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GLOBAL MACRO RESEARCH

— JAPAN: A WINDOW FOR OPTIMISM

NOVEMBER 2024





EXECUTIVE SUMMARY

- The Japanese economy has been on a rollercoaster ride, but recent decades have been characterised by growth rates well below other developed markets.
- A window for optimism has now opened, and the Bank of Japan has started to tighten policy for the first time since 2007.
- We believe there are three reasons to remain optimistic over the next few years:
 - real rates are underpinning growth,
 - corporate Japan has become more profitable, and
 - more profitable corporates are paying higher wages.
- Longer-term, Japan faces formidable challenges:
 - demographics are a severe headwind for growth,
 - overseas expansion means less domestic investment,
 - the Bank of Japan's balance sheet is a vast problem, and
 - long-term debt sustainability remains questionable.
- We remain concerned about the long-term outlook for Japan given the huge challenges it faces, but we believe there are two key impacts for international markets:
 - during this window of optimism, Japanese investors are likely to become more focused on domestic yields, removing an important source of demand for some overseas bond markets; and
 - a longer-term trend is that corporates are likely to remain an important source of foreign direct investment (FDI) as they continue to invest overseas.
- In October 2024, the ruling party lost its majority in Lower House elections. This will require greater co-operation with minority parties to pass legislation going forward and increases political instability. Smaller parties such as the Democratic Party for the People have advocated for policies such as reducing sales taxes, and gaining their support may require a return to more expansionary fiscal policies than had looked likely.

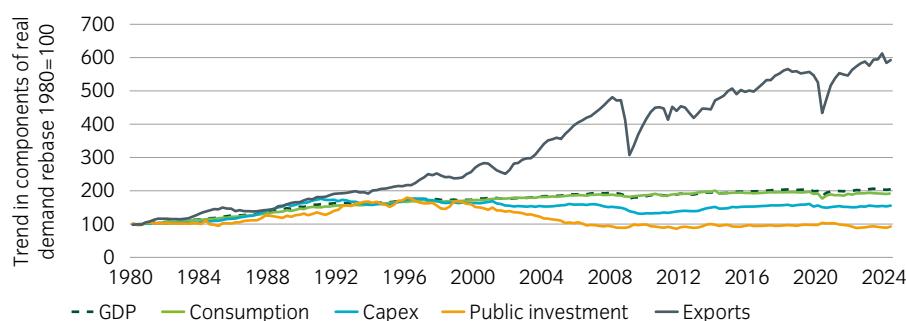
JAPAN'S LOST DECADES TO THE PRESENT TIME



THE ECONOMIC BOOM AND BUST

The Japanese economy has been on a rollercoaster ride over recent decades. In the post-war years Japan's economy expanded rapidly, led by investment. This culminated with a property and stock market boom in the late 1980s which was followed by bust and then stagnation. Over-investment running up to and during the boom, by both consumers and corporates, led to an increase in leverage. When land and property prices collapsed, it severely impacted household and corporate balance sheets, increasing non-performing loans, and requiring years of deleveraging. This period was then followed by the financial crisis, the Tohoku earthquake, the pandemic and the Ukraine war, all compounded by slow demographic decline. During Japan's lost decades Japan experienced the lowest growth amongst its developed market peers; domestic demand barely grew, with exports the only driver (see Figure 1).

