Monthly Report of Prospects for Japan's Economy

February 2024

Macro Economic Research Center

Economics Department

The Japan Research Institute, Limited

https://www.jri.co.jp/english/periodical/

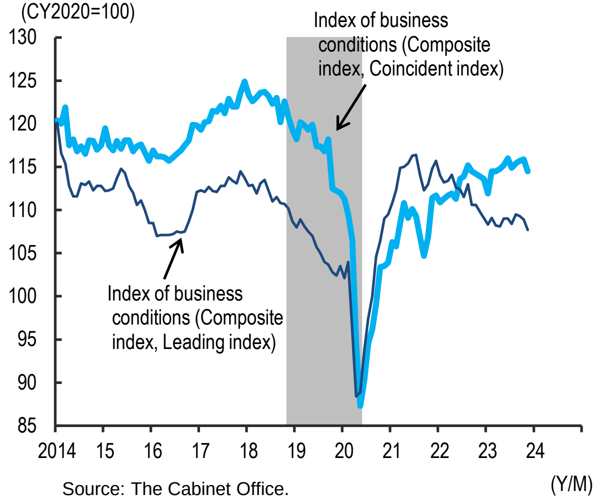
This report is the revised English version of the January 2024 issue of the original Japanese version.

Disclaimer:

The General Situation – The economy recovered moderately, despite stalls in some areas

Figure 1-1 Economic Activity

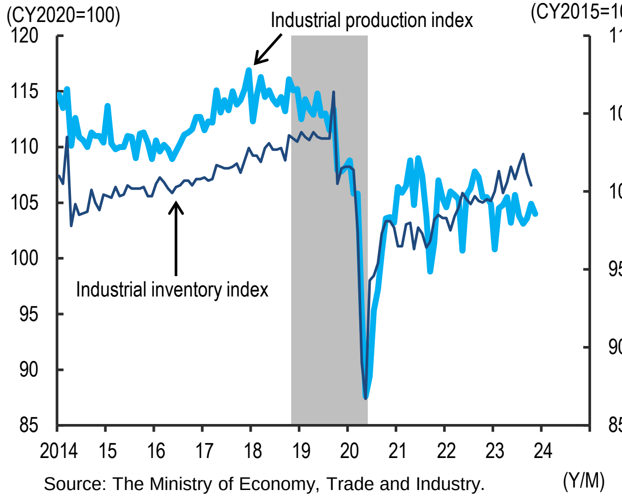
The coincident index of business conditions showed improvement
The leading index remained unchanged.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

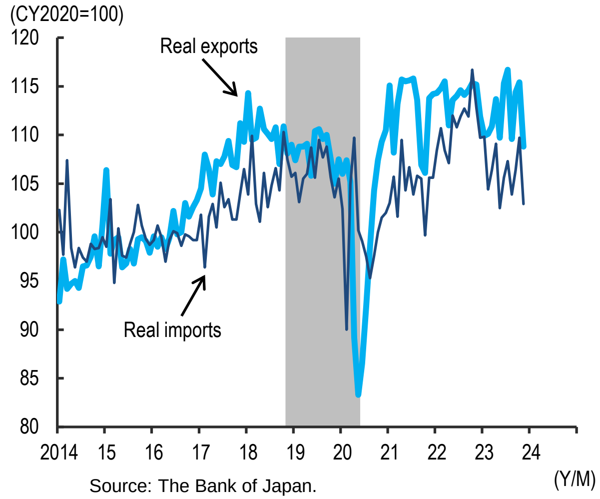
Industrial production moved back and forth.
Economic activity in the service sector showed a recovery.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

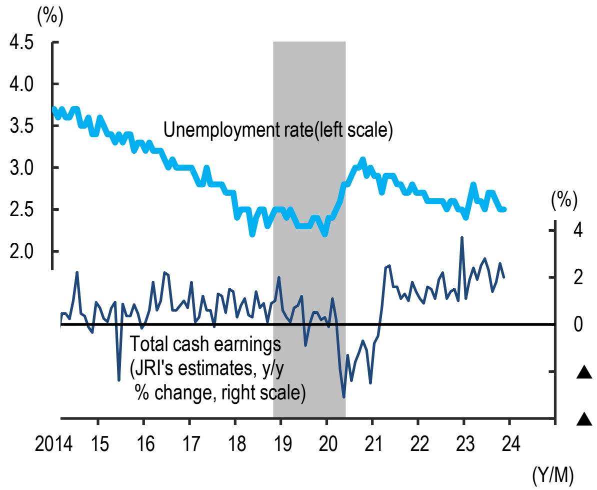
Exports decreased due to weak global demand for goods.
Imports decreased mainly in energy-related sectors.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

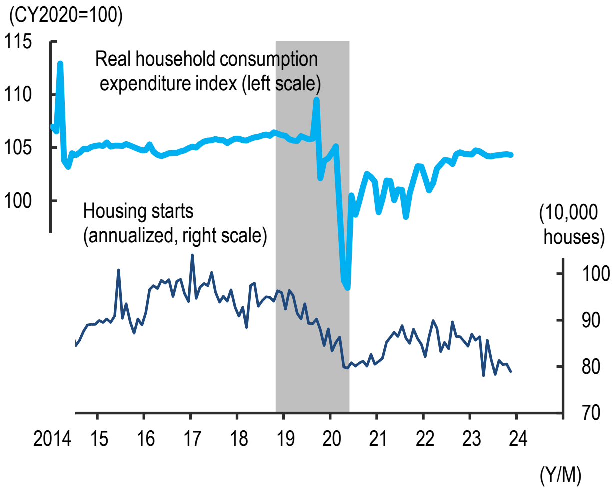
The unemployment rate stayed in the mid-2% range.
Nominal wage growth remained at the 2% level.



Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labor and Welfare.

Figure 1-5 The Household Sector

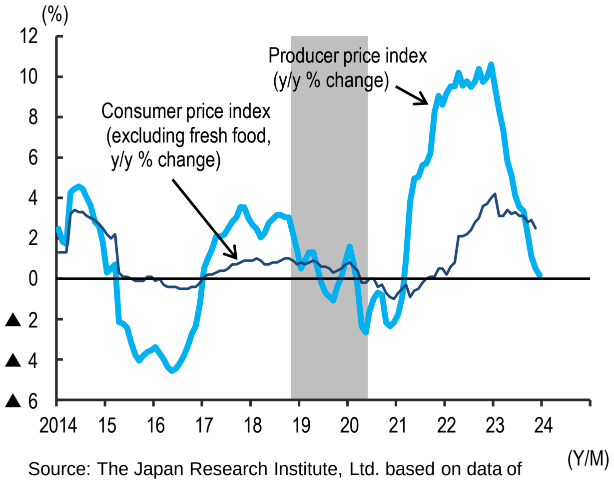
Consumption remained on a recovery track.
Housing starts showed weak developments.



Source: The Japan Research Institute, Ltd. based on data of The Cabinet Office, The Ministry of Land,Infrastructure, Transport and Tourism.

Figure 1-6 Prices

Corporate price inflation declined sharply.
Consumer price inflation also decelerated moderately.



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Internal Affairs and Communications, The Bank of Japan.

∗ The shaded area indicates the recession phase.

Business confidence improved in both manufacturing and non-manufacturing sectors

◆ Automobiles and accommodation and food services led the way

Corporate sentiment has improved. The Bank of Japan's (BOJ) Tankan Survey for December 2023 indicated that the diffusion index (DI) for business conditions for large manufacturing enterprises rose for the third consecutive quarter, increasing by 3% compared to the previous survey. Robust sales in automobiles led the overall growth. The figure for large non-manufacturing enterprises also increased by 3% compared to the previous survey, marking the seventh consecutive quarterly rise. The accommodation and food services sector, experiencing a recovery in demand, maintained its strong performance. Additionally, many industries saw business improvements primarily driven by the price pass-through for goods and services.

◆ Manufacturing moved back and forth

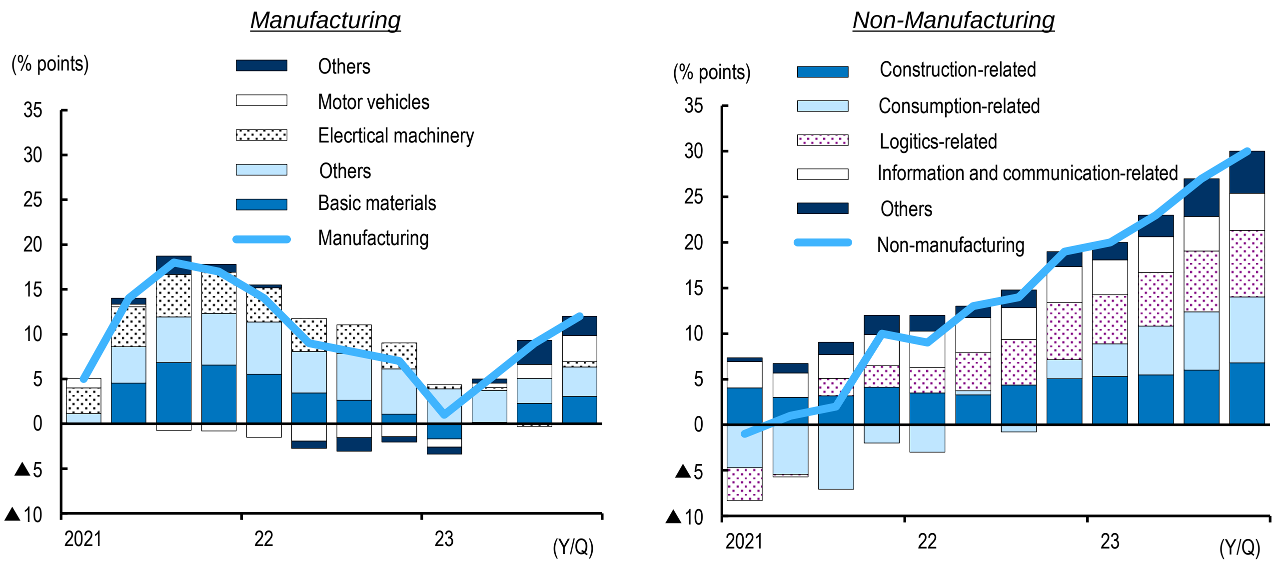
In November 2023, the industrial production index saw its first decline in three months, dropping by 0.9% from the previous month. Across various industries, production witnessed a downturn, particularly in electrical machinery and information and communication equipment, influenced by the global decline in demand for goods.

The future production plan for December 2023 anticipates a 6.0% month-on-month increase, with a subsequent 7.2% month-on-month decrease projected for January 2024. However, potential downward pressures on production may arise from the temporary suspension of production and shipments by certain automakers (not factored into the production plan) and the impact of the Noto Peninsula earthquake.

