Japan 2023 Macro Outlook

Moderate expansion despite global slowdown

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SUMMARY

- A global slowdown will likely weigh on Japan's export sector in 2023, but the ongoing post-covid recovery in Japan itself could more than offset the headwinds.
- Rising household consumption and corporate capital investment are the two pillars of improving domestic demand. A potential surge in foreign visitors could provide additional support. Overall, we expect the Japanese economy to expand at the same moderate rate of 1.5% in 2023 as in 2022.
- We expect core inflation in Japan to peak in early 2023 after reaching a multi-decade high. We remain sceptical about any wage-driven inflation dynamic proving sustainable.
- While a new governor will be appointed to the Bank of Japan (BoJ) in 2023, we believe a monetary policy U-turn is unlikely. Extremely high public debt means the central bank will have to be very careful in managing interest rates. The potential easing of inflation in 2023 should also ensure that changes in BoJ policy are minor.

POST-COVID RECOVERY IS WELL UNDERWAY

The Japanese government and people have taken a more cautious stance to the coronavirus than many other developed countries.[1] This has allowed Japan to achieve a covid fatality rate significantly lower than in the US and most European countries.[2] The flip side is that the post-covid economic recovery in Japan has come later and is more gradual than most of its peers'.

[1] For example, Japan didn't re-open its border to individual tourists until October 2022, much later than in the US or most European countries. As of time of writing, voluntary mask wearing is still ubiquitous in public areas in Japan, even though it's not a government requirement.
[2] The observed case-fatality ratio in Japan is 0.2%, compared to 1.1% in the US and Canada, 0.9% in UK and 0.4% in Germany and France. Source: Johns Hopkins University (https://coronavirus.jhu.edu/data/mortality).

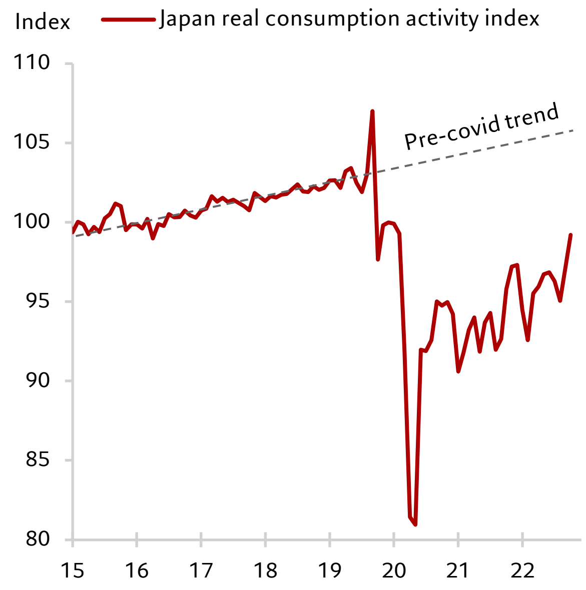
The desynchronisation between Japan's business cycle and other developed economies' means that, while we expect the US and Europe to head into a recession in 2023, Japan will likely stay on a path of moderate expansion despite the external headwinds.

We see at least three positive elements likely supporting the Japanese economy in 2023.

Household consumption. Household spending is gradually recovering in Japan as the economy re-opens. Retail sales have been rising since early 2022, with the latest reading in October at 4.3% year on year (y-o-y). However, in real terms (adjusted for inflation) household expenditure expanded by only 1.2% y-o-y in October, much lower than the change in nominal terms (5.7%). Inflation probably has also weighed on consumer confidence, which in October reached its lowest point since mid-2020.

