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Japan's Economy: Monthly Outlook (Feb 2024)

Positive growth of around 1% with inflation of 2% expected through FY2025

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Summary

- In light of the announcement of the Oct-Dec 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 +1.3% in FY2023, and +0.8% in FY2024, and +1.3% in FY2025 (on a calendar year basis we expect +0.4% in 2024 and +1.4% in 2025).

- The rate of wage increases in the 2024 spring wage negotiations may rise to the 4% level, and this means that real wages will likely shift upwards on a y/y basis in the Jul-Sep period of 2024. Due to the cycle created by wage increases and price pass-through, the trend in the inflation rate is expected to stabilize at around 2%. Meanwhile, the economy is expected to be supported by recovery production for motor vehicles, growth in inbound consumption, the recovery in the consumption of services, the high level of household savings, the recovery in the silicon cycle, and comprehensive economic stimulus measures including income tax cuts. Continued vigilance is necessary regarding downside risk in the overseas economy, and the possibility of rising domestic interest rates and the rapid appreciation of the yen must be kept in mind as well.

- We assume that the Bank of Japan (BOJ) will eliminate its Quantitative and Qualitative Monetary Easing with Yield Curve Control (YCC) and lift its negative interest rate policy (raising the short-term interest rate to 0-0.1%) in April 2024, after which it will raise interest rates at a gradual pace while closely monitoring economic and price conditions (the short-term interest rate will be raised to 0.25% in the Oct-Dec 2024 period, followed by additional rate hikes at a pace of 0.50% per annum). However, an accommodative monetary environment will be maintained, with real short-term interest rates remaining in negative territory throughout the forecast period.

1. Outlook for Real GDP through FY2025

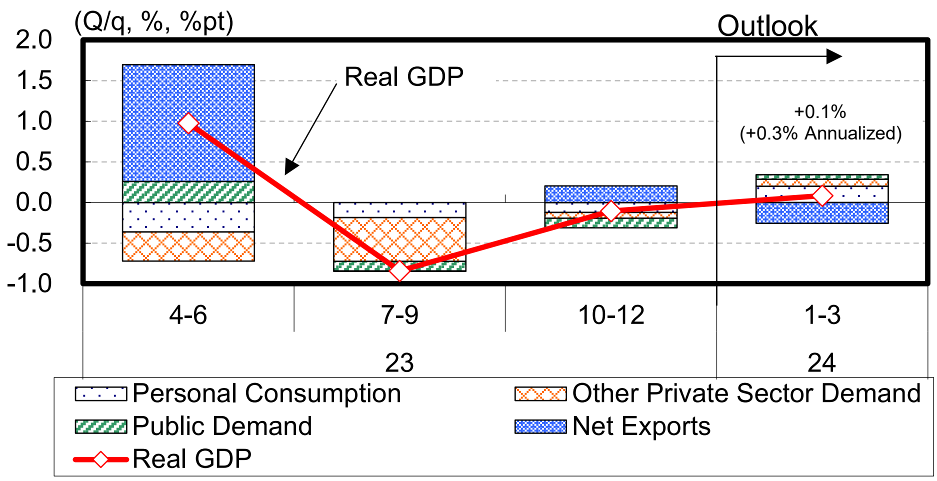
Oct-Dec 2023 period real GDP suffers negative growth for second consecutive quarter

The real GDP growth rate for Oct-Dec 2023 (1st preliminary est) was down by -0.4% q/q annualized (-0.1% q/q). Though only a narrow range of decline, it was the second consecutive quarter of negative growth (chart 1)[1]. While exports grew, private sector demand components such as personal consumption and capex were sluggish, creating a strong sense of stagnation.

Looking at performance by demand component (Chart 1), in the area of private sector demand, all categories suffered declines. Personal consumption declined for the third consecutive quarter at -0.2% q/q. Real employee compensation, which has continued on a downward trend recently, grew by +0.1% in the Oct-Dec period of 2023. It is thought that the fact that the income environment has not improved much was a factor in keeping down consumption. However, consumption was influenced by sluggish business for seasonal goods due to warmer than normal temperatures, Capital expenditure also declined for the third consecutive quarter at -0.1%. Uncertainty about the outlook for external demand, such as continued monetary tightening in Europe and the US, weighed on investment activity, while in addition, construction investment was likely to have been affected by delays due to high resource prices and labor shortages.

As for public sector demand, government consumption and public investment declined, but in the area of overseas demand, both goods and services grew. While there was a pause in growth of motor vehicle related goods which had until recently been reaping the benefits of recovery production in motor vehicles, capital goods and information related goods saw progress in moving toward a comeback. In the area of services, usage fees for intellectual property rights grew significantly due to situations at individual companies, and growth in the number of foreign tourists visiting Japan also helped push up performance. Since the increase in exports exceeded that of imports, net exports shifted to the plus side.

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



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

Real GDP in Jan-Mar 2024 expected to shift into positive growth though only by a little

Real GDP growth in the Jan-Mar 2024 period is expected to turn positive, albeit modestly, at an annualized rate of +0.3% y/y (Chart 1). Production activities will be restrained due to the suspension of operations at some plants of motor vehicle manufacturers, and a reactionary decline in intellectual

[1] See the DIR report by Keiji Kanda and Munehisa Tamura dated 15 February 2024, Oct-Dec 2023 1st Preliminary GDP Estimate.