◆ Inbound tourism demand rebounded

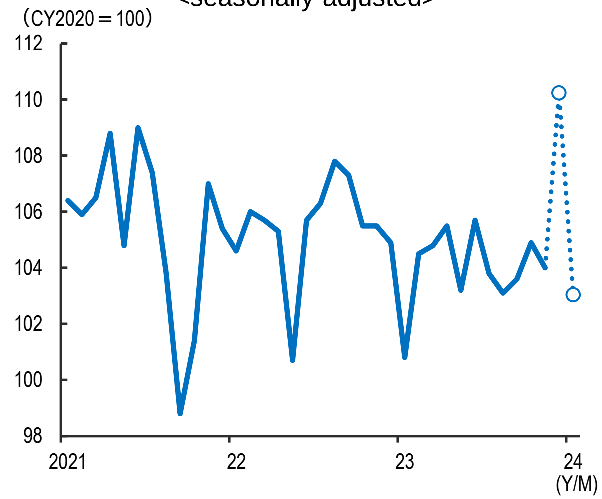
Inbound tourists to Japan in November 2023 reached 2.44 million, recovering to the same level as the pre-COVID-19 pandemic. Although the recovery of Chinese visitors to Japan has been slow, there has been a consistent rise in the number of tourists from East Asia excluding China and the US.

Figure 2-1 DI for Business Conditions of Large Companies



Source: The Japan Research Institute, Ltd. based on data of The Bank of Japan

Figure 2-2 Index of Industrial Production <seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Economy, Trade and Industry.
Note:Dotted lines are postponed based on the forecast index of manufacturing production (December and January).

Recovery in demand for goods provides a tailwind for capital investment

◆ Subdued foreign demand weighs on capital investment

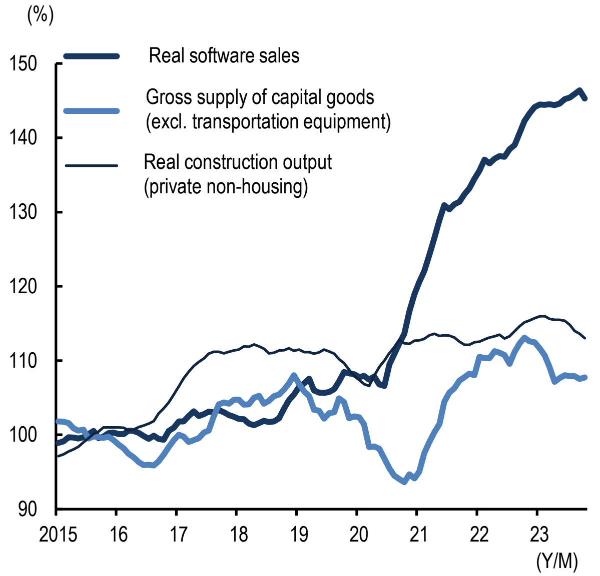
Capital investment has been experiencing a gradual recovery, but specific sectors continue to lag. Software investment has shown resilience, driven by a growing demand for labor-saving and information-oriented solutions. However, investments in machinery and construction have been sluggish. The overall backdrop includes a weakening global demand for goods and a perception of excess capacity particularly in industries heavily reliant on foreign demand, such as electrical and general machinery, limiting the willingness to invest in expanding production capacity.

◆ Capital investment will steadily increase

Capital investment will remain robust in the future. Corporate appetite for capital investment continues to be strong, buoyed by high corporate earnings. According to the Business Outlook Survey for the October-December quarter of 2023, corporate capital investment projections (including software, excluding land) for FY2023 indicated a year-on-year growth of 11.1%, surpassing previous years. In particular, the corporate sector is aggressively investing in digital technology for labor-saving and streamlining amid various backgrounds, such as worsening labor shortages.

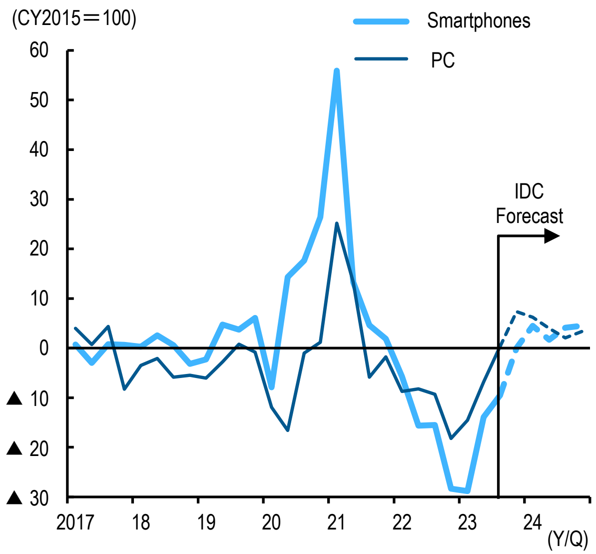
A cyclical pickup in demand for goods provides a tailwind for capital investment through increasing exports. The global semiconductor demand has recently hit the bottom, as PCs and smartphones, which once experienced significant growth in their stay-at-home demand during the COVID-19 pandemic, are entering a replacement period. Moreover, a growing demand for generative AI adds to the overall dynamics in the semiconductor market. The global capital investment cycle looks set to move into an upward phase as the worst is over for global companies' capacity utilization ratios. As demand increases for production facilities and semiconductor manufacturing equipment in which Japan has a competitive edge, capital investment to expand production capacity will likely intensify.