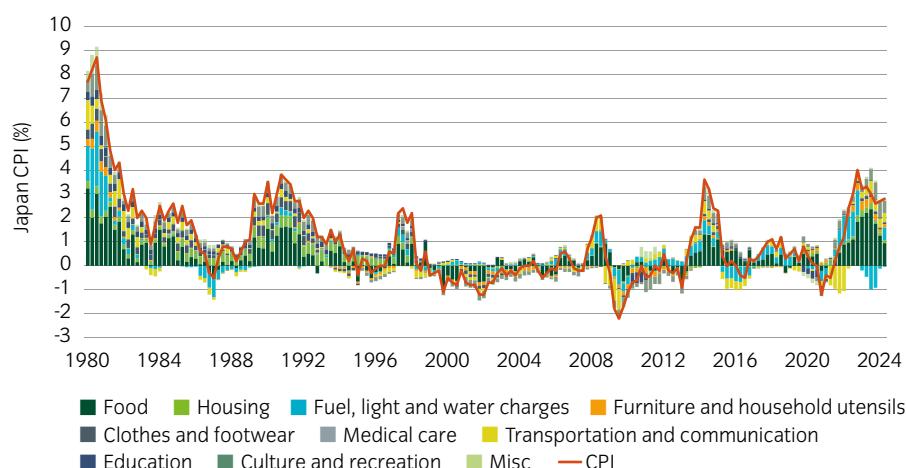
Figure 1: Japan's lost decades saw most parts of the economy stagnate¹



THE BATTLE AGAINST DEFILATION

Unsurprisingly, given the lack of domestic demand, the low-growth environment was accompanied by an extended period of exceptionally low inflation. Neither large-scale fiscal expansion nor monetary easing were effective in driving inflation higher; in fact, for many years, Japan experienced deflation. This saw the Bank of Japan reduce interest rates to zero in 1999 and, other than a short period from 2006 to 2008, rates remained at zero until 2024.

Figure 2: Japan faced a constant battle with deflation during its lost decades²



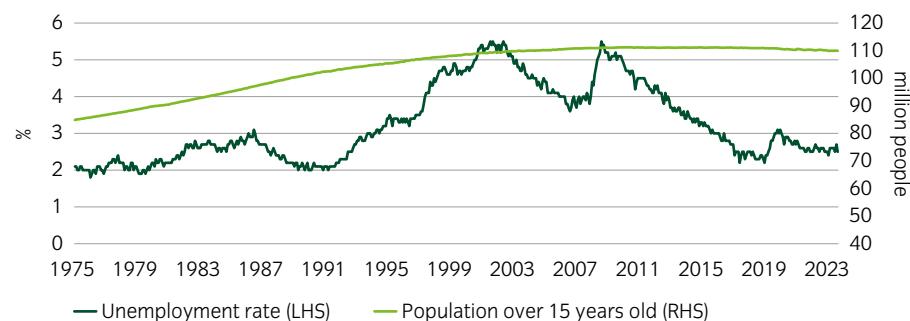
¹ Japanese Cabinet Office (CAO) as at 4 October 2024.

² Source: Macrobond. Japanese Statistics Bureau, Ministry of Internal Affairs and Communications. Data as at 4 October 2024.

THE DEMOGRAPHIC CHALLENGE TO JAPANESE LABOUR MARKETS

Following the economic bust, unemployment gradually climbed a high of 5.5% in June 2002, a peak to which it later returned after the global financial crisis. But the aging Japanese population has become a growing problem and, although measures to increase participation by older workers and women have been effective, the labour pool has stagnated, rising by only a few million since the late 1990s. These demographic challenges have led to a lower unemployment rate but have become a concern for Japanese businesses. Data compiled by the Teikoku Databank³ in its annual employment trends survey for 2023 showed more than 50% of firms reported a shortage of full-time employees.

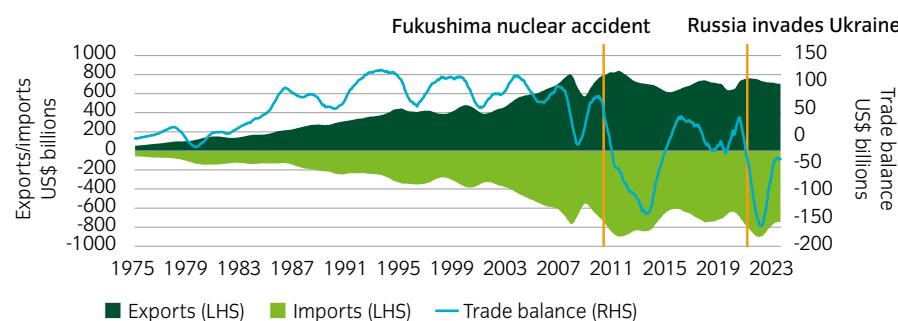
Figure 3: Unemployment rate versus total population⁴



