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Japan’s Economy: Monthly Outlook (May 2024)

Economic Outlook Revised: Gradual Recovery Continues with Improvement in Income Environment and Other Factors

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Summary

- In light of the announcement of the Jan-Mar 2024 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 +1.0% in FY2024, and +1.4% in FY2025 (on a calendar year basis we expect +0.4% in 2024 and +1.7% in 2025).

- The rate of wage increases in the 2024 spring wage negotiations was considerable, and this means that real wages will likely shift upwards on a y/y basis in the Jul-Sep period of 2024. Regular salary increases of general workers rose +1.8% y/y in FY2023, while in comparison to this rate, regular salary increases are expected to rise to the middle of the 3% level in FY2024. Meanwhile, Japan’s economy can expect to find underlying support and growth factors including the Flat-amount Cut of Personal Income Tax and Personal Residence Tax, recovery production in motor vehicles, growth in inbound consumption, the high level of household savings, and the recovery of the silicon cycle. 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 raise interest rates further at a gradual pace, while closely monitoring economic and price conditions. According to our main scenario, we expect 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 twice yearly, totaling 0.50% annually. However, an accommodative monetary environment will likely be maintained, with real short-term interest rates remaining in negative territory throughout the forecast period. If there is increasing risk of higher prices due to the further weakening of the yen, we believe that the BOJ will raise long-term interest rates through a more flexible pace of government bond purchases or a reduction in the amount of purchases.

1. Positive Growth of Around 1% Expected to Continue with Recovery of Consumption and Other Factors

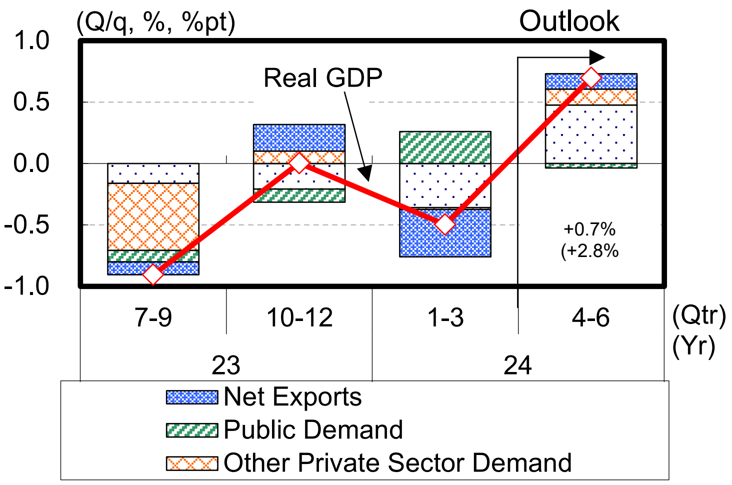
Jan-Mar 2024 period real GDP suffers downturn due to motor vehicle production cuts, but personal consumption shows signs of recovery

The real GDP growth rate for Jan-Mar 2024 (1st preliminary est) was down by -2.0% q/q annualized (-0.5% q/q)[1]. In addition to the major decline in production for some motor vehicle manufacturers associated with the authentication fraud issue, the GDP growth rate also received downward pressure from special factors, specifically a reactionary decline in the export of some services.

During the Jan-Mar period, the total of domestic sales volume and exports of motor vehicles declined by nearly 300,000 units in comparison to the Oct-Dec period of 2023 (estimated by DIR based on seasonally adjusted figures). Multiplying this decrease by the average unit price and taking into consideration the influence of reduced imports of parts and other items, economic losses due to production cuts in motor vehicles can be estimated at around 0.7 tril yen on a GDP basis (the influence on the GDP growth rate is estimated to be around -2%pt q/q annualized). Considering the effects on related industries, economic losses could be even greater.

Looking at performance by demand component (Chart 1), in the area of private sector demand, all categories suffered declines except for private sector inventories in comparison to the previous period. As for public sector demand, government consumption and public investment both achieved growth. Meanwhile, in the area of overseas demand, exports declined. Imports, which reflect domestic demand, also fell. But since the decrease in exports exceeded that of imports, net exports shifted to the negative side.

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



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

Private consumption was in the negative numbers on a y/y basis for the fourth consecutive quarter. This is the first time that this has occurred since the global financial crisis of 2008[2] (Apr-Jun period of 2008 to Jan-Mar period of 2009). However, the effect of the decline in motor vehicle production during the Jan-Mar period of 2024 was especially significant, and if we exclude this factor, consumption actually

[1] See the DIR report by Keiji Kanda and Munehisa Tamura dated 16 May 2024, *Jan-Mar 2024 1st Preliminary GDP Estimate.*

[2] The subprime loan problem (loans to borrowers with low creditworthiness) that emerged with the bursting of the U.S. housing bubble triggered the global financial crisis of 2008, plunging the world economy, including Japan, into a major recession.

shows signs of recovery. Looking at goods and services, while durables fell by -12.2% q/q, services, which account for over 50% of private consumption, grew by +1.0%, and semi-durables also shifted into growth. Non-durables declined slightly at -0.1%, but remained steady, despite the 2% rise in the deflator.

