6 Sep 2024 (No. of pages:14)

Japanese report: 22 Aug 2024

Japan’s Economy: Monthly Outlook (Aug 2024)

Economic Outlook Revised: Moderate Recovery Seen, Centering on Domestic Demand

Economic Research Dept.
Keiji Kanda
Shotaro Kugo
Munehisa Tamura
Kazuma Kishikawa
Kanako Nakamura

Summary

- In light of the announcement of the Apr-Jun 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 +0.9% in FY2024, and +1.3% in FY2025 (on a calendar year basis we expect +0.1% in 2024 and +1.6% in 2025).

- We expect real wages to continue growing during the 2024 Jul-Sep period and beyond due to wage hikes continuing at a high level as a result of the 2024 spring wage negotiations. We also expect the underlying inflation rate to stabilize at around 2% due to the cycle of wage increases and price pass-through. 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. However, vigilance is necessary regarding downside risk in the overseas economy and the possibility of appreciation of the yen.

- We assume that the Bank of Japan (BOJ) will raise the short-term interest rate to 0.50% in the Jan-Mar 2025 period, followed by additional rate hikes at a pace of once every six months, 0.25%pt at a time, while closely monitoring economic and price conditions. However, an accommodative monetary environment will likely be maintained, with real short-term interest rates remaining in negative territory throughout the forecast period. We expect the influence of reductions in the amount of government bond purchases by the BOJ on the long-term interest rate to be limited for the time being.

1. Moderate Recovery Seen, Centering on Domestic Demand, but Caution Required Regarding Worsening External Environment

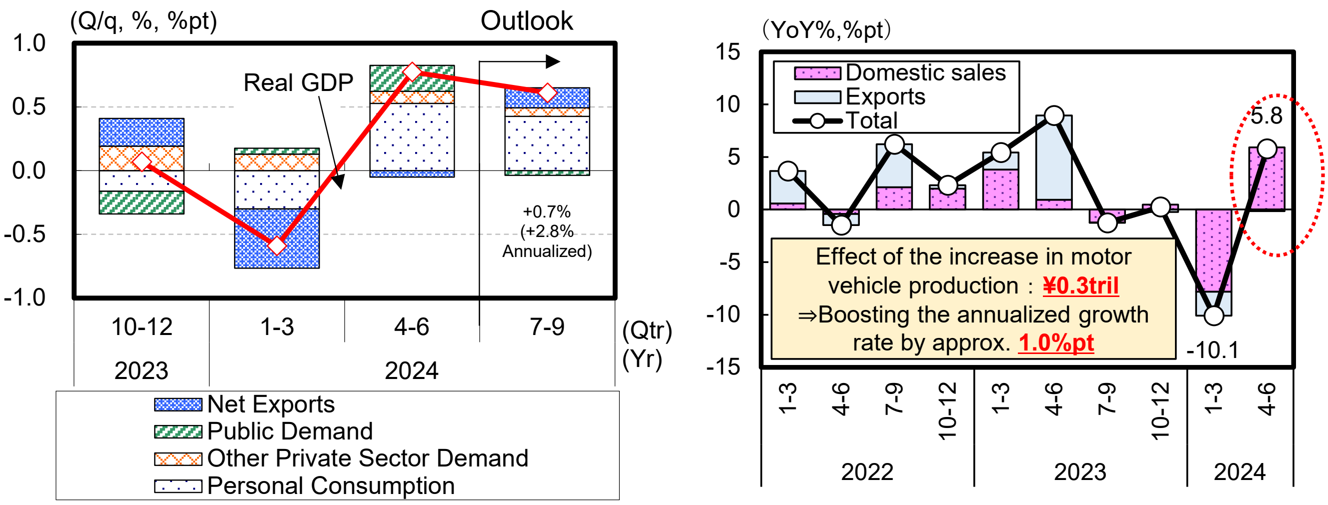
After three quarters of stagnation, Japan's economy may have entered a recovery phase in the Apr-Jun period

The real GDP growth rate for Apr-Jun 2024 (1st preliminary est) was at +3.1% q/q annualized (+0.8% q/q)[1] (Chart 1, left side).

During the Jan-Mar period, the main factor leading to negative growth in Japan's real GDP was production cuts by certain motor vehicle manufacturers due to the authentication fraud issue. During the Apr-Jun period, progress was made in the normalization of production, boosting private consumption, capex, and exports. Multiplying the increase in motor vehicle sales and exports by the average unit price while at the same time taking into account the impact of increased imports of parts and other items, we estimate that the increase in motor vehicle production boosted real GDP by about 0.3 tril yen in the Apr-Jun period (boosting the annualized growth rate by about 1.0%pt y/y, Chart 1, right). The effects of the 2024 Noto Peninsula Earthquake having settled down are also believed to have contributed to positive growth in the Apr-Jun period.

Looking at performance by demand component in the Apr-Jun period (Chart 1), in the area of private sector demand, all categories achieved growth in comparison to the previous period except for private sector inventories. As for public sector demand, government consumption and public investment both achieved growth. Meanwhile, in the area of overseas demand, both exports and imports grew, but since the growth in exports was below that of imports, net exports registered a slightly negative margin.

Real GDP Growth Rate Results & Outlook (Left); Economic Effects of Recovery in Motor Vehicle Production（Right） **Chart 1**



Source: Cabinet Office, Ministry of Finance, Japan Automobile Dealers Association, Japan Mini Vehicle Association; compiled by DIR.
Notes: Figures in the left side chart are seasonally adjusted. The right side chart is the sum of domestic sales (excluding imports) and exports, seasonally adjusted by DIR. The economic impact of increased motor vehicle production in the Apr-Jun period of 2024 is calculated by multiplying the increase from the previous period by the average price and deducting the portion of imported intermediate goods.