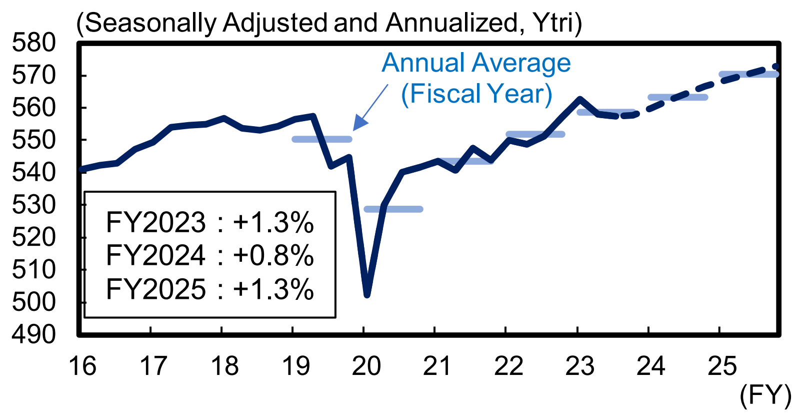
property and other royalties will be seen in service exports. On the other hand, personal consumption is expected to turn to growth backed by an improved income environment due to lower inflation, and capex is also expected to turn to growth backed by a rebound from three consecutive quarters of declines and the recovery of the Chinese economy.

The Noto Peninsula Earthquake of 2024, which occurred on January 1, caused extensive damage mainly in Ishikawa Prefecture[2]. However, the loss to Japan as a whole was small in relation to the size of the economy, and reconstruction demand and production substitution to other regions are expected to occur. Therefore, the impact on real GDP growth in the Jan-Mar period is expected to be limited, but the results of the Indices of Industrial Production and other data to be released in the near future will be closely watched.

Growth rate of Japan's real GDP in FY2024 seen at +0.8% with +1.3% seen in FY2025

Chart 2 shows changes in real GDP according to our main scenario, along with the outlook for overseas economies which provides the assumptions behind our outlook. This is based on our latest outlook for overseas economies dated February 21 provided by our in-house expert on the overseas economy. For details see the economic outlooks for the various countries included.

Outlook for Japan's Real GDP (Left) and Assumptions Regarding Overseas Economies (Right) Chart 2



US, Eurozone & China
Real GDP Growth Rate

US	2023 : +2.5% 2024 : +2.0% 2025 : +1.7%
Eurozone	2023 : +0.5% 2024 : +0.8% 2025 : +1.5%
China	2023 : +5.2% 2024 : +5.0% 2025 : +4.5%

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.

Japan's real GDP growth rate according to our main scenario is expected to be +1.3% y/y in FY2023, +0.8% in FY2024, and +1.3% in FY2025 (+0.4% in 2024 and +1.4% in 2025 on a calendar year basis).

The outlook for the FY2024 growth rate has been revised downwards by 0.4%pt based on recent performance in comparison to our previous report of December 8, 2023 (*Japan's Economic Outlook No. 219 Update* (Japanese only)). However, it comes to +1.0% when carryover (real GDP growth rate that can be achieved with zero q/q growth in each quarter) is excluded. Growth is therefore expected to exceed the previous outlook by +0.7%. The new outlook for FY2025 presented in this report projects positive growth of more than 1% as exports and capex accelerate, while personal consumption decelerates moderately.

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[2] The amount of damage in Ishikawa Prefecture in terms of stock is tentatively estimated to be around 1.1-1.5 tril yen, and in terms of flow, around 35-45 bil yen in the first month after the earthquake. Given the size of Ishikawa Prefecture's economy (real GDP for FY2019 is just under 400 bil yen/month), this suggests that the earthquake had a serious impact on economic activity. For more information, see our "Japan Economic Outlook: January 2024" (January 23, 2024) (Japanese only).

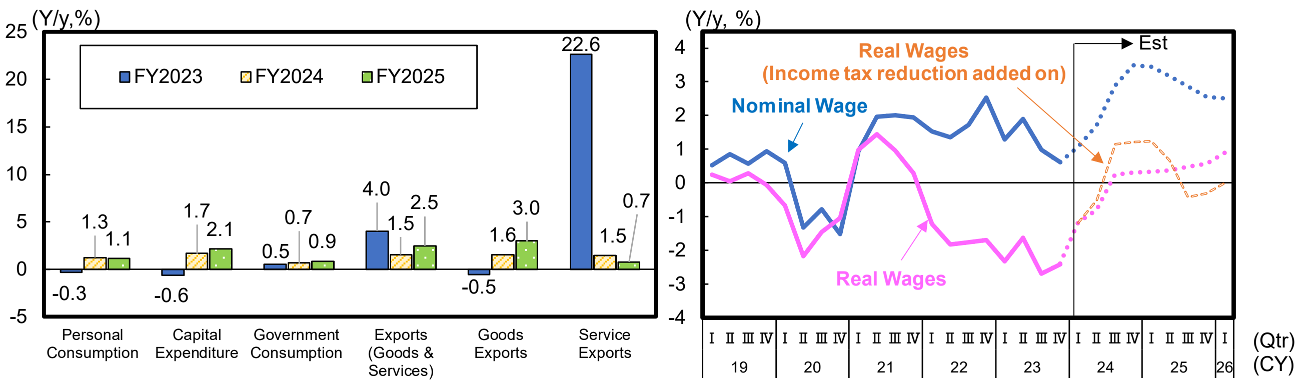
Major demand components are expected to perform as illustrated in the left side of Chart 3. Of these, personal consumption is expected to gain underlying support throughout the forecast period from an improved income environment due to continued major wage increases in the spring labor negotiations and the settling down of price highs, as well as the withdrawal of household savings that accumulated significantly after the Corona crisis. In FY2024, the growth rate is expected to be relatively high, driven by pent-up demand for motor vehicles, which is expected to emerge through the summer, a recovery in service consumption, and a flat tax cut of 40,000 yen per person. We expect real wages to turn positive in the Jul-Sep 2024 period, and thereafter to rise around 1% y/y (see Chart 3, right; and for background, see Chapter 2).

In terms of capex, we expect to see investment in renewal and capacity expansion, which companies have been postponing due to the Corona crisis and high prices, as well as investment in labor-saving measures to cope with labor shortages. Software investment and R&D investment related to digitalization and green technology are also expected to increase. Aggressive wage hikes by companies will result in lower relative prices of capital, which will stimulate demand for labor-saving investments. On the other hand, caution should be exercised in the possibility that increased uncertainty over the outlook for overseas economies will dampen the appetite for capex, centering on the manufacturing sector.