Real GDP in Apr-Jun 2024 expected to grow by +2.8% q/q annualized

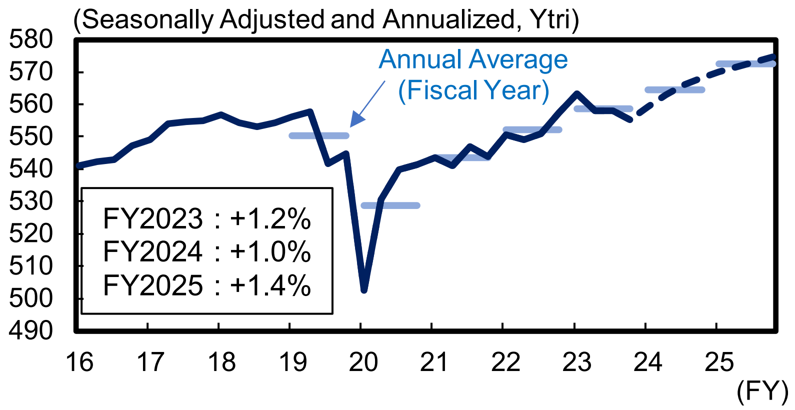
Real GDP growth in the Apr-Jun 2024 period is expected to shift into positive growth at an annualized rate of +2.8% y/y (+0.7% q/q), due to recovery production in motor vehicles and an improved income environment for households (Chart 1).

Domestic motor vehicle production capacity has been largely back to normal as of April, hence recovery production in order to eliminate order backlog is expected during the Apr-Jun period. This will also be a factor leading to growth in personal consumption, exports, and capital expenditure. In addition, exports of semiconductor related goods are picking up due to the recovery of the silicon cycle, and exports of goods are expected to achieve growth. As for exports of services, inbound demand should provide an upward push. Moreover, the major wage hikes in the spring labor negotiations and the Flat-amount Cut of Personal Income Tax and Personal Residence Tax, will improve the income environment for households, providing a boost for the recovery in personal consumption (see Chapter 2).

Summary of overseas economic outlook: caution regarding high prices, US presidential election, Middle-East situation, and China's real estate slump

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 May 22 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 :	＋2.5%
	2025 :	＋2.0%
Eurozone	2023 :	＋0.5%
	2024 :	＋0.7%
	2025 :	＋1.4%
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 expected to record around 1% in positive growth in FY2025

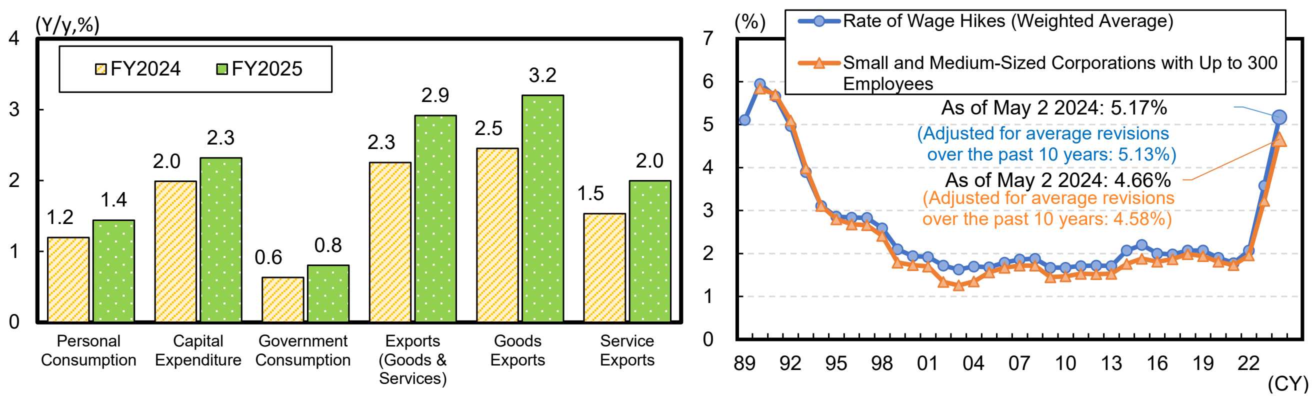
Based on the above overseas economic outlook, Japan's real GDP growth rate according to our main scenario is expected to be +1.0% in FY2024, and +1.4% in FY2025 (+0.4% in 2024 and +1.7% in 2025 on a calendar year basis).

The outlook for the FY2024 growth rate has been revised upwards by 0.1%pt based on recent performance in comparison to our previous report of March 11, 2024 (*Japan's Economic Outlook No. 220 Update* (Japanese only)). Results of the Jan-Mar 2024 period fell below original expectations due to production cuts in motor vehicles, and this has become a factor in rebound expected during the Apr-

Jun period, which has grown in scale. The outlook for FY2025 has also been revised upwards in comparison to our previous outlook by 0.1%pt. However, when carryover (real GDP growth rate that can be achieved with zero q/q growth in each quarter) is excluded, y/y growth is expected to be at 0.7%, the same level as our previous outlook. While personal consumption is expected to gradually slow, capital expenditure is expected to heat up, hence our outlook sees the GDP growth rate continuing at around +1% q/q annualized.

Major demand components are expected to perform as illustrated in the left side of Chart 3. The FY2025 growth rate is expected to be generally higher than the previous fiscal year. However, much of this relies on carryover. When this effect is excluded, all demand components with the exception of services exports are expected to experience a slowdown in comparison to FY2024.