Private consumption grew for the first time in five quarters. The income environment, which is seen as having been the major factor behind the continued declines in consumption, has improved, with per capita real employee compensation growing by +0.8%. This represents an acceleration of growth in comparison to recent plateau periods, including the Oct-Dec period of 2023 (+0.1%) and the Jan-Mar period of 2024 (+0.0%). It appears that the effects of major wage hikes of the 2024 spring labor

[1] See the DIR report by Keiji Kanda and Munehisa Tamura dated 15 Aug 2024, *Apr-Jun 2024 1st Preliminary GDP Estimate.*

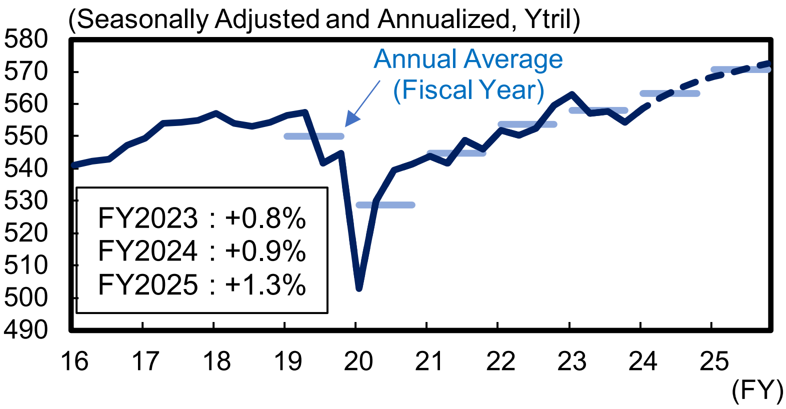
negotiations have become manifest. The Flat-amount Cut of Personal Income Tax and Personal Residence Tax which began in June may also have boosted consumption.

Until the Jan-Mar period of 2024, Japan's economy had been stagnant for three quarters, but appears to have entered a recovery phase as of the Apr-Jun period. Our outlook for the real GDP growth rate in the Jul-Sep period of 2024 sees continued recovery for private sector demand, with a second consecutive quarter of positive growth seen at +2.4% q/q annualized (+0.6% q/q) (Chart 1, Left).

Outlook for real GDP growth rate revised, with +0.9% expected in FY2024, and +1.3% in FY2025

Chart 2 illustrates our main scenario for the trend in real GDP, based on our outlook for overseas economies. Our latest outlook for overseas economies dated August 21 is 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 :	+2.6%
	2025 :	+1.9%
Eurozone	2023 :	+0.5%
	2024 :	+0.8%
	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.

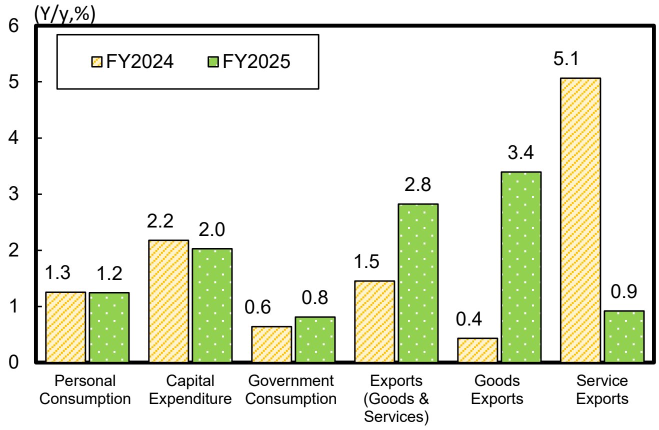
Based on the above overseas economic outlook, Japan's real GDP growth rate according to our main scenario is expected to be +0.9% in FY2024, and +1.3% in FY2025 (+0.1% in 2024 and +1.6% in 2025 on a calendar year basis).

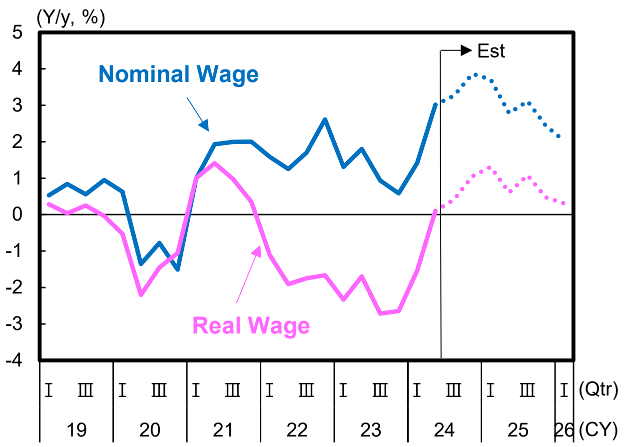
The outlook for the FY2024 growth rate remains unchanged from our recent report of June 10, 2024 (*Japan's Economic Outlook No. 221 Update* (Japanese only, hereafter "our previous outlook")). This was due to the fact that with the retroactive revision of the Quick Estimate of Construction Investment on July 1, the amount of carryover (real GDP growth rate that can be achieved with zero q/q growth in each quarter) was reduced, while in addition, personal consumption, capital expenditure, and public investment were revised upwards based on recent developments. Meanwhile, the outlook for FY2025 was revised downwards by 0.2%pt in comparison to our previous outlook. This was based on the assumption that there would be a reactionary decline in some demand components which were revised upwards in FY2024. 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 on the left side of Chart 3. Personal consumption, discussed in detail in Chapter 2, is expected to continue to achieve moderate growth, backed by an improving income environment due to major wage hikes in the 2024 spring labor negotiations, and the withdrawal of household savings, which are at a high level.

Real per capita employee compensation, which corresponds to real wages in the GDP statistics, shifted into positive territory on a q/q basis during the 2024 Apr-Jun period, and is expected to continue to maintain positive growth in the future (Chart 3, Right). In addition, the Flat-amount Cut of Personal Income Tax and Personal Residence Tax that has been in effect since June and pent-up demand for motor vehicles are expected to provide underlying support for demand and consumption for the time being (Chart 4). It is estimated that the Flat-amount Cut of Personal Income Tax and Personal Residence Tax will boost personal consumption by around 0.3-0.7 tril yen (taking into consideration induced imports, contribution in GDP terms would be around 0.2-0.5 tril yen)[2]. The consumption stimulation effect seems quite small compared to the 3.3 tril yen tax reduction, however, the tax reduction is concentrated in June and July, so the effect is expected to appear mostly in the Jul-Sep period. (A reactionary decline is expected to occur in the Oct-Dec period or later.)

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.

