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MCC CIE Papers

Publisher:

MCC Center for International Economy

Address:

1113 Budapest, Tas vezér utca 3-7.

https://cie.mcc.hu

Editor:

Csaba Moldicz

This paper and its conclusions reflect solely the private opinion of the authors and cannot be regarded as the official position of the Mathias Corvinus collegium Foundation.

Budapest 2024.

ISSN 3004-2607

Awakening after the lost decades?
Japan's Economy in 2023 and 2024

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Abstract

Japanese economy has continued to grow strongly since 2023, in contrast to its sluggish growth of the past few decades. According to preliminary estimates by the Institute of International Relations and Area Studies at Ritsumeikan University, Japan's GDP growth rate will be about 1.9% in 2023 and 0.6% to 0.7% in 2024. This data indicates that Japan's economic situation in 2023 is already better than that of other advanced countries. Our research finds that balancing domestic demand growth with trade deficits, and dealing with upward inflationary pressures, will be severe challenges for the Japanese economy to extricate itself from a long-term sluggish growth cycle.

Keywords: Japanese economy, low interest rates, rebound in exports, household consumption, prolonged inflation, manufacturing, artificial intelligence

The economy grew faster than expected

In the second half of 2021, Japan gradually stepped out of the pandemic, not only with a steady economic recovery, but also with positive growth for 10 consecutive quarters. Since the beginning of 2023, the Japanese economy has maintained an average growth rate of about 1.6% for three consecutive quarters. In terms of prosperity, since October 2021, except for a few months, Japan's service PMI has been above the threshold, and the manufacturing PMI has generally maintained in an expansion range, implying a good expectation on Japan's economic recovery and growth. Compared with the long-term low or even negative growth in the past, the growth performance of the Japanese economy for the past three years has shown short-term resilience and a high degree of prosperity. According to the Organization for Economic Co-operation and Development (OECD), it's expected that Japanese economy will grow by 1.7% in 2023, 1% in 2024, and 1.2% in 2025. However, the International Monetary Fund (IMF) predicts that Japan's nominal GDP in 2023 will be about $4.23 trillion, falling from the third position to the fourth in the world, and Germany, who is expected to overtake Japan, will have a GDP of about $4.43 trillion, and according to AFP in February this year, Japan's nominal GDP in 2023 will be about $4.2 trillion, while Germany's will be about $4.5 trillion. Although the sharp decline in the JPY exchange rate is an important reason why Japan has lost its position of the world's third-largest economy, there are still obstacles to Japan's economic recovery and growth. According to the annualized quarter-on-quarter statistics, Japan's GDP growth rate fell to -2.1% in the third quarter of 2023, compared with 3.7% and 4.5% in the first and second quarters, respectively. UBS forecasts that Japan's real GDP growth will reach or exceed its potential growth rate by 0.5% in 2024-2025. As tide of exports and consumption falling, the momentum of Japan's economic growth will weaken, and external uncertainty will enhance the difficulty for the economic growth.

