JAPAN

THE LONG ROAD TO NORMALISATION

The Bank of Japan has made an admittedly expected, yet nonetheless historic, decision to end its so-called Negative Interest Rate Policy (NIRP), against the backdrop of an almost unprecedented long-term rise in the general price level. However, monetary normalisation will be an incremental process, with the current weak business activity, illustrated by an expected negative growth rate in the first quarter of 2024 and low expectations for the entire year, leaving no scope for any significant tightening.

The average annual growth rate for Japanese GDP stood at +1.9% in 2023, following on from +0.9% in 2022. This figure, which can be viewed as healthy, was nevertheless mainly due to growth carried over from the previous year (+0.5 pp) and a dynamic first quarter, with the year-on-year GDP growth rate standing at +2.3% y/y in Q2 2023. However, the second half of 2023 saw a sharp downturn in economic activity, with Japan only barely escaping a technical recession, with quarterly growth of +0.1% in Q4 following a contraction of -0.8% in Q3. This downturn is due to weak domestic demand, which is itself linked to rising prices (see below) and interest rates. As a matter of fact, private consumption and residential investment contracted over the last two quarters, which, together with the fall in public investment, adversely affected growth. Conversely, the resurgence in foreign trade, which was made possible thanks to a +2.6% q/q rise in exports in Q4 2023, added +0.15 pp to the quarterly growth rate, preventing the country from falling into a technical recession as a result.[1]

According to our forecast, Japanese GDP should contract slightly during the first quarter of 2024 (-0.2% q/q), as a result of the earthquake on 1 January and disruptions to car production. After this the economic recovery will probably be modest, with supply problems, particularly on the labour market, adding to the issue of sluggish domestic demand. In March 2024, the unemployment rate remained low at 2.6%, while the employment rate was 62.8%, a figure that was improving overall. However, despite this improvement, there has still been a notable drop in the number of labour market participants in absolute terms. Therefore, we are expecting an average annual growth rate of +0.4% in 2024, which is well below the rate for the previous year.

A HISTORIC MOMENT FOR JAPANESE MONETARY POLICY

In line with our expectations, the Bank of Japan (BoJ) decided to raise its key rate, the uncollateralized overnight call rate, during its monetary policy meeting in March. Therefore, by raising the target short-term interest rate to +0.0 - +0.1%, the institution altered interest rates for the first time since 2016. This increase is historic, as it brings the curtain down on the NIRP policy that had been in place for 17 years, with Japan being the only country which still had a negative key rate at the start of 2024. At the same time, the policy of yield curve control was discontinued. The BoJ believes that, as it is close to hitting its 2% target inflation rate in a smooth and sustainable manner, these two tools have fulfilled their role.

These changes are occurring against a backdrop of a massive change in the inflation regime in Japan. As a matter of fact, the key measurement for core inflation (excluding processed food) hit an annual average of +2.3% in 2022 and +3.1% in 2023, thereby exceeding the inflation target (raised from 1% to 2% in 2013) for the first time since 2014, a year that was already diverging from national inflation standards. In addition, the figure of +4.2% y/y in January 2023 was the highest since 1981. Finally, we revised our core inflation forecasts for the entirety of 2024 upwards to +2.9%, from +2.4% previously. On the one hand, this is the result of government decisions that are likely to raise energy inflation, i.e. the upward revision of the leverage on renewable energy (a contribution to the energy transition charged on electricity bills) and the non-extension of subsidies for electricity and gas from the summer onwards. On the other hand,

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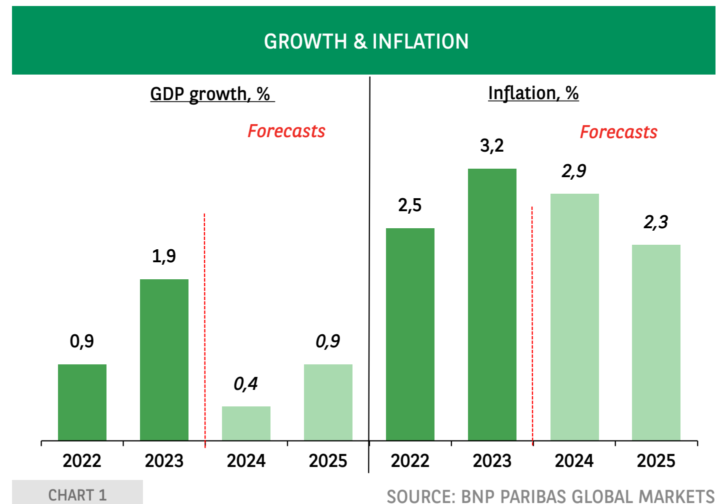

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

RENGO, the Japanese Trade Union Confederation, announced an average wage increase of +5.3% y/y, which exceeded expectations and was the largest rise for more than 30 years. However, at the same time, such a rise may trigger and fuel inflation and inflation expectations. This is in line with the BoJ's objective, for which a virtuous wage-price spiral must contribute towards achieving target inflation, but may raise fears about inflation sticking above 2%.

Japanese monetary policy is expected to normalise very gradually once this first stage has passed. The summary of the BoJ's opinions following its March meeting includes the assertion that the economy is not currently in a situation that requires rapid interest rate hikes. The end of negative interest rates is also not being presented as a transition to monetary tightening. This echoes the statements made by Governor Kazuo Ueda, following the BoJ meeting, that financial conditions should remain accommodating for the time being. Therefore, we are expecting half-yearly hikes, bringing the key rate up to +0.25% at the end of 2024 and up to +0.75% at the end of 2025. However, the risks around this scenario are on the upside, in view of the inflation forecasts and the current weakness of the yen. As of 3 April 2024, USD/JPY parity stood at 151.9, compared to around 115 at the start of 2022 and 130 at the start of 2023. While this weakness in the yen is fuelling fears about imported inflation, it has recently buoyed corporate profits. In particular, the currency has depreciated somewhat following the most recent monetary policy meeting, which can be attributed to the BoJ's stance on the need to maintain flexible financial conditions. Should the trend continue, this could result in calls for more substantial or faster movements by the central bank and/or interventions on the foreign exchange market.

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1 The first GDP estimate for Q4 2023 indicated a contraction of -0.1% q/q, meaning that Japan was in a technical recession.