Government consumption is expected to continue growing centering on medical and nursing care as the aging of the population progresses. While the decline in expenses associated with COVID-19 , such as testing programs and vaccinations will weigh on performance bringing a certain amount of decline in FY2023, the effects will gradually wear off in FY2024, and growth is expected to accelerate.

Finally, in terms of exports, goods exports in FY2023 are expected to fall below that of the previous year, but this should turn to growth in FY2024, with acceleration of growth expected in FY2025. Pent-up demand for automobiles is expected to lose steam in FY2024, but on the other hand, a pickup in the overseas economies and the recovery in the silicon cycle should bring upward pressure on overall exports. As for services exports, the number of foreign tourists visiting Japan grew significantly in FY2023, and as was previously mentioned, usage rates for intellectual property were on the rise in the Oct-Dec period of the fiscal year, bringing the expectation that services exports will exceed growth of +20% in comparison to the previous year. While a major slowdown is expected in FY2024 once the effects of the high rate of usage fees for intellectual property have peaked out, favorable performance will be maintained due to the growth in the number of foreign tourists visiting Japan.

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



Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, Cabinet Office; compiled by DIR.
Note: The dotted lines in the right side of the chart are values estimated by DIR.

2. Important Factors in Japan’s Economy through FY2025

(1) Major factors in future of Japan’s economy organized under four basic categories

Chart 4 brings together a list of important factors affecting Japan’s economy through FY2025 based on recent developments. The four categories covered here are Cyclical Rise in Wages and Prices, Supporting Factors and Growth Factors in Japan’s Economy, Fiscal and Monetary Policy, and Major Downside Risk Factors for Japan’s Economy (see chapter 3 for our outlook for prices and monetary policy).

Important Factors in Japan’s Economy through FY2025 — Chart 4

Cyclical Rise in Wages and Prices

○Major increases in wages to continue

⇒The rate of wage increases in the 2024 spring wage negotiations may rise to the 4% level (3.58% in FY2023 according to JTUC calculations), with high level of growth expected to continue through FY2025. Real wages are expected to shift upwards on a y/y basis in the Jul-Sep period of 2024, with growth up to around 1% expected over the course of FY2025.

○Inflation is here to stay

⇒Price pass-through of increase in personnel expenses due to wage hikes will spread, and the rate of inflation (based on Japan’s CPI excluding fresh food and energy) is expected to stabilize at around 2%.

○Chronic labor shortage

⇒Surplus labor is currently at a low level, and the population between ages 20-24, which was marking time over the past ten years, is heading for another decline. From the viewpoint of labor supply, wage hikes and investment in labor-saving methods are being promoted, but the business activities of the service industry and construction may be hindered in the future.

Supporting Factors and Growth Factors

○Recovery production in motor vehicles (clearance of order backlog)

⇒Recovery production is expected to continue through the summer of 2024. Pent-up demand on the part of households is expected to reach 330,000 units (or 0.9 tril yen) by the end of January 2024.

○Growth in inbound demand

⇒There is now a full-fledged recovery in the number of Chinese tourists visiting Japan, whose number was down by -56% in December 2023 in comparison to the same month in 2019. Meanwhile, the total number of foreign tourists visiting Japan (25,070,000 in 2023) is expected to reach 39 million in 2024, and 41 million in 2025. This translates to amounts of real consumption totaling 4.4 tril yen in 2023, 5.6 tril yen in 2024, and 6.0 tril yen in 2025.

○Recovery in consumption of services

⇒The margin for recovery in consumption was 2 tril yen as of the Oct-Dec period of 2023 (annualized amount). If real wages rise, the pace of recovery has a chance of accelerating.

○High level of household savings

⇒Household financial assets grew by +236 tril yen between the end of December 2019 and the end of September 2023. Of this, cash and deposits grew by +105 tril yen. The asset effect may now go to work with the rise in stock prices.

○Recovery in the silicon cycle (Global semiconductor market conditions)

⇒The silicon cycle entered a recovery trend in 2024, and this trend is expected to continue in 2025. The shipment-inventory balance of electronic parts and devices in Taiwan and South Korea, which hold a high share of the market for the most advanced semiconductors, is improving.

Fiscal and Monetary Policy

○Japanese Government’s comprehensive economic measures

⇒Measures are expected to have the effect of raising real GDP by 9 tril yen over the next approximately three years. The flat tax cut of 40,000 yen per person will increase real wages by nearly 1% for a period of one year beginning in June 2024.

○BOJ monetary policy

⇒YCC to be eliminated and negative interest rates removed in April 2024 (-0.1% → 0.0-0.1%). Accommodative policy will be retained, while raising interest rates moderately. (0.25% in Oct-Dec period of 2024, then additional increases of 0.50% per annum at a time after that point.)

Major Downside Risk Factors for Japan’s Economy

○Major deterioration of US economy (credit crunch due to long-term monetary tightening)

⇒If the lending attitude of US banks continues at the current level, the effect on real GDP on an annual basis will be -0.6% for the US and -0.4% for Japan.

○Increased tensions in the Middle East and Ukrain

⇒If crude oil prices were to rise to 150 USD/bbl, the annual impact on Japan's real GDP is estimated to be about -0.7%.

○China’s excessive debt problem becomes manifest

⇒China’s excess capital stock due to stagnant technology and other factors totals 2,840 tril yen (this is the deviation rate from the long-term trend of the capital coefficient).

○Intensifying US-China conflict (appearance of economic security risks)

⇒Important materials such as rare metals and rare earths will become difficult to procure. Japan may participate in US restrictions on investing in China.

○Domestic long-term interest rate highs and rapid yen appreciation

⇒Interest differential between US and Japan will shrink due to changes in monetary policy in both countries. Purchasing power parity (around 90-120 yen/dlr) will become a concern.

Source: Various Sources; compiled by DIR.