Outlook for Major Demand Components (Left), Weighted Average Rate of Wage Increases Compiled by Japanese Trade Union Confederation (Right) Chart 3



Source: Cabinet Office, Japanese Trade Union Confederation "Results of Fifth Aggregated Result of Companies' Responses of Annual Spring Labor Negotiations" (May 8, 2024) (Japanese only); compiled by DIR.

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 withdrawal of household savings that accumulated significantly after the Corona crisis. In FY2024, the growth rate is expected to get a boost from pent-up demand for motor vehicles, which is expected to emerge through the fall, and the flat tax cut of 40,000 yen per person.

According to the results of the fifth aggregated result of companies' responses released by Japanese Trade Union Confederation on May 8, the weighted average rate of wage increases (including regular salary increases) in the spring labor negotiations of 2024 was 5.17%, the highest level in 33 years (Chart 3 right). Even small and medium-sized companies with less than 300 employees are likely to realize a significant wage increase, at 4.66%. We expect y/y growth of real wages to turn positive in the Jul-Sep 2024 period, and thereafter to remain around +1% above the previous year's level (see Chapter 2 for details).

In terms of capital expenditure, we expect to see investment in renewal and capacity expansion, which companies had been postponing due to the Corona crisis and high prices. In addition to investment in labor saving due to the worsening labor shortage, and the decrease in the relative cost of capital associated with aggressive wage hikes on the part of corporations, software investment associated with the digital transformation (DX) and the green transformation (GX), as well as R&D investment are also expected to increase. However, caution should be exercised with 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 FY2024, the effects will gradually wear off in FY2025, and growth is expected to accelerate.

Finally, in terms of exports, goods exports are expected to continue achieving growth with pent-up demand for motor vehicles appearing, the recovery of the silicon cycle, and the comeback in overseas economies. As for services exports, a certain amount of weakening is expected in FY2024 in the form of a reactionary decline in response to the significant growth in FY2023 due to the recovery of inbound consumption, as well as the high rate of usage fees for intellectual property during the last half of FY2023. However, growth in FY2025 is expected to accelerate gradually due to the steady increase in inbound consumption.

2. Key Points in the Future of Japan's Economy: Real Wages Expected to Grow in Jul-Sep Period of FY2024

2.1 Major supporting factors and boosts to Japan's economy, and downside risks

Chart 4 brings together a list of major supporting factors and boosts to Japan's economy, as well as downside risks based on recent developments. Prices and the Bank of Japan (BOJ) 's monetary policy are covered in chapter 3.

Supporting factors and boosts to economy

There are five major factors expected to influence Japan's economy in FY2025. These are improvements in the household income environment due to wage hikes and the tax reduction, recovery production in motor vehicles (elimination of order backlog), growth in inbound demand, the high level of household savings, and the recovery of the silicon cycle.

As will be explained in more detail in the following section, due to the major increase in the rate of wage hikes in the 2024 spring labor negotiations, including the increased growth rate of regular salaries, real wages (real per capita employee compensation) are expected to shift into positive territory on a y/y basis during the Jul-Sep period of 2024 (Chart 6 right). After that point they are expected to continue growing at an annualized rate of around +1%[3], which is the equivalent of the growth rate of labor productivity in recent years. On the other hand, the Flat-amount Cut of Personal Income Tax and Personal Residence Tax of 40,000 yen per person (total of income tax and resident tax, including dependents) is to be implemented in June 2024. The child allowance will also be enhanced from the October payment of the same year (the first payment after the increase will be in December of 2024)[4]. The major wage hikes in the spring labor negotiations, and the government tax cut as well as benefit programs, should be a big boost to the strengthening of the recovery in personal consumption, which has recently suffered from continued declines.

Pent-up demand for motor vehicles, which emerged due to the inability of production to keep up with demand, is estimated at approximately 370,000 units (or around 1.0 tril yen as of end April 2024) in terms of households[5]. Carryover demand is also expected for exports and corporate use. Considering the

[3] The growth rate in labor productivity (Real GDP per worker per hour) from the year 2000 to 2019 was +1.0% annualized. The average growth rate has remained the same from the Jan-Mar period of 2022 to the Jan-Mar period of 2024.
[4] Income restrictions will be eliminated and the payment period will be extended to high school age. The monthly allowance will be 15,000 yen for children aged 0 to 2, 10,000 yen for children aged 3 to high school age, and 30,000 yen for the third and subsequent children, regardless of age.
[5] For the method of calculating pent-up demand for motor vehicles, see the DIR report dated 2023 September 8, *"Japan's Economic Outlook No. 218 Update"* (Japanese only).

pace at which carryover demand has occurred in the past, recovery production in motor vehicles to eliminate order backlog is expected to continue through the fall of 2024.

Major Supporting Factors and Boosts to Japan's Future Economy, and Downside Risks Chart 4

Supporting Factors and Boosts to Economy

○Improvements in household income environment due to wage hikes and tax reduction

⇒Due to the major increase in the growth rate of regular salaries in the 2024 spring labor negotiations, **real wages are expected to shift into a growth trend on a y/y basis during the Jul-Sep period of 2024**.
The Flat-amount Cut of Personal Income Tax and Personal Residence Tax of 40,000 yen per person is to be implemented in June 2024, and the child allowance will also be enhanced from the October payment of the same year (to be paid in December).

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

⇒Expected to **continue through fall of 2024**. Pent-up demand from households (carryover demand) seen at **370,000 units (1.0 tril yen) as of end April 2024**.