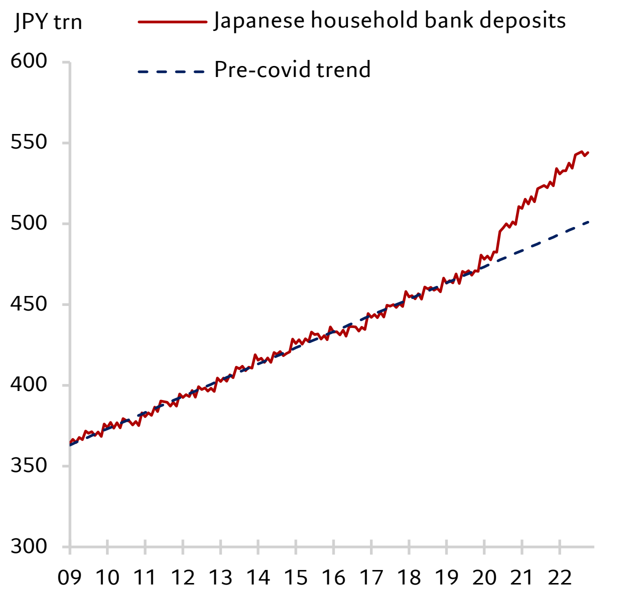
Nonetheless, we still think the recovery in Japanese household consumption has some way to go, since it is still 6-7% below where it should be according to pre-covid trends in real terms. While the recovery is gradual and definitely not linear, the trend continues to point upward *(Chart 1).* In addition, there is significant pent-up demand in Japan, as indicated by excess household savings. The amount of cash on Japanese personal bank accounts is about JPY43 trn more than what the pre-covid trend would suggest it should be *(Chart 2).* This is equivalent to 8% of Japanese GDP. The gradual deployment of this cash as the economy continues to normalise, as we expect, will provide additional support to household consumption.

Chart 1: Japan real consumption activity index



Source: Pictet WM CIO Office & Macro Research, Bank of Japan, December 2022.

Chart 2: Excess household savings in Japan



Source: Pictet WM CIO Office & Macro Research, Bank of Japan, December 2022.

Incoming tourism. Visa-free tourism to Japan resumed on 11 October 2022. Incoming visitors jumped on the news. In October, nearly 500,000 foreign visitors arrived in Japan, more than double the number in the previous month (206,000). But this is still over 80% below the historical peak reached in July 2019 *(Chart 3).* Therefore, there is plenty of room for growth on this front. The massive

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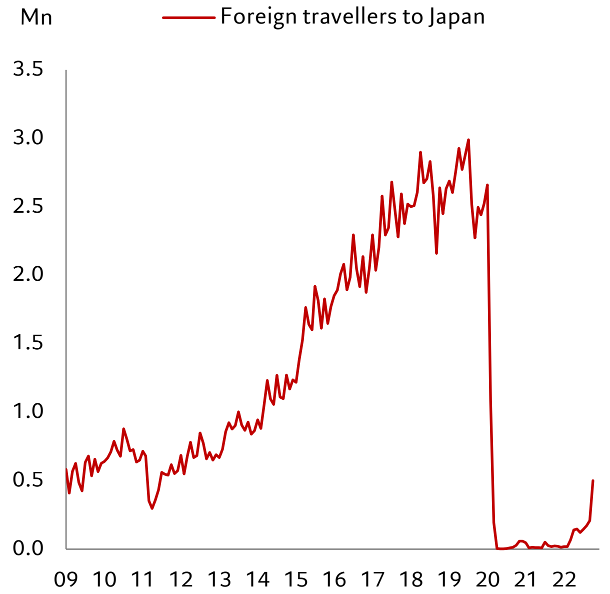
depreciation of the yen this year (-18.8% year-to-date) makes a trip to Japan a lot more attractive for many foreigners.