Cyclical Rise in Wages and Prices
High level of wage hikes to bring upward shift in real wages on a y/y basis in Jul-Sept 2024

According to our main scenario, the cyclical rise in wages and prices is expected to accelerate. The rate of wage increases in the 2024 spring labor negotiations, including regular salary increases, is estimated to be 3.8%[3], surpassing the previous year's rate (3.58% based on JTUC data), which was at its highest level in 30 years. Given the recent positive attitude toward wage increases not only from the workers' side but also from the employers' side, such as unions, there is a possibility that the rate of wage increase in the 2024 spring wage negotiations will reach the 4% level. As the trend toward price pass-through to handle increased labor costs through higher wages expands, the inflation rate, which has been on a downward trend since the fall of 2023, is expected to stabilize at around 2% y/y (Chart 7).

Real wages have been in negative territory on a y/y basis since the Jan-Mar period of 2022. The main factor in pushing wages down in 2022 was the high prices of imports[4]. In 2023, the impact of high import prices subsided, but a decline in labor's relative share replaced it as a negative factor. Labor's relative share was 53.1% (seasonally adjusted, nominal employee compensation divided by nominal GDP) in the Jul-Sep period of 2022, the highest level in over 40 years except for the Apr-Jun period of 2020 when the economy deteriorated significantly due to the Corona crisis. Subsequently, while companies became more active in price pass-through, the pace of nominal wage increases was relatively slow, and labor costs adjusted in real terms through the spring of 2023.

Labor's relative share has been stable at around 50.5% from the Apr-Jun period to the Oct-Dec period of 2023, and is near its long-term average. If it remains stable in the future, the y/y growth rate of real wages will recover to a level similar to the labor productivity growth rate (around +1%[5]).

In this regard, when using principal component analysis[6] to create an index that tends to lead real wages by two quarters, the negative range of the leading index rapidly shrinks toward the middle of 2024, suggesting the possibility that the y/y change in real wages will turn positive in the second half of 2024[7]. In our main scenario, we expect real wages to turn positive in the Jul-Sep period of the same year, taking into account the substantial wage hikes in the spring labor negotiations, as well as the calming down of high prices (Chart 3,right).

With surplus labor having declined to around 300,000, aggressive wage hikes by corporations is likely to continue

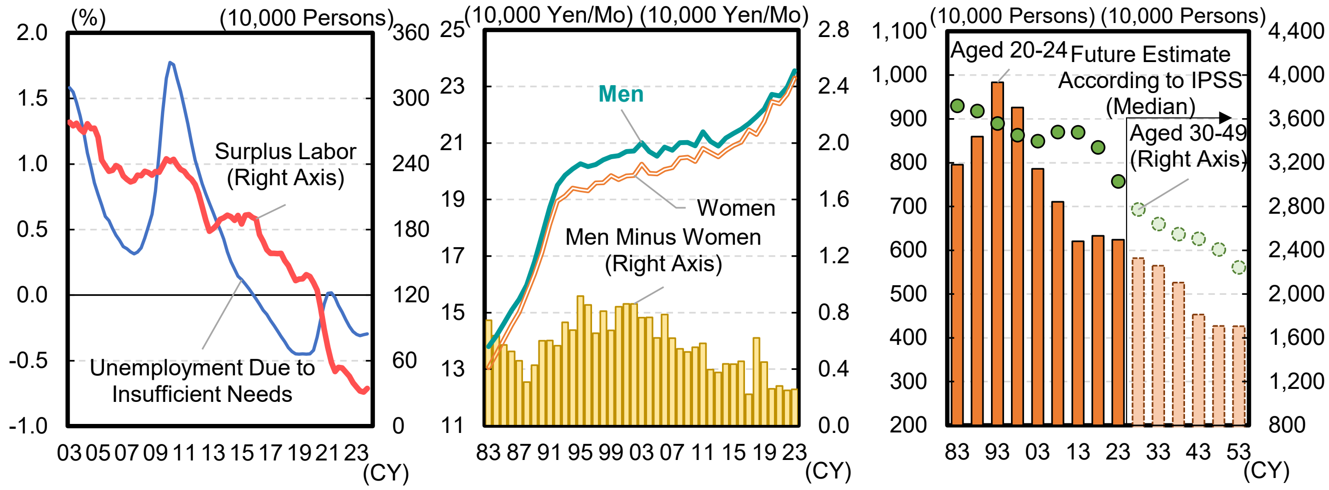
Aggressive wage hikes by corporations are likely to continue through the middle of the current decade. With the decline in population progressing in the mid to long-term, competition between corporations to acquire human resources will increase.

The margin for labor supply growth already appears to be shrinking. Defining surplus labor force (potential room for increase in the number of workers) as the difference between the potential labor force as defined by the Bank of Japan in its Outlook for Economic Activity and Prices (October 2017) and the working population, the surplus labor force declined from about 2.8 million in 2003 to about 300,000 in 2023 (Chart 5, left). The reason why the number of workers increased through the 2010s even as the

[3] The results are based on estimates using as explanatory variables which affect the rate of wage increases in the spring labor negotiations, including corporate performance, labor supply and demand, CPI growth rate, and terms of trade (all of which are the previous year's values).
[4] See our previous outlook for details.
[5] Labor productivity (real GDP per worker hour) increased at an annual rate of +1.0% from 2000 to 2019, and the average rate of increase from Jan-Mar 2022 to Oct-Dec 2023 was about the same.
[6] A statistical method to identify trends (first principal components) that are common to multiple variables.
[7] For more information, see "Japan's Economic Outlook for 2024" (December 21, 2023) (Japanese only).

working-age population declined was due to a decrease in the surplus labor force resulting from the increased labor participation of women and other workers. In the 2020s, the number of people who wanted to work among the non-working population declined by about 500,000 due to the Corona crisis, accelerating the decline of the surplus labor force. The labor supply-demand balance is tight, with the unemployment rate due to insufficient needs (the unemployment rate that will be eliminated when labor demand recovers) currently in negative territory. However, the margin for new labor supply is shrinking, and this is already affecting the expansion of business activities in the service and construction industries.