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. The growth rate is expected to increase from FY2024 through FY2025, but much of this is due to carryover as was explained earlier. Hence on a four-quarter basis, we expect a general slowdown in the growth rate starting in FY2024. As for services exports, in addition to growth in inbound consumption centering on FY2024, business services are also expected to provide underlying support for the growth trend.

[2] For details, see *Japan's Economy: Monthly Outlook (June 2024)* (Japanese only).

2. Key Points in the Future of Japan's Economy, and Outlook for Real Wages

(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. The outlook for prices and the Bank of Japan (BOJ) 's monetary policy are covered in chapter 3.

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 other factors

⇒**Real wages are expected to continue rising during the Jul-Sep period of 2024 and beyond**. **Although the rate of wage hikes will decline in the spring labor negotiations in FY2025**, a high level of growth is still expected to be maintained at **4.2%** (based on the aggregated result level released by Japanese Trade Union Confederation). In addition to the resumption/extension of the flat tax cut and the high energy price measures, **the child allowance will also be enhanced** from the October payment of 2024.

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

⇒Pent-up demand was at **240,000 units (0.6 tril yen) as of end July 2024, and recovery production is expected to continue through around Fall 2024**. The increase in real wages will ease the decline in production levels after recovery production ends.

○Growth in inbound demand

⇒With the **full recovery in the number of Chinese tourists visiting Japan**, the number of visitors arrivals to Japan (25,070,000 in 2023) is expected to grow to **36,000,000 in 2024 and 40,000,000 in 2025**. Our outlook for inbound demand has been revised downwards in light of sluggish growth in the number of foreign visitors to Japan other than Chinese, and the recent appreciation of the yen.

○High level of household savings

⇒**Since the end of December 2021,** just after the decline in real wages, household financial assets have grown by **+157 tril yen as of the end of March 2024** (+134 tril yen on a net basis excluding liabilities). A negative wealth effect could be triggered with the recent volatility of the stock market if a correction in stock prices occurs, and this could bring downward pressure on consumption of savings that have been built up.

○Recovery of the silicon cycle

⇒**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

○Downturn in US economy due to long-term monetary tightening

⇒**If holding down the increase in wages and prices is insufficient despite the worsening of the employment situation, interest rate cuts may not move forward**, and if monetary tightening moves into the long-term, it could lead to recession. If stock prices fall, **the US real GDP could worsen, falling to nearly 2%.**

○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.

○Rapid Appreciation of the Yen

⇒**The effect on Japan's real GDP** if the yen appreciates by 10 yen to the dollar (on an annual basis) **would be around -0.2%**. As the monetary policies of the US and Japan become clearer, **purchasing power parity (around 90-120 yen/dlr)** would also become more noticeable.

○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 -0.7%.**

○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**.

Source: Various Sources; compiled by DIR.

Supporting factors and boosts to economy

As was the case in our previous outlook, 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 other factors, 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.

Per capita real employee compensation grew by +0.3% y/y in the Apr-Jun period of 2024. Though modest, this represented the first time in ten quarters that this statistic has registered growth. Until now, our outlook had seen the shift into positive territory as occurring in the Jul-Sep period, but special cash earnings grew more than expected, and the shift occurred earlier than previously forecast. Positive growth is expected to continue in the future, with annual growth of around +1% seen through FY2025[3], a growth rate that corresponds to that of labor productivity (Chart 3, Right – real wages expected to shift into positive territory on a quarterly basis during the Jul-Sep period of 2024 according to the Ministry of Health, Labour and Welfare's "Monthly Labour Survey").

One of the assumptions behind this outlook is the fact that base-pay increases on scheduled cash earnings are to be implemented mostly by small to medium enterprises during the summer of 2024 (covered in more detail later in this report), and while the rate of wage hikes will decline in the spring labor negotiations in 2025 compared to the previous year, wage hikes are still expected to exceed 4%, and price highs are expected to settle down. Meanwhile, government policy will also contribute to the improving income environment. In addition to the Flat-amount Cut of Personal Income Tax and Personal Residence Tax and the resumption/extension of high energy price measures[4], the child allowance will also be enhanced from the October payment of 2024[5] (this will show up in salaries in December of the same year).

As was discussed earlier in this report, normalization of motor vehicle production has progressed, but order backlog seems to be still at a high level. Pent-up demand for motor vehicles, which emerged due to the inability of production to keep up with demand, is estimated at approximately 240,000 units (or around 0.6 tril yen as of end July 2024)[6]. Recovery production in motor vehicles to eliminate order backlog is expected to continue through the fall of 2024. Production levels are expected to decline once recovery production has ended, but the increase in wages is expected to boost demand for motor vehicles and ease the decline in production somewhat.

The number of Chinese tourists visiting Japan has recently been at a low level, down 25% as of June 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[7], growth continued all during the same year on a month-to-month basis starting in February (growth has averaged around +8% m/m from April to June of 2024, seasonally adjusted by DIR). Growth in the number of visitors to Japan centering on Chinese tourists is expected to continue in the future, with the number of foreign tourists visiting Japan expected to reach around 36,000,000 in 2024 (real consumption amount of 6.4 tril yen) in comparison

[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 +0.8% annualized from the Jan-Mar period of 2022 to the Jan-Mar period of 2024.
[4] Subsidies for electricity and gas, which ended in May 2024 (on amounts used), will be implemented from August to October as "Emergency Assistance for Overcoming Severe Summer Heat," (originally in Japanese; translated by DIR.) and the fuel subsidy program to curb extreme price increases (gasoline subsidy) will continue only within the same year.
[5] 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.
[6] 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).
[7] 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.

to 25,070,000 in 2023 (real consumption amount of 4.5 tril yen), and then to grow to around 40,000,000 in 2025 (real consumption amount of 6.5 tril yen). At this time, the number of foreign tourists visiting Japan other than Chinese tourists is sluggish. Yen appreciation has also progressed since the beginning of July 2024 through the beginning of August. For this reason, we have revised our outlook for inbound demand downwards in comparison to our previous outlook.