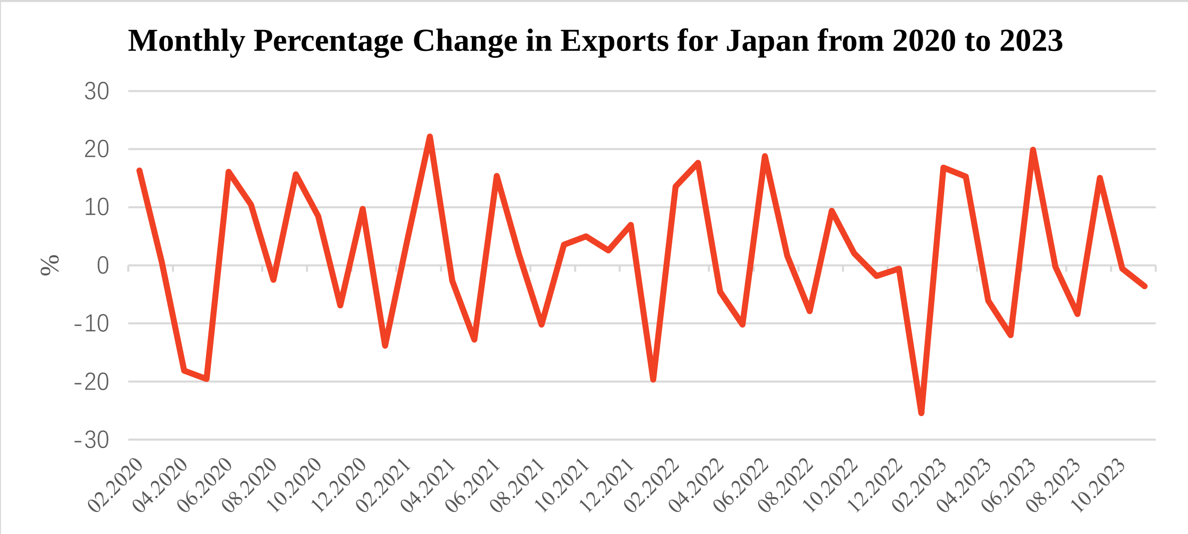
Japan's GDP Growth Rates 2020-2022

Year	GDP Growth Rate (%)
2020	-4.28
2021	2.14
2022	1.03
2023	1.9
2024(E)	1
2025(E)	1.2

Source: own compilation based on data from the World Bank and OECD and Ritsumeikan University

Exports showed a rebound

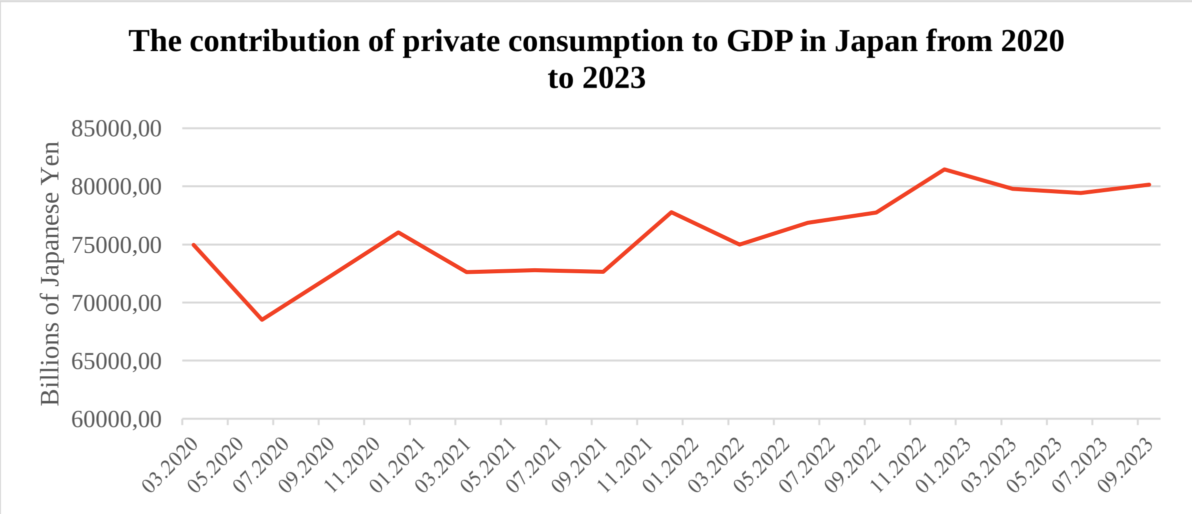
Japan's trade deficit narrowed in the first half of FY 2023, as evidenced by positive export growth and declining imports. However, since October 2023, Japan's exports have been gradually slowing down, with year-on-year growth rate declining to 1.6%. Due to the rising inflation, real wages have fallen, and household consumption has been dragged down, adding to the uncertainty of economic growth. Our study finds that actual household consumption in real terms in Japan fell year-on-year for the seventh consecutive month in September 2023. The new Japanese administration has launched the New Economic Policy (NEP), which aims to help the Japanese economy get back on track. As Prime Minister of Japan, Mr. Fumio Kishida announced a plan for the implementation of a "new capitalist" economic policy, focusing on promoting a shift in household assets from savings to investment, education, and science and technology. On November 2, 2023, the Japanese government passed a comprehensive economic stimulus package of up to JPY 17 trillion at an interim cabinet meeting. Where JPY 6.5 trillion will be used for tax cuts, including company income tax, personal income tax, and real estate tax reductions, JPY 4.5 trillion will be used for subsidies for small and medium-sized companies, self-employed, and other key areas, and JPY 6 trillion will be used for fiscal expenditure, including infrastructure investment, scientific and technological innovation, education and training, and international cooperation. The Japanese government estimates that the stimulus package will increase GDP by about 1.5 percentage points and create about 500,000 jobs. However, it will take time and data to test and evaluate the smooth implementation of the plan and its expected impact, and it's expected to be difficult to reverse the slowdown in exports and consumption. Once Japan ends the era of negative interest rates, the cost of bond issuance in companies will increase, and the appreciation of JPY will dampen the increase in export prices. In terms of external demand, it is expected that the global economy will slow down in 2024, overseas demand may contract, and exports from Japan will also be dragged down to a certain extent. It is also worth mentioning that the depreciation of JPY has brought positive benefits to the export industry, especially companies such as Toyota have performed well in the global market. However, this depreciation has put inflationary pressures on industries and consumers that rely on the domestic market.



