster than expected, the Bank of Japan may decide to eliminate its yield curve control (YCC) in the first half of FY2024.

1. High Growth Seen in FY2023, but Low Growth Expected in FY2024

Apr-Jun period real GDP achieved high growth, but private sector demand was sluggish

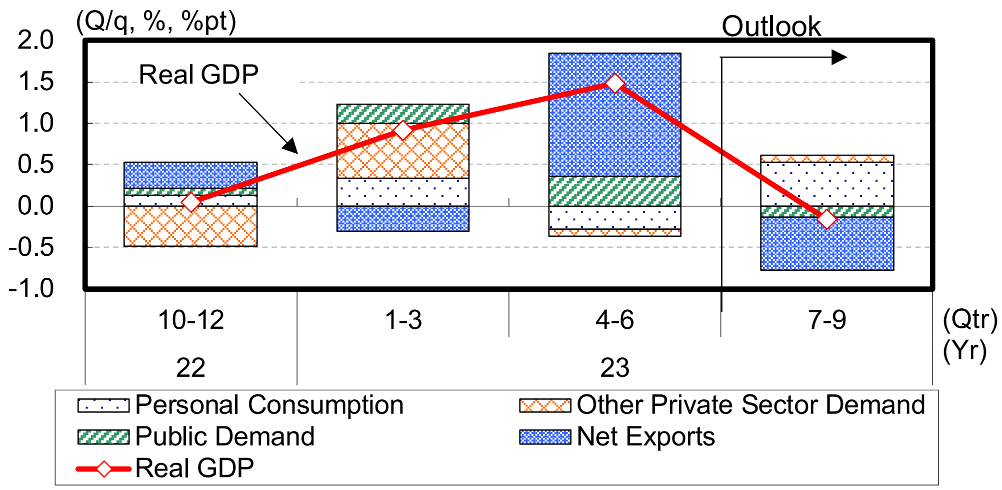
The real GDP growth rate for Apr-Jun 2023 recorded growth of +6.0% q/q annualized (+1.5% q/q), recording its third consecutive quarter of growth (chart 1)[1]. The actual GDP amount hitting a historic high. Motor vehicle exports and inbound consumption (foreign visitors to Japan) grew, while imports declined, leading to a significant increase in net exports (overseas demand), which was the main reason for the high growth in real GDP. However, the situation is not as good as the GDP growth rate suggests, with domestic demand declining for the first time in two quarters.

Looking at performance by demand component, in the area of private sector demand, while personal consumption and inventories suffered declines, housing investment and capital expenditure registered growth. As for personal consumption, the shift of COVID-19 to Category V Infectious Diseases on the Infectious Diseases Control Law provided a boost for the consumption of services including eating out and travel, but durable goods such as household electronics, as well as non-durables, suffered major declines. As for public sector demand, both government consumption and public investment grew, and overseas demand performed well, with net exports registering growth as was mentioned earlier.

The terms of trade improved due to the decline in the import deflator, resulting in a 4.4 tril yen reduction in the annualized amount of income outflows (trade losses) to foreign countries. As a result, real Gross Domestic Income (GDI), which is real GDP plus trade losses, grew at an annualized rate of +9.7% y/y, up further from +6.7% in the Jan-Mar period. The further easing of the negative impact of imported inflation on the income environment is believed to have supported economic activity by households and corporations.

Real GDP growth in the Jul-Sep 2023 period is expected to be -0.6% y/y, the first negative growth in four quarters. This is largely due to a reactionary decline in response to Apr-Jun period performance, and domestic demand is expected to return to a recovery trend.

Real GDP Growth Rate Results & Outlook **Chart 1**



Source: Cabinet Office; compiled by DIR.
Notes: Figures are seasonally adjusted.

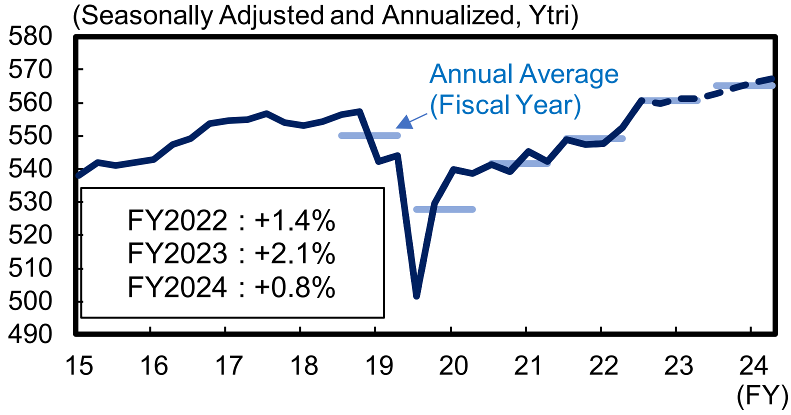
Real GDP is expected to grow by +2.1% in FY2023, but FY2024 Revised Downwards to +0.8%

Chart 2 shows real GDP according to our main scenario, and our outlook for overseas economies on which the scenario is based. The overseas economic outlook is based on the latest (as of August 21)

[1] See the DIR report by Keiji Kanda and Munehisa Tamura dated 15 August 2023, [Apr-Jun 2023 1st Preliminary GDP Estimate.]

forecasts of our staff in charge of each country. For details, please refer to the economic outlook for each country.

Outlook for Japan's Real GDP and Assumptions Regarding Overseas Economies **Chart 2**



US, Eurozone & China
Real GDP Growth Rate

US	2022 : ＋2.1% 2023 : ＋2.0% 2024 : ＋0.8%
Eurozone	2022 : ＋3.4% 2023 : ＋0.7% 2024 : ＋1.1%
China	2022 : ＋3.0% 2023 : ＋5.4% 2024 : ＋4.3%

Source: Produced by DIR based on data from Cabinet Office and various countries.
Note: The dashed line in the chart represents predicted values as estimated by DIR. Outlooks for the US, Eurozone and China are based on predictions by DIR's in-house expert.

With this overseas economic outlook, Japan's real GDP growth rate according to our main scenario is expected to be +2.1% y/y in FY2023 and +0.8% in FY2024 (+2.2% in 2023 and +0.9% in 2024 on a calendar year basis).