FROM TRADE SURPLUS TO TRADE DEFICIT

For a generation, Japan's diverse, innovative and highly diverse industrial companies were major exporters allowing Japan to run a sizeable trade surplus despite its lack of natural resources. Japanese corporates remain major global exporters. However, since the Tohoku earthquake and tsunami in 2011, which led to the Fukushima nuclear accident, Japan has closed most of its nuclear power reactors and now relies on imported fossil fuels for much of its energy needs. The import of fuel and food, where domestic production is insufficient, has led to a deterioration in the trade balance which was then compounded by the energy crisis following the start of the Ukraine war (see Figure 4).

Figure 4: Japan's trade surplus became more vulnerable to energy prices after 2011⁵



³ Source: Survey of Corporate Attitudes Toward Employment Trends in FY2023, February 2023, Teikoku Databank.

^{4,5} Source: Insight and Bloomberg. Data as at 31 August 2024.

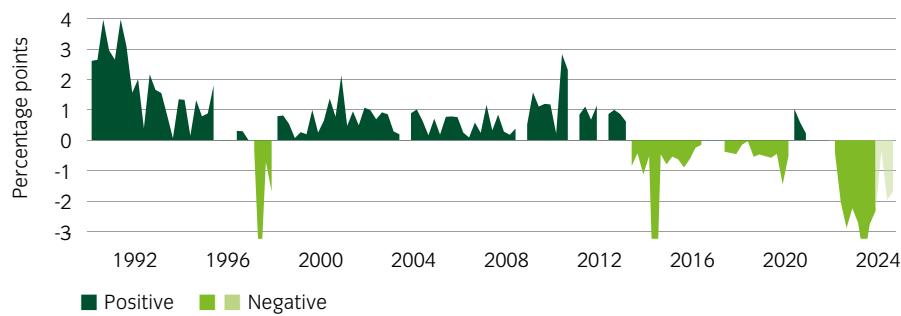
A WINDOW FOR OPTIMISM HAS OPENED

With the Bank of Japan raising rates for the first time in decades, and Japanese equity markets performing well, many are questioning whether Japan has now finally exited its low-growth era. In our view, the answer to that depends on whether a short-term or longer-term view is being taken. There are three key reasons we believe the current optimistic outlook for the Japanese economy is likely to be sustained over the next few years:

1 REAL RATES ARE UNDERPINNING GROWTH

An important factor driving growth over recent years has been the level of real interest rates. Although nominal interest rates have been at zero for most of the last 20-plus years, real rates have fluctuated significantly over that period (see Figure 5). Until 2012, real rates were relatively high as the economy experienced periods of deflation, and even in the years following the introduction of the Bank of Japan's yield-curve control policy, real rates were only modestly negative. It is only since the start of the Ukraine war, when import prices surged, that real rates moved into negative territory.

Figure 5: Real policy rates should support domestic growth over the coming years⁶



2 CORPORATE JAPAN HAS BECOME MORE PROFITABLE

Although Japanese corporate profits slumped during the pandemic, profitability has been on an upward trend for over a decade and reached new record levels in 2024. This rise in profits has been driven by a broad range of factors. Having gone through a painful period of deleveraging, many corporates had significantly improved their balance sheets through the early part of the century. This created a positive backdrop for the launch of Abenomics in 2012, with the third 'arrow' of Prime Minister Shinzo Abe's structural reforms focused on improving long-term growth – including improvements in corporate governance and measures to increase competitiveness⁷. In 2023, the Tokyo Stock Exchange launched a series of measures⁸ to build on these reforms for listed companies, seeking further improvements in corporate governance, capital efficiency and profitability. Japanese exporters have also gained from a weaker yen.

