JAPAN

POLITICAL INSTABILITY AND VERY GRADUAL MONETARY NORMALISATION

The Japanese economy continues to be characterised by weak growth, which slowed in Q3. The positive momentum in inflation and wages is in line with the Bank of Japan's objectives. This picture should enable the Bank to continue its gradual monetary tightening. However, domestic political developments (general elections resulting in a loss of political strength for the government), as well as external ones (Donald Trump's victory) are not helping stability.

A REBOUND IN ANNUAL GROWTH AHEAD

Japanese growth slowed to 0.3% q/q (-0.2 pp) in the third quarter after catching up in Q2. We expect the same advance in Q4. As a result, the average annual growth rate in 2024 would be negative, standing at -0.2%, a significantly lower result than in 2023 (+1.7%), due to the negative carryover and the contraction in Q1.

Q3 growth was underpinned by private consumption (+0.7% q/q, +0.1 pp), which was the main driver of growth, far ahead of residential investment (+0.4% q/q, -0.8 pp). Conversely, productive investment was disappointing (-0.1% q/q, -1.0 pp), as was public demand. Finally, the largest negative contribution came from foreign trade, with growth in imports (+1.8% q/q) significantly exceeding growth in exports (+1.8% q/q).

In 2025, the sequential pace is set to be more moderate, with quarterly growth rates of around +0.1% q/q, more in line with the Cabinet Office's estimated potential growth. For the year, growth is expected to amount to 0.7%, significantly higher than in 2024, thanks to the improvement in household disposable income. However, the potential rebound in Japanese growth remains limited by supply constraints (*see below*).

LABOUR SUPPLY IMPASSE

The Japanese labour market - and, ultimately, the economic growth outlook - continues to suffer as a result of labour shortages. In Q4, the Tankan factor utilization index deteriorated further, linked to this lack of labour supply, to a record low (2003). Growth in the labour force, which is likely to address this problem, has stalled in recent months. The unemployment rate, which stood at 2.5% in October, has risen only marginally since the start of the year (+0.1 pp).

On the wage front, the latest figures, dating from September, show contractual wage growth set to hit a 30-year high, at +2.5% y/y. On the other hand, the real wage index is struggling to settle into positive territory on a long-term basis. In fact, two months of declining year-on-year change (with August and September at -0.8% and -0.4%, respectively) were followed two consecutive months of improvement.

UPWARD MOMENTUM FOR INFLATION

Inflation seems to have picked up again in Q4. After falling back in September due to the return of subsidised energy bills, both core inflation (excluding unprocessed food) and the new-core (excluding energy as well) index posted a monthly increase of +0.6% in October (after -0.3% and +0.1% in September, respectively). Divergent movements (-0.2 pp and +0.2 pp) brought the year-on-year change in the two indices closer together, at +2.3% y/y, while base effects from the previous year pointed to weaker figures. Inflation in services, at +1.5% y/y in October, which is particularly closely watched, has also gained momentum in recent months, with the exception of September. Finally, Tokyo inflation in November, a leading national inflation indicator, was also part of this acceleration trend (core at +2.2% y/y, +0.4 pp).

GROWTH AND INFLATION

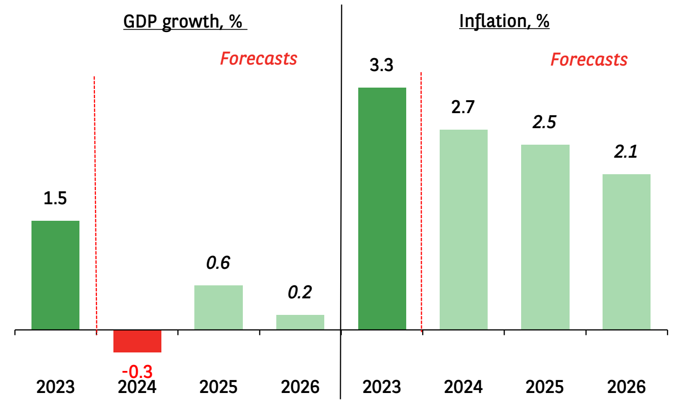

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

In 2025, the growing power of the wage-price loop and a persistently weak yen should keep core inflation above its 2% target, before returning to around this level from Q4 and into 2026.

POLITICAL INSTABILITY SET TO CONTINUE

Early general elections were held on 27 October. They were called by Shigeru Ishiba, following his appointment as leader of the Liberal Democratic Party (LDP) and head of government, replacing Fumio Kishida. The vote resulted in the LDP losing its absolute majority (233) in the House of Representatives, dropping from 259 to 191 elected members. In addition, the support of its traditional ally Komeito (24 seats) is insufficient to secure a majority position. This is a rare occurrence, not seen since 2009 in Japanese politics. However, Ishiba managed to hold on to the post of Prime Minister thanks to a minority vote on 11 November.