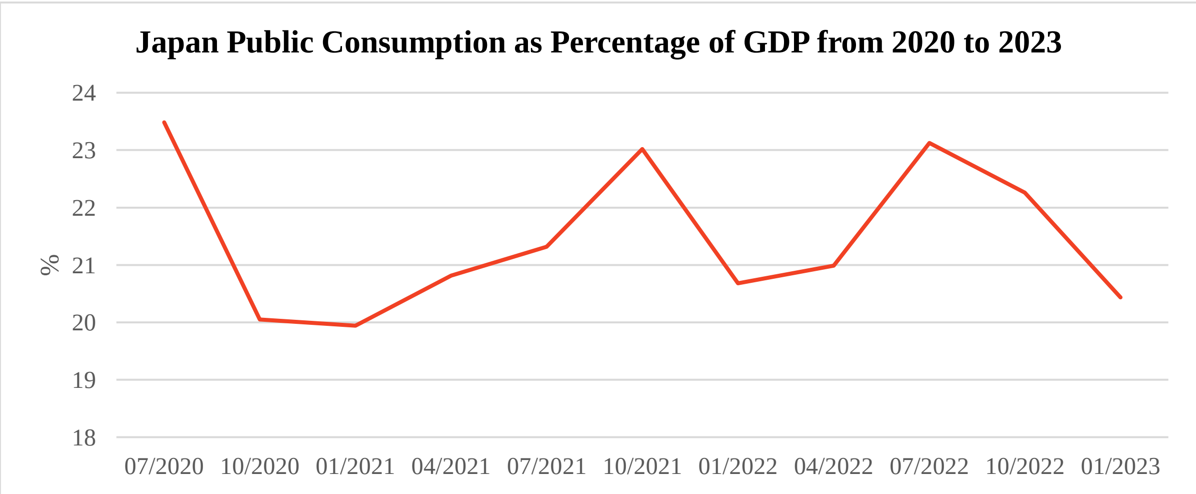
Source: own compilation based on data from the Ministry of Finance of Japan

The endogenous momentum of the Japanese economy is still insufficient

Since the beginning of 2023, Japan's household consumption performance has been tepid, with the average consumer confidence index in the first 10 months being 34.86, significantly lower than the pre-pandemic level of more than 40. In the first nine months of 2023, Japan's business sales grew by only 1.7% year-on-year, and the real growth rate is still negative after adjusting for prices. The depreciation of JPY and the decline in purchasing power caused by inflation are still the main factors that inhibit domestic demand, and it is difficult to significantly improve the "low-desire society" formed by the aging population through short-term recovery. At present, only sustained growth and being away from deflation can promote a change in the long-term expectations of Japanese residents, thereby achieving endogenous and sustainable growth. For the Japanese government, including the current Fumio Kishida administration, the strategy to promote economic growth has always been how to deal with the problem of a declining birthrate and an aging population. Allowing foreigners to become Japan's workforce is one of the measures taken by Fumio Kishidab administration. There are currently about 1.8 million foreigners working in Japan, but the proportion is very low compared to other countries (which is already more than 10% in many developed countries). It is impossible to judge whether the introduction of foreign labor and the acceptance of foreign immigrants are good, but from an economic point of view, it is important to see how the integration of new workers into Japan from outside Japan will greatly benefit the country's overall economic growth.