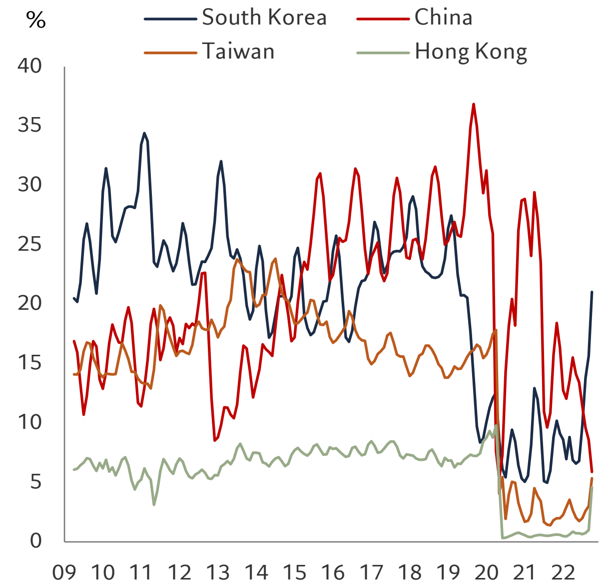
Chinese tourists, who used to account for nearly one third of all visitors to Japan, are still largely absent due to the stringent covid controls imposed by the Chinese government until very recently. As China is now starting the journey towards a full re-opening, we expect Japan to welcome a rising number of Chinese in 2023, especially in the second half of the year *(Chart 4).*

Chart 3: Number of foreign travellers to Japan



Source: Pictet WM CIO Office & Macro Research, Japan National Tourism Organisation, December 2022

Chart 4: Share of foreign visitors by main source



Source: Pictet WM CIO Office & Macro Research, Japan National Tourism Organisation, December 2022

Corporate capital investment. Corporate investment in Japan, which collapsed in the wake of the global financial crisis in 2008, has been rising since Shinzo Abe started his second premiership in 2013. The rise was interrupted by the pandemic, but now seems to be heading back towards its pre-covid trend *(Chart 5).*

The revival in corporate investment is not limited to manufacturing. The latest available data for Q3 show that capital investment in the non-manufacturing sectors, mainly services, has also picked up. With the domestic economy continuing to recover, investment in the services sector could rise further, especially on labour-saving technologies as the Japanese workforce shrinks *(Chart 6).*

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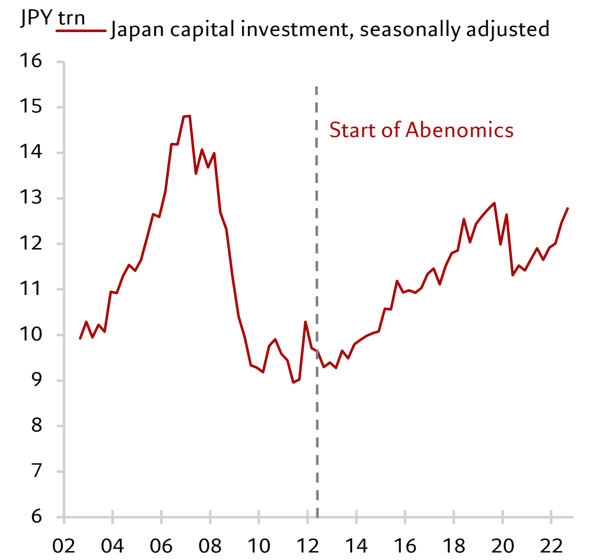
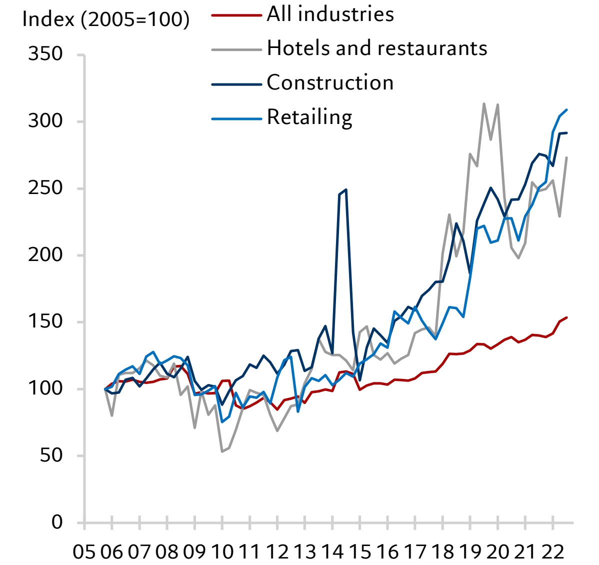
Chart 5: Corporate capital investment in Japan (with seasonal adjustment)



Source: Pictet WM CIO Office & Macro Research, Ministry of Finance of Japan, December 2022.