○Growth in inbound demand

⇒With the **full recovery in the number of Chinese tourists visiting Japan**, the number of foreigners visiting Japan (25,070,000 in 2023) is expected to grow to **38,000,000 in 2024 and 43,000,000 in 2025**. (Amount in real consumption (4.4 tril yen in 2023) is estimated at **6.5 tril yen in 2024 and 7.0 tril yen in 2025**.)

○High level of household savings

⇒Household financial assets grew to **+256 tril yen between end December 2019 and end December 2023 (of this, cash and deposits account for +120 tril yen)**. Possibilities are that the **asset effect** may be triggered with the rise in the stock market.

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

⇒**The silicon cycle, which entered a recovery phase in 2024, is expected to continue its current trend in 2025**.
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, is improving.

Downside Risks to Japan's Economy

○US monetary tightening continues into the long-term (unexpected economic deterioration occurs due to postponement of interest rate cuts)

⇒If the US bank lending attitude remains at the current level (as of April 2024), **the effect on real GDP (on an annual basis) will be -0.6% for the US and -0.4% for Japan**.

○Trump winning the US presidential election

⇒**US economy could deteriorate significantly and inflation could heat up again** due to major hikes in tariff rates and strengthening of restrictions on immigration.

○Growing tensions in the Middle East and Ukraine

⇒If the price of crude oil were to rise to 150 USD/bbl, **the impact on Japan's real GDP (annual basis) would be around -0.6%**.

○Emergence of China's excessive debt problem

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

○Intensification of US-China conflict (emergence of economic security risks, etc.)

⇒Procurement of **rare metals, rare earths**, and other important materials will become difficult. **Japan may join US restrictions on investment in China**.

○Domestic long-term interest rate highs and sharp appreciation of the yen

⇒The differential between the US and Japan long-term interest rates shrinks due to **shift in policies**. **Purchasing power parity (around 90-120 yen/dlr)** could become a concern.

Source: Various Sources; compiled by DIR.

The number of Chinese tourists visiting Japan has recently been at a low level, down 27% in April 2024 in comparison to the same month of 2019. However, on a seasonally adjusted basis, we see that with the exception of October 2023 when there was a downswing caused by the issue of releasing treated water from the Fukushima Daiichi Nuclear Power Station[6], growth continued all during the same year on a month-to-month basis starting in February (Growth has averaged around +10% m/m from January to April of 2024, seasonally adjusted by DIR). A full recovery in the number of Chinese tourists visiting Japan is expected in the future, and along with the effects of the weak yen, the number of foreign tourists visiting Japan is expected to reach around 38,000,000 in 2024 in comparison to 25,070,000 in 2023, and then to grow to around 43,000,000 in 2025.

[6] This was an issue that led to the deterioration of Japan-China relations in August 2023 when treated water accumulating at TEPCO's Fukushima Daiichi Nuclear Power Station was discharged into the ocean.

The high level of household savings is expected to continue providing underlying support for personal consumption. Household financial assets grew to +256 tril yen between end December 2019 and end December 2023 (of this, cash and deposits account for +120 tril yen). Stock prices have been maintaining high levels recently, and this may stimulate personal consumption further, leading to 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.

Downside Risks to Japan's Economy

The major downside risks to Japan's economy are many, centering on overseas economies. Concretely speaking, these are US monetary tightening continuing into the long-term (causing unexpected economic deterioration due to postponement of interest rate cuts), Trump winning the US presidential election, growing tensions in the Middle East and Ukraine, emergence of China's excessive debt problem, intensification of US-China conflict (emergence of economic security risks, etc.), and domestic long-term interest rate highs and sharp appreciation of the yen.

Of these, Trump winning the US presidential election (known as "Trump risk"), is covered in detail in our current outlook of 2024 May 22, *"Japan's Economic Outlook No. 221"* (Japanese only), while other risk factors are covered in our previous outlook of 2024 Mar 11, "Japan's Economic Outlook No. 220 (Update)" (Japanese only)).

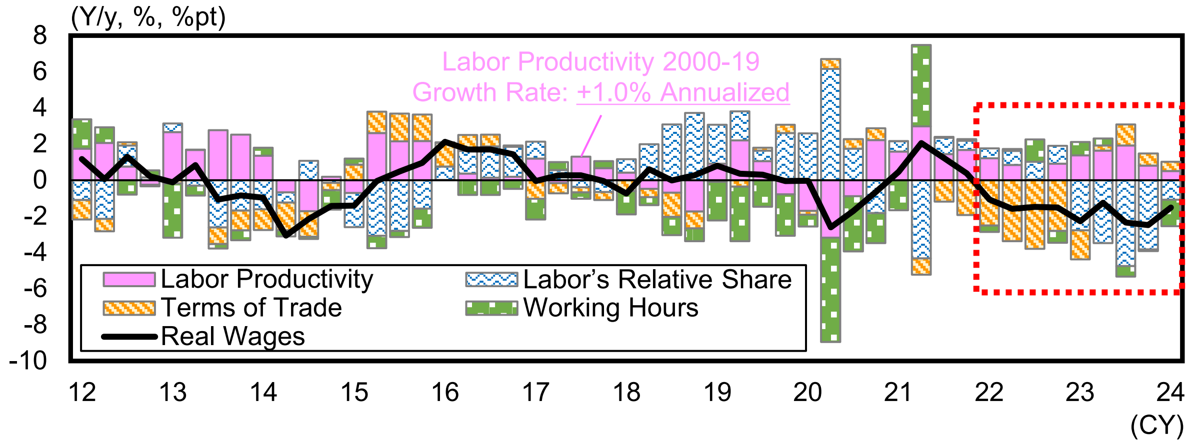
2.2 Wage increase accelerating in macro terms due to major increase in regular salaries