Our outlook for growth rate in 2023 was revised upwards by 0.6%pt in comparison to the June 8, 2023 report, *"Japan's Economic Outlook No. 217 Update"* (Japanese only, our previous outlook). This is mainly due to the downward revision of imports and upward revision of exports and housing investment[2] based on the April-June period results. Our view that Japan's economy will continue recovering despite price highs due to economic normalization, accelerated wage hikes, and accommodative fiscal and monetary policies, remains unchanged from our previous outlook.

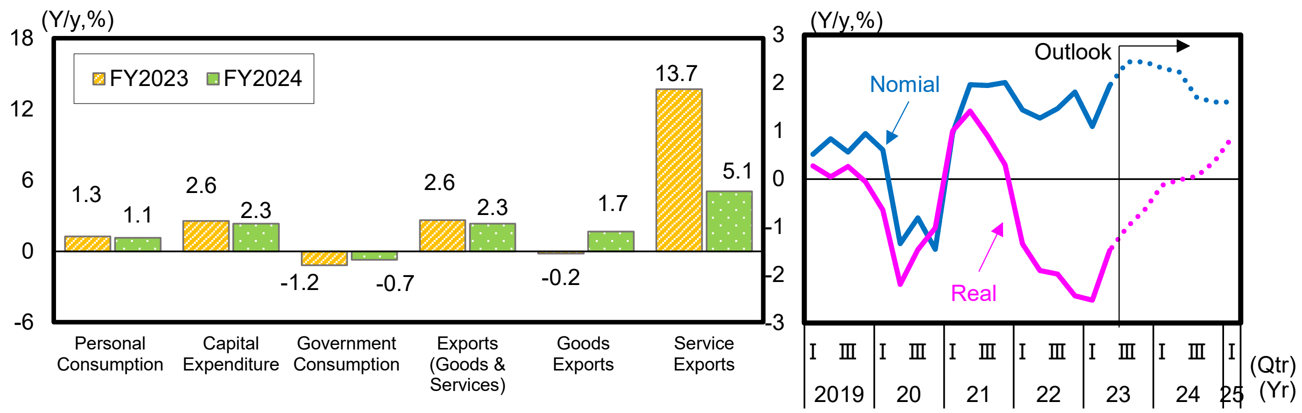
The outlook for the FY2024 growth rate has been revised downwards by 0.4%pt in comparison to the previous outlook. The growth rate declined largely due to the impact of the previous fiscal year's forecast of high growth of more than 2%. As discussed below, growth will likely remain moderate, partly due to demand having completed its cycle of recovery accompanying the normalization of economic activity (see Chart 8 below).

Major demand components are expected to perform as illustrated in the left side of Chart 3. Of these, personal consumption is expected to continue to grow, centering on consumption of services and motor vehicles, due to the normalization of economic activity. Even amid persistently high prices, consumption will be supported by accelerating wage hikes and the declining inflation rate, which will boost real wages (Chart 3, right), and by the withdrawal of household savings that accumulated substantially during the COVID-19 crisis. However, the recovery in personal consumption is expected to moderate in FY2024 as economic activity normalizes.

[2] Following the retroactive revision of the Ministry of Land, Infrastructure, Transport and Tourism's "Quick Estimate of Construction Investment," which serves as the basic statistics, the past trends of housing investment were significantly revised. Housing investment at the time of the GDP 2nd preliminary results of the Jan-Mar 2023 period continued the decline recorded in mid-2022 and then marked time. On the Apr-Jun GDP 1st preliminary result, however, there was a clear pickup from the Oct-Dec period of 2022, confirming that housing investment was in fact recovering.

Capital expenditure will pick up in renewal and capacity expansion, especially in the non-manufacturing sector, as the normalization of domestic economic activity accelerates. Investments to respond to greening and digitalization will also likely provide underlying support. However, caution should be exercised with the possibility that the manufacturing sector may hold back on investment due to growing uncertainty over the outlook for overseas economies.

Outlook for Major Demand Components (Left), Outlook for Wages (Per Capita Employee Compensation) (Right) **Chart 3**



Source: Cabinet Office, Ministry of Internal Affairs and Communications; compiled by DIR.
Note: The dotted lines in the chart on the right are DIR estimates.

Government consumption is expected to decline moderately through the end of FY2023 as the boost from infectious disease countermeasures, such as testing programs and vaccinations wear off. Thereafter, we expect a return to the pre-COVID-19 crisis trend, in which spending increased mainly on medical and long-term care benefits associated with the aging of the population.

Finally, in terms of exports, goods exports in FY2023 will be about the same as the previous year. While the pent-up demand for automobiles that began to emerge in the spring will support exports during FY2023, the impact of the overseas economic slowdown on other goods is expected to remain strong until the end of FY2023. In FY2024, exports are expected to increase moderately due to the recovery of overseas economies and the entry into the recovery phase of the silicon cycle (the boom-bust cycle seen in the global semiconductor market). As for services exports, inbound consumption is expected to recover significantly in FY2023, especially among Chinese visitors to Japan, as the ban on group tours to Japan has been lifted. We expect an increase in FY2024 as well, but at a slower pace.

While care must be taken regarding overseas risks, high growth is expected in FY2023 due to seven positive factors

Although we continue to be wary of downside risks to exports due to the worsening of overseas economies, as we pointed out in our previous outlook, the Japanese economy in FY2023 has a relatively large number of factors that will support the economy.

Specifically, the following can be pointed out: (1) recovery production in motor vehicles and elimination of order backlog in machinery orders due to resolution of supply constraints , (2) inbound consumption to achieve further recovery, (3) room for recovery in consumption of services, (4) accelerated wage hikes, (5) withdrawal of "excess savings" easing the impact of high prices, (6) a pause in import inflation and the effects of a weak yen, (7) continuation of accommodative fiscal and monetary policies (Chart 4).