The new cabinet has announced a slight increase in the fiscal stimulus for FY2024 (which ends on 31 March 2025). This amounts to 13.9 trillion yen (2.3% of GDP), up from 13.2 trillion yen in 2023. The plan, which includes allowances for low-income households and continued subsidies on energy bills, has yet to be approved by Parliament. The Prime Minister is in favour of continuing to support households as long as wage growth does not exceed inflation. In addition, the new political configuration provides fertile ground for further budgetary support in 2025. The survival of the current government depends in particular on the support - or lack of it - of the Democratic Party for the People (DPP), which is in favour of tax cuts.

MONETARY POLICY

The Bank of Japan was cautious after its unexpected key rate hike last summer, keeping the uncollateralized overnight call rate stable at +0.25% at the two consecutive meetings in September and October. However, the BoJ is sticking to its scenario of «*continuing to raise the key rate and adjusting the degree of monetary easing*» on the basis of its forecasts for growth and core inflation (1.1% and 1.9%, respectively, in FY2025). Our own forecasts predict three rate hikes (+25 bps for each) in 2025, taking the key rate up to +1.0% by the end of next year, its highest level since 1995.

Furthermore, while the outcome of the US presidential election will have an impact on the Japanese economy (*see box*), Kazuo Ueda admitted that he was taking movements in the yen seriously in his «*economic and inflation projections*». He also said that if the JPY were to weaken further with inflation above 2%, this would call for countermeasures on the part of the BoJ.

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JAPAN AGAINST SUPPLY CONSTRAINTS

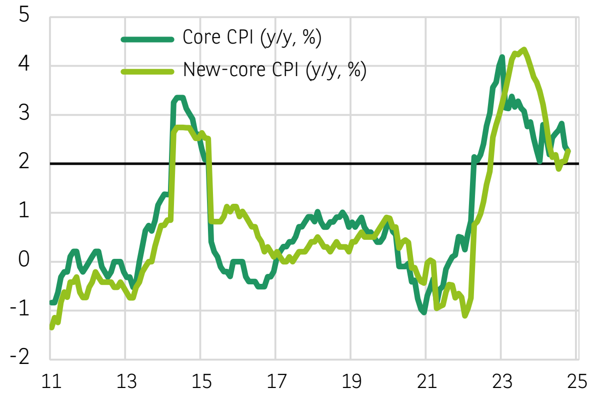

CHART 2 SOURCE: MACROBOND, BNP PARIBAS

INFLATION ABOVE ITS TARGET

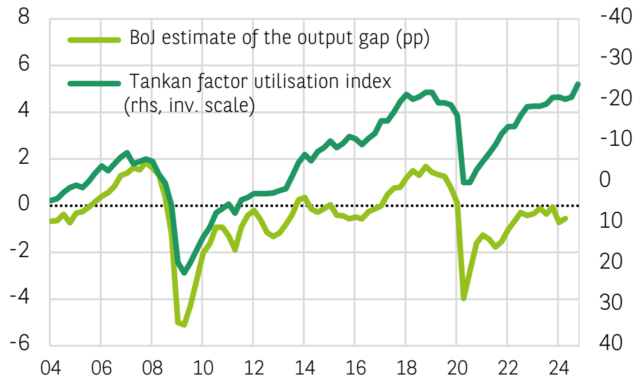

CHART 3 SOURCE: BANK OF JAPAN, BNP PARIBAS

JAPAN AND THE RETURN OF DONALD TRUMP

For Japan, Donald Trump's victory brings with it heightened geopolitical uncertainty, particularly on defence issues, but also on the economic front. On the economic front, the main risks relate to measures on customs tariffs and the potentially inflationary consequences of Trump's plans. The application of higher tariffs on Japanese products would damage the price competitiveness of its exporting companies (with little possibility of absorbing this in margins due to already sluggish domestic demand), with negative consequences for the growth of a country for which the United States is the leading export market (22% in 2023). In addition, China, Japan's second-largest market, is likely to be particularly targeted by Trump, with average effective tariffs rising to 40% (+25 pp) in Q1 2026 after an incremental increase, which could mean more negative effects through the indirect channel of a Chinese slowdown.

The yen could also deteriorate further against the US dollar if the US trade deficit were to narrow and, above all, if the Federal Reserve were to maintain its restrictive policy as a result of the expected rise in US inflation (since customs duties are borne by the end consumer). An appreciation in the USD/JPY exchange rate is generally favourable for Japanese equities and, in this case, could help to mitigate the impact of the tariff hikes. In fact, in Q2 2024, domestic companies' nominal profits broke the record set a year earlier, against a backdrop of a downward trend in the JPY. Conversely, higher imported inflation and greater monetary restraint to reduce the interest rate differential with the US would have a negative impact on demand, which is already structurally endemic.