Figure 3-1 Private-Sector Capital Investment-Related Indicators by Type<seasonally adjusted>



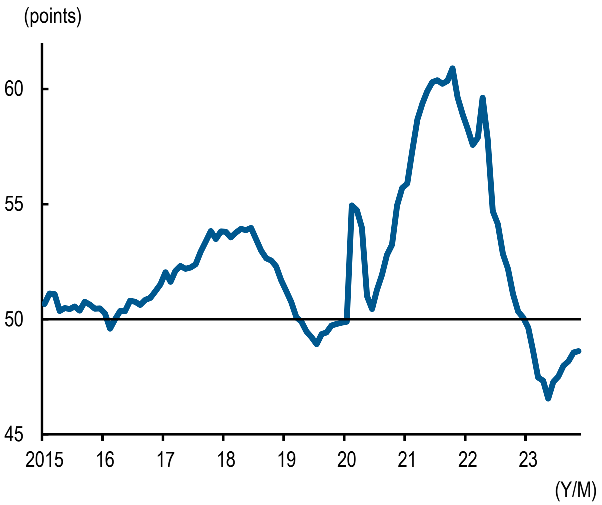
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Economy, Trade and Industry.
Note: Backward 6-month moving average.

Figure 3-2 Worldwide PC and Smartphone Shipments <YoY>



Source: The Japan Research Institute, Ltd. based on data of The IDC、Bloomberg.L.P.

Figure 3-3 Global Manufacturing PMI Equipment Utilization Index



Source: The Japan Research Institute, Ltd. based on data of The S&P Global.

Household income environment improved moderately

◆ Nominal wage growth expanded

The growth of scheduled cash earnings of general workers remained unchanged, at 1.5% year-on-year in November 2023. Part-time workers' hourly wages grew by 4.6% year-on-year, with some fluctuations. However, such growth failed to keep pace with the increase in consumer prices, with real wages falling 3.0% year-on-year for the 20th consecutive month of decline.

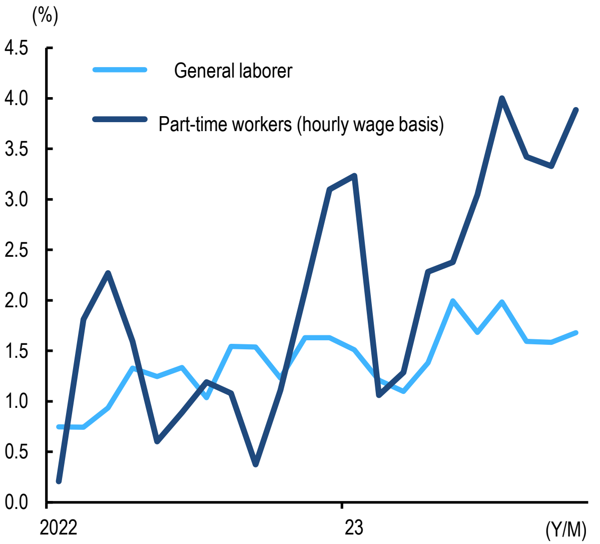
Wage growth is poised to accelerate. Fueled by robust corporate earnings, inflation, and a growing awareness of labor shortages, the anticipated wage increase rate (including regular salary increments) after the 2024 the spring wage offensive will be around 3.8%, surpassing last year's rate. Wages for part-time and non-regular employees will also witness an uptick in line with the rising minimum wages and the tightening conditions in the labor supply-demand landscape. Several companies have announced substantial wage hikes for FY2024, while others are beginning to signal their intentions to implement continuous wage increases.

◆ Housing starts weakened mainly for owner-occupied houses

The number of new housing starts in November 2023 showed the first decline in two months, down 4.0% from the previous month. By type of housing use, rental housing remained steady, while owner-occupied houses showed a marked decline. The substantial increase in construction costs, propelled by higher material prices and labor costs, has created a downward pressure on demand.

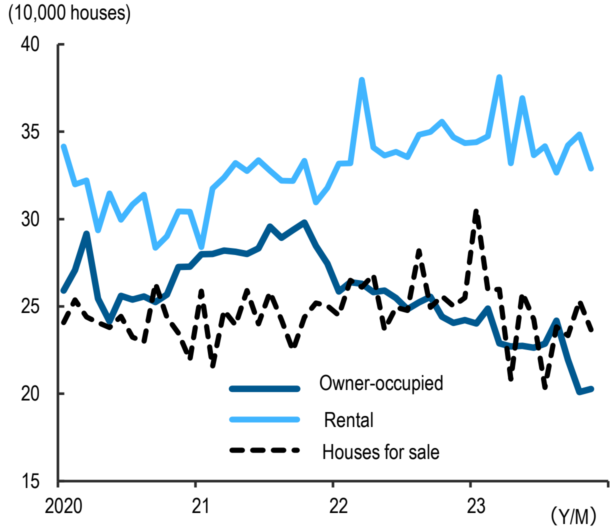
The outlook for housing starts in the coming years appears subdued. Although an enhancement in the household income environment could provide support, the decreasing number of households and the potential rise in interest rates associated with the normalization of monetary policy are expected to weigh on housing investment significantly.