Seven Positive Factors for Japan's Economy **Chart 4**

Factor	Comments
(1) Recovery production in motor vehicles and elimination of order backlog in machinery orders due to resolution of supply constraints	Pent-up demand for motor vehicles for household use alone is estimated to be approximately 1.4 tril yen as of the end of July. (Other sources of demand include exports and corporations.)
(2) Inbound consumption to achieve further recovery	The number of visitors centering on tourism from China is expected to recover, with growth in inbound consumption in 2023 expected to grow by over 3 tril yen in comparison to the previous year.
(3) Room for recovery in consumption of services	If the ratio of service consumption to disposable income grows to reach the level it was at in the 2019 Jul-Sep period, growth from the 2023 Apr-Jun period and beyond could reach around 7 tril yen.
(4) Accelerated wage hikes	The rate of wage increase in the spring wage negotiations attained their highest level in 30 years. The national average minimum wage now exceeds 1,000 yen.
(5) Withdrawal of "excess savings" easing the impact of high prices	Household savings, which accumulated at a pace exceeding that which was recorded before the spread of COVID-19, totaled approximately 45 tril yen as of the end of June 2023 (the equivalent of 15% of the amount of consumption in 2022).
(6) A pause in import inflation and the effects of a weak yen	Trading losses have shrunk by around 9 tril yen over the most recent three quarters. The weak yen in 2023, during which the normalization of economic activity has progressed, is now a plus for the Japanese economy (good yen depreciation).
(7) Continuation of accommodative fiscal and monetary policies	At its July 2023 Monetary Policy Meeting, the BOJ decided on operational flexibility in the volatility of long-term interest rates. This means a decrease in the likelihood of an early termination of YCC (yield curve control).

Source: Produced by DIR.

Of the seven favorable factors listed above, those that have changed from the previous forecast include the following: (1) Recovery production of motor vehicles will begin in earnest in the Apr-Jun period, and (2) the lifting of the ban on group tours will bring a full-fledged recovery in the number of Chinese visitors to Japan. As for (6), trading losses narrowed for three consecutive quarters through the Apr-Jun period of 2023, and the yen weakened against the dollar at a rapid pace. As discussed below, unlike in 2022, when the normalization of economic activity was delayed, the yen's depreciation is expected to have a net positive effect on the Japanese economy.

In the following, we will discuss in turn these three areas: recovery production of motor vehicles, inbound consumption, and the effect of the yen's depreciation. Monetary policy (7) will be discussed in Chapter 2.

Recovery Production of Motor Vehicles: should run its course by the end of FY2023 considering the trend in pent-up demand

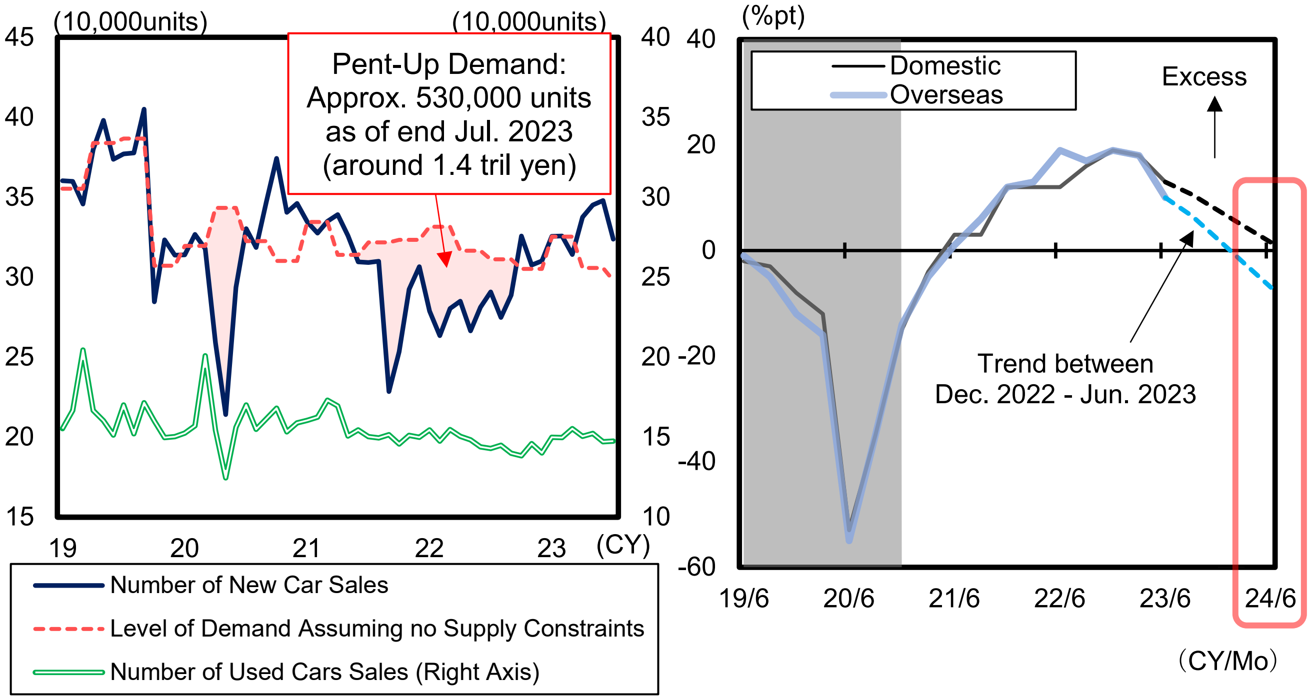
The shortage in semiconductors has gradually eased up since the latter part of 2022, and as of the Apr-Jun period of 2023, the industrial production index for large passenger cars had grown by 30% in comparison to the Oct-Dec period of 2022. Production increases for motor vehicles and related industries have been providing a boost to domestic economic activity.

Looking at new car sales for domestic passenger vehicles, we see that the pace of growth has accelerated, with the monthly average of 315,000 units in the Oct-Dec period of 2022 increasing to 322,000 units in the Jan-Mar period of 2023, and 344,000 units in the Apr-Jun period of 2023 (seasonally adjusted by DIR). Estimating the level of demand in the absence of supply constraints, new car sales clearly exceeded this level from around April 2023. It appears that recovery production in response to pent-up demand is in full swing (Chart 5, left). Pent-up demand for households alone amounted to approximately 530,000 units (approximately 1.4 tril yen in value) as of the end of July, and it is believed to be accumulating in exports and corporate customers as well.