Labor Supply and Surplus Labor (Left); Starting Salary for New College Graduates (Center); Population by Age Group (Right) **Chart 5**



Source: Ministry of Health, Labour and Welfare, National Institute of Population and Social Security Research, Ministry of Internal Affairs and Communications, The Japan Institute for Labour Policy and Training, Bank of Japan (Outlook for Economic Activity and Prices (Oct. 2017)); compiled by DIR.

Notes: 1) Unemployment due to Insufficient Needs (unemployment that would be resolved if labor demand were to recover) shown in the chart at far left is estimated by the Japan Institute for Labour Policy and Training. Surplus labor is found by subtracting labor force population from the potential labor force population (=employed + unemployed due to insufficient needs + non-labor force population who are seeking employment). We use the Bank of Japan’s definition of potential labor force population (2017). All items are backward 4-quarter moving averages of quarterly data.

2) Figures in the center chart were extended using a y/y comparison of monthly scheduled earnings of college graduates aged 20-24. Starting salaries prior to 2019 are retroactively based on 2019 recalculated values with the same estimation method because of different survey methods and definitions. Future estimates by the National Institute of Population and Social Security Research shown at right are median birth (median death) projections.

Against this backdrop, companies have been stepping up their hiring of new graduates. Japanese companies, which tend to emphasize long-term employment and in-house training, tend to concentrate the hiring of new graduates, and it is important to strengthen the hiring of new graduates in order to secure workers in their 30s and 40s who will play key roles in the company. As shown in the center of Chart 5, starting salaries for new college graduates have strengthened their upward trend since the mid-2010s, and this trend has accelerated in recent years. In addition, the gap in starting salaries between men and women has been narrowing, mainly due to the fact that the difference in job types between men and women has become smaller.

Looking at the population trend of those aged 20-24, including new college graduates, the population actually stabilized in the low 6 million range in the 2010s. According to the National Institute of Population and Social Security Research's median birth (median death) projection, the population is expected to enter a phase of full-scale decline in the 2020s (Chart 5 right). The population in their 30s and 40s declined sharply in the 2010s as the so-called "junior baby boomers" (or second-generation baby boomers born between 1971 and 1974) moved into their 50s, and is expected to continue to decline in the 2020s and beyond due to the declining birthrate.

If companies raise starting salaries but are reluctant to raise wages for middle-aged and older employees, the wage curve will flatten, which may affect the ability to recruit middle-aged and older workers. If

Japanese companies are to secure human resources while maintaining membership-based employment, which is common among Japanese companies, it will be necessary to raise the wage curve as a whole. The trend toward higher wages against the backdrop of demographic trends is likely to continue over the medium to long term, and companies will be increasingly required to balance wage increases with the maintenance and expansion of earnings by improving their ability to pass on prices through higher value-added products and services, and by creating workplace environments that enable diverse work styles.

Supporting Factors and Growth Factors in Japan's Economy

The five main factors expected through FY2025 are: recovery production in motor vehicles (clearance of order backlog), growth in inbound demand, recovery in consumption of services, a high level of household savings, and recovery in the silicon cycle (global semiconductor market conditions).

Pent-up demand on the part of households as of the end of January 2024 is estimated at 330,000 units (around 0.9 tril yen)[8], and is thought to exceed export and corporate demand. Based on the pace of carryover demand to date, recovery production in motor vehicles is expected to continue through the summer of 2024[9]. On the other hand, as of December 2024, foreign tourists visiting from China were at -56% in comparison to the same period of 2019, contrasting with the +33% growth in visitors from other countries or regions. The number of foreign tourists visiting Japan from China is expected to fully recover in 2024 with a total of 39 million expected in comparison to the 25,070,000 in 2023, and growth of around 41 million seen in 2025.

The consumption of services is seen as continuing to have room for recovery. Based on age group, disposable income, real interest rate gap (the gap between real interest rates and the natural rate of interest), and net financial assets, we estimate the theoretical value (long-term trend) of personal consumption to be about 2 tril yen (annualized amount) higher than the actual value for the Oct-Dec period of 2023. This is mainly due to service consumption, and in particular, the slow-recovering expense categories are vulnerable to the impact of real wages and other factors (for details, see previous outlook). From a different perspective, the pace of recovery may accelerate at a time when real wages are on an upward trend.

High levels of household savings are expected to continue to support personal consumption. Household financial assets have increased significantly since the Corona crisis, growing by 236 tril yen (including 105 tril yen in cash and deposits) from the end of December 2019 to the most recent end of September 2023. With stock prices rising markedly in the recent past, personal consumption may be stimulated through the asset effect.

The silicon cycle as seen in global semiconductor sales bottomed out in the spring of 2023. In November of the same year, it turned positive on a y/y basis for the first time in a year and three months, and has continued to improve in recent months. The balance of shipments and inventories in the electronic components and devices industry in Taiwan and South Korea, which have a high market share in advanced semiconductors and other products and move ahead of the silicon cycle, is improving. The silicon cycle entered a recovery phase in 2024 and is expected to continue to recover in 2025, which will boost domestic production of semiconductor-related goods.

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[8] For estimation method of pent-up demand on the part of households, see the September 8, 2023 report, *"Japan's Economic Outlook No. 218 Update"* (Japanese only).

[9] In our previous outlook, we had assumed that recovery production in motor vehicles would end in the first half of 2024, but in light of the suspension of operations at some plants of motor vehicle manufacturers, we have pushed back the end of recovery production to the summer of the same year.

Major Downside Risk Factors for Japan's Economy

There are many downside risk factors for the economy during the forecast period, mainly in overseas economies. Specifically, these include a significant deterioration in the US economy (credit crunch due to prolonged monetary tightening), the emergence of China's excessive debt problem, growing tensions in the Middle East and Ukraine, intensification of the US-China conflict (emergence of economic security risks), and a sharp rise in domestic long-term interest rates and yen appreciation.