The high level of household savings is expected to continue providing underlying support for personal consumption. Since the end of December 2021, just after the decline in real wages, household financial assets have grown by +157 tril yen as of the end of March 2024, reaching 2,199 tril yen (+134 tril yen on a net basis excluding liabilities, totaling 1,808 tril yen). On the other hand, although stock prices have recently been at a high level, they have become unstable as evidenced by the largest-ever decline in the Nikkei Stock Average on August 5. If stock prices adjust sharply, it will put downward pressure on personal consumption through a negative wealth 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. The index of industrial production for electronic parts and devices shifted into decline on y/y basis in June 2024, but averaged with the first half of the year it is actually moving toward a growth trend reflecting the recovery of the silicon cycle. 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, and considering the fact that the silicon cycle tends to last around four years, having entered a recovery phase in 2024 it should continue to recover in 2025, boosting 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, progressive appreciation of the yen, growing tensions in the Middle East and Ukraine, emergence of China's excessive debt problem, and intensification of US-China conflict (emergence of economic security risks, etc.).

Of these, US monetary tightening continuing into the long-term causing economic deterioration, and progressive appreciation of the yen are covered in detail in Chapter 3 of our current outlook of 2024 August 21, *"Japan's Economic Outlook No. 222"* (Japanese only, hereafter "our current outlook"). If a US recession and yen appreciation of 10 yen to the dollar were to occur simultaneously, Japan's FY2024 real GDP growth rate is estimated to decline by 0.9%pt. Meanwhile, Trump winning the US presidential election (known as "Trump risk"), which was taken into consideration in our previous outlook, could mean the manifestation of higher tariffs and stricter immigration controls based on former President Trump's own statements. According to our estimates, this would cause a maximum 3.40% decline in the US GDP and push the inflation rate up by 2.75%pt. Other risk factors are covered in our previous outlook of 2024 Mar 11, "Japan's Economic Outlook No. 220 (Update)" (Japanese only).

(2) Factors Behind Increase in Real Wages, and Outlook for Future

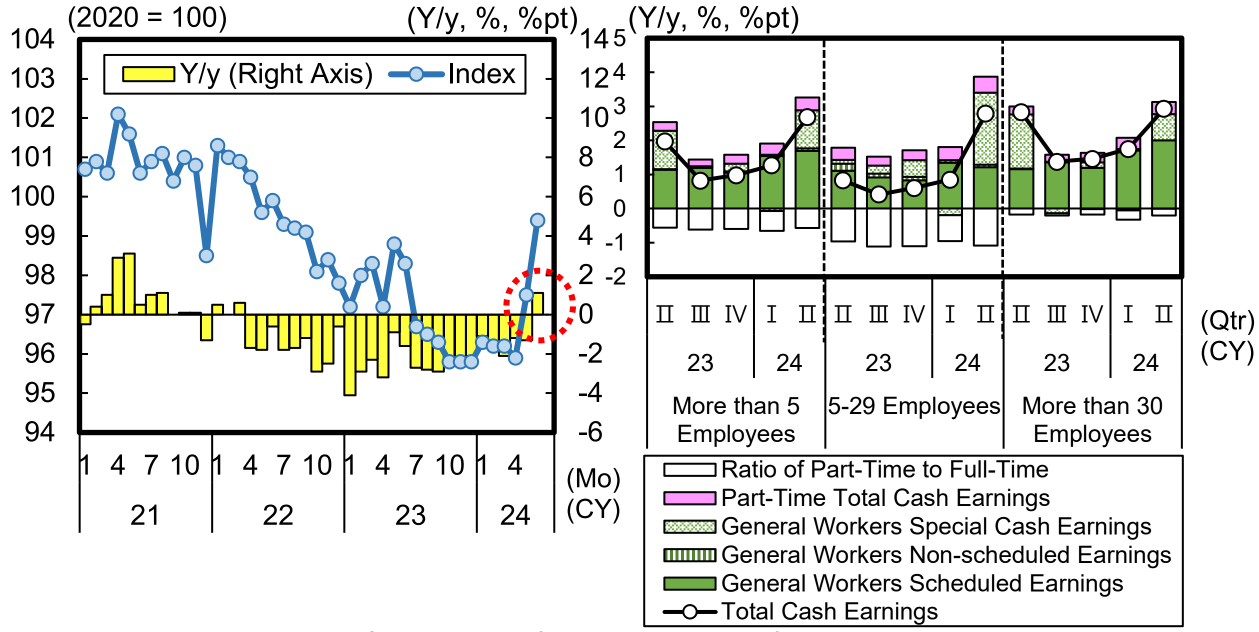
Real wages shift into positive growth on y/y basis in June 2024 due to major wage hikes and increases in bonus pay

As was mentioned previously, the income environment has been improving recently. According to the Ministry of Health, Labour and Welfare's "Monthly Labour Survey," real wages grew by +1.1% y/y (preliminary figures) in June 2024, shifting into positive territory for the first time in 27 months (Chart 5, Left). Meanwhile, looking at the seasonally adjusted figures, we see that real wages were in a declining trend from the beginning of 2022, but then stopped declining in the fall of 2023. Until spring of 2024 they were marking time. Then major growth of two consecutive months has continued since May.

Behind these developments are the increase in basic salaries associated with the major wage hikes of the 2023 and 2024 spring wage negotiations, and high bonus pay during the summer of 2024. Looking at a factor analysis of total cash earnings (in nominal terms) in comparison to the previous year seen from a macro viewpoint (companies with five or more employees), we see that in addition to the trend of an increasing contribution to this figure from regular salaries of general workers including regular employees, the increase in special cash earnings including bonus pay during the Apr-Jun period of 2024 provided a major boost to the overall result (Chart 5, Right). Meanwhile, in terms of contribution to wage growth from growth in scheduled cash earnings of general workers, companies with thirty or more employees made a larger contribution than companies with 5-29 employees. This is interpreted as being a reflection of the fact that the larger the company, the higher the rate of wage hikes in the spring labor negotiations of 2023 and 2024 tended to be.

On the other hand, it was small businesses that recorded especially large growth in special cash earnings during the Apr-Jun period of 2024. In comparison to the +4.5% y/y growth in special cash earnings of general workers recorded by companies with thirty or more employees, those with 5-29 employees achieved major growth of +19.5%. It is assumed that in many cases, small businesses handled the question of improving compensation by increasing lump-sum payments such as bonuses, while holding down raises in basic salaries which would lead to an increase in fixed expenses[8].