Source: own compilation based on data from the Japan Institute for Social and Economic Affairs



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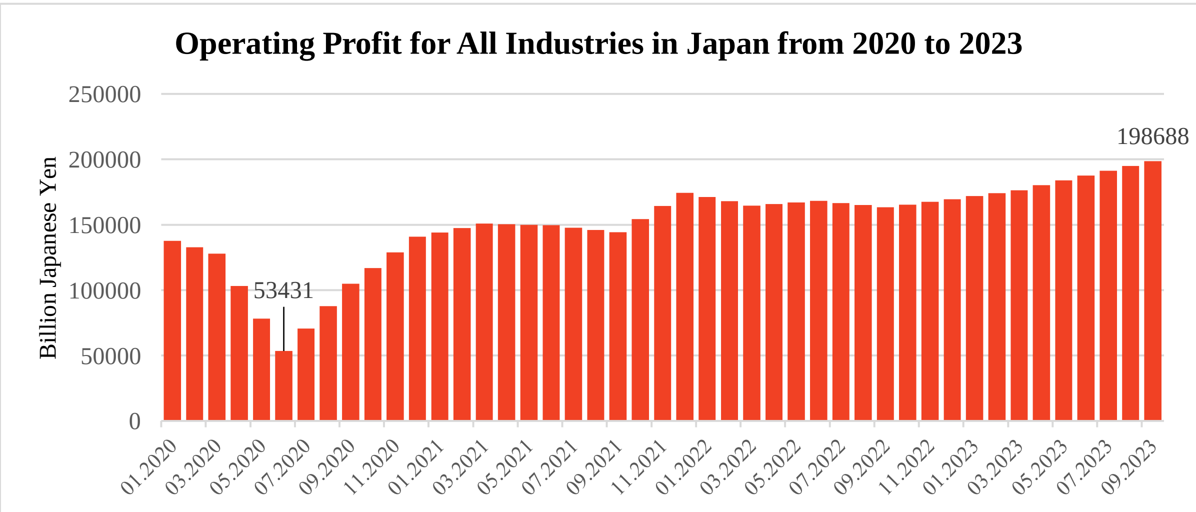
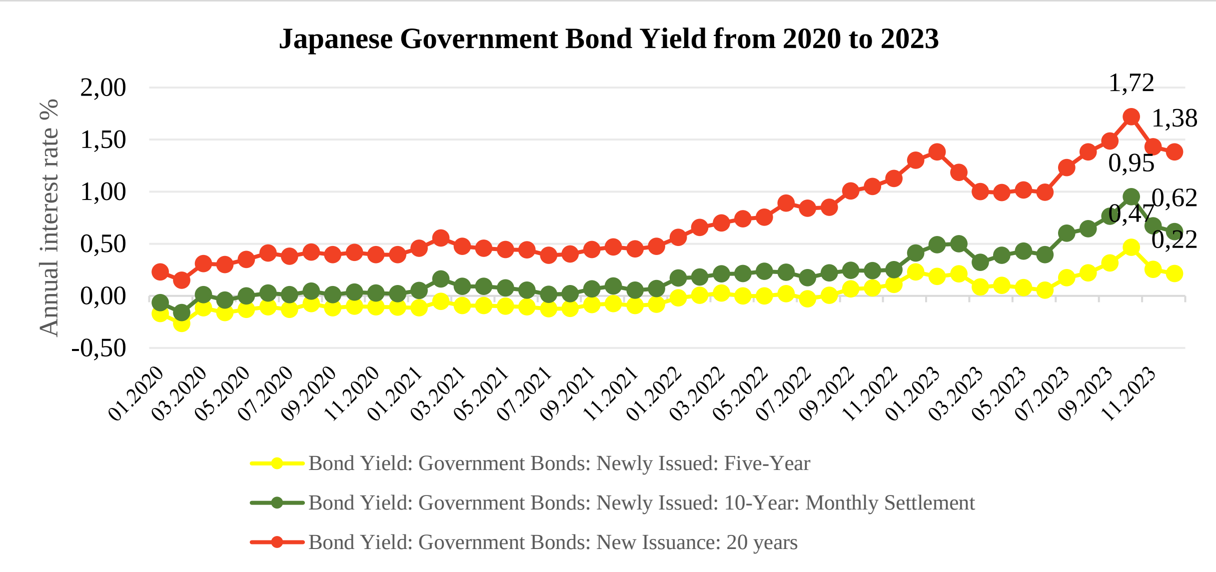