In the US, the possibility of a credit crunch cannot be ruled out due to prolonged monetary tightening caused by factors such as the persistently high rate of service price inflation. In China, the real estate recession is protracted and the risk of excess debt is smoldering. If the deviation of the capital coefficient from its long-term trend is considered as excess capital stock, the size of the excess capital stock is about 2,840 tril yen.

Although it is a tail risk, Chart 6 shows the results of our calculations of the impact on real GDP in each country and region in the event of a rapid deterioration in the financial environment in the US and China. We assume two cases: (1) US bank lending attitude remains at the current level (January 2024), and (2) US banks become as rigid as they were at the time of the international financial crisis of 2008. In China, we assumed two cases: (1) the real estate market shrinks by more than 10% (the same size as during the international financial crisis of 2008[10]), and (2) bank lending declines by 20% (the same size as the decline between 1997 and 2005 in Japan).

If the risk scenario plays out in the US, the impact on US real GDP will be -5.0% to -0.6% (on an annual basis). In the case of China, the impact would be -7.8% to -1.3%. The impact on Japan's real GDP under each risk scenario for the US and China would be about the same, ranging from -2.9% to -0.5%. In our main scenario, Japan's real GDP growth rate for FY2024 is +0.8%, which could turn negative if such tail risks materialize. Continued attention should be paid to sudden changes in the financial environment in the US and China.

Effect on Real GDP if US-China Tail Risk Appears (Annual Basis) **Chart 6**

(%)

		Global Economy	Japan	US	China	Euro Area	Emerging Nations(Excluding China)
	＜US Risk Scenario (1)＞ Bank lending attitude remains same as current level	▲ 0.5	▲ 0.4	▲ 0.6	▲ 0.3	▲ 0.5	▲ 0.6
	＜US Risk Scenario (2)＞ Bank lending attitude becomes as strict as during the international financial crisis of 2008	▲ 4.0	▲ 2.9	▲ 5.0	▲ 2.3	▲ 3.6	▲ 4.5
	＜China Risk Scenario (1)＞ Real estate market shrinks by more than 10% (same size as during international financial crisis of 2008)	▲ 0.7	▲ 0.5	▲ 0.2	▲ 1.3	▲ 0.2	▲ 0.8
	＜China Risk Scenario (2)＞ Bank lending declines by 20% (Same size as the decline between 1997 and 2005 in Japan)	▲ 4.1	▲ 2.8	▲ 1.2	▲ 7.8	▲ 1.3	▲ 4.9

Source: Ministry of IMF, Haver Analytics; compiled by DIR.

Note: For details on estimation method see the December 8, 2022 report, *"Japan's Economic Outlook No. 215 Update"* (Japanese only) and the June 8, 2023 report, *"Japan's Economic Outlook No. 217 Update"* (Japanese only). US Risk Scenario (1) current level is January 2024. In China Risk Scenario (1), the same size as during international financial crisis of 2008 refers to the period between the beginning of the financial crisis in September 2008 through August 2009 when the y/y trend in real estate investment fell far below the usual trend, a decline of over 10%pt.

[10] The downside of real estate investment (y/y) from the trend is assumed to be the downside (over 10% pt) in the one-year period immediately after the international financial crisis of 2008 (September 2008 to August 2009). For details, please refer to the December 8, 2022 report, *"Japan's Economic Outlook No. 215 Update"* (Japanese only).

In addition, growing tensions in the Middle East and Ukraine could lead to a sharp rise in resource prices. If the price of crude oil were to rise to 150 USD/bbl, our short-term macroeconomic model estimates the impact on Japan's real GDP (annual basis; same below) to be -0.7%.

The escalation of the US-China confrontation may affect the production activities of Japanese firms because of obstacles to the procurement of rare metals, rare earths, and other important commodities that are heavily dependent on China, and because Japan may join the restrictions on investment in China that the US is preparing to impose. If Mr. Trump is elected president of the United States in November 2024, not only US-China relations but also relations among Western nations could change significantly.

Domestic long-term interest rates may rise more than expected as the Bank of Japan normalizes its monetary policy, and the dollar-yen rate may turn to yen appreciation through a narrowing of the Japan-US interest rate differential. If the concerns of market participants shift to purchasing power parity (PPP), the yen's appreciation may accelerate, based on the 1973 relative PPP (estimated from the difference in the growth rates of three price indexes between the two countries (consumer prices, corporate prices, and unit labor costs) based on 1973 exchange rates) and the absolute PPP (the exchange rate at which the prices of goods and services between the two countries are in equilibrium) published by the Organization for Economic Cooperation and Development (OECD). The reason is that the yen appreciates significantly above recent market rates, at around 90-120 yen to the dollar. If the yen were to appreciate to these levels, macroeconomic models estimate the impact on real GDP to be -0.5% in the case of 120 yen to the dollar and -1.1% in the case of 90 yen to the dollar.

3. Outlook for Prices and Monetary Policy

Outlook for new core-core CPI around +2% in both FY2024 and FY2025

On an all items basis, less fresh food, core CPI is projected to increase by +2.8% y/y in FY2023, +2.7% y/y in FY2024, and +2.0% in FY2025 assuming recent resource prices and exchange rates (Chart 7). On an all items basis, excluding fresh food and energy, which easily reflects the underlying tone of prices (new core-core CPI), the forecast is +3.8% in FY2023, +1.9% in FY2024, and +2.0% in FY2025.

During the deflationary period, it was difficult to pass on increased labor costs to sales prices, but this situation has been improving recently[11]. As mentioned above, the severe labor shortage is expected to be prolonged, and companies will need to secure labor through aggressive wage increases. The trend toward shifting higher labor costs onto selling prices will also continue.

Based on the assumed rate of wage increases in the spring labor negotiations, taking into account recent changes in corporate pricing behavior, and estimating the inflation rate if this level continues, the BOJ's 2% price stability target will be achieved when the rate of wage increases is in the 3% range[12]. The wage hike rate is expected to reach the 4% level in 2024, and is expected to remain high in 2025 and beyond. The cyclical upward mechanism of wages and prices will function, and inflation is expected to stabilize at around 2% in the second half of our forecast period.