Figure 4-1 Scheduled Cash Earnings <YoY>



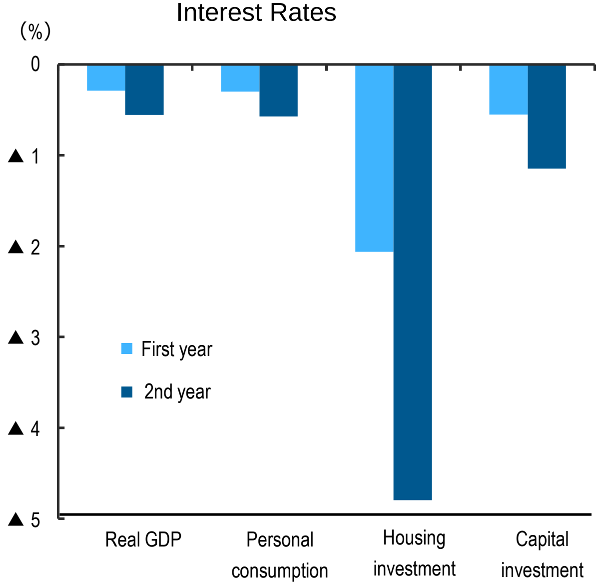
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Health, Labour and Welfare.
Note: Adjusted for data fault caused by the replacement of surveyed companies.

Figure 4-2 Housing Starts <annualized, seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Land, Infrastructure, Transport and Tourism.

Figure 4-3 Impact of 1% Increase in Short-Term Interest Rates



Source: The Japan Research Institute, Ltd. based on data of The Nikkei Inc.
Note: Estimated based on NEEDS Japan economic model. Percentage deviation from the level that would have occurred if interest rates had not risen.

Imported inflation subsides while wage hikes exert inflationary pressure

◆ Price hikes in service items have expanded

Core CPI growth in November 2023 contracted from the previous month to 2.5% year-on-year. The significant drop in energy prices resulted from a delayed response to the earlier decline in resource prices during the summer of 2023, facilitated by the fuel cost adjustment system. Additionally, the rate of price increase in other goods items slowed as imported inflationary pressure eased. Meanwhile, the service items maintained persistent high price growth, driven by the increasing inflationary pressure from rising wages. The frequency distribution of price increases for services indicates a decrease in the number of items with unchanged prices and an increase in the number of items with rising prices.

Core CPI growth is expected to slow to around 2% through the second half of 2024. The reduction and termination of the government's countermeasures against higher prices could push up energy prices, and pressure for price hikes on the back of rising wages would intensify. Still, the trend of price hikes caused by the high cost of raw materials will likely subside.

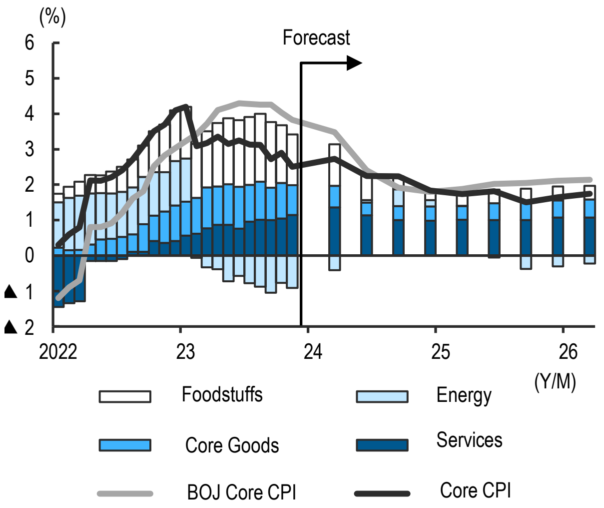
◆ Long-term interest rates will rise moderately

The BOJ decided to maintain the current accommodative monetary policy at its December 2023 Monetary Policy Meeting.

Long-term interest rates showed a downward trend. Lower U.S. long-term interest rates and the results of the BOJ meeting have reduced speculation of an early policy correction.

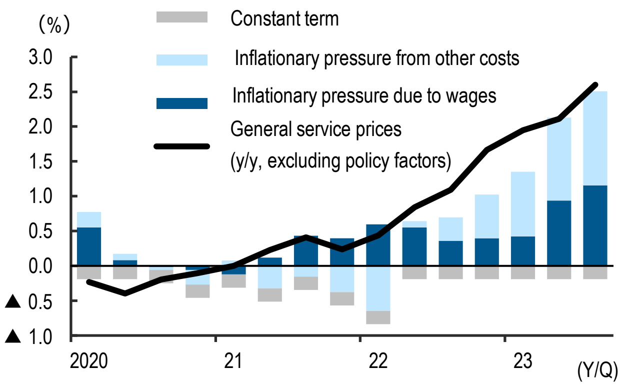
The BOJ will likely lift negative interest rates toward the end of spring, after confirming the sustainability of wage hikes through the spring wage offensive and concluding that there is greater certainty of meeting the price target. Long-term interest rates will likely follow a gradual upward trend as the market perceives a continued recovery in the domestic economy and changes in the BOJ's monetary policies.

Figure 5-1 Consumer Price Index <YoY>



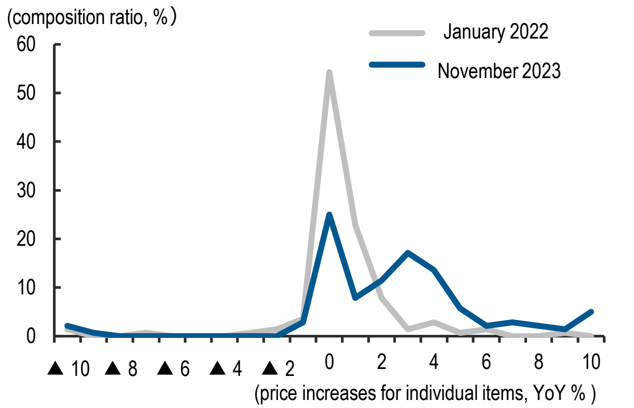
Source: The Japan Research Institute, Ltd. based on the data of Ministry of Internal Affairs and Communications.
Note:Projected periods are quarterly values. Fuel oil price easing measures are assumed to end in April 2024, and electricity and gas price easing measures are assumed to halve in May of the same year and end in June.