Source: own compilation based on data from the Japan Institute for Economic and Social Research

The Bank of Japan adheres to an accommodative monetary policy and keeps the whole society in a low interest rate environment

Unlike the US and European central banks that have raised interest rates in the face of rising inflation, the Bank of Japan has remained dovish since the current round of global inflation. Since 2016, Japan's policy rate has remained unchanged at -0.1% under the guidance of "Abenomics", only to be "forced" to make several adjustments to the 10-year government bond ceiling under the YCC[1] policy under market pressure. From the yield curve of Japanese treasury bond, due to the lack of elasticity of both short end and long end interest rates, the yield of the mid end one-year treasury bond cannot reflect inflation fluctuations. As core inflation has risen since 2022, Japan's real interest rate has fallen rapidly, once falling below -4%, while the lowest real interest rate that Abenomics policy could push down before the pandemic was around -1.1%. This perfectly solved the problem that real interest rates cannot fall further after interest rates reach the zero lower bound due to persistent deflation. In contrast, the current level of actual interest rates in the United States and Europe has returned to positive, and in the United States it is even close to about 2%. As a result, Japan's excessively low actual interest rates have continued to provide a stimulus to the economic recovery. A prolonged period of inflation above the monetary policy target has driven a marginal shift in Japan's monetary policy. In 2023, Japan eased its YCC policy twice, with the Bank of Japan easing the YCC curve control range to 1% in July and the 1% rigid upper limit again to the reference limit in October. In January 2024, the Governor of the Bank of Japan said that the Bank of Japan will continue to rely on data to make decisions and may continue until April, and the market expects that Japan may phase out negative interest rates in the second quarter of 2024. Looking ahead, Japan's monetary policy may gradually remove the YCC policy and exit the negative interest rate range, but the pace will be slower. As Japanese economy's recovery and inflation become more persistent, market expectations for the Bank of Japan's monetary policy normalization continue to rise, and the Bank of Japan is expected to withdraw its YCC and negative interest rates policies. However, considering that Japan has been in an accommodative market environment for a long time, and the rise in interest rates will not only rapidly increase the cost of debt, but also may trigger the risk of asset repricing again, it is expected that the Bank of Japan will be more cautious in marginal adjustment and the pace of easing will be relatively slow.

[1] Yield Curve Control (YCC) is a monetary policy where a central bank sets targets for interest rates on long-term government bonds to control the shape of the yield curve. This strategy helps manage economic objectives like inflation and growth. The Bank of Japan notably uses YCC, buying or selling bonds to maintain these targeted interest rates.



Source: own compilation based on data from the Bank of Japan

Japan's economic recovery has driven up prices, and the characteristics of long-term inflation are gradually emerging

As of the end of 2023, Japan's CPI year-on-year growth rate has exceeded the monetary policy target of 2% for 21 consecutive months, and once reached 4.2% in January 2023, a 42-year high. Although Japan's inflation level has declined in the second half of 2023 due to factors such as weak external demand, declining exports, and rising bases, the year-on-year growth rate of CPI in December has fallen to 2.6%, but the characteristics of prolonged inflation have been reflected. On the one hand, core inflation is still at a high rate, with Japan's core CPI growing at 3.1% year-on-year in 2023, significantly exceeding the monetary policy target of 2%.

Annual Consumer Price Index (CPI) and Yearly Change in Japan from 2015 to 2022

2020=100

Year	CPI	Annual change
2015	98.1	
2016	98.4	0.3
2017	99.4	1
2018	99.7	0.3
2019	100.5	0.8
2020	99.3	-1.2
2021	100.1	0.8
2022	104.1	4

Source: own calculation based on data from the Statistics Bureau of the Ministry of Internal Affairs and Communications Japan