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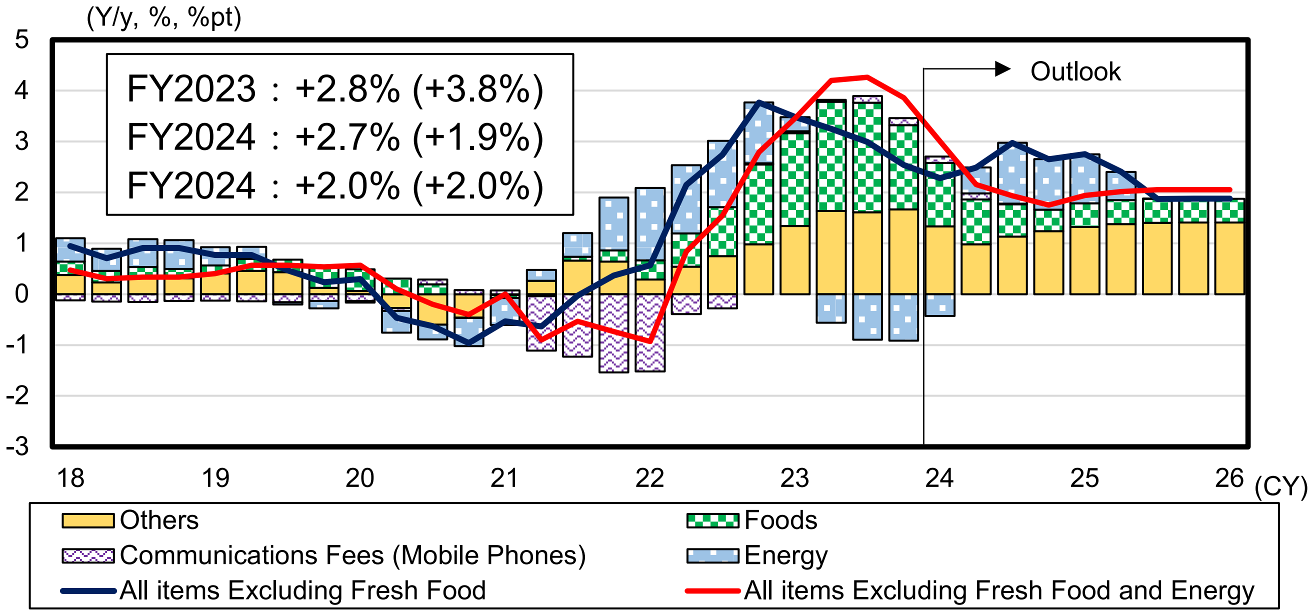
[11] For background on changes in corporate behavior, see the DIR report by Kanako Nakamura and Shotaro Kugo, dated February 1, 2024, "Trends in Price Pass-Through by Input Cost" (Japanese only).

[12] For details on estimation method, see the DIR report by Shotaro Kugo, dated June 16, 2023, "Characteristics of Inflation and Implications for Monetary Policy as Seen in Supply-Demand Factor Decomposition and Trends by Distribution Process" (Japanese only).

Outlook for CPI (Excluding Fresh Food; Figures in Parenthesis Excluding Fresh Food and Energy)
Chart 7



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 April 2024 (energy bills will be reduced until end of May with the subsidy amount reduced by half).

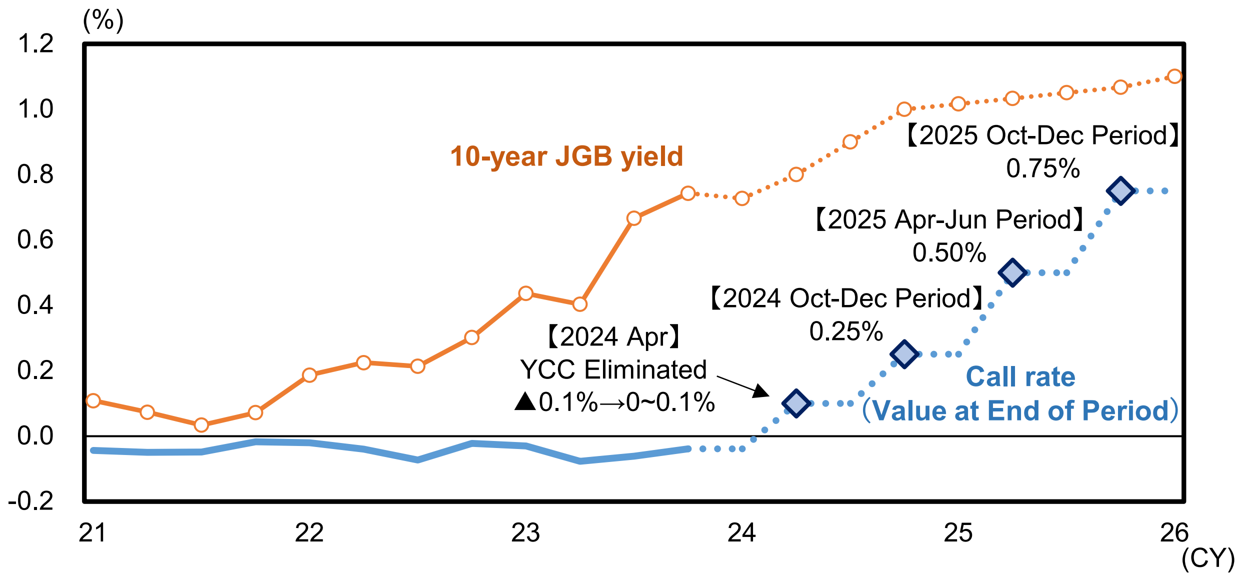
BOJ expected to eliminate YCC and negative interest rates in April 2024

The BOJ is expected to (1) eliminate the YCC and (2) lift its negative interest rate policy (shift to a zero-interest rate policy) at its April monetary policy meeting when the results of the 2024 spring wage negotiations are known to some extent. If the rate of wage increases in the 2024 spring trade negotiations reach a high level as expected, the probability of achieving the price stability target will increase, and the need for exceptional easing measures such as YCC and negative interest rates will diminish, giving way to normal easing measures.