Level of Real Wages & Y/Y Comparison (Left); Change in Total Cash Earnings & Factor Analysis **Chart 5**



Source: Ministry of Health, Labour and Welfare; compiled by DIR.
Note: Index figures in the left side chart are seasonally adjusted. The chart on the right covers companies with five or more employees.

Wage hikes of over 4% expected in 2025 spring labor negotiations in addition to major increase in public servant salaries and minimum wage

Real wages and real per capita employee compensation are expected to continue moderate growth after the effects of the high level of special cash earnings have worn off. An additional positive factor here is the implementation of major wage hikes affecting the salaries of public servants. The National Personnel Authority recommended a revision in salaries as of FY2024 and recommended a monthly average increase of 2.76% in the monthly salaries of general office workers in the national civil service to the

[8] This may be the inside story behind the previous year’s poor performance in terms of payments.

Cabinet and the Diet. This is the first time in 32 years for a raise to exceed the level of 2%. Before the raise is reflected in actual salaries it will be necessary to wait for a revision of the law. Meanwhile, the recommendation of the National Personnel Authority will also be referred to in revising the wages of civil servants working for local governments. Expectations are high for future wage increases for local public servants.

In addition, a major increase in the minimum wage, which directly impacts the wages of part-time workers, is expected in October. On July 25, the Central Minimum Wages Council reported that the minimum wage increase for FY2024 will be 50 yen nationwide uniformly (converted to the national weighted average increase rate of 5.0%) (Chart 6, Left)[9]. Based on the reports of local minimum wages councils in 45 prefectures known at the time of this writing (August 22), we estimate that the increase will be a nationally weighted average of about 51 yen (about 5.1% rate of increase). More than half of the regions exceeded the standard amount, including Ehime Prefecture, which reported an increase of 59 yen.

Aggressive wage increases are expected to continue in the 2025 spring wage negotiations. According to the 7th (final) aggregated result of responses released by the Japanese Trade Union Confederation (RENGO) on July 3, the rate of wage increases in the 2024 spring labor negotiations (including regular salary increases) was a weighted average of 5.10%, the highest level it has reached in 33 years. Based on an estimation formula with explanatory variables including corporate earnings, labor supply and demand, the growth rate in prices, and other factors, the rate of wage hikes in the 2025 spring labor negotiations (converted to the RENGO aggregate result,including regular salary increases) is estimated to be at around 4.2% (Chart 6, Right). Although this represents a decline in comparison to 2024 due to the slowdown in the growth rate in prices and corporate earnings, it still maintains at the 4% level, which exceeds that of 2023.

The number of employed persons has continued to grow despite the decrease in population, due to progress in work force participation on the part of women and the elderly in the 2010s. However, the margin for growth in these demographics has shrunk significantly[10]. In recent years the job change market has become more active, and competition for human resources has intensified. Corporate actions to prevent employees from leaving, such as improving working conditions, have become more prominent[11]. The aggressive wage hikes in the spring wage negotiations can also be seen as another aspect of this corporate strategy. According to a recent population projection (medium-fertility (medium-mortality) projection) published by the National Institute of Population and Social Security Research, the working age population between ages 15-64 is expected to decline by nearly 30% over the next thirty years, and the labor shortage is likely to become more serious. Hence, the number of firms engaging in substantial wage increases and other measures to secure human resources is expected to grow in the future.

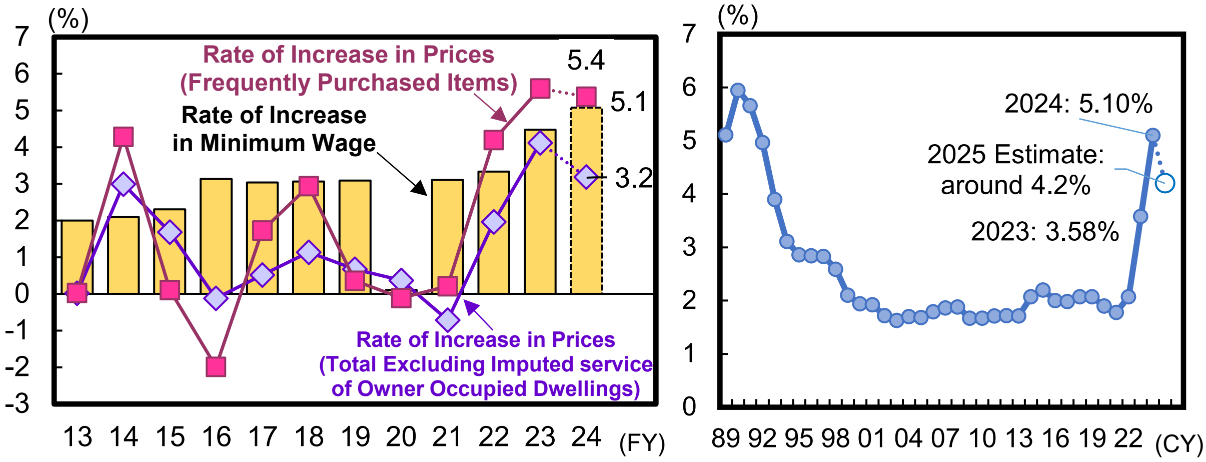
---

[9] The minimum wage is revised by comprehensively taking into account the living expenses of workers, wages of workers, and the ordinary enterprises' ability to pay the wages (the three factors required to be taken into account by Article 9, Paragraph 2 of the Minimum Wage Act). In FY2024, particular emphasis was placed on the living expenses of workers. The Central Minimum Wages Council reported the need for a substantial increase in the minimum wage in order to maintain the purchasing power of low-wage workers, given that the rate of price increases remains high and the rate of price increases for frequently purchased items, including daily necessities, exceeds 5% from the previous year. For details, see “Report of the Subcommittee on Guidelines of the Central Minimum Wages Council,” (Material from the 69th Central Minimum Wages Council, July 25, 2024) (Japanese only).

[10] For details, see the Daiwa report dated 18 March 2024 by Munehisa Tamura, entitled “The Shrinking Margin of Growth in Labor Supply” (Japanese only).

[11] For details, see “Japan’s Economy: Monthly Outlook (March 2024)” (Japanese only). In addition, The Cabinet Office's “Annual Report on the Japanese Economy and Public Finance 2024” (August 2024) also points out that the number of companies that are working to improve employee compensation to cope with labor shortages has increased significantly in recent years.