Figure 5-2 Factor Decomposition of Price Increases in The Services Sector



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, The Ministry of Internal Affairs and Communications.
Note:Regression with general service prices as the explained variable and service wages and input costs as the explanatory variables. Each variable is year over year. The estimation period is from January-March 2016 to July-September 2023. Wages are the predetermined salaries of general workers in the service sector. Input costs are final demand price index for services (excluding exports).

Figure 5-3 Frequency Distribution of Consumer Price Inflation <services>



Source: The Japan Research Institute, Ltd. based on the data of The The Ministry of Internal Affairs and Communications.
Note:Histogram width is 1 percentage point (central 0% range -0.5 to +0.5% y/y). The left end of the histogram shows the percentage of items with a price increase of less than -9.5% y/y, while the right end shows the percentage of items with a price increase of +9.5% y/y or more.

Topic①: Export contraction by stronger yen weakens

◆ Export volume sensitivity to exchange rates declines

The exchange rate has shifted towards a stronger yen. In the dollar-yen market, the yen's depreciation peaked in November 2023, as the market foresaw a decrease in the gap between domestic and foreign interest rates, particularly with the decline in U.S. long-term interest rates. Market participants anticipate a continued moderate appreciation of the yen.

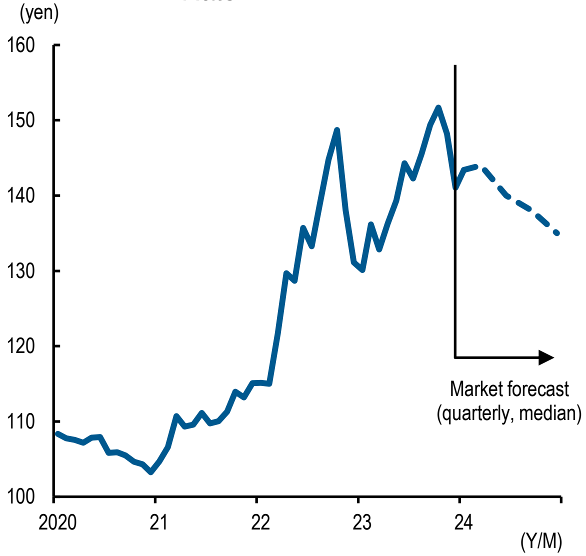
Generally, a stronger yen tends to depress export volumes by elevating export prices denominated in foreign currencies. However, this impact has been diminishing in recent years. The reduction in export volume caused by a 1% appreciation in the yen has decreased to about 0.1% since 2010, equivalent to only about a quarter of the level in the 2000s.

◆ Changes in production and export structure serve as the backdrop

One factor contributing to the reduced sensitivity of export volumes to exchange rate fluctuations could be the diminishing impact of exchange rate pass-through. Over the past 40 years, there has been a continuous decline in firms' tendency to pass on the effects of exchange rate fluctuations on export prices. In recent years, the pass-through rate of export prices to a 1% yen appreciation shock has come down to just around zero.

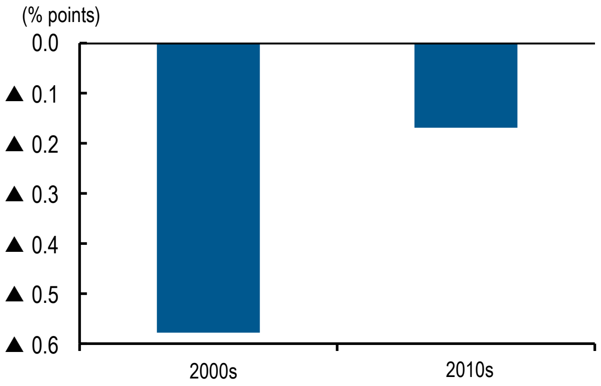
The underlying cause of this trend lies in a transformation of production and export structures among Japanese firms. Through the relocation of production bases overseas and the establishment of a global specialization system, cross-border transactions within the company's group have expanded. Consequently, the company's exports have become less susceptible to fluctuations in exchange rates. In addition, the decline in the companies' price control due to intensifying competition in overseas markets has also contributed to the difficulty of adjusting to the strong yen by raising prices.

Figure 6-1 Trends in The U.S. Dollar-yen Exchange Rate



Source: The Japan Research Institute, Ltd. based on data of The Bloomberg.

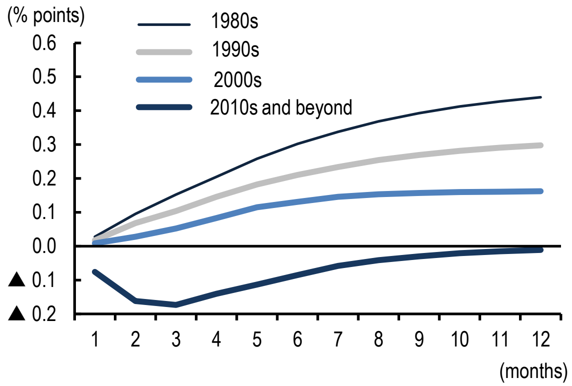
Figure 6-2 Downward Pressure on Export Volume Due to 1% Yen Appreciation Shock



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Finance, Bank of Japan, and Netherlands Bureau for Economic Analysis.

