Japan

The odd one out

- The economic recovery has been weak, largely hampered by Covid-19, but that leaves some potential for growth.
- Short-term, the economy will enjoy tailwinds from loosening supply chain issues, the weak yen and pent-up private spending. Another fiscal boost in 2023 will support growth, but a global recession will weigh heavy on exporters.
- Inflation is moving higher, but we expect a global recession will keep unions' focus on job security in the spring wage negotiations, obstructing a price-wage spiral.
- Our base case is that Bank of Japan's yield curve control remains in place, but the risk of an involuntary exit with potential large consequences to financial markets has increased significantly.

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Lagging behind

Japan has missed out on the global economic recovery following the first reopening after Covid-19 lockdowns. The pandemic has weighed heavily on the cautious Japanese consumers and on the world's second largest car manufacturer, as supply constraints have been a key obstacle to production. Japan has shipped about 1 million fewer cars in 2020 and 2021 compared to 2019 and the recovery has just picked up slightly during H2 2022, but still far off the pre-pandemic levels of 4.4 million a year. The headwinds to the manufacturing sector have also spilled over to capex. In Q3 2022, GDP remained 2.9% below Q3 2019-levels, far behind the rest of the G7. Capex and private spending have been the key underperformers, and Japan has fallen back to old habits with public spending as a key growth driver. A strong trend in machinery orders bodes well for a recovery in corporate investments in the short-term, but a global recession will likely keep capex below pre-pandemic levels. For two years, households have saved extensively, as soft lockdowns continuously weighed on consumers. Only in Q2 when the lockdown was abolished did the savings rate decline. This also means that, consumers still have a lot of savings from the pandemic, which can be released if Covid-19 does not flare up again.

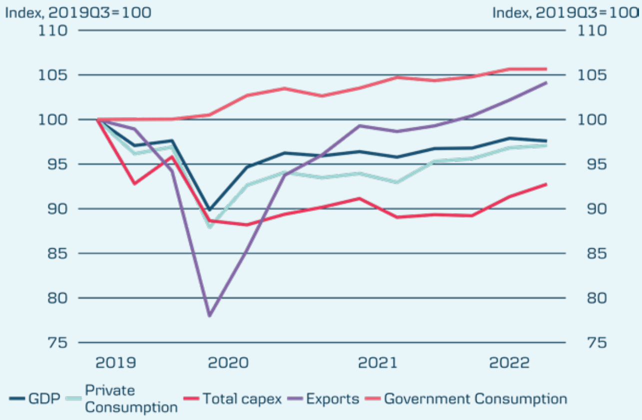
After another Covid-19 wave over the summer, the economy has hit a sweet spot in Q4 with a low number of new cases supporting the service sector. A historically weak yen is also boosting exports and supply chain bottlenecks are easing. That is also why we see Japan, at least to some extent, catching up with the global economy in Q4-Q1. Eventually, the slowdown in Japan's largest trading partners, US and China, will weigh on Japanese exporters who are largely sensitive to the global business cycle. A JPY39trillion (over 7% of GDP) supplementary fiscal package will shield consumers from the energy crisis and support the further recovery in Japan next year. However, fiscal packages like these have a history of not being fully used. With the government picking up large parts of the energy bills next year, we continue to see room for modest private consumption growth in 2023. That said, inflation will also weigh on Japanese consumers, which is aready reflected in low consumer confidence.

The Japanese labour market is notoriously tight, but reflects the weak recovery so far. That is, unemployment remains above old lows and the jobs-to-applicants ratio is far off the tightest levels in 2018 when there was more than 160 job openings for every 100 applicants.

Global recession gets in the way of reflation

As inflation and yields have surged on a global scale, the contrast to Japan has become still more evident. Headline inflation has increased significantly, but less dramatically compared to the US and the euro area. The Bank of Japan's (BoJ) preferred measure, CPI excluding fresh food, has hit the highest level since the early 1980s, weighing on consumers who have been used to very little price moves for many years. Price increases are spreading now and inflation excluding food and energy stands at 1.5%. This largely reflects a historically large shock to import prices and inflation still looks to have a temporary nature.