Major mitigation of downward pressure on real wages due to decline in labor's relative share

As was mentioned previously, the rate of wage hikes in the 2024 spring labor negotiations are at a 33-year high. Real wages on a y/y basis were hovering in negative territory since the beginning of 2022, causing a drag on personal consumption. The degree to which the current aggressive wage hikes on the part of corporations will improve the income environment of households is something that will be closely watched into the future.

First we look at a breakdown of the year-to-year rate of change in four major factors in Chart 5 as a means of better understanding the background which caused the past decline in real wages (real per capita employee compensation). These are (1) labor productivity, (2) labor's relative share, (3) terms of trade, and (4) working hours (or man-hours). The chart tells us that terms of trade were the main negative factor pushing down wages in 2022. Terms of trade became a positive factor bringing a boost to wages in 2023, but then labor's relative share became a negative factor holding real wages down. At one point its contribution to the year-to-year rate of change was more than -4%pt.

Breakdown of Factors Influencing Real Wages (Real Per Capita Employee Compensation) Chart 5



Source: Cabinet Office, Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.
Note: Labor productivity is the growth rate in real GDP per worker per hour. Real wages is the total of employee compensation and mixed income expressed as a real value and divided by number of workers. Terms of trade is the change in the ratio of the personal consumption deflator and the GDP deflator.

Downward pressure on real wages from the factor of labor's relative share has started to calm down recently. The number of corporations which are aggressively raising wages in consideration of the labor shortage and the situation with prices is in a growth trend, and labor's relative share is expected to stop declining[7].

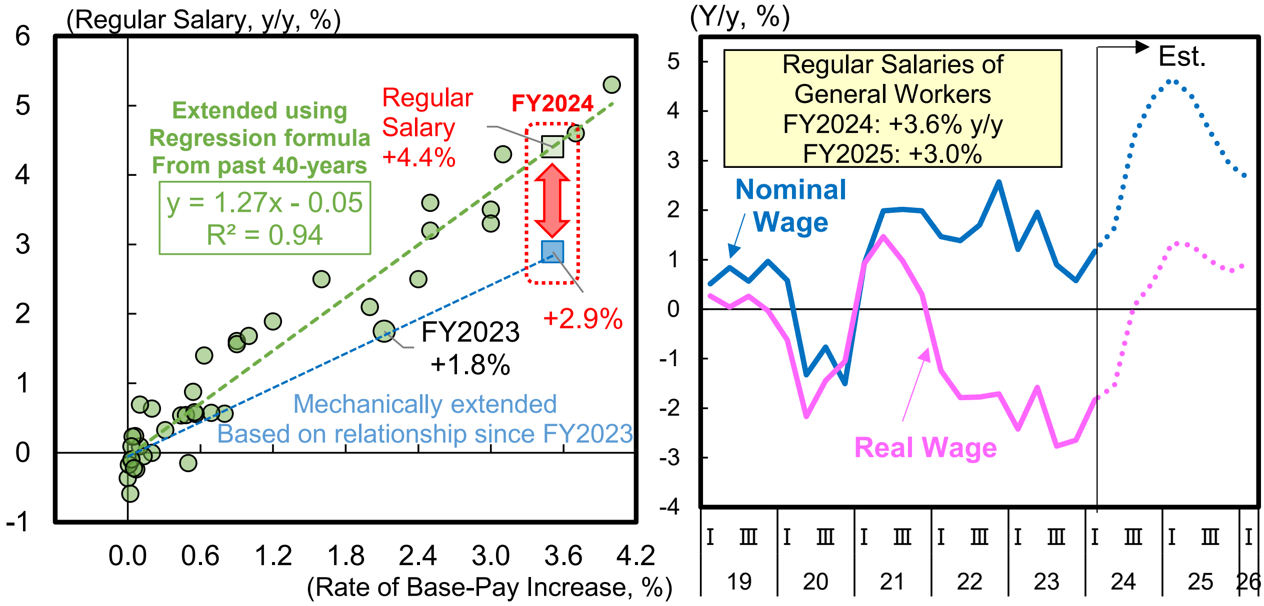
Regular wages to grow to the middle of the 3% level on a y/y basis, while real wages in the Jul-Sep period of 2024 leaning in a positive direction

In thinking about the influence of wage hikes in the 2024 spring labor negotiations on the rate of increases in wages in macro terms, it is necessary to take a look at the increase in base-pay excluding the regular salary increase. Generally speaking, the regular salary increase refers to the fixed amount that salaries are raised annually following the wage curve based on seniority. Therefore, if the composition of the workforce by age and length of service remains constant, the total amount of salaries paid by a company will not increase even if regular salary increases are implemented. In contrast, the base-pay increase raises the entire wage curve upward. It increases the total amount of salaries paid by the company and directly boosts macro wages.