Rates of Increase in Minimum Wage & Prices (Left), Outlook for Rate of Increase in Wages in 2025 Spring Wage Negotiations (Right) **Chart 6**



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

Notes: 1) The rate of increase in prices shown in the left side chart is the annual average of each year through September (FY2024 figures are the average of prices between October 2023 and June 2024). The rate of increase in minimum wage for FY2024 was estimated assuming that the increase in areas where a report has not been issued as of August 22 will follow the average increase by rank in areas where a report has already been issued.

2) The chart on the right shows the results of responses gathered based on the average wage method. The outlook for the rate of wage increase in 2025 was produced using an estimation method which includes the following explanatory variables: (1) Growth in sales, (2) CPI growth rate, (3) Demand shortage unemployment rate, (4) Terms of trade (logarithmic conversion), (5) Dummies (through 1988 and from 2023 and beyond), and (6) Constant term. ((1)-(4) are previous year's values, with (1) at 10%, and (2), (4), and (5) meeting 1% significance level. Estimate covers the period 1976-2024. The adjusted coefficient of determination is 0.92.) The explained variable rate of wage increase uses the actual results of the Japanese Trade Union Confederation final results from 1989 and beyond, and through 1988, the Ministry of Health, Labour and Welfare's "Survey on Wage Increase."

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 +2.4% y/y in FY2024, and +2.1% in FY2025 (Chart 7). On an all items basis, less fresh food and energy (new core-core CPI), the forecast is +2.0% in both FY2024 and FY2025.

Both core CPI and new core-core CPI have been revised downwards for FY2024 and FY2025 in comparison to our previous outlook. The primary cause is that the assumptions behind the yen exchange rate have been revised in favor of a significant appreciation of the yen. Since this will hold down the rise in import prices, growth in intermediate input costs (the first force according to the BOJ[12]), which was the major cause of the rise in prices, is expected to slow down increasingly beginning in the middle of FY2024.

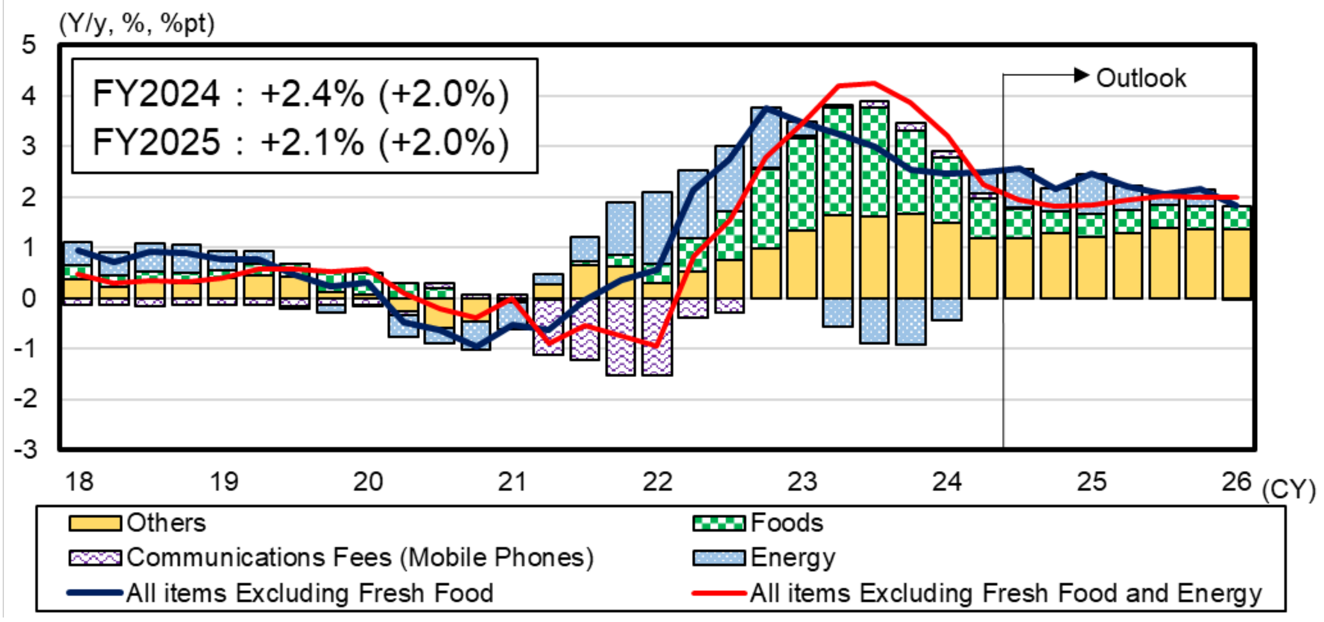
On the other hand, corporate efforts to implement price pass-through (called the second force by the BOJ) as a means of dealing with increased personnel costs associated with the major wage hikes in the spring labor negotiations, will likely spread further than was experienced in 2023. The second force is expected to strengthen beginning in the second half of FY2024, and the underlying inflation rate will likely rise. 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.

As for core CPI, the outlook for FY2024 has been revised downwards significantly in comparison to our previous outlook. The major reason behind this revision is the June announcement by the government that the fuel subsidy program to curb extreme price increases will be extended. The government will implement "Emergency Assistance for Overcoming Severe Summer Heat" between August and October, and the fuel subsidy program to curb extreme price increases (gasoline subsidy) will continue with a limitation within the year. CPI y/y growth is expected to be pushed down by around 0.3-0.6%pt per month by "Emergency Assistance for Overcoming Severe Summer Heat (originally in Japanese; translated by DIR)[13]."

[12] Speech by Governor UEDA in Osaka (Japan's Economy and Monetary Policy) : Bank of Japan (boj.or.jp) (2023/9/25)

[13] Estimated results use as a reference the downward pressure on CPI experienced due to the fuel subsidy program to curb extreme price increases (gasoline subsidy) in June 2024 (the Ministry of Internal Affairs and Communications estimate was -0.25%pt).

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 subsidies for electricity and gas will be implemented from August to October as "Emergency Assistance for Overcoming Severe Summer Heat (originally in Japanese; translated by DIR)," and the fuel subsidy program to curb extreme price increases (gasoline subsidy) will continue until the end of December.