On the other hand, in the 2023 Haruto labor negotiations[2], the average wage increased by 3.6%, the highest level since 1993. Japan's Haruto labor negotiations are linked to inflations in Japan. Haruto labor negotiations in Japan are a very special system of wage determination, and Japanese companies make an annual adjustment to the wages of their employees. In other words, the labor unions have to discuss the salary issues with the companies and their employees every year to determine the annual salary increase. There is a special relationship between Japanese labor unions and companies, which is reserved from the history. Japan has entered a society with a low birthrate and an aging population, but before that, Japan's labor unions were in a very strong position, and at that time, the growth of companies and society was also relatively good, and employees would discuss salary increases with the union every month. However, it is a burden for companies to do this every month, and it is a good thing for both parties to do it once a year, but now that things have evolved, from a macroeconomic perspective, there is a problem with discussing salaries once a year. If an employee's salary has not changed for a long time, then the employee's expectation of a salary increase will decrease, because it is the norm for prices to not rise and wages not to rise, and this is the problem. As a result, Japan's economic growth, wages, and inflation will remain low. It can be seen that improving productivity is crucial, which Japanese scholars have been exploring. As long as productivity increases, wages will also increase, which is also very positive for the growth of the economy as a whole. So, in which areas in Japan the productivity should be improved? Prices in Japan's service sector have not risen for 10 years, for example, the prices of services such as watching movies and going to the gym have not changed for many years. The same is true for the financial sector. Improving productivity in these industries is an issue.

The manufacturing sector remains strong, and areas such as artificial intelligence still need to be enhanced

According to the 2023 Manufacturing White Paper released by Japan, the number of major products made in Japan is 825 and the number of varieties with a global market share of more than 60% is 220, far exceeding the United States, Europe and China. According to the statistics of the World Bank, from 1996 to 2020, Japan's R&D expenditure as a proportion of GDP has been steadily rising, which in 2020 reached 3.27%, while 3.42% and 3.11% respectively in the same period in the United States and Germany. In terms of the number of patents, according to the statistics of the World Intellectual Property Organization (WIPO), Japan's share of global PCT patent applications increased from 10.26% in 2000 to 18.14% in 2022, while the United States and South Korea accounted for 21.19% and 7.93% in the same period, respectively. Overall, Japan's technological innovation in frontier areas remains competitive, which also creates positive conditions for technology companies to make profits. According to a survey, the net profit of listed companies in Japan is expected to increase by 13% year-on-year in FY 2023 (as of March 2024). The total amount of budget requests from the Japanese government in the field of science and technology in FY 2024 will increase by 14.7% compared to the previous year. At the same time, the Japanese government and scientific research institutions have successively launched the "Health Care Strategy" and the "Medical Research and

[2] Haruto labor negotiations refer to the collective negociations organized by Japanese labor unions every Spring to raise workers' wages.

Development Promotion Plan", as well as the "Quantum Technology Innovation Strategy". Our research indicates that due to the Japanese government's vigorous implementation of semiconductor industry policies, the world's major chip companies have announced a total investment of more than 13 billion US dollars in Japan since 2021. In general, overseas investors have increased their investment in Japanese science and technology, and the profitability of Japanese technology companies has improved, and the manufacturing industry has maintained strong competitiveness, but it still faces bottlenecks in new energy, artificial intelligence, chip manufacturing and other fields.

Summary

2023 has been a good year for the Japanese economy, and we are cautiously optimistic about the Japanese economy in 2024. Exports and domestic consumption remain the main drivers of growth, especially for semiconductor-related products. However, the growth rate in 2024 may not be as fast as in 2023, but it will still be a steady growth. Whether Japan's long-term negative interest rate environment and inflation can actually raise the wages of Japan's salaried class will be an important issue for Prime Minister Kishida, who has been suffering from low approval ratings in recent days. The Bank of Japan is likely to gradually adjust its monetary policies to meet the challenges posed by rising economic growth and inflation. Wage negotiations will continue to be a key issue for Japan's labor market, and it is expected that the Haruto that ends in April will be an annual negotiation between the government and labor unions to achieve a balance between wage growth and economic growth. In terms of economic transformation and industrial upgrading, the Japanese government and companies have invested more in partial innovation, and the fields of semiconductor chips, automobiles and precision manufacturing are at the world's leading level, but there are weak points in the fields of digital economy, Internet and new energy, and the momentum to support economic growth is weak. It remains to be seen whether Japan can completely break its long-term structural crux of "low growth, low interest rates, low inflation, and high debt".