In fact, the practice of base-pay increases has contributed greatly to growth in wages for general workers (full-time workers). Chart 6 left is a scatter diagram which plots the rate of base-pay increases over the last 40 years (1984-2023) and y/y growth in regular salaries of general workers on a graph. In order to find the rate of base-pay increases until FY2014, we referred to the Ministry of Health, Labour and Welfare's "Comprehensive Survey on Wages," while from FY2015, we used figures compiled by Japanese Trade Union Confederation. Meanwhile, for y/y growth in regular wages until FY1993, we performed our own calculations based on the Ministry of Health, Labour and Welfare's "Basic Survey on Wage Structure," and "Monthly Labour Survey" from FY1994.

[7] For details, see the DIR report dated 2024 May 22, *"Japan's Economic Outlook No. 221"* (Japanese only) , Chapter 3.

Rate of Base-Pay Increase and Growth Rate of Regular Salaries of General Workers (Left), Outlook for Per Capita Employee Compensation (Right) **Chart 6**



Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, Cabinet Office, Japanese Trade Union Confederation; compiled by DIR.

Note: On the left side of the chart, the rate of base-pay increases before 2014 are from the Ministry of Health, Labour and Welfare's "Comprehensive Survey on Wages," while after 2015, we used figures compiled by Japanese Trade Union Confederation. Meanwhile, for y/y growth in regular wages before FY1993, we performed our own calculations based on the Ministry of Health, Labour and Welfare's "Basic Survey on Wage Structure," and "Monthly Labor Survey" after 1994. The dotted lines shown in the chart at right are estimated values produced by DIR.

The rate of increase in base-pay in the 2024 spring labor negotiations was 3.57% according to the results of the fifth aggregated result of companies' responses released by Japanese Trade Union Confederation, and possibilities are high that the final figure will be around 3.5%. When this figure is extended using a regression formula covering the most recent period of forty years, we see that the rate of increase in regular salaries of general workers has accelerated significantly to +4.4% in FY2024 in comparison to +1.8% in FY2023.

However, the FY2023 result falls below the regression line. This indicates that small and medium-sized enterprises (SMEs), which are not included in the Japanese Trade Union Confederation figures, were cautious about implementing an increase in base-pay. If we mechanically extend these figures based on the ratio of the rate of increase in base-pay in FY2023 and the rate of increase in regular salaries in that same year, we find that regular salaries are up by +2.9% in FY2024. Most recently, while cyclical growth of wages and prices cannot be said to have reached a sufficient level, price pass-through is progressing more smoothly, and considering the fact that the tendency to raise base-pay has spread to SMEs, the growth rate in regular salaries in FY2024 is expected to fall somewhere between the above two cases. Our estimate of y/y growth falling around the middle of the 3% level is a ballpark figure falling between the two estimated figures of +4.4% and +2.9% described above.

Our outlook for regular salaries of general workers in FY2024 is +3.6% y/y. Furthermore, growth is expected to remain high at +3.0% in FY2025. The decline in the growth rate of prices is expected to be a negative factor for the rate of increase in wages, but as was argued in our previous outlook, competition amongst corporations for human resources is becoming increasingly severe with expectations that population decline will continue into the mid to long-term. We expect real wages (real per capita employee compensation) to move along the lines shown in Chart 6 right, reflecting the outlook for growth rate in prices as indicated in the following chapter. Real wages are expected to shift into the positive direction on a y/y basis during the Jul-Sep period of 2024, and then maintain a growth rate of around +1%, equivalent to the level of labor productivity in recent years.

3. Outlook for Prices and Monetary Policy

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

On an all items basis, less fresh food, core CPI is projected to increase by +3.1% y/y in FY2024, and +2.4% in FY2025 assuming recent resource prices and exchange rates (Chart 7). On an all items basis, less fresh food and energy, which easily reflects the underlying tone of prices (new core-core CPI), the forecast is +2.2% in both FY2024 and FY2025.

