JAPAN

EXTERNAL FEARS AND PAUSE IN THE MONETARY ADJUSTMENT

Japan is heading for a year without quarterly growth. Domestic demand is still constrained, with nominal wages rising at a slower pace than inflation. In addition, the trade policy of the United States, Japan's largest export market, poses a downside risk. The monetary adjustment carried out by the Bank of Japan is jeopardized by the fragility of growth and developments in the US.

2025: TOWARDS A GROWTH-LESS YEAR

The near stagnation in 2024 (annual average growth of +0.1%) masked an improvement throughout the year, with real GDP up 0.4% q/q in Q3 and up 0.6% q/q in Q4, but the negative carry-over effect from 2023 (-0.3 pp) and the contraction in Q1 (-0.5% q/q) adversely affected the average annual result. Our growth forecasts for 2025 indicate a moderate or even negative quarterly pace. The Japanese economy's high exposure to the turmoil triggered by the US administration underpins these expectations.

In fact, the United States is the leading destination for Japanese exports of goods (cf. *Chart 2*). They accounted for JPY 21.3 trillion in 2024, or 3.5% of Japan's nominal GDP. Therefore, the US decision to apply a 24% "reciprocal tariff" to Japanese imports from 9 April has been implying a significant downside risk to Japanese growth. This remains the case insofar as, while the reciprocal tariff has been suspended and replaced by a lower level of 10% for 90 days, a sectoral tariff of 25% on automobiles, which account for a third of Japanese exports to the United States, has applied since 3 April.

A Japan/United States agreement is conceivable in the short term. But this is likely to be to the detriment of the country's economy, thereby not fully erasing the negative impact on growth. In addition, the indirect effects of the disruption to international trade, the climate of uncertainty and the slowdown of other partners — principally China — are likely to persist. Thus, the upcoming challenges for exporters and the negative fallout of uncertainty on corporate investment will be the main forces driving growth down in the short-term.

SUBDUED REAL WAGE GROWTH

In January 2025, growth in scheduled contractual wages hit +3.1% y/y, its highest level since 1992, boosted by an unemployment rate of 2.5%. On the other hand, real wages were struggling to make any lasting progress (-1.8% y/y over the same period), which is an obstacle to reviving domestic demand via household consumption.

Nominal wages are expected to continue to grow dynamically this year. The Rengo trade union confederation announced an agreement for a 5.46% wage increase at the end of the annual negotiations for 2025. This is the highest increase since 1991, and an improvement on the already sizeable figure for 2024 (+5.1%). In addition, the Bank of Japan's Summary of Opinions (January 2025) points to a medium-term "shift away from the zero norm", i.e. persistently sluggish nominal wage growth, which should eventually feed the wage-price spiral.

INFLATION STILL ABOVE THE TARGET

Headline inflation has recently accelerated (from +2.3% y/y in October 2024 to +3.7% in February 2025), due to rising energy prices (+6.9% y/y in February) and rice prices (+80.9%). Core inflation (excluding unprocessed food, up from +2.3% to +3.0%) and new-core inflation (excluding energy, up from +2.3% to +2.6%) have risen more moderately. On the other hand, the price of services, a relevant index of households' propensity to consume and feed a wage-price spiral, has struggled to gain momentum (+1.3% in February).

GROWTH AND INFLATION

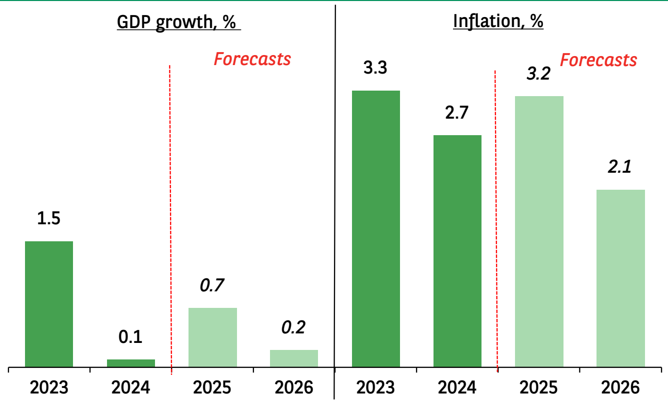

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

In addition, core inflation is expected to decelerate over the course of 2025, falling from +3.2% y/y in Q1 to +2.7% in Q4, before remaining slightly above the 2% target in 2026. However, the dynamics of food inflation pose an upside risk. The good news is that optimism about Japan's ability to escape deflation over the long term is reflected in the 10-year breakeven inflation rate (1.6% in February, an all-time record, before 1.5% in March).