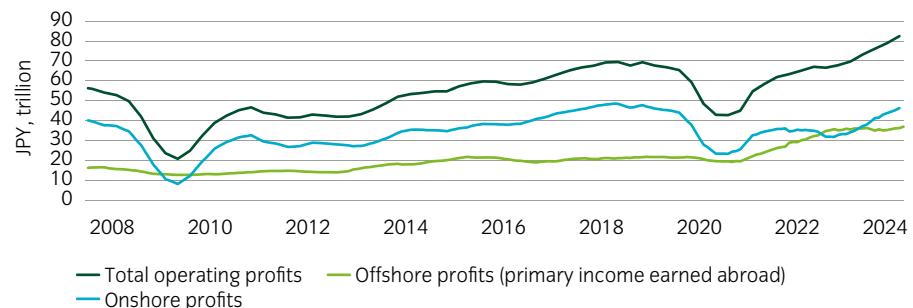


⁶ Source: Macrobond. BIS (The Bank for International Settlements), OECD and Bank of Japan. Data as at 4 October 2024.

⁷ Source: [Three Arrows of "Abenomics" and the Structural Reforms of Japan: Inflation Targeting Policy of the Central Bank, Fiscal Consolidation, and Growth Strategy \(PDF\)](#), August 2014, Asian Development Bank Institute.

⁸ Future Initiatives Regarding ["Action to Implement Management that is Conscious of Cost of Capital and Stock Price" \(PDF\)](#), 30 August 2024, Japan Exchange Group.

Figure 6: Corporate profits have trended upwards driven by both domestic and overseas profits⁹



3 MORE PROFITABLE CORPORATES ARE PAYING HIGHER WAGES

The first period of sustained inflation for a generation prompted demands for higher wages from workers, and encouraged by the authorities, large Japanese corporates agreed to material wage raises. Wage growth then broadened to smaller more domestically focused firms, including those within the service sector. With inflation returning towards 2%, real wage growth has been rising by more than 2% and surveys of wage intentions suggest it can remain positive in the near term.

THE FORMIDABLE CHALLENGES AHEAD

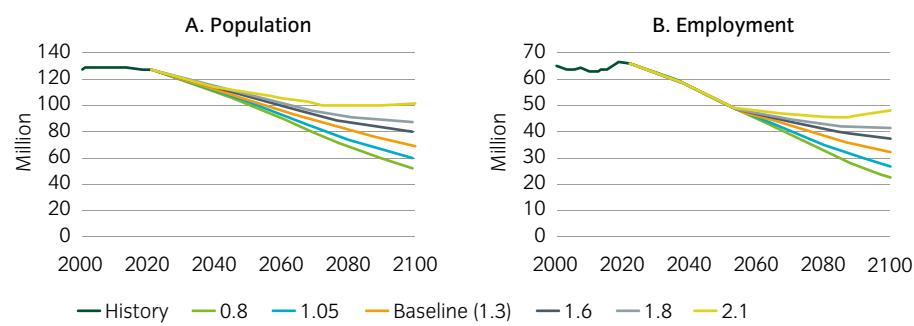
In the longer term, the challenges facing Japan are significant, and likely insurmountable.

DEMOGRAPHICS ARE A SEVERE HEADWIND FOR GROWTH

Japan's population is aging, and the country's birth rate is very low. Under all plausible scenarios for the birth rate, the population will decline significantly over the next few decades (see Figure 7). Although the number of foreign workers in Japan has been on an upward trend, it is not sufficient to prevent a rapid contraction in labour supply over time and Japan already has a high participation rate given its age profile. The government is attempting to increase fertility rates under its Strategy for Children's Future policy launched in 2023, which expands support for parents, but even in a scenario where the fertility rate increases to 2.1, the labour market still wouldn't stabilise until the 2080s.

This structural decline in the working-age population will act as a severe headwind for growth, making it very difficult for potential GDP to remain positive over the medium-term.