Looking at supply and demand conditions DI for motor vehicles according to the results of the BOJ Tankan survey, we see that domestic and overseas excess demand (equivalent to pent-up demand) rose to an extremely high level in the second half of 2022, but has been on a downward trend since March 2023, partly due to recovery production (Figure 5, right). If pent-up demand were to emerge at the pace seen between December 2022 and June 2023, then recovery production would end around March 2024 for overseas demand and around June 2024 for domestic demand.

Motor vehicle production has been accelerating recently, and if this pace continues, the recovery production to meet domestic and overseas pent-up demand is expected to be completed by the end of FY2023. The automotive industry has a broad base, and while recovery production could be a factor in supporting the domestic economy, it should be noted that such an economic buoyancy effect is unlikely to be expected in FY2024.

Domestic Pent-Up Demand for Motor Vehicles (Left), Supply and Demand Conditions DI for Motor Vehicles According to BOJ Tankan Survey (Right) Chart 5



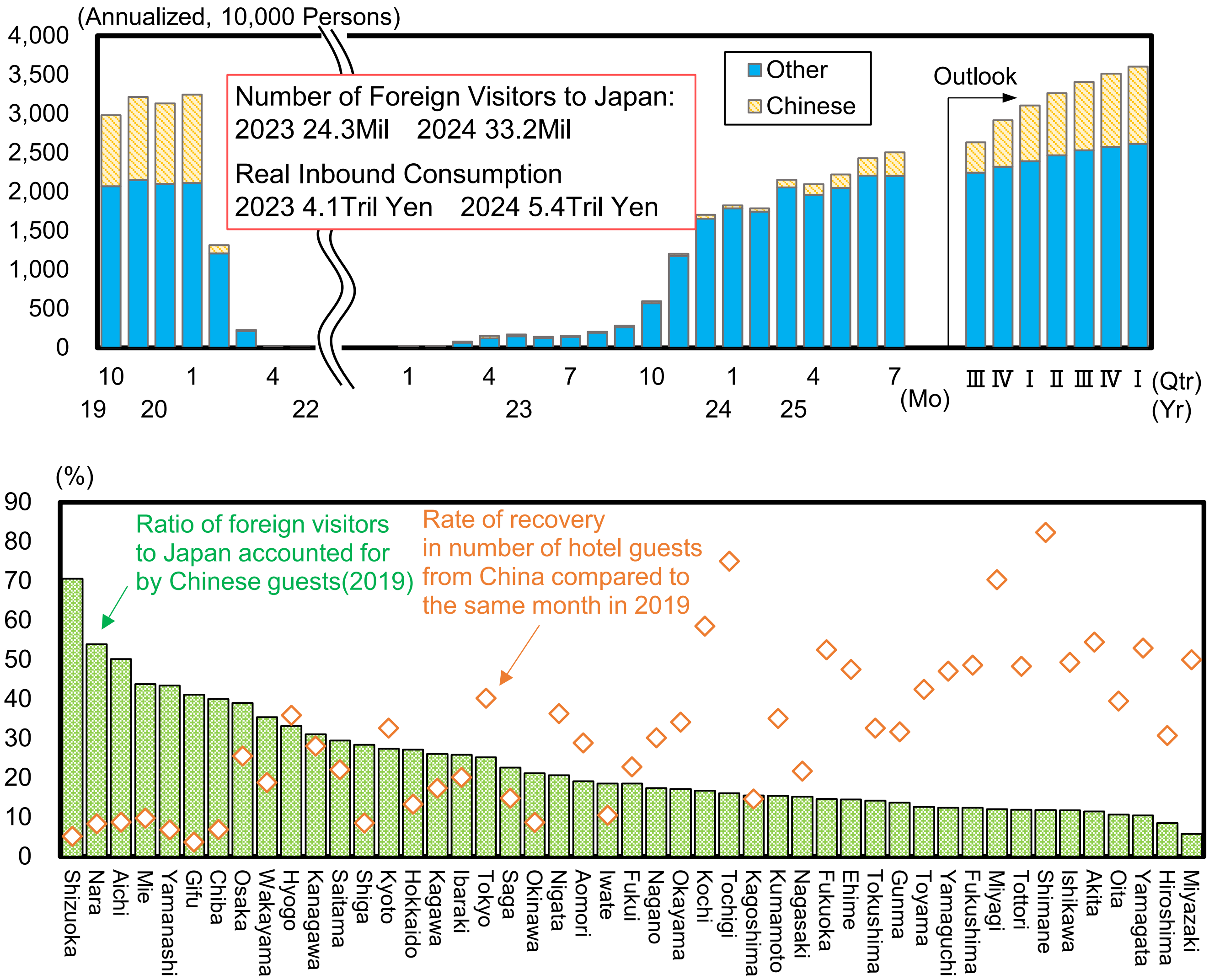
Source: Bank of Japan, Cabinet Office, Ministry of Internal Affairs and Communications, Japan Automobile Dealers Association, National Federation of Light Vehicle Associations of Japan; compiled by DIR.
Note: Figures shown in the chart on the left were seasonally adjusted by DIR. For estimation method, see the DIR report dated 19 August 2022, *Japan's Economic Outlook No. 214* (Japanese only), Chart 2-13. The shaded areas in the chart at the right represent periods of recession.

Inbound Consumption: With the lifting of restrictions on group tours, real consumption in 2023 is expected to reach around 4.1 tril yen

The number of foreign visitors to Japan in July 2023 was 2.32 million, a further increase from June, when the number exceeded 2 million for the first time in three years and five months, recovering to 77.6% of the number recorded during the same month of 2019. While the number of visitors from countries and regions excluding China exceeded the pre-Corona crisis level at 103.4%, the number of Chinese visitors to Japan remained at a low level of 29.8%. The lifting of the ban on group tours in China will provide a further boost to inbound travel, which continues to recover rapidly.