A LARGER BUDGET BUT FEWER BOND ISSUES IN 2025

The budget for fiscal year 2025 (April 2025 - March 2026) was passed by the House of Representatives on 4 March 2025. Having failed to win an absolute majority in last autumn's elections, the Liberal Democratic Party has been forced to make a JPY 300 billion reduction in the draft budget initially adopted by Shigeru Ishiba's cabinet, an event which has not occurred since 1996. The final version of the budget amounts to JPY 115.2 trillion (+2.6% y/y), an all-time record, and includes a +9.7% increase in defence spending, making it an expansionary budget. However, the increase in tax revenues, linked to corporate sector profits, will lead to a significant reduction in bond issues (-24.2% y/y). On the other hand, there is a high likelihood that a supplementary budget will be adopted in view of the current downside risk on growth.

MONETARY TIGHTENING: NO MORE HIKES IN 2025

The Bank of Japan (BoJ) has kept gradually adjusting its monetary stance, with the uncollateralized overnight call rate rising to +0.5% (+25 bps) in January, before remaining unchanged in March. The process, which began in January 2024, was meant to continue provided that the BoJ's forecasts materialise: these include a core inflation forecast of +2.4% for the 2025 fiscal year (starting on 1 April), with risks trending upwards, compared with +2.8% according to our forecasts.

However, we anticipate the rate hikes to interrupt for the remaining quarters of 2025. The BoJ's cautiousness, rooted in the fragile demand and the risk of market destabilization, will be even more important in the ongoing environment of uncertainty and the anticipated slowdown in growth. Monetary tightening would resume cautiously in 2026, with a policy rate amounting to +1.0% by year-end.

The maintenance of a restrictive monetary policy in the United States should prevent the JPY from strengthening, which is rather good news for the Japanese economy. According to our forecasts, the USD/JPY will remain above 150 in 2025.

CONTRARY DEMOGRAPHICS

Japan is facing a structural labour shortage. Admittedly, female participation (15-64 year olds) has risen sharply, from around 60% at the start of the century to 76% in 2024, helping the total activity rate to hit 81.6%. But this progress is hampered by demographics. The population of 15-64 year olds has been declining since 1998, while the proportion of people aged 65 and over has reached 29% of the total population — a world record. This constrained labour supply is contributing to weak potential growth, which the Cabinet Office estimates at +0.6% per year. In addition, the number of hours worked has fallen over the years: the annual average was 1,643 in 2024 compared with 2,064 in 1990, adversely affecting potential growth by -0.3 pp.

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MAIN EXPORT MARKETS FOR JAPANESE GOODS (JPY TRN, 2024)

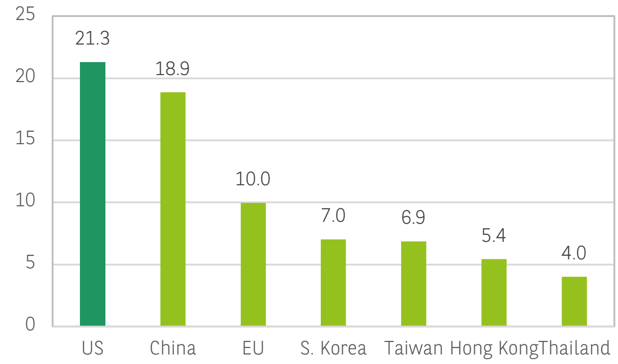

CHART 2

SOURCE: MACROBOND, BNP PARIBAS

Budget Challenges

Japan has the highest level of public debt as a percentage of GDP in the world, at 251% in 2025, according to the IMF. This is expected to fall slightly to 245% in 2029, as inflation supports nominal GDP and tax revenue increases. Alongside strong domestic holdings, the appeal of Japanese debt has increased with the rise in 10-year yields from 0% at the end of 2021 to 1.5% in March 2025. In addition, the current political situation - minority government, weak confidence - is an obstacle to possible consolidation. More generally, Japanese governments face an ambivalent situation. On the one hand, the extraordinarily high level of the public debt ratio suggests the importance of consolidation. On the other hand, the weakness of potential growth, the endemic weakness of domestic demand and the ageing of the population are all factors that will generate new expenditure to remedy them, and which in any case complicate any consolidation that would further worsen the economic situation.

In addition, the change in monetary paradigm represents a new difficulty for the Japanese government in terms of interest charges. From 2013 onwards, the Bank of Japan's quantitative and qualitative easing (QQE) policy has helped to absorb debt issues, boost the central bank's credibility with other investors, and keep interest rates at particularly low (or even negative) levels. However, the monetary adjustment began in 2024 includes the end of yield curve control and a plan to halve the monthly pace of JGB purchases by the BoJ by 2026 (to JPY 3 trillion from JPY 4.4 trillion today). Thus, in March 2025, 10-year bond yields on JGBs exceeded +1.5%, their highest level since 2008. Consequently, the -0.7pp reduction in the primary deficit that we anticipate between 2024 and 2026 would be absorbed by the increase in the interest burden and the total deficit would change little (-0.1 pp to 2.7% of GDP).