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

At its Monetary Policy Meeting held at the end of July 2024, the BOJ decided to raise its target rate for short-term interest rates (uncollateralized overnight call rate) from around 0-0.1% to around 0.25%, in addition to presenting a plan to reduce its purchases of long-term JGBs.

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 0.50% in the Jan-Mar 2025 period, followed by additional rate hikes at a pace of 0.25%pt approximately every six-months (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[14]. 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.

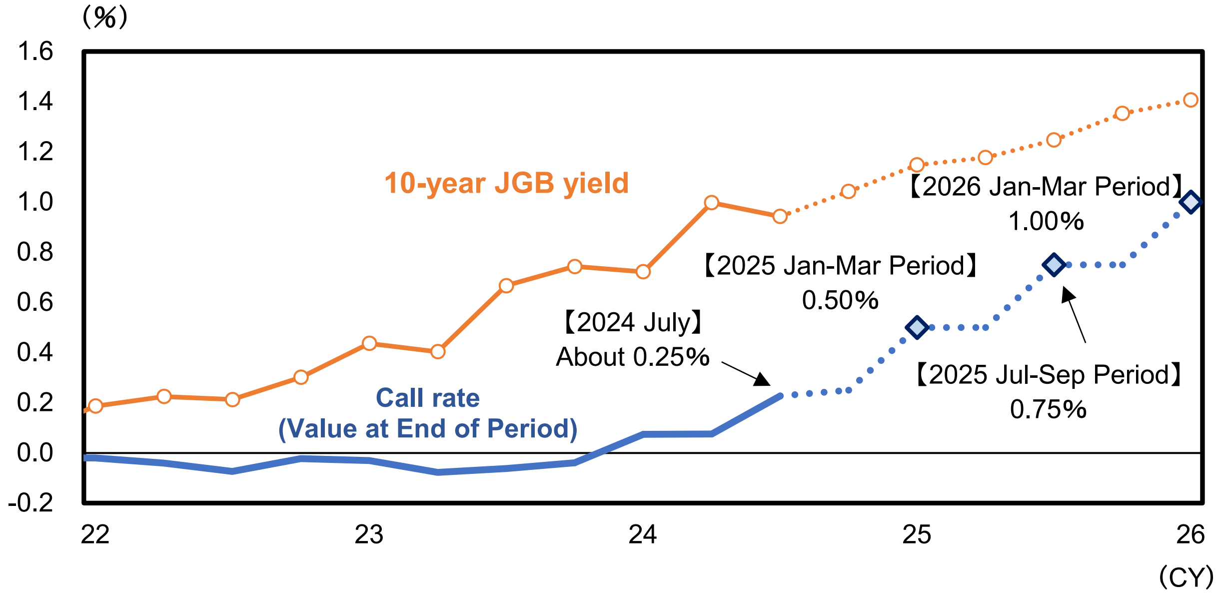
We expect the yield on the 10-year JGB (long-term interest rate) to rise to around 1.4% in the final stage of the forecast period (Chart 8). The BOJ's interest rate hikes will be a factor in pushing up long-term interest rates. On the other hand, we assume that the Fed will start cutting interest rates 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.

As is argued in Chapter 4 of our current outlook, influence of the long-term interest rate on the short-term interest rate due to the decrease in the BOJ's purchases of JGBs is expected to be limited. However, looking ahead to 2040, possibilities are that there will be strong upward pressure on the long-term interest rate due to changes in the structure of JGB holdings. To mitigate the risk of rising interest rates

[14] For details see the DIR report dated 11 March 2024, *Japan's Economic Outlook No. 220 (Update),* (Japanese only).

as the BOJ moves toward monetary policy normalization, it is crucial for the government to make steady progress towards fiscal soundness and suppress the increase in outstanding JGBs.

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. Dotted lines are DIR estimates.

Net interest income of households to grow to over 0.3 tril yen with interest rate increase to 0.25%

The Bank of Japan's additional interest rate hikes will have a ripple effect on various interest rates, including lending and deposit rates, and will affect the real economy. In our 2023 December 8 outlook, *"Japan's Economic Outlook No. 219"* (Japanese only), we estimated the impact of interest rate hikes on net interest income by economic entity, and found that net interest income will decline for corporations, the government, and the Bank of Japan, but will increase for households and financial institutions.

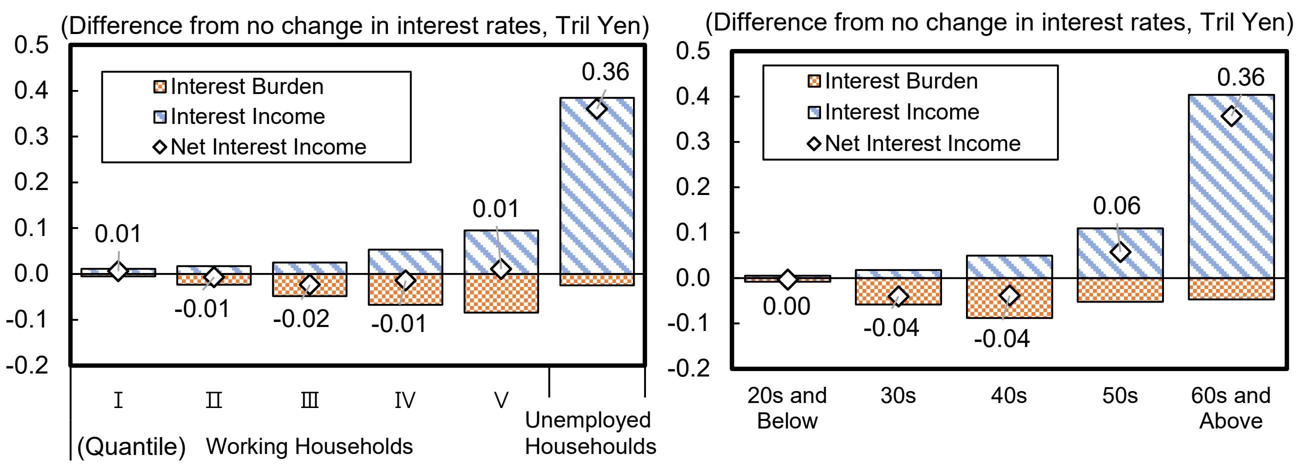
As for the household sector, while interest income on ordinary deposits etc. will grow due to the additional interest rate hikes, interest payments on variable-rate mortgages are also expected to increase. Assuming a 0.09%pt increase in interest on ordinary deposits, and an 0.15%pt increase in the variable mortgage rate based on current conditions[15], we estimate that net interest income of households will increase by about 0.33 tril yen. This is because the recent balance of ordinary deposits is about 650 tril yen, which is much larger than the amount in liabilities (variable mortgage loans are estimated to be about 170 tril yen).