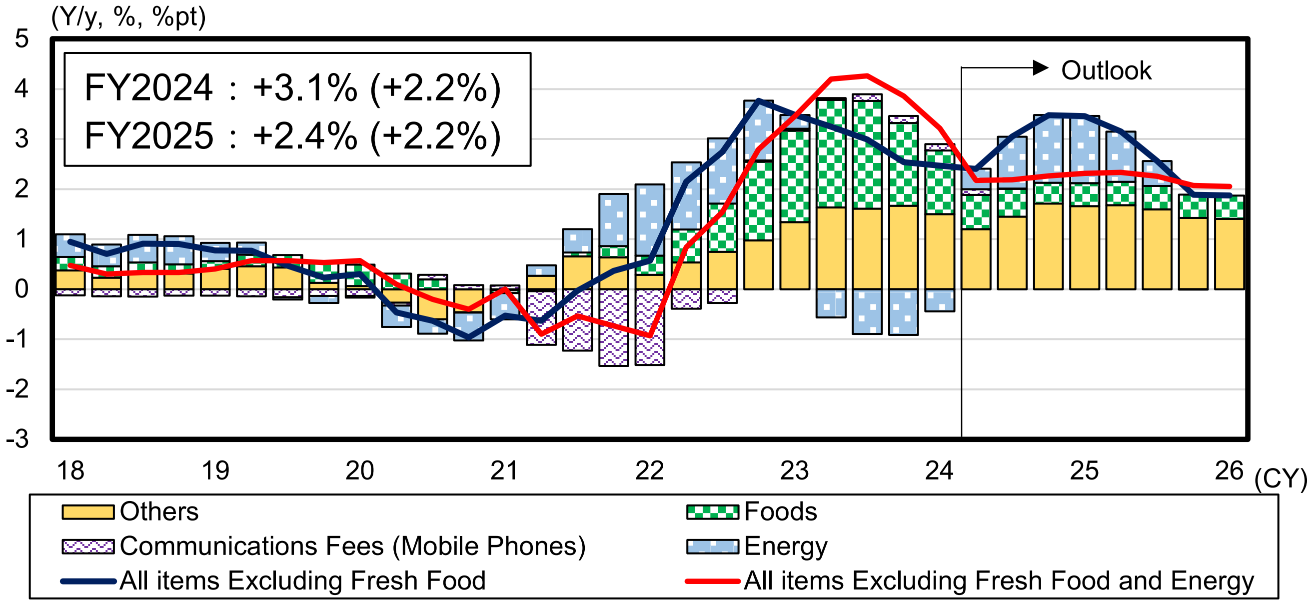
The sharp rise in import prices has run its course, and growth in intermediate input costs (the first force[8] according to the BOJ), which was the major cause of the rise in prices, is expected to gradually slow. The pace of the slowdown is expected to pick up during the first half of FY2024, and the “Others” category as shown in Chart 7, which illustrates the underlying tone of prices, is expected to see a decline in growth rate. On the other hand, corporate efforts to implement price pass-through (called the second force by the BOJ) as a means of dealing with increased personnel costs associated with the major wage hikes in the spring labor negotiations, will likely spread further than was experienced in 2023. The second force is expected to strengthen beginning in the middle of FY2024, and the underlying inflation rate will likely rise.

As for energy, the fuel subsidy program to curb extreme price increases (also known as the gasoline subsidy) has been extended. However, its expiration date was undecided at the time this report was being written. While the growth rate in core CPI will continue to be held down during the period it is in effect, a reactionary effect is expected during the year following its expiration when it will become a factor influencing an increase in core CPI. Along with this, the subsidy program to curb extreme price increases in electricity and gas utilities will also reach the end of its effective period at the end of May 2024, and this too is likely to experience a reactionary effect. Furthermore, prices will also likely be forced upwards by the FY2024 rise in the unit price of the charge for promoting renewable energy generation.

Cyclical growth in wages and prices will become established in FY2025, and new core-core CPI is expected to experience stable growth of around +2% y/y.

[8] Speech by Governor UEDA in Osaka (Japan's Economy and Monetary Policy) : Bank of Japan (boj.or.jp)

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 September 2024.

BOJ expected to raise interest rates gradually, while maintaining an accommodative financial environment

We expect the BOJ to implement additional interest rate hikes at a gradual pace, while closely monitoring the economic and price situation. According to our main scenario, the short-term interest rate is expected to be raised to 0.25% in the Oct-Dec 2024 period, followed by additional rate hikes at a pace of 0.25% twice a year, totaling 0.50% annually in 2025 and beyond (Chart 8).

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[9]. 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.

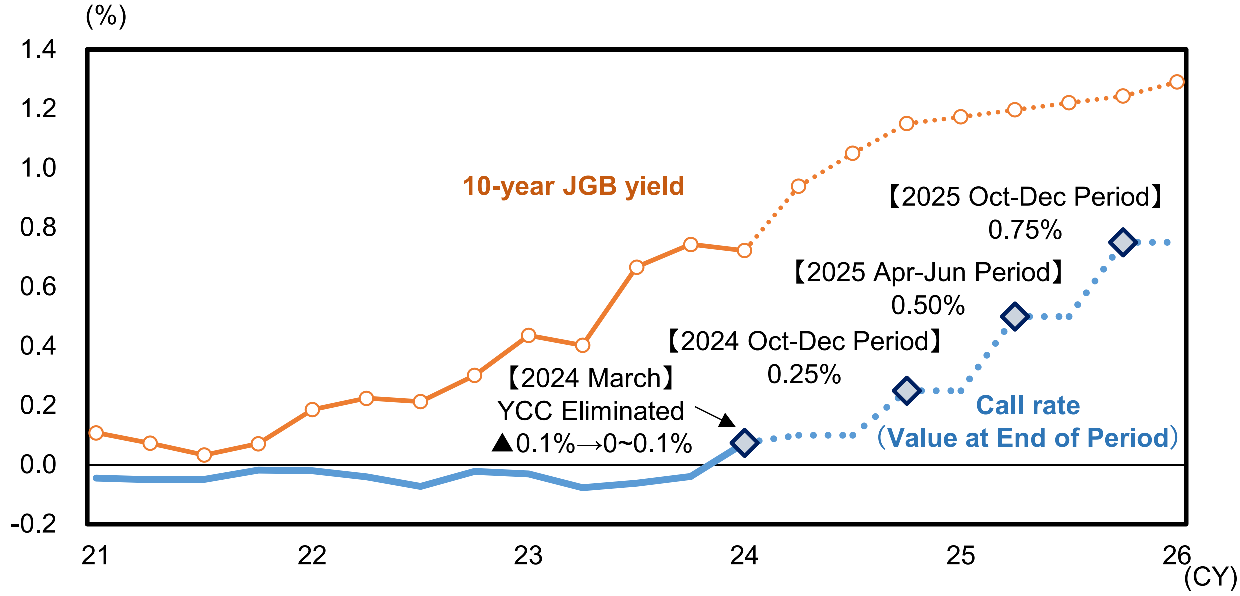
We expect the yield on the 10-year JGB (long-term interest rate) to rise to around 1.20% in the final stage of the forecast period (Chart 8). The BOJ's interest rate hikes will be a factor in pushing up long-term interest rates. On the other hand, we assume that the Fed will start cutting interest rates in the US in the Jul-Sep period of 2024. US long-term interest rates are expected to decline gradually, which will put downward pressure on Japanese long-term interest rates.