Figure 7: Japan's demographic time bomb¹⁰



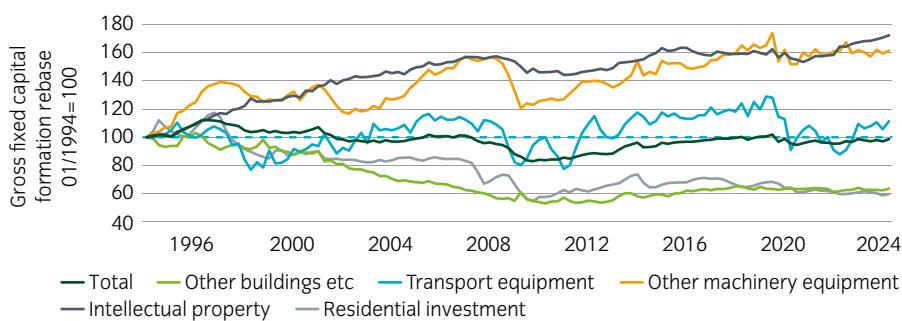
⁹ Macrobond, Japanese Ministry of Finance, BoJ. As at 7 October 2024.

¹⁰ Source: [Addressing demographic headwinds in Japan: A long-term perspective](#), 24 April 2024, OECD.

OVERSEAS EXPANSION MEANS LESS DOMESTIC INVESTMENT

Historically Japan has generated high levels of productivity growth. However, labour shortages are making Japanese corporates reluctant to make investments in Japan. This is a concern as lower investment will reduce near-term growth but may also lead to reduced innovation and weaker productivity in the long run. The shrinking population means there is little chance that residential investment could counterbalance this, and in fact this is more likely to be a further headwind to long-term growth (see Figure 8).

Figure 8: Investment is likely to be a further headwind¹¹

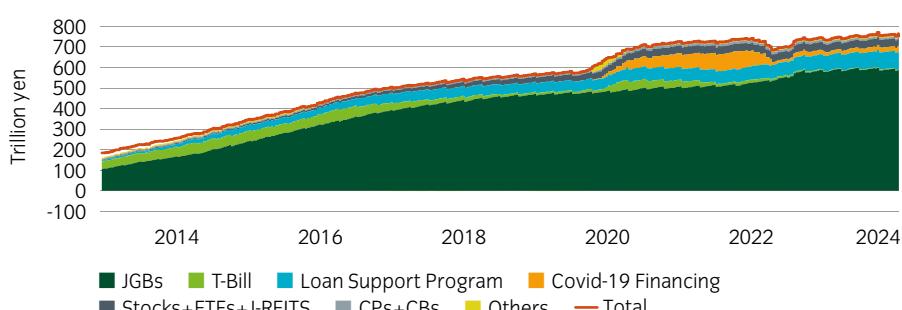


THE BANK OF JAPAN'S BALANCE SHEET IS A VAST PROBLEM

While the Bank of Japan is normalising policy there are some concerns that the Bank will need to pay interest on excess reserves, causing it to run at a loss, particularly since many of its assets are low-yielding Japanese government bonds. There are two factors which suggest this is likely to be true for only a short period. Firstly, as the central bank scales back Japanese government bond reinvestment, it naturally reduces banks' excess reserves as it increases the supply of Japanese government bonds available to the market, much of which will end up being bought by banks. Secondly, the reinvestment that the central bank does undertake will be in Japanese government bonds that have much higher yields, increasing the bank's own interest income. During the transition period there is an additional mitigation in the income generated by the Bank of Japan's ETF holdings. The strength in Japanese corporate earnings means that the bank's income from ETFs is almost comparable to the income it receives from its much larger Japanese government bond portfolio. As long as the normalisation in monetary policy occurs slowly and over an extended period, it is unlikely that the bank will incur meaningful losses.

However, a much bigger question is what happens to the bank's balance sheet in the long term. If, as we expect, this period of policy normalisation ultimately proves unsustainable, then the bank will at some stage be forced to reduce rates and restart its asset purchases. The bank should have a window to reduce its balance sheet over the next few years, but with assets well over 100% of GDP, its dominance of Japanese markets is likely to remain a vast problem – the long-term consequences of which remain highly uncertain.