When the above amount of increase in net interest income is considered in terms of the attributes of the head of household (Chart 9), we see that the larger portion of this increase benefits unemployed households and people in their sixties and older. Many of these are pensioners who have built up more savings than other households, and many of them have paid off their mortgages making it easier to gain benefits from higher interest. On the other hand, middle income working households in the 30-40-year-old age group have actually experienced a decline in net interest income. These households are also in their child-rearing years and carry a relatively large amount of liabilities such as mortgages which exceed savings.

[15] In response to the Bank of Japan's additional interest rate hike, many financial institutions raised their savings rates from 0.01% to 0.10%. In addition, the short-term prime rate, the base rate for variable mortgages, was raised from 1.475% to 1.625%.

However, the impact of the additional interest rate hike on households with mortgages is expected to be limited. Based on the average balance of variable mortgages in the “FY2023 Survey of Private-sector Mortgage Loans” (Japanese only) conducted by the Ministry of Land, Infrastructure, Transport and Tourism, we estimate that a 0.15%pt increase in interest rates will only increase monthly payments by over ¥2,000 per month per household. In addition, many existing contracts have a “5-year rule” under which monthly payments remain unchanged for 5 years in principle even after interest rates rise. Although the amount of debt will increase, the increase in debt relative to income will be contained because many households have increased their salary levels in response to the large wage hikes in the spring labor negotiations.

Influence of BOJ’s Interest Rate Increase to 0.25% on Net Interest Income of Households (Left: Employment Status & Income Bracket; Right: Age Group of Head of Household) Chart 9



Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Notes: 1) In regard to amount of increase in the case where interest on ordinary deposits grows from 0.01% to 0.10%, interest burden is estimated based on the amount of increase in the case where the short-term prime rate grows from 1.475% to 1.625%.
2) Figures in chart are on an aggregate household basis. Influence on household net interest income is broken down by household attributes using the “2019 National Survey of Family Income and Expenditure” (Ministry of Internal Affairs and Communications).

Japan’s Economic Outlook No. 222 (August 21, 2024) Chart 10

		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	563.0	557.2	557.6	554.3	558.6	561.9	564.7	567.0	568.3	569.7	571.1	572.5	558.2	563.1	570.5
	Q/q %	0.6	−1.0	0.1	−0.6	0.8	0.6	0.5	0.4	0.2	0.2	0.2	0.3			
	Q/q %; annualized	2.4	−4.0	0.3	−2.3	3.1	2.4	2.0	1.6	1.0	1.0	1.0	1.0			
	Y/y %	2.0	1.3	0.9	−0.9	−0.8	0.8	1.3	2.2	1.8	1.4	1.1	1.0	0.8	0.9	1.3
														(1.7)	(0.1)	(1.6)
Private Consumption	Q/q %	−0.8	−0.3	−0.3	−0.6	1.0	0.8	0.5	0.4	0.3	0.2	0.2	0.2	−0.6	1.3	1.2
Private Residential Investment	Q/q %	1.4	−1.2	−1.1	−2.6	1.6	−1.1	−0.8	−0.5	−0.5	−0.5	−0.5	−0.5	0.3	−2.5	−2.3
Private Non-Resi. Investment	Q/q %	−2.1	−0.1	2.1	−0.4	0.9	0.4	0.4	0.4	0.5	0.5	0.6	0.6	0.3	2.2	2.0
Government Consumption	Q/q %	−1.2	0.6	−0.1	0.3	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	−0.5	0.6	0.8
Public investment	Q/q %	1.0	−1.9	−1.7	−1.1	4.5	−2.3	0.3	0.3	0.3	0.3	0.3	0.3	0.7	1.1	0.5
Exports	Q/q %	3.2	0.1	3.0	−4.6	1.4	1.6	1.4	1.0	0.4	0.4	0.4	0.4	2.8	1.5	2.8
Imports	Q/q %	−4.1	1.3	2.0	−2.5	1.7	0.8	0.6	0.5	0.5	0.4	0.4	0.4	−3.2	2.2	2.0
Nominal GDP	Q/q %; annualized	8.2	−0.3	2.8	−1.0	7.4	3.8	3.9	3.5	2.3	2.4	2.3	2.3	4.9	3.3	2.8
GDP deflator	Y/y	3.7	5.2	3.9	3.4	3.0	2.3	2.2	2.3	1.6	1.6	1.4	1.3	4.0	2.4	1.5
Industrial production	Q/q	1.2	−1.4	1.1	−5.1	2.7	2.1	1.1	0.7	0.4	0.4	0.3	0.3	−1.9	1.2	2.5
Core CPI	Y/y	3.2	3.0	2.5	2.5	2.5	2.6	2.2	2.5	2.2	2.1	2.2	1.8	2.8	2.4	2.1
Unemployment rate	%	2.6	2.6	2.5	2.5	2.6	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.6	2.5	2.3
Trade balance (goods, services)	Y tril; annualized	−0.08	−0.06	−0.04	0.07	0.08	0.23	0.25	0.50	0.50	0.75	0.75	1.00	0.07	0.50	1.00
Current account balance	Y tril; annualized	0.40	0.67	0.74	0.72	1.00	0.94	1.04	1.15	1.18	1.25	1.35	1.41	0.63	1.03	1.30
Major assumptions																
Crude oil price (WTI futures)	$/bbl	73.6	82.2	78.5	76.9	80.7	76.8	74.4	74.4	74.4	74.4	74.4	74.4	77.8	76.5	74.4
Exchange rate	Yen/$	137.4	144.5	147.9	148.5	155.8	150.3	146.6	146.6	146.6	146.6	146.6	146.6	144.6	149.8	146.6

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.