For the time being, the main risk associated with operating Japan’s monetary policy will be a high inflation rate due to the progressively weak yen. If this risk is actualized, one of the methods that the BOJ can use is to slow the pace of government bond purchases or reduce the amount of purchase. This would cause the long-term interest rate to rise. It is known that the exchange rate is closely linked to the differential between the long-term interest rates in the US and Japan rather than the short-term rates. In addition, the influence of long-term interest rate hikes on the economy is comparatively lower than that of short-term interest rates[10]. For these reasons, rather than raising short-term interest rates, encouraging

[9] For details see the DIR report dated 11 March 2024, *Japan’s Economic Outlook No. 220 (Update),* (Japanese only).
[10] For details see the DIR report dated 8 December 2023, *Japan’s Economic Outlook No. 219 (Update),* (Japanese only).

long-term interest rates to rise would effectively ease the pressure on the yen's depreciation while limiting the negative impact on the economy.

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



Source: Ministry of Finance, Bank of Japan; compiled by DIR.
Note: The long-term interest rate is a period average, while the short-term interest rate is the value as of the end of the period.

Japan's Economic Outlook No. 221 (May 22, 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	563.1	558.0	558.0	555.3	559.1	563.0	566.1	568.2	570.0	571.6	573.0	574.5	558.8	564.3	572.5
	Q/q %	1.0	-0.9	0.0	-0.5	0.7	0.7	0.5	0.4	0.3	0.3	0.3	0.3			
	Q/q %; annualized	4.1	-3.6	0.0	-2.0	2.8	2.8	2.2	1.5	1.3	1.1	1.0	1.0			
	Y/y %	2.3	1.6	1.2	-0.2	-0.7	0.9	1.5	2.3	1.9	1.5	1.2	1.1	1.2	1.0	1.4
														1.9	0.4	1.7
Private Consumption	Q/q %	-0.7	-0.3	-0.4	-0.7	0.9	0.9	0.7	0.5	0.3	0.2	0.2	0.2	-0.6	1.2	1.4
Private Residential Investment	Q/q %	1.8	-0.9	-1.4	-2.5	0.0	-0.1	-0.3	-0.5	-0.6	-0.6	-0.7	-0.7	0.6	-3.1	-2.1
Private Non-Resi. Investment	Q/q %	-1.7	-0.2	1.8	-0.8	0.8	0.7	0.6	0.5	0.5	0.6	0.6	0.7	0.4	2.0	2.3
Government Consumption	Q/q %	-0.1	0.3	-0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.5	0.6	0.8
Public investment	Q/q %	2.2	-0.3	-0.2	3.1	-1.6	0.1	0.2	0.2	0.2	0.2	0.2	0.2	4.1	0.8	1.0
Exports	Q/q %	3.8	0.3	2.8	-5.0	2.8	1.6	1.1	0.6	0.7	0.6	0.5	0.4	3.0	2.3	2.9
Imports	Q/q %	-3.6	0.9	1.8	-3.4	2.2	1.2	0.9	0.6	0.6	0.5	0.4	0.3	-3.3	2.2	2.3
Nominal GDP	Q/q %; annualized	10.7	-0.6	2.7	0.4	4.4	5.3	4.5	3.5	3.1	2.6	2.3	2.0	5.3	3.2	3.2
GDP deflator	Y/y	3.7	5.2	3.9	3.6	2.5	2.2	2.2	2.0	2.1	1.9	1.6	1.4	4.1	2.2	1.7
Industrial production	Q/q	1.2	-1.4	1.1	-5.1	4.0	1.6	1.0	0.4	0.3	0.4	0.5	0.5	-1.9	1.9	2.1
Core CPI	Y/y	3.2	3.0	2.5	2.5	2.4	3.0	3.5	3.5	3.2	2.6	1.9	1.9	2.8	3.1	2.4
Unemployment rate	%	2.6	2.6	2.5	2.5	2.5	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	-0.1	-0.1	-0.0	0.1	0.1	0.1	0.3	0.3	0.5	0.5	0.8	0.8	0.1	0.3	0.8
Current account balance	Y tril; annualized	0.4	0.7	0.7	0.7	0.9	1.1	1.2	1.2	1.2	1.2	1.2	1.3	0.6	1.1	1.2
Major assumptions																
Crude oil price (WTI futures)	$/bbl	73.6	82.2	78.5	76.9	81.2	79.8	79.8	79.8	79.8	79.8	79.8	79.8	77.8	80.1	79.8
Exchange rate	Yen/$	137.4	144.5	147.9	148.5	155.2	156.3	156.3	156.3	156.3	156.3	156.3	156.3	144.6	156.0	156.3

Source: Compiled by DIR.

Note: Shaded areas are DIR estimates. The price of crude oil and the exchange rate are assumed to be fixed at recent levels.