Note:Estimated from the impulse response function of a VAR model consisting of export volume, world imports (excluding Japan), real effective exchange rate, and three dummy variables (Lehman shock, Great East Japan Earthquake, and Corona disaster). Cumulative 12-month response of export volumes to a 1% appreciation shock.

Figure 6-3 Pass-Through to Export Prices From a 1% Appreciation Shock to The Yen



Source: The Japan Research Institute, Ltd. based on The Bank of Japan.

Note:Cumulative response of export prices to a 1% shock of yen appreciation, estimated from the impulse response function of a VAR model consisting of three variables: export prices (in contract currency), nominal effective exchange rate, and firm prices (domestic final goods).

Topic②: Estimated GDP loss caused by the Noto Peninsula earthquake will reach just under 100 billion yen

◆ Production/business activity and demand for tourism have taken a hit

The significant damage caused by the Noto Peninsula earthquake in January 2024 has inflicted a severe economic impact on the affected areas. Two primary routes of adverse effects stand out.

The first is the stagnation of production and business activities. Damage to vital assets like factories and roads, coupled with delays in the return of disaster victims to work, is compelling businesses to grind to a halt in their production and operations. The recovery process exhibited variation when examining past seismic events with a seismic intensity of 7. The aftermath of the Great East Japan Earthquake was prolonged due to supply chain disruptions and power supply constraints. In contrast, the Kumamoto and Hokkaido Eastern Iburi Earthquakes experienced a temporary decline but recovered to pre-disaster levels within a few months. This time, there are early signs of recovery, with some companies resuming production activities, indicating a potential avoidance of a prolonged economic downturn.

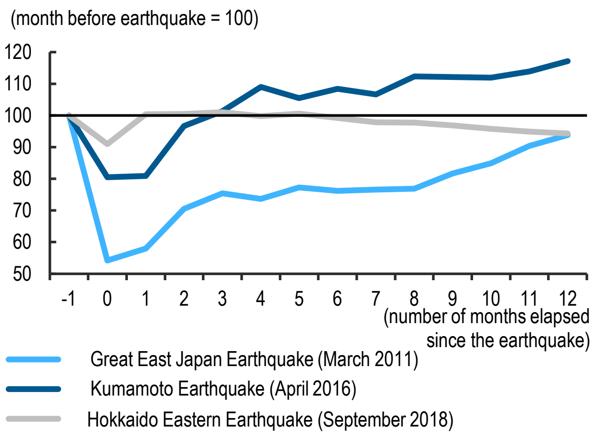
The second is the significant impact on tourism demand. Cancellations of overnight stays are on the rise, particularly in Ishikawa and Toyama prefectures. Historical examples reveal that while the drop in travel demand from Japanese tourists tends to rebound relatively quickly, foreign demand exhibits a more prolonged decline.

Based on estimates derived from earthquakes such as the Kumamoto Earthquake, the projected loss to GDP is approximately 97.4 billion yen. The overall impact on the Japanese economy is expected to be limited, accounting for about -0.02% of GDP.

◆ Beware of adverse spillover through the supply chain

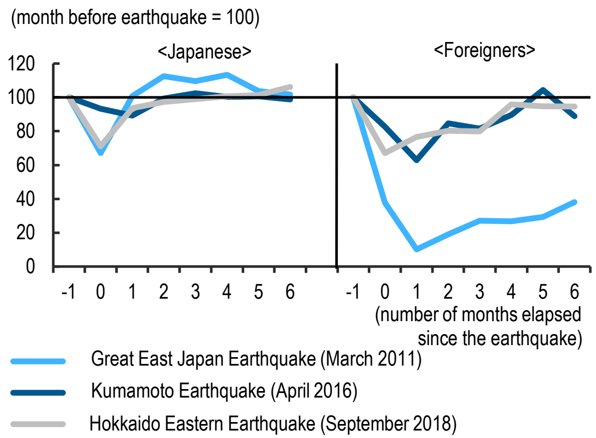
However, the stagnation of production and business activities through the supply chain requires caution. Estimates that consider the adverse effects of supply chain disruptions indicate that the decline in GDP caused by the stagnation of production and business activities in Ishikawa Prefecture could be as significant as -224 billion yen. Adverse effects will likely spread to various industries, particularly within the manufacturing sector.

Figure 7-1 Industrial Production in The Affected Region



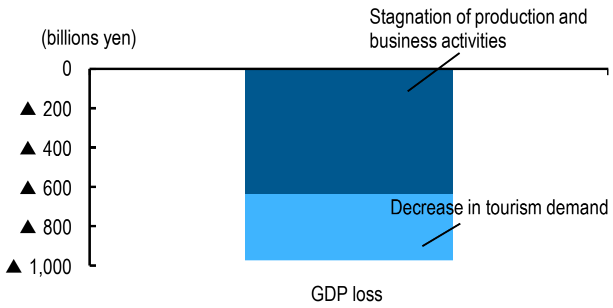
Source: The Japan Research Institute, Ltd. based on data of The Cabinet Office and each prefecture.
Note: Legend: Figures in parentheses ( ) indicate the month in which the earthquake occurred. Great East Japan Earthquake: Iwate, Miyagi, and Fukushima Prefectures; Kumamoto Earthquake: Kumamoto Prefecture; Hokkaido Bombei East Earthquake: Hokkaido.

Figure 7-2 Total Number of Overnight Stays in The Affected Area <seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Land, Infrastructure, Transport and Tourism.
Note: The Great East Japan Earthquake is for the Tohoku region, the Kumamoto Earthquake is for the Kyushu region, and the Hokkaido earthquake is for Hokkaido.