Chart 6: Investment in software in select industries in Japan



Source: Pictet WM CIO Office & Macro Research, Ministry of Finance of Japan, December 2022.

In contrast to the domestic recovery, **waning external demand for Japanese goods could be a challenge in 2023**. Growth in Japanese exports (in yen terms) remained elevated at 25.3% y-o-y in October, partly helped by the weak yen. As we expect the US and Europe to head into a recession next year (although a shallow one) and as the windfall gains from yen depreciation disappear on a year-over-year basis, growth in Japanese exports will likely decline in 2023. While China's re-opening could provide some support, the moderate pick-up in growth that we expect in China next year may not be sufficient to fully offset the loss in momentum in other major economies.

All in all, **we expect the Japanese economy to expand by a moderate 1.5% in 2023**, about the same pace as this year.

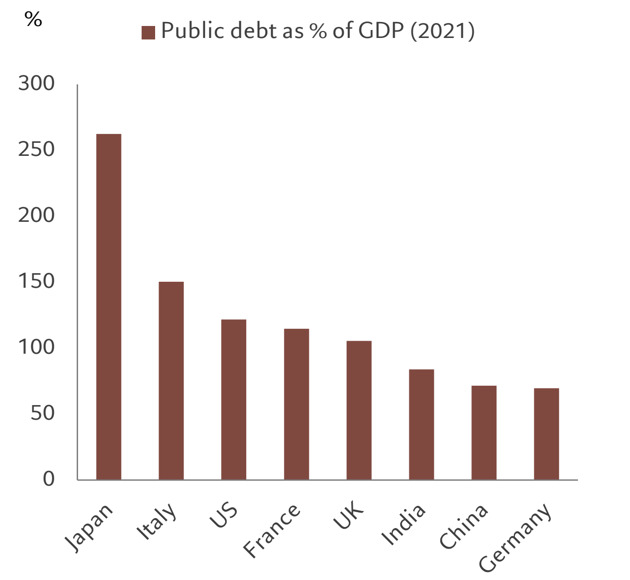
BOJ WILL HAVE A NEW GOVERNOR, BUT NOT A POLICY U-TURN

On the policy front, the Bank of Japan (BoJ) is now the only major developed central bank that is still in ultra-easing mode. Haruhiko Kuroda, the current BoJ governor and the mastermind behind the bank's monetary easing over the past decade, is set to step down in April 2023.

While markets will keep guessing who Mr. Kuroda's successor will be until the final announcement, a more important question is how the monetary policy framework may evolve under a new governor. In our view, two factors are crucial in assessing the BoJ's future policy stance.

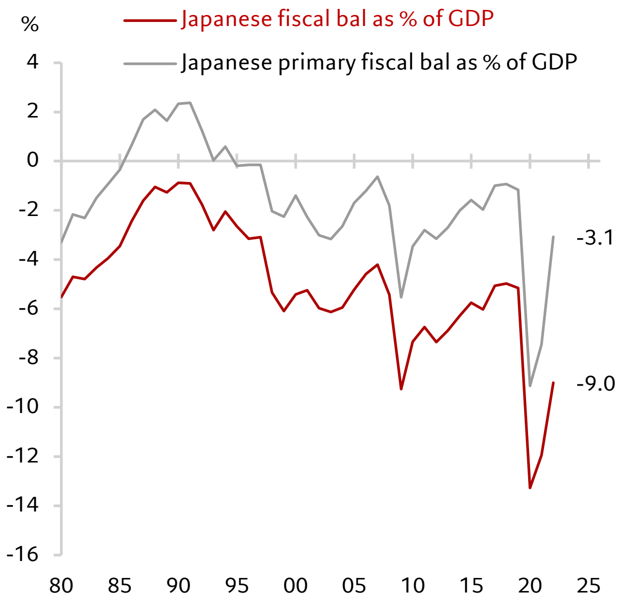
The first is to recognise that monetary policy in Japan is well coordinated with fiscal policy (aka "the first and second arrows" of Abenomics) and that low interest rates are essential for the sustainability of Japan's fiscal conditions. With a public debt-to-GDP ratio of 263% in 2021, Japan arguably is one of the most 'debtdominated' economies in the world *(Chart 7).* Japan's fiscal deficit is projected to reach 9% of GDP in 2022, with nearly two thirds of it going on government debt servicing *(Chart 8).* In addition, the Japanese government has just announced another major fiscal stimulus package of JPY29 trn, equivalent to about 5.3% of GDP, designed to mitigate the pain on households and business of rising prices. In this environment, the BoJ will have to be extremely careful in managing interest rates. A sharp increase in government bond yields is not feasible from a government funding perspective.

