JAPAN

AN EVER WEAKER YEN?

While quarterly growth and inflation are expected to rise in the second quarter, the Bank of Japan is proceeding cautiously following its decision in March to end negative interest rates. A new plan for the pace of bond purchases will therefore be presented in July, while we expect just one further rate hike this year, probably in September. In addition, the domestic currency has continued to deteriorate, prompting the authorities to intervene in the foreign exchange market and fuelling fears of imported inflation.

In line with our expectations, Japanese activity fell again in the first quarter of 2024, with GDP contracting by -0.5% q/q. One-off events contributed to this decline, namely the New Year's Day earthquake on the Noto Peninsula and disruptions to automobile production, the latter leading to a 5.2% q/q drop in the industrial production index, including a 17.1% fall in the motor vehicles component. However, beyond these factors, the Japanese economy has been characterised by prolonged sluggishness since Q2 2023. A technical upturn should allow for a significant advance in the second quarter (+0.7% q/q), before growth slows again, resulting in an annual average of just +0.3% in 2024 (-1.6pp compared with 2023).

STEP-BY-STEP

The latest inflation data show a fairly sharp fall in core inflation (index excluding fresh food) from +2.6% to +2.2% y/y in April. However, this result should be followed by a re-acceleration in the coming months, due to government measures on energy tariffs and the so-called "virtuous" circle between wages and inflation (as the record wage increases since the 1990s announced at the beginning of the year as part of the Shunto become more widespread). We therefore expect core inflation to rise to +2.8% y/y in Q4 2024 and to return to +2.0% in the second half of 2025.

Following the decision to end the negative interest rate policy at its meeting in March, the Bank of Japan maintained its target for the uncollateralized overnight call rate in the range of +0.0% to +0.1% at the two subsequent meetings. Our central scenario remains that of a very gradual hike, with the next move (+0.15pp) in September, which would be the last of the year. In addition, the central bank has announced that it will unveil a detailed plan at its July meeting for a reduction in the pace of its purchases s over the next 1-2 year(s). This step should bring Japanese monetary policy closer to normalisation, meaning the use of the (non-negative) interest rate target as the main tool for adjustment.

The situation is ambivalent in several respects for the BoJ. It has to deal with inflation that is persistently above the 2% target, potentially calling for higher interest rates, and with inflation expectations, as measured by the 10-year breakeven rate, rising (1.53% at 14 June) but still below the target. On the other hand, the pace of inflation is weighing on demand in the absence of real incomes catching up, but accelerating tightening could further penalise it.

FEAR FOR THE YEN

The yen underwent another episode of marked depreciation in the first half of 2024. On 14 June 2024, 1 US dollar was equivalent to JPY 157.33, compared with JPY 141.13 on 1 January: the Japanese currency is thus trading at its lowest level in 34 years against the greenback. Similarly, the most recent data published by the Bank for International Settlements report a fall in the Japanese real effective exchange rate of -4.6% YTD in April 2024. A significant proportion of recent variations are due to external factors. In particular, US inflationary developments have led the markets to postpone their expectations of Fed rate cuts, and the interest rate differential is a key factor in explaining the relative value of currencies.

GROWTH AND INFLATION

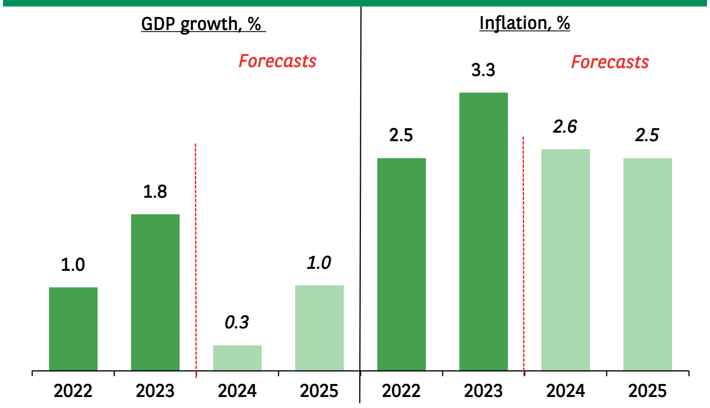

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The weakening of the yen may be favourable for the Japanese economy. In 2023, it led to record profitability for domestic companies (quarterly average of 26.1 trillion yen), while exports were the main driver of GDP growth. Conversely, the deterioration in the currency is fuelling fears of imported inflation, at least temporarily, as Japan's energy supplies are dependent on the outside world and denominated in US dollars. We therefore need to assess the ability of a rise in energy inflation to drag core inflation along with it, through second-round effects.

Given the size of its foreign exchange reserves (1.3 trillion US dollars as of 5 April 2024, the second largest in the world), Japan has the option to intervene in the markets to protect its currency. Data from the Ministry of Finance show that it intervened to the tune of 62 billion US dollars on 29 April and 2 May in response to the fall in the yen. However, the scope of this type of action is uncertain, not to say limited, as currency movements are fundamentally a function of the relative attractiveness of currencies (linked, for example, to interest rate differentials, growth rates or geopolitical factors). Our central scenario suggests a relative recovery in the yen, which would appreciate to USD 1 = JPY 148 by Q4 2025, but would be broadly stable against the euro. Moreover, in the long run, the normalisation of monetary policies should, in theory, buoy the Japanese currency due to the associated reduction in the interest rate differential between recently relaxed policies (US, eurozone) and the BoJ's ultra-accommodative starting point.

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