Figure 9: The Bank of Japan has dramatically expanded its balance sheet in recent decades¹²



¹¹ Source: Macrobond. Japanese Cabinet Office. Data as at 4 October 2024.

¹² Source: Macrobond. Bank of Japan. Data as at 4 October 2024.

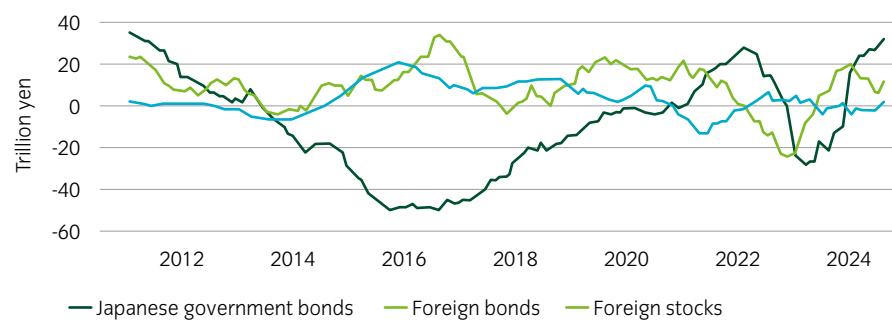


LONG-TERM DEBT SUSTAINABILITY REMAINS QUESTIONABLE

The uncertain outlook for long-term GDP raises questions about debt sustainability. At present, Japanese households and corporates have a large stock of savings, much of it invested overseas, whilst the government is a net debtor albeit with much of that debt sitting on the central bank's balance sheet. So, in the near term, pressures are likely to be limited. However, as the demographic headwinds to potential growth grow over time, there is a risk to debt sustainability if debt continues to increase while GDP structurally declines.

Compounding this problem, as the population has aged so household saving rates have declined, and this is unlikely to change given the demographic challenge ahead. For now, higher Japanese government bond yields are increasing the attractiveness of domestic investment, with yields in excess of other major government bond yields on a hedged basis. This has made Japanese funds more willing to allocate to local debt and, although there appears not to have been active disinvestment of foreign holdings by Japanese investors so far, any decision by the Government Pension Investment Fund to increase its target weight in Japanese government bonds would likely prompt a broader move amongst Japanese institutions.

Figure 10: Japanese investors have returned to Japanese government bond markets¹³



CONCLUSION

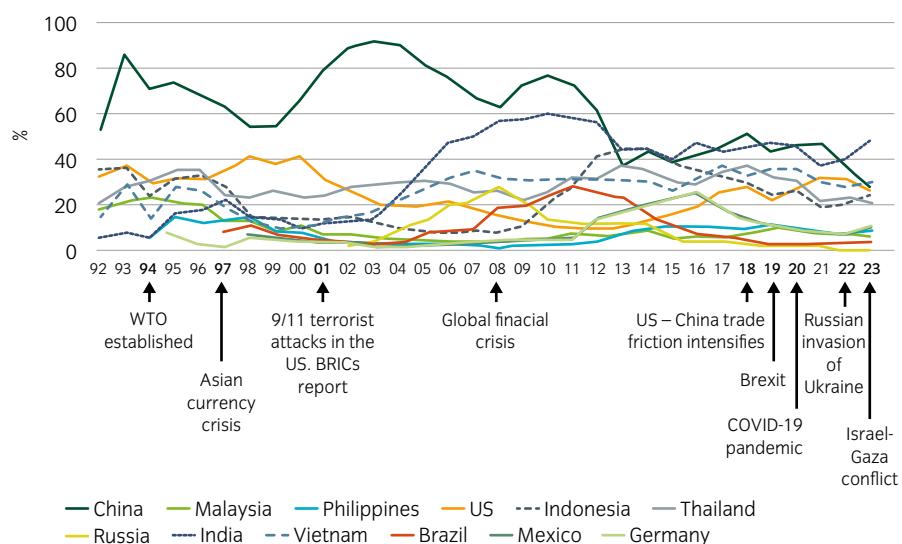
Although we remain concerned about the long-term outlook for Japan given the huge challenges it faces, the current window of optimism could last for some years yet. This leads us to two main conclusions:

