THE ECONOMIC SHIFT

Turning the Page: Japan's Economy and What Lies Ahead

Geopolitical conflict, the COVID-19 pandemic, and a persistent population decline have collectively brought Japan to the end of its prolonged period of low inflation. This, in a nutshell, is how some of the BofA Global Research Japan team described the current economic transformation to the 1,200 participants at its 2024 Japan Conference.

The big question now is, can this recovery be sustained?

"We think inflation is here to stay," said Izumi Devalier, Head of Japan Economics Research, BofA Global Research, adding that she expects inflation to be sustained at around the Bank of Japan (BoJ) 2% target over the medium-term.

For more than two decades, four BoJ governors[1] had hoped for this turnaround as they grappled with zero inflation even deploying a radical policy of setting negative interest rates to stimulate inflation and growth.

It took the long tail of two globally disruptive events and one secular, domestic trend to finally see the return of inflation and the end of negative rates. The one-two punch of the pandemic and the Ukraine conflict ushered in massive supply chain chaos, which precipitated a spike in global commodity prices, leaving Japan exposed to external price shocks.

"I think the reason why the Covid import price shock was so powerful was because the degree of the rise in input costs was so significant that corporates really had no choice but to pass some of this on to consumers. And because everybody faced the same challenges, they ended up hiking prices at the same time," explained Devalier.

Simultaneously, the slow-moving demographic certainty of Japan's aging population has led to acute labor shortages, impinging on domestic productivity. If companies wanted to secure workers for factories, wages had to go up.

"We expect the economy to recover from here, and the BoJ to continue hiking beginning next year or mid next year, and inflation to keep being pressured by wages," said Claudio Irigoyen, Chief Economist, BofA Global Research at the 2024 Japan Conference.

Weak yen: An inflation driver?

With the economy still in the early days of this transformation, the BoJ is carefully treading between ensuring inflation is sustained, but not runaway, while managing orderly rate hikes. Policymakers are cautiously watching how fast prices are rising and the external factors that could accelerate them.

Although a weak yen can be a competitive advantage for Japanese exporters relative to other suppliers, it can cause higher imported inflation.

Shusuke Yamada, Chief Japan FX & Rates Strategist of BofA Global Research, expects the yen to remain weak, driven by the carry trade and the continued large volumes of overseas investments by Japanese firms seeking higher-yielding returns. The outlook of the yen, Yamada added, depends largely on the U.S. Federal Reserve policy decisions in the next few months of 2024 and whether the U.S. can pull off a soft economic landing.

Higher than expected inflation could complicate the BoJ's job of managing interest rates. In July 2024, the BoJ hiked its policy rate to around 0.25% from a range of 0% to 0.1% — the highest since 2008.[2]

[1] https://www.boj.or.jp/en/about/outline/history/pre_gov/index.htm
[2] https://www.bloomberg.com/news/articles/2024-07-31/boj-hikes-interest-rate-unveils-plan-to-cut-back-bond-buying

The bank has indicated that it intends to stay on course to raise interest rates further but will also ensure that market volatility does not hurt businesses.[3]

"Even with the hike to 0.25% with underlying inflation and inflation expectations running at 1.5%, real interest rates are still extremely low, which means that monetary policy is still accommodative. So, even if they (BoJ) don't do anything, policy will be stimulative, and they risk inflation rising faster than they would like," said Devalier.

According to Yamada, another scenario is where price increases are sustained, but wages grow slower than inflation this could then turn into a vicious cycle for the yen. He said slower wage growth creates more incentive for households to sell the yen to pursue inflation-protective strategies overseas, thus keeping the yen weak for longer.

Inflation: A catalyst for corporate productivity

"On the other hand, inflation could prompt companies to make better capital allocation decisions and bolster corporate productivity", said Masashi Akutsu, Japan Chief Equity Strategist, BofA Global Research. In an inflationary environment, Japanese companies would do better to turn surplus cash into meaningful capital expenditures.

"When inflation is caused by a labor shortage, as it is now, companies have to keep raising wages to attract talent, and to do that, they have to fundamentally change their price strategy and hike prices. They have to concentrate their business resources where they are strongest and improve productivity," said Akutsu.

Many Japanese companies are moving in this direction. A recent annual survey conducted by the Development Bank of Japan revealed that more than 9,000 large and medium-sized companies plan to increase their domestic capital spending by 21.6% in fiscal year 2024. This marks the third consecutive year of rising investment levels. The survey found that companies are pouring money into expanding semiconductor production capacity and electrification, including electric vehicles.[4] Approximately 90% said that they have also raised wages.

The upward pressure on wages will potentially lead to the culling of low productivity, "zombie firms," businesses that are unprofitable and struggling to survive, according to Devalier. As of 2023, Japan had an estimated 250,000 zombie firms, jumping by nearly a third over the pandemic.[5] Sustained increases in productivity are viewed as key to keeping Japan's GDP growth steady. In the second quarter of 2024, Japan's GDP expanded by 0.80% over the previous quarter, marking a recovery from a 0.6% contraction in the first quarter. The BofA Global Research team expects a gradual expansion from the third quarter onwards.

And while the team emphasize that Japan's recovery is still in its early phases, the outlook for the economy is bright.

"What is happening right now is a transitional period for Japan, where the structural changes to the economy are sowing the seeds, I think, for higher productivity down the line and it's a good time to invest in Japanese corporates," said Devalier.

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[3] https://www.reuters.com/markets/asia/boj-must-raise-rates-if-firms-keep-spending-says-board-member-takata-2024-09-05/
[4] https://www.dbj.jp/en/topics/investigate/2024/html/20240806_204917.html
[5] https://www.cnbc.com/2024/02/09/japans-stock-markets-are-rallying-will-zombie-firms-be-a-threat.html

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