Chart 7: Public debt as % of GDP



Source: Pictet WM CIO Office & Macro Research, International Monetary Fund, December 2022.

Chart 8: Headline and primary fiscal balance as % of GDP in Japan



Source: Pictet WM CIO Office & Macro Research, Ministry of Finance of Japan, December 2022

The second consideration, of course, is inflation. As elsewhere, inflation in Japan has also been rising. In October, core inflation in Japan (all items excluding fresh food, but including energy) hit 3.8%—the highest reading in four decades. In our view, core inflation will likely push even higher in the rest of 2022 before peaking in early 2023 thanks to lower energy inflation, more favourable base effects and government subsidies (scheduled to start in January 2023, *Chart* 9).

What's more uncertain at this point is wage growth. So far, this has remained moderate. Wages grew by 1.8% y-o-y in October, in line with the average growth rate seen in recent years *(Chart 10).* But there are media reports of labour unions planning to demand much higher salary increases in the upcoming spring wage negotiations. But even if the negotiations result in larger wage increases next year, for structural reasons we remain sceptical that they will be sustained or that we will see a wage-inflation spiral in Japan.

With these considerations in mind, our expectation is that the BoJ may conduct a comprehensive review of its current monetary policy framework once a new leadership team steps in next spring. This may lead to some minor tweaks to its existing yield curve control (YCC) framework, such as widening the band within which the 10-year JGB (currently at 25bps around zero) is allowed to fluctuate or moving the

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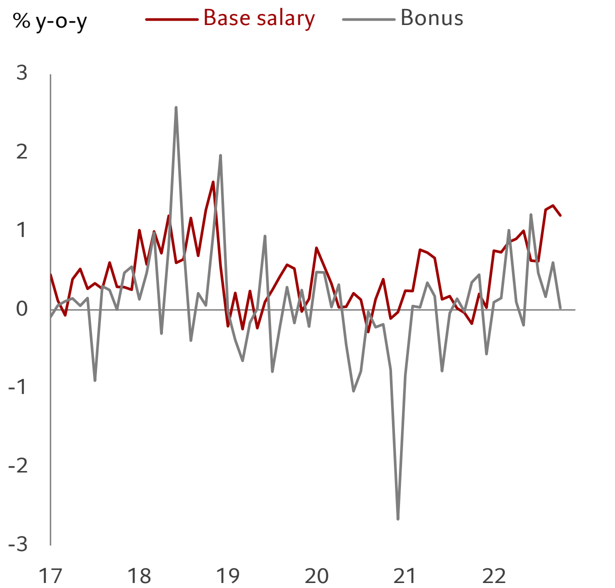
anchor point of its YCC from the 10-year to the five-year JGB. But we do not expect any major policy U-turns such as rate hikes or a complete removal of YCC in the foreseeable future.

Chart 9: Core inflation in Japan and changes in crude oil prices in yen terms

Source: Pictet WM CIO Office & Macro Research, Bloomberg Financial LP, December 2022

Chart 10: Growth in wages in Japan, base salary vs. bonus



Source: Pictet WM CIO Office & Macro Research, Ministry of Health, Labour and Welfare of Japan, December 2022

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