Figure 7-3 Direct GDP Downside Impact of Noto Peninsula Earthquake



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Finance, Tokyo Shoko Research Ltd.
Note: Impact of stagnation in production and business activities in East Japan is estimated based on Tsutsumi et al. (2016) "Estimated Impact of the 2016 Kumamoto Earthquake". Economic activity in Ishikawa Prefecture fell -15% in one month. Stock loss rate is assumed to be the same as that of the Kumamoto earthquake. Infrastructure restoration rate and return to work rate are assumed to recover to 100% after one month. Decline in tourism demand is assumed to be the same level as that of the Kumamoto earthquake in Hokuriku region for the Great East Japan Earthquake, Tohoku region for the Kumamoto earthquake, Kyushu region for the Kumamoto earthquake, and Hokkaido for the Hokkaido earthquake.

Japan economic forecast: FY23: +1.6%, FY24: +1.2%

◆ Strong corporate earnings act as a starting point

A gradual recovery led by domestic demand is anticipated for the Japanese economy in the foreseeable future. Strong corporate earnings will likely lead to positive spending, including wage increases that outpace higher prices and an expansion of future-oriented capital spending.

Personal consumption will likely recover moderately through spending of excess savings accumulated in the COVID-19 pandemic and improvement of the employment and income environment. The room for a rebound in service consumption remains limited, but durable goods consumption will drive the recovery as price hikes subside.

Capital investment by companies will increase, underpinned by high corporate earnings. Amid a worsening labor shortage, digital investment will increase mainly for labor-saving purposes, and the onshoring of production bases will also progress.

The adverse effects of the Noto Peninsula earthquake have so far proven marginal.

◆ The growth rate for FY2023 will be +1.6%

The real growth rate will be +1.6% in FY2023, +1.2% in FY2024, and +1.0% in FY2025, respectively. The potential growth rate, currently expected to be in the mid-zero percentage in the near term, will rise to around +1% by 2025 through the improvement in labor productivity

Figure 8 Projections for GDP Growth and Main Indicators of Japan (as of January 16, 2024)

(%, changes from the previous fiscal year)

	CY2023		CY2024				CY2025				CY2026	FY2023	FY2024	FY2025
	7~9	10~12	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3			
	(Actual)	(Projection)										(Projection)		
Real GDP	▲ 2.9	1.7	1.6	1.6	0.9	1.1	1.0	1.0	1.0	0.9	0.9	1.6	1.2	1.0
Private Consumption Expenditure	▲ 0.6	2.0	1.5	1.8	0.6	1.0	0.9	0.8	0.8	0.7	0.7	0.3	1.2	0.8
Housing Investment	▲ 2.1	0.1	0.0	▲ 0.1	▲ 0.1	▲ 0.1	▲ 0.2	▲ 0.2	▲ 0.3	▲ 0.3	▲ 0.3	2.0	▲ 0.2	▲ 0.2
Business Fixed Investment	▲ 1.8	2.8	3.0	3.5	3.1	2.4	1.8	2.0	2.2	2.2	2.0	0.2	2.7	2.1
Private Inventories (percentage points contribution)	(▲ 1.9)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(▲ 0.2)	(▲ 0.1)	(▲ 0.0)
Government Consumption Expenditure	1.3	0.3	0.2	0.1	0.0	0.0	0.0	0.2	0.2	▲ 0.3	0.0	0.7	0.2	0.1
Public Investment	▲ 3.1	2.2	1.2	1.2	1.0	0.8	0.8	0.8	0.4	0.4	0.4	2.8	1.0	0.6
Net Exports (percentage points contribution)	(▲ 0.4)	(0.0)	(0.3)	(0.1)	(0.1)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	(0.2)	(1.4)	(0.1)	(0.2)
Exports of Goods and Services	1.5	4.6	3.1	1.7	1.7	2.2	2.6	2.8	3.0	3.2	3.2	3.4	2.4	2.8
Imports of Goods and Services	3.2	4.3	1.6	1.2	1.4	1.4	1.6	2.0	2.1	2.3	2.3	▲ 2.5	1.8	1.9

(% changes from the same quarter of the previous year) (% changes from the previous fiscal year)

	CY2023 7~9	10~12	CY2024 1~3	4~6	7~9	10~12	CY2025 1~3	4~6	7~9	10~12	CY2026 1~3	FY2023	FY2024	FY2025
Nominal GDP	6.9	6.0	5.0	2.8	3.7	3.0	2.6	2.2	2.1	1.9	2.1	6.0	3.0	2.1
GDP deflator	5.3	4.3	3.8	2.3	2.1	1.7	1.3	1.1	1.1	0.9	1.0	4.3	1.8	1.0
Consumer Price Index (excluding fresh food)	3.0	2.5	2.7	2.2	2.2	1.8	1.7	1.8	1.5	1.6	1.7	2.9	2.0	1.7
Unemployment Rate (%)	2.6	2.5	2.5	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.2	2.6	2.4	2.3
Exchange Rates (JY/US$)	145	148	145	142	139	136	134	132	130	129	128	143	135	130
Import Price of Crude Oil (US$/barrel)	83	91	80	78	80	82	81	76	74	73	72	84	78	73

Source: The Cabinet Office; The Ministry of Internal Affairs and Communications; The Ministry of Economy, Trade and Industry;The Ministry of Finance.
The projection figures are based on those of The Japan Research Institute, Ltd.