After the lifting of the negative interest rate policy, we assume a shift to a virtually zero interest rate policy (-0.1% call rate raised to 0.0-0.1%). After that, we expect the BOJ to implement additional interest rate hikes at a gradual pace, while closely monitoring economic and price conditions. Although there is much uncertainty, our main scenario assumes that the BOJ will raise short-term interest rates to 0.25% in the Oct-Dec period of 2024, followed by additional rate hikes at a pace of about 0.50% per year (twice a year) in 2025 and beyond (Chart 8).

Outlook for Long and and Short-Term Interest Rates in Japan **Chart 8**

(CY)



Source: Ministry of Finance, Bank of Japan; compiled by DIR.

The real short-term interest rate (the level of the call rate minus the inflation rate) is expected to rise moderately but remain in negative territory throughout the forecast period. Japan's natural rate of interest is estimated to be near zero at present[13]. The real interest rate will remain below the natural rate of interest (the real interest rate gap will be negative), maintaining an accommodative financial environment throughout the forecast period.

We expect the yield on the 10-year JGB (long-term interest rate), which has recently been above 0.7%, to rise to around 1% (Chart 8). The Bank of Japan's interest rate hikes, albeit at a slower pace, will be a factor in pushing up long-term interest rates. On the other hand, as mentioned earlier, we assume that the Fed will start cutting interest rates in the US in mid-2024. US long-term interest rates are expected to decline gradually, which will put downward pressure on Japanese long-term interest rates.

The concern after the removal of YCC is a sharp rise in long-term interest rates due to speculative activities. While a gradual rise in long-term interest rates based on economic and price fundamentals is desirable, a sharp rise in long-term interest rates due to speculative activities would adversely affect the real economy and financial markets. To avoid such a situation and stabilize long-term interest rates, the BOJ is expected to retain its limit operations even after YCC is eliminate.

[13] For details see the DIR report dated 23 January 2024, *Japan's Economy: Monthly Outlook (Jan 2024)* (Japanese only)

Japan’s Economic Outlook No. 220 (February 21, 2024) Chart 9

		2023			2024				2025				2026	FY2023 (CY)	FY2024 (CY)	FY2025 (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	562.6	557.9	557.3	557.8	560.0	562.4	564.7	566.8	568.4	569.9	571.4	572.8	558.8	563.5	570.6
	Q/q %	1.0	-0.8	-0.1	0.1	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3			
	Q/q %; annualized	4.0	-3.3	-0.4	0.3	1.6	1.8	1.6	1.5	1.1	1.1	1.0	1.0			
	Y/y %	2.3	1.7	1.0	0.0	-0.5	0.8	1.4	1.6	1.5	1.3	1.2	1.0	1.3	0.8	1.3
														1.9	0.4	1.4
Private Consumption	Q/q %	-0.7	-0.3	-0.2	0.4	0.5	0.6	0.4	0.4	0.3	0.2	0.2	0.2	-0.3	1.3	1.1
Private Residential Investment	Q/q %	1.8	-0.6	-1.0	0.0	-0.5	-0.6	-0.6	-0.7	-0.7	-0.8	-0.8	-0.9	1.5	-2.0	-2.8
Private Non-Resi. Investment	Q/q %	-1.4	-0.6	-0.1	0.5	0.6	0.5	0.5	0.5	0.5	0.6	0.6	0.6	-0.6	1.7	2.1
Government Consumption	Q/q %	-0.1	0.3	-0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.5	0.7	0.9
Public investment	Q/q %	2.2	-1.0	-0.7	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	2.9	0.6	1.2
Exports	Q/q %	3.8	0.9	2.6	-1.7	0.5	0.4	0.6	0.6	0.6	0.7	0.6	0.6	4.0	1.5	2.5
Imports	Q/q %	-3.6	1.0	1.7	-0.4	0.4	0.4	0.3	0.3	0.5	0.5	0.5	0.5	-2.6	1.7	1.8
Nominal GDP	Q/q %; annualized	10.4	-0.2	1.2	2.7	4.0	4.2	3.9	3.6	3.0	2.5	2.4	2.3	5.3	3.2	3.1
GDP deflator	Y/y	3.7	5.2	3.8	3.2	2.5	2.1	2.4	2.3	2.1	2.0	1.6	1.4	4.0	2.3	1.8
Industrial production	Q/q	1.4	-1.2	1.3	-0.4	0.4	0.6	0.5	0.4	0.4	0.5	0.5	0.5	-0.5	1.2	1.9
Core CPI	Y/y	3.2	3.0	2.5	2.3	2.5	3.0	2.7	2.7	2.4	1.9	1.9	1.9	2.8	2.7	2.0
Unemployment rate	%	2.6	2.7	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.5	2.4	2.3
Trade balance (goods, services)	Y tril; annualized	-0.1	-0.1	-0.0	-0.0	0.1	0.1	0.3	0.3	0.5	0.5	0.8	0.8	-0.0	0.3	0.8
Current account balance	Y tril; annualized	0.4	0.7	0.7	0.7	0.8	0.9	1.0	1.0	1.0	1.1	1.1	1.1	0.6	0.9	1.1
Major assumptions																
Crude oil price (WTI futures)	$/bbl	73.6	82.2	78.5	76.7	79.2	79.2	79.2	79.2	79.2	79.2	79.2	79.2	77.8	79.2	79.2
Exchange rate	Yen/$	137.4	144.5	147.9	148.7	150.2	150.2	150.2	150.2	150.2	150.2	150.2	150.2	144.6	150.2	150.2

Source: Compiled by DIR.

Note: Shaded areas are DIR estimates.