The top of Chart 6 shows the number of foreign visitors to Japan and the forecast for inbound consumption. In our previous forecast, we had assumed that the number of Chinese visitors to Japan would make a full recovery during the Jul-Sep period of 2023. Therefore, the upward revision to the forecast of inbound consumption due to the lifting of the ban on group tours is slight. On the other hand, the recent depreciation of the yen is likely to be a factor boosting the outlook for inbound consumption. According to our *Japan Economic Outlook: January 2023* (Japanese only) , a 20% depreciation of the yen against the dollar will boost per capita spending by 6% and the number of foreign visitors to Japan by 7% per year. Taking these effects into account, the number of foreign visitors to Japan in 2023 is expected to be 24.3 million (up by 20.5 million in comparison to the previous year), and real inbound consumption is expected to be 4.1 tril yen (up 3.2 tril yen in comparison to the previous year).The number of foreign visitors to Japan in 2024 will exceed the 2019 level.

Trends in Foreign Visitors to Japan and Outlook for Inbound Consumption Amount (Top), Trends in Number of Chinese guests (Bottom) **Chart 6**



Source: Japan National Tourism Organization, Japan Tourism Agency, Cabinet Office; compiled by DIR.
Note: Figures in the top chart were seasonally adjusted by DIR. The number of foreign hotel guests as shown in the bottom chart is the total number of hotel guests at facilities with 10 or more employees in 2019. The ◇ mark denotes the comparison to the same month in 2019 in the number of Chinese guests in May 2023.

The impact of the growing number of Chinese tourists to Japan varies greatly by region. The ratio of foreign visitors to Japan accounted for by Chinese tourists by prefecture in 2019 was particularly high in Shizuoka (71%), Nara (54%), and Aichi (50%) (total number of overnight stays for facilities with 10 or more employees, Chart 6, bottom). In these regions, the recovery in the number of Chinese overnight visitors has been particularly slow. From a different perspective, these regions have much room for revitalization of the tourism industry through a full-fledged recovery of Chinese tourists to Japan. It is also noteworthy that even regions with similar percentages of Chinese overnight visitors in 2019, such as Tottori and Shimane, show differences in the degree of recent recovery.

As mentioned above, the lifting of the ban on group tours is likely to strengthen the recovery trend among Chinese visitors to Japan, but the pace of recovery may be slower than expected in the future. This is because, as we pointed out in *Japan Economic Outlook: July 2023* (Japanese only), Chinese tourists have increasingly tended to choose countries and regions other than Japan as their travel destinations since the Corona crisis. It remains to be seen whether this trend will continue after the ban on group tours is lifted.

Effects of the Weak Yen: Yen depreciation is a plus for the Japanese economy with normalization of economic activity progressing

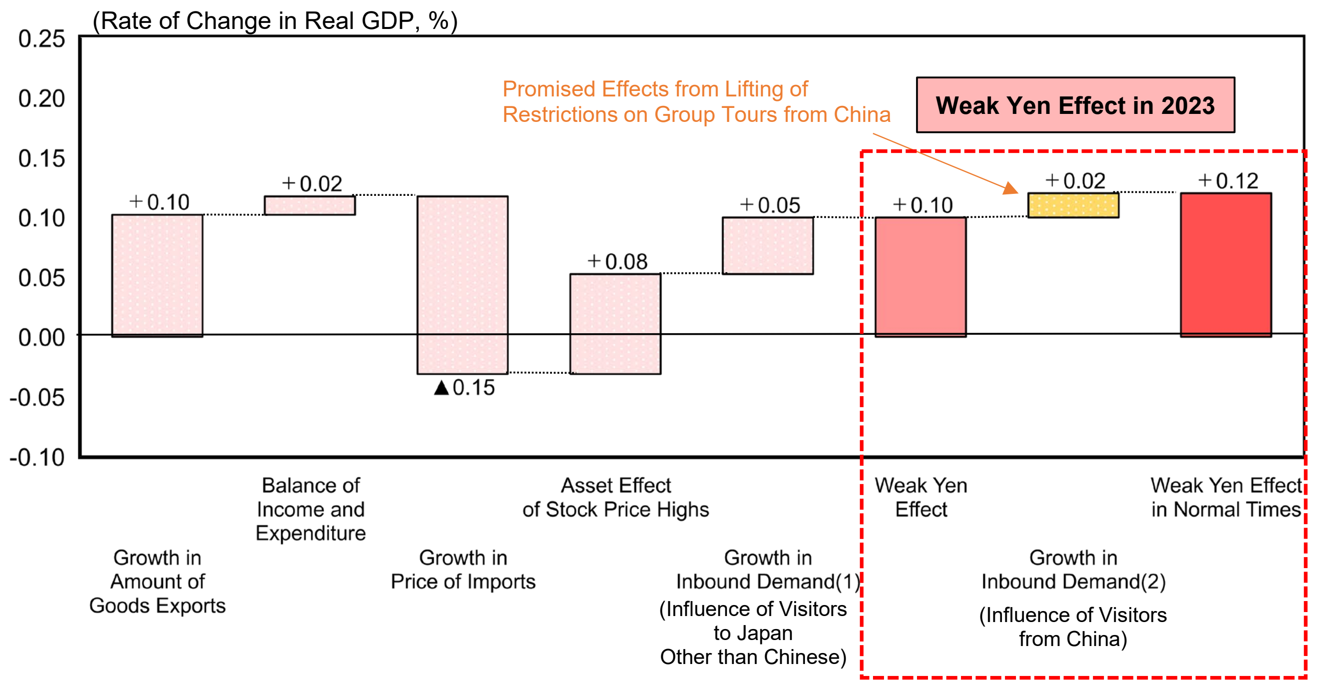
The rapid depreciation of the yen against the US dollar from spring to fall of 2022 was accompanied by much discussion about whether the net economic effect on the Japanese economy would be positive or negative.

In this regard, in our June 8, 2022 report, *Japan's Economic Outlook No. 213 Update* (Japanese only), we estimated that, although the depreciation of the yen occurring under normal economic conditions is seen as a net positive, in 2022 the positive effects were less likely to materialize due to delays in the normalization of economic activities (supply constraints for automobiles and other products, strict waterfront measures, etc.). The negative impact of higher import costs was larger. In other words, the depreciation of the yen in 2022 was evaluated as so-called "bad yen depreciation."