1. **Japanese corporates are likely to continue to invest overseas:** The demographic challenge is only going to make labour shortages worse in the years ahead. Although migrant inflows are increasing, analysis by the Japan International Cooperation Agency concludes that there will be a shortage of 970,000 foreign workers by 2040. Unless something changes, or the concept of a robotic workforce truly moves from the realms of science fiction to reality, this will force continued investment by Japanese corporates into overseas production facilities. The Japan Bank for International Cooperation conducts an annual survey of where Japanese companies are looking to direct future investments (see Figure 11). This highlights some notable trends. For example, the sharp decline in the number of companies looking to invest in China, with a corresponding increase in interest in India. It is also interesting that post the US election in 2016, Japanese corporates switched from investing in Mexico to investing in the US, and there appear to be no signs that this has changed during the most recent presidential term.

¹³ Source: Bloomberg. Bank of Japan, Ministry of Finance. Data as at 30 September 2024.

¹⁴ Source: [Building a Multicultural and Inclusive Society: What is Needed as Communities Become More Global and Schools and Workplaces Become More Diverse](#), 26 September 2024, Japan International Cooperation Agency.

Figure 11: Japanese corporate investment trends¹⁵

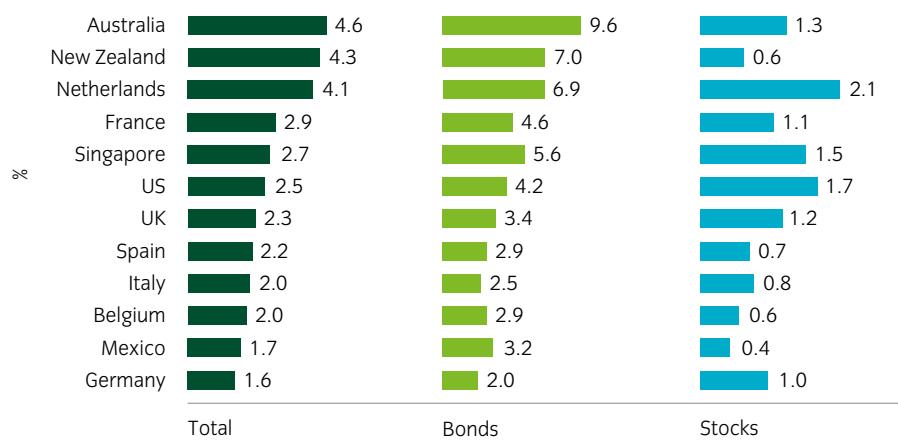


2. **Japanese investors moving home would impact overseas markets:** Higher domestic yields mean there is no longer a reason for Japanese investors to look abroad in search of income. The search for yield during the zero-rates period has left Japanese investors holding around \$4.4 trillion in overseas assets, down from a peak of \$5 trillion, but still a substantial amount (see Figure 12). In some bond markets Japanese investors built up holdings that represent a meaningful proportion of outstanding issuance (see Figure 13). If this demand has come to an end, or even turns to outright sales, it could be an important factor for long-term yields in those markets most impacted.

Figure 12: Japan's overseas assets¹⁶



Figure 13: Japanese funds overseas investments¹⁷



¹⁵ Source: Data reveals the latest trends in overseas business development by Japanese companies, May 2024, Japan Bank for International Cooperation.

¹⁶ Source: Bloomberg, IMF. Data as at 30 June 2024.

¹⁷ Source: Japan's \$4 Trillion 'Carry Trade' Begins to Slowly Unwind, 1 October 2024, Bloomberg.



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