Still not caught up



Source: Japanese Cabinet Office, Macrobond Financial

The pandemic has been hard on car manufacturers

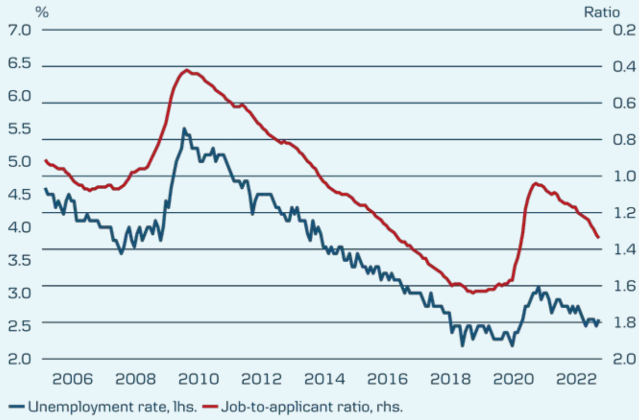
Source: Japan Automobile manufacturers association, Macrobond Financial

Large accumulated savings

Source: Japanese Cabinet Office , Macrobond Financial

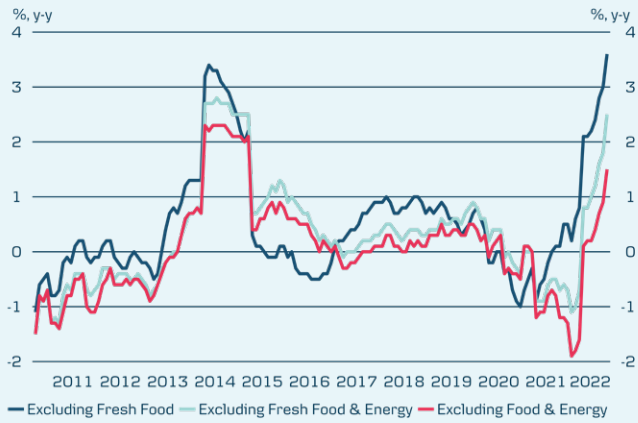
This delicate situation leaves BoJ as the odd one out among major central banks as they have fiercely defended their yield curve control (YCC) policy with massive bond buying. Japan's status as a major energy importer and the lack of tourists have driven a historical trade deficit. This has spiralled the yen to a 50-year low, adjusted for inflation. The BoJ has intervened several times in the FX market during the fall on behalf of the Ministry of Finance to support the yen. That leaves the BoJ pumping yen into the market with the one hand and buying them with the other. This is an unsustainable situation that could have serious repercussions for financial markets if the global pressure for higher yields forces the BoJ to give up on the YCC. See FX Research: Bank of Japan's Gordian knot. We still see this as a risk scenario, though, and our main scenario it that the YCC remains in place. The annual Shunto spring wage negotiations will show if companies are finally increasing workers' base pays by enough to potentially create a wage-price spiral, which is essentially what BoJ wishes for and what other central banks fear. We think the global recession will tip priorities towards job security and that will get in the way of any significant increase in wage growth and sustainable reflation. Springtime will be crucial for monetary policy in Japan, as the second and last terms of governor Kuroda and his two deputies run out. They are all fierce advocates of reflating the economy and the big question is, whether they will be replaced by doves or if the prime minister sees an opportunity to tweak BoJ leadership in a more hawkish direction.

Room for tighter labour market



Source: Japanese Statistics Bureau, Japanese Ministry of Labour and Macrobond Financial

Core inflation still modest but moving higher



Source: Japanese Statistical Bureau, Macrobond Financial

Historically weak yen

Source: Macrobond Financial

Macro forecasts - Japan

% y/y	2020	2021	2022	2023	2024
GDP	-4.7	1.7	1.4	0.7	0.9
Private Consumption	-5.9	1.1	3.0	0.9	0.8
Total fixed Investments	-5.0	-1.3	-0.8	1.3	0.6
Public Consumption	2.3	2.1	1.6	0.6	0.5
Exports	-11.7	11.9	4.7	2.5	1.5
Imports	-6.8	5.1	8.0	3.2	0.5
Unemployment rate (%)	2.8	2.8	2.6	2.8	2.8
CPI. excl. fresh food (y/y)	-0.2	-0.2	2.2	2.4	1.4
BoJ rate on deposit facility*	-0.1	-0.1	-0.1	-0.1	-0.1
10 year bond rate target*	0.0	0.0	0.0	0.0	0.0

*Note: *end-year*
Source: Macrobond Financial, Danske Bank

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