In 2023, however, the normalization of economic activity has made sufficient progress and the economic situation has generally recovered, which is expected to result in "good yen depreciation." Chart 7 shows the results of our macroeconomic model, which estimates the impact of the yen's depreciation against the dollar on real GDP in 2023, broken down by factor. Here, we assume two cases: one in which the dollar-yen exchange rate in 2023 remains unchanged at the January 2023 level (130.5 yen/dlr) and the other in which the yen depreciates by 10%.

Real GDP will be boosted by about 0.10% with a 10% depreciation of the yen against the dollar. If the effect of lifting the ban on group tours in China is included, the economic effect would increase to about 0.12%. While it is certain that the yen's depreciation against the dollar directly worsens the earnings of domestic demand-related industries, when dynamic paths and spillover effects are taken into account, the yen is seen as a factor boosting the Japanese economy.

Influence of 10% Dollar Appreciation Against the Yen on Real GDP in 2023 (Difference from Case in which Dollar/Yen Rate Marks Time from Beginning of the Year) Chart 7



Source: Produced by DIR.
Note: Chart shows the results of our macroeconomic model. The impact of each factor includes ripple effects; the difference between the two cases is estimated assuming that the dollar-yen exchange rate in 2023 remains flat at the January 2023 level (130.5 yen/dlr) and depreciates by 10%. Growth in inbound demand includes the impact of a decrease in outbound demand.

Japan's economy in FY2024 lacks favorable factors, and risks of early normalization of monetary policy and yen appreciation are lurking in the background

As described above, the Japanese economy is expected to continue to recover in FY2023, mainly driven by domestic demand, due to the many factors that will boost the economy, resulting in a high growth rate of about 2%. However, there is a strong possibility that it will run out of steam in FY2024 (Chart 8).

Of the seven favorable factors listed in Chart 4, items related to the normalization of economic activity, such as recovery production of motor vehicles, inbound consumption, and service consumption, are not expected to boost the economy in FY2024, or their effects will be limited. The contraction of trade losses is also expected to settle down during FY2023.

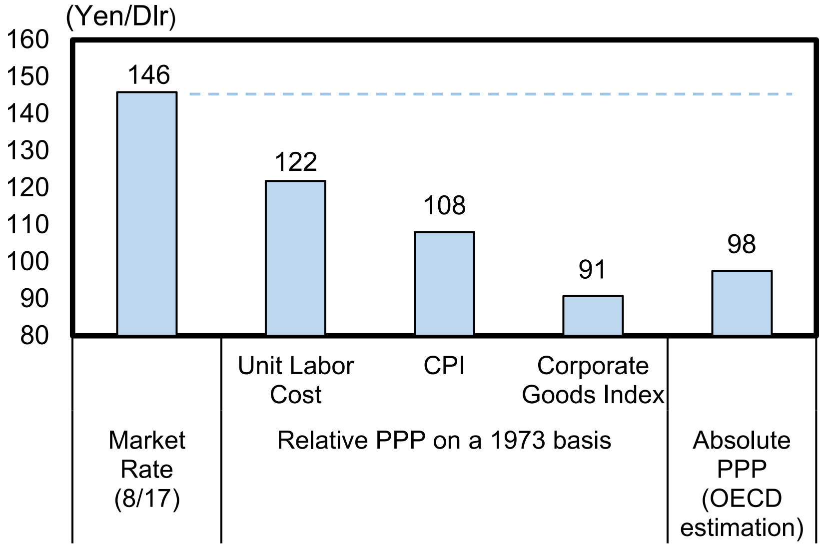
Main Factors in Japan's Economy in FY2024 Chart 8

○ The process of the normalization of the domestic economy will be complete, and its effects on boosting the economy will decline significantly.
○ Inflation in Europe and the US is expected to slow down, and interest rate cuts are likely. The silicon cycle could enter a recovery phase.
○ As in FY2023, we need to remain vigilant against a significant deterioration in the US economy due to stricter lending attitudes of US banks, escalating tensions in the Ukraine, the emergence of China's excessive debt problem, and the escalation of the US-China confrontation.
○ The BOJ will most likely end its yield curve control policy during the first half of FY2024 at the earliest. If the direction of US-Japan monetary policy changes, the dollar-yen exchange rate could shift into yen appreciation against the dollar.
→ Positive factors for Japan's economy are scarce in FY2024, and risks such as early normalization of monetary policy and yen appreciation are lurking in the background.

Source: Produced by DIR.

Turning our gaze now toward the overseas economy, the economic outlook for the US and European economies according to our main scenario is for interest rate cuts to be implemented during 2024, mainly due to weakening inflationary pressures. In addition, if the silicon cycle, which has recently shown signs of bottoming out, enters a recovery phase, this could support an increase in semiconductor-related exports and production in FY2024. On the other hand, as in FY2023, we need to remain vigilant against a significant deterioration in the US economy due to stricter lending attitudes of US banks, escalating tensions in the Ukraine, the emergence of China's excessive debt problem, and the escalation of the US-China confrontation.

Recent Dollar-Yen Rate and Assessment of Purchasing Power
Chart 9



Source: Cabinet Office, Ministry of Internal Affairs and Communications, Bank of Japan, BEA, BLS, FRB, OECD, Haver Analytics; compiled by DIR.
Note: Absolute PPP is the estimate for 2022. Relative PPP and unit labor cost base PPP are estimated using data from the Apr-Jun period of 2023, while CPI and corporate price-based PPP make use of July data.

The dollar-yen rate may shift from a weaker yen to a stronger yen. One of the factors behind the yen's recent depreciation is the difference in monetary policy between the US and Japan. As mentioned above, the Federal Reserve is expected to cut interest rates during 2024 according to our main scenario, while the Bank of Japan may review its monetary easing framework as early as July 2024, as discussed below.

