JAPAN

A MONETARY SHIFT IS DRAWING NEAR

Faced with a natural disaster and a political crisis, 2024 is off to a rocky start for Japan. However, the economic impacts of the earthquake that struck the country's west coast on 1st January 2024 are expected to be fairly limited due to the authorities' effective preparations and quick response in dealing with this type of event. After an expected growth of +0.4% q/q in the fourth quarter of 2023, activity should slow in the first quarter of 2024, although it will remain positive at 0.2% q/q. The fall in inflation and bond yields at the end of 2023 is providing some breathing room for the BoJ, which is expected to end its negative interest rate policy in March or April. The road to monetary normalisation will be challenging for the BoJ, which, through its large-scale purchases of government bonds, has exacerbated the liquidity problems and volatility in the JGB market.

On the political front, the start of 2024 is going to be difficult for Japanese Prime Minister Fumio Kishida. The Liberal Democratic Party (LDP) has been at the centre of a scandal since December 2023, with several of its members having failed to declare funds received in their political capacities, as required. Fresh information published at the start of the year have put the issue back in the spotlight, despite the members involved being sacked from the government during a reshuffle in December. Kishida's popularity is at rock bottom, plummeting to the lowest levels seen for a Prime Minister since 1947. Kishida's current mandate as LDP President ends in late September 2024, when the party elections are due to take place, but he could be forced to resign before this autumn.

The economic situation is also being affected, with activity remaining volatile in 2023. During the first half of the year, growth was driven by service exports after the final border restrictions linked to the Covid-19 crisis were belatedly lifted and thanks to tourism inflow (+1.2% q/q in Q1 and +0.9% q/q in Q2). This momentum then petered out and weak private demand (household consumption and corporate investment) pulled down Q3 growth (-0.7% q/q). We are anticipating an upturn in activity in Q4 2023 (+0.4% q/q), which would result in an average annual growth rate of 2.1% for 2023.

Despite rising production costs and ongoing acute labour shortages[1] , the picture for Japanese companies in 2023 remained positive overall, particularly in relation to profits (before interest and taxes), which hit a record high in Q3 2023[2] . The depreciation of the yen has contributed to a significant rise in profits repatriated from abroad. However, it is mainly large companies with foreign subsidiaries and greater market power than small and medium-sized companies that have benefited from this effect.

The rise in consumer prices is showing signs of easing, with inflation excluding fresh food falling back to 2.1% y/y in December in the Tokyo region from a high of 4.3% y/y in January 2023. This has seemingly been positive for household confidence, which rose for the fourth consecutive month in December. This should support consumer spending, which is still far below pre-pandemic levels. However, with salaries stagnating, real wage growth remained in negative territory throughout the year, decreasing by 3.0% y/y in November 2023.

A RISKY CHANGE IN MONETARY POLICY

The BoJ continued to pursue an expansionary monetary policy in 2023. Additional flexibility was only added to the Yield Curve Control (YCC) policy, with two consecutive increases (in July, followed by October) to the intervention ceiling on 10-year government bonds. The negative interest rate policy (NIRP) remained in place. Japanese decision-makers, who have been influenced by years of low inflation, are looking to foster home-grown and sustainable price increases by strengthening a price-wages virtuous cycle.

GROWTH & INFLATION

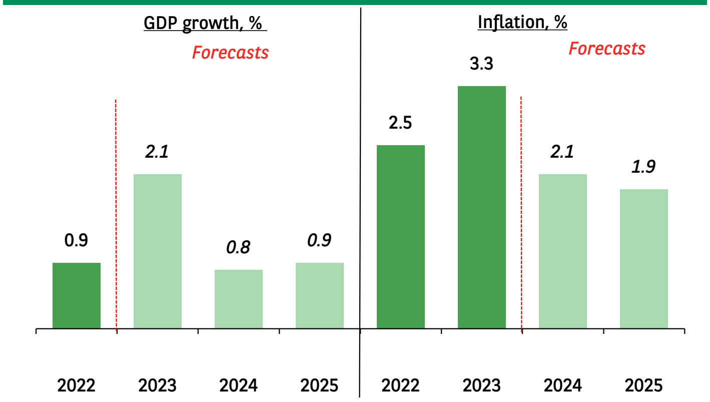

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

With this in mind, the annual wage negotiations (*shunto*), which will take place in the first quarter of 2024, should provide valuable information to BoJ members. The meeting on 18 and 19 March (the first post-*shunto* meeting) could therefore see an initial rate hike, which would bring the curtain down on almost eight years of negative key rates as a result. A second hike is expected before the end of 2024.

Therefore, 2024 is set to be the year of the monetary pivot in Japan. However, this pivot will be in the opposite direction to the anticipated pivots for other central banks, as it will not lead to a rate cut, but instead will involve the first rate hike in 17 years. Exiting the NIRP poses a major challenge for the BoJ, which continued to buy a large amount of government bonds in 2023 as part of its YCC policy. The share of JGBs held by the Japanese central bank, which had exceeded the symbolic threshold of 50% in Q1 2023, stood at 51.5% in Q3. In addition, some institutions, which hold a significant amount of government bonds on their balance sheets, would be potentially exposed to rising bond rates. This is particularly the case for insurance and pension funds, for which government securities account for more than a third of their assets, according to the Flow of Funds data from the BoJ. Ultimately, the BoJ's monetary normalisation, coupled with the start of an easing cycle by the US Federal Reserve and the ECB, is expected to reduce the 10-year yield differential between Japan and other developed economies. This could encourage Japanese investors, who have a strong presence on global bond markets, to repatriate some of their investments to Japan and result in the yen sharply appreciating.

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1 BNP Paribas Charts of the Week, Recruitment difficulties intensify in Japan, 10 January 2024
2 Source: Japanese Ministry of Finance. Year-to-date corporate profits, before interest and taxes, stand at JPY 73.2 trillion, a record figure. They account for 12.3% of GDP, which is not far off the all-time high of 12.5% recorded in Q3 2018.