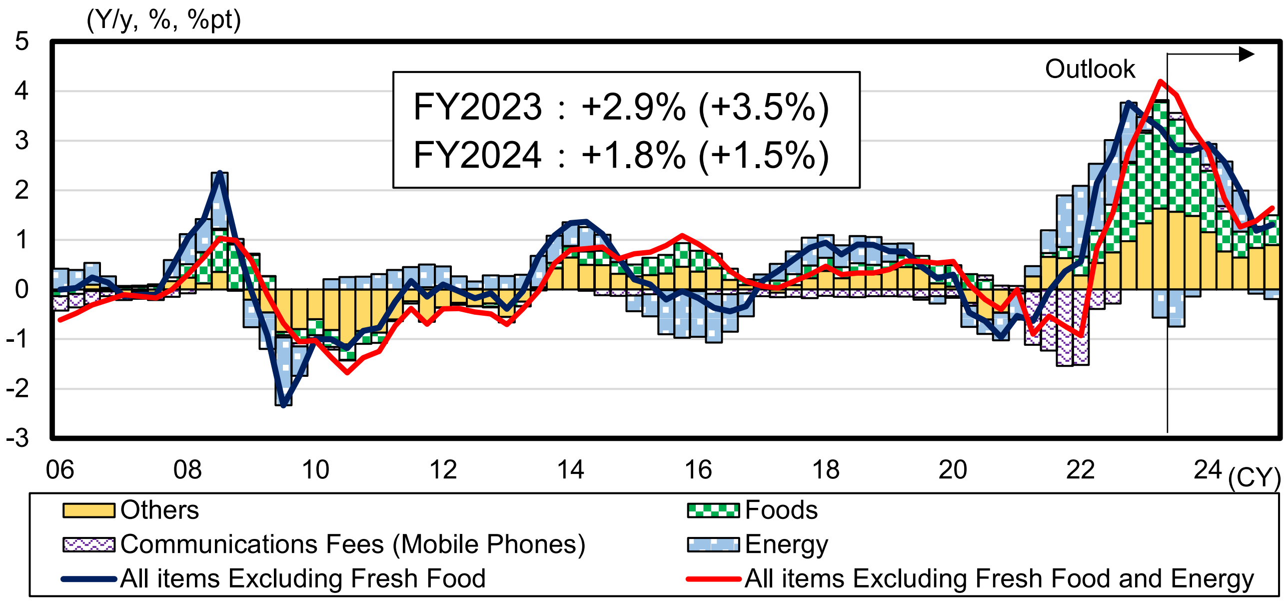
As we pointed out in our December 8, 2022 report, *Japan's Economic Outlook No. 215 Update* (Japanese only), the impact and sensitivity of the Japan-US interest rate differential on the dollar-yen rate has tended to decrease in the past as the US interest rate hike nears its end. If market participants' attention this time shifts to economic fundamentals other than interest rate differentials, such as purchasing power parity (PPP), the pressure for the yen to appreciate against the dollar will gradually increase (Chart 9).

2. Outlook for Japan's Prices and Monetary Policy

Outlook for Core CPI in FY2024 is +1.8% y/y, and if the upward trend continues, 2% in FY2025

On an all items basis, excluding fresh food, Core CPI is projected to increase by 2.9% y/y in FY2023 and by 1.8% y/y in FY2024, assuming recent resource prices and exchange rates (Chart 10). On an all items basis, excluding fresh food and energy, the forecast for the Jan-Mar 2025 period, the final period of the forecast period, is about 1.6% y/y. If the pace of increase at the end of the forecast period continues, underlying inflation is expected to reach 2% during FY2025.

Outlook for CPI (Excluding Fresh Food; Figures in Parenthesis Excluding Fresh Food and Energy)
Chart 10



Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Price outlook assuming resource prices and exchange rates at the time of preparation. Assumes that high energy price measures will be implemented until the end of September 2023 (energy bills for Feb-Oct period will be reduced).

In food and beverage products, price increases continue to be implemented for a wide range of items. According to a survey by Teikoku Databank on price revision trends, the number of items scheduled for price hikes in 2023 exceeded 30,000 as of the end of July[3]. Although the pace of price hikes has slowed compared to the past, there is a possibility of another round of price hikes in the fall, particularly for alcoholic beverages and seasonings. However, the y/y rate of change in food prices will gradually decline as the behind-the-scenes effects of the price hikes in 2022 are felt.

In the energy sector, price increases by the seven major electric power companies, including Tokyo Electric Power Company, will be a factor pushing up prices. Furthermore, gasoline prices have also been rising recently: as of August 14, 2023, the national average price of gasoline (regular) was 181.9 yen/liter, the highest level in 15 years. The background to this is the rise in fuel prices and the reduction of subsidies for the reduction of fuel oil prices, but the subsidies are scheduled to end at the end of September 2023, and gasoline prices may rise further after October. According to various reports, an extension of this measure is being considered within the government, but the details of this are unknown at the time of this writing and are not reflected in our price forecasts. On the other hand, the government's price hike countermeasures include the "recommended business menu" that includes reducing the burden of LP gas prices, and these policies are likely to push prices down to some extent in the future.

[3] Teikoku Databank, "Major 195 Food Companies Price Revision Trend Survey - August 2023" (July 31, 2023) (Japanese only).

We assume that the framework for monetary easing measures will be maintained for the time being, but may be reviewed as early as the first half of FY2024

At its July 2023 Monetary Policy Meeting, the BOJ decided to make the operation of its yield curve control (YCC) more flexible. While the Bank of Japan decided to keep the range of fluctuation in long-term interest rates at +/- 0.5% as before, it changed its position to target level. In addition, the yield on the 10-year bond was raised from 0.5% to 1.0% in the fixed-rate bond-buying operation[4].

The "Outlook for Economic Activity and Prices (July 2023)," released at the same time as the July meeting, significantly raised the price outlook for FY2023[5] from the April forecast of +1.8% y/y to +2.5% y/y. On the other hand, the outlook for prices in FY2024 and beyond was generally maintained at 1.9% y/y in FY2024 (up from 2.0% y/y in April) and 1.6% y/y in FY2025 (the same as in April).

As inflation increases, long-term interest rates are more likely to rise. The stronger the upward pressure, the greater the adverse effects on bond markets and other markets that could result from YCC’s restraining interest rate hikes. The rationale behind the increased flexibility is to increase the sustainability of the YCC while preventing such risks from materializing.

Assuming our price outlook (Chart 10), underlying inflation will not reach 2% over the forecast period. Therefore, in the main scenario of this outlook, we assume that the current framework of monetary easing measures will be maintained (the BOJ will begin normalizing monetary policy in FY2025, when it is expected to reach 2%).

With further upward pressure on wages, the pace of increase in underlying inflation could exceed that of the main scenario. In this case, the BOJ will probably release a "multilateral review" and eliminate the YCC, including fixed-rate bond-buying operations, as early as the first half of FY2024 at its monetary policy meeting, after which it will lift negative interest rates while keeping a close eye on economic and price conditions.

Immediate risks in monetary policy management include not only an upward swing in inflation, which the BOJ is wary of, but also a rise in long-term interest rates. In consideration of the latter issue, the nature of fixed-rate bond-buying operations are very important. The unique feature of these operations is the BOJ's commitment to purchase an unlimited amount of JGBs at a specific yield. If the market believes that the BOJ will fulfill this commitment in the future, the BOJ can induce the yield on JGBs to fall below the target level. If the BOJ always buys JGBs at a specific price (yield), market participants holding JGBs will have no incentive to sell them into the market at a price lower than that price (higher than that yield). As a result, the yield on JGBs will be lower than the level of the yield on JGBs purchased in the fixed-rate bond-buying operations.

This is the second time in the past year that the BOJ has raised the purchase yield in its limit operations, following December 2022. As long-term interest rates approach the current ceiling of 1%, it is more likely that the BOJ will again raise its fixed-rate bond-buying operations purchase yield as a precautionary measure. If such a scenario prevails in the bond market, there will be an acceleration in the BOJ's attempt to sell JGBs before the BOJ raises the yield on its fixed-rate bond-buying operations (while the BOJ purchases JGBs at a higher price). The risk of a sudden easing of the supply-demand balance in the market and a rise in long-term interest rates above the upper limit should be borne in mind.

[4] A fixed-rate bond-buying operation is an operation in which the Bank of Japan purchases an unlimited number of JGBs at a specified yield.
[5] Median price on a y/y basis in the policy committee outlook for core CPI.

Japan's Economic Outlook No. 218 (August 21, 2023) Chart 11

		2022			2023				2024				2025	FY2022 (CY)	FY2023 (CY)	FY2024 (CY)
		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	Y tril; annualized	549.0	547.3	547.6	552.6	560.7	559.8	561.1	561.2	562.8	564.5	565.9	567.2	549.2	560.6	565.1
	Q/q %	1.3	-0.3	0.0	0.9	1.5	-0.2	0.2	0.0	0.3	0.3	0.3	0.2			
	Q/q %; annualized	5.1	-1.2	0.2	3.7	6.0	-0.6	0.9	0.1	1.2	1.2	1.0	0.9			
	Y/y %	1.7	1.5	0.4	2.0	2.0	2.3	2.5	1.5	0.5	0.8	0.9	1.1	1.4	2.1	0.8
														1.0	2.2	0.9
Private Consumption	Q/q %	1.8	0.0	0.2	0.6	-0.5	1.0	0.8	0.4	0.1	0.1	0.1	0.1	2.5	1.3	1.1
Private Residential Investment	Q/q %	-1.8	-0.1	0.9	0.7	1.9	-1.2	0.4	0.0	-0.4	-0.4	-0.4	-0.4	-3.0	2.1	-1.1
Private Non-Resi. Investment	Q/q %	1.7	1.7	-0.7	1.8	0.0	0.8	0.6	0.6	0.5	0.6	0.6	0.5	3.1	2.6	2.3
Government Consumption	Q/q %	0.4	0.0	0.2	0.1	0.1	-0.8	-1.3	-1.0	0.4	0.4	0.2	0.2	0.7	-1.2	-0.7
Public investment	Q/q %	0.1	1.1	0.3	1.7	1.2	0.4	0.4	0.2	0.2	0.1	0.1	0.1	-3.1	3.5	0.8
Exports	Q/q %	1.9	2.4	1.5	-3.8	3.2	0.6	0.8	0.6	0.5	0.6	0.6	0.5	4.5	2.6	2.3
Imports	Q/q %	1.1	5.5	-0.1	-2.3	-4.3	4.1	1.0	1.0	0.2	0.2	0.2	0.2	7.2	-1.1	2.7
Nominal GDP	Q/q %; annualized	4.1	-3.3	4.9	9.5	12.0	-0.5	2.4	2.0	2.0	1.5	1.8	1.7	2.0	5.3	1.8
GDP deflator	Y/y	-0.3	-0.4	1.2	2.0	3.4	4.0	3.2	2.2	1.1	1.1	0.9	0.7	0.7	3.2	1.0
Industrial production	Q/q	-1.5	3.1	-1.7	-1.8	1.4	2.5	1.5	1.0	-0.1	-0.1	0.1	0.1	-0.3	2.8	1.9
Core CPI	Y/y	2.1	2.7	3.8	3.5	3.2	2.8	2.8	2.9	2.6	2.0	1.2	1.3	3.0	2.9	1.8
Unemployment rate	%	2.6	2.6	2.5	2.6	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.6	2.4	2.3
Trade balance (goods, services)	Y tril; annualized	-14.8	-22.3	-20.6	-14.9	-3.5	-9.9	-10.8	-10.9	-10.6	-10.5	-10.2	-9.9	-18.0	-8.7	-10.2
Current account balance	Y tril; annualized	12.8	4.1	9.9	11.0	23.8	22.2	21.8	21.1	21.9	22.6	23.2	23.6	9.4	22.2	22.8
Major assumptions																
Crude oil price (WTI futures)	$/bbl	108.5	91.4	82.6	76.0	73.6	79.3	80.4	80.4	80.4	80.4	80.4	80.4	89.6	78.4	80.4
Exchange rate	Yen/$	129.6	138.4	141.4	132.3	137.4	143.9	145.8	145.8	145.8	145.8	145.8	145.8	135.4	143.2	145.8

Source: Compiled by DIR.

Note: GDP through Apr-Jun 2023: actual; thereafter: DIR estimates.