

Japan in the World

The outlook for the economy under awakened inflation

January 2023

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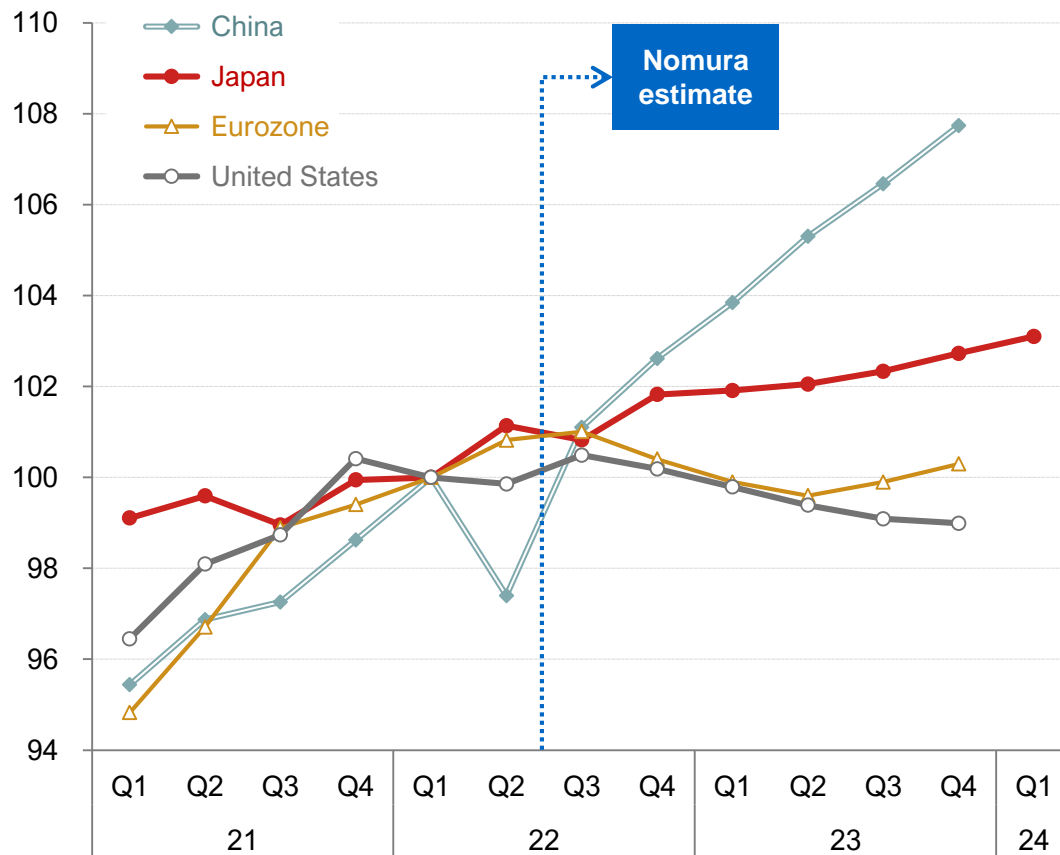
The outlook for the economy under awakened inflation

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Japan's economic cycle is in an advantageous position

Estimates for real GDP of major countries and regions

(Q1 2022 = 100)



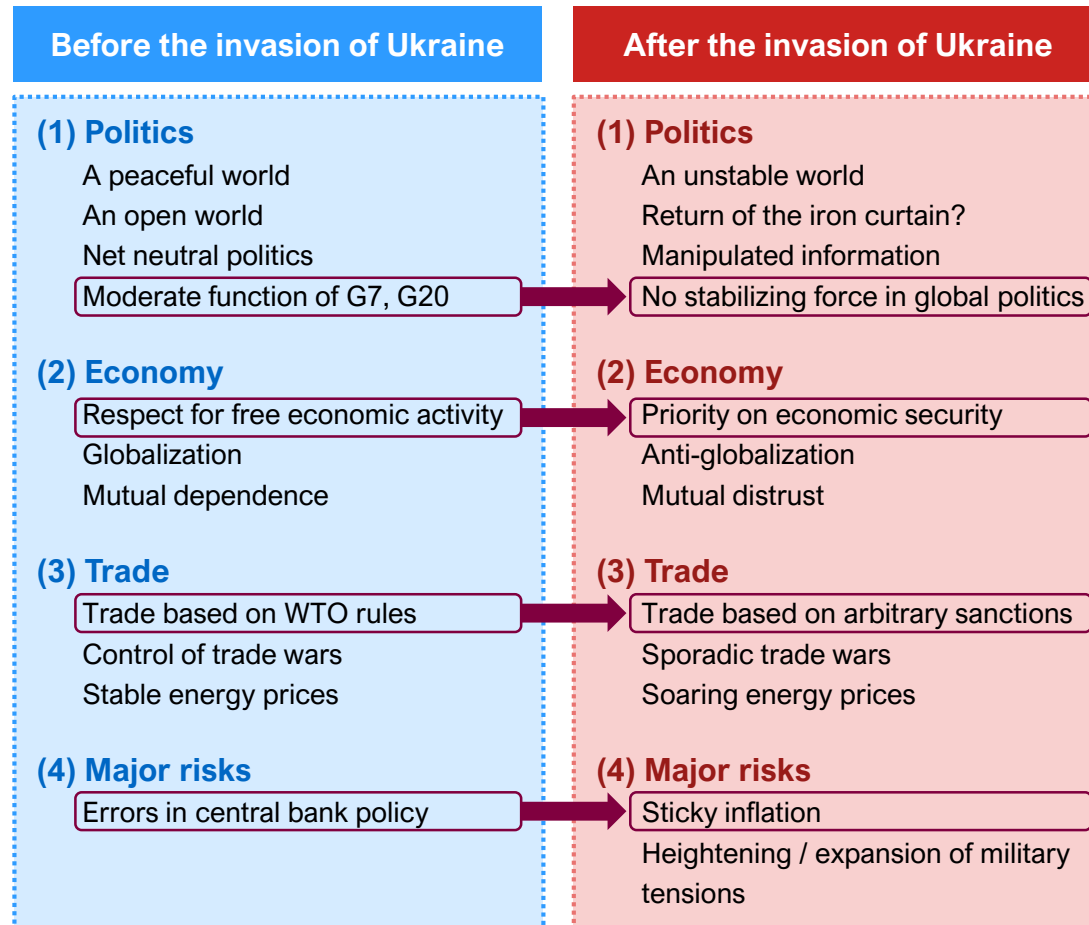
While many countries made steps toward coexisting with COVID-19 in 2022, the world faced new issues, including (1) geopolitical tension stemming from Russia's military invasion of Ukraine, (2) acceleration of inflation, and (3) simultaneous monetary tightening (hikes in interest rates) by many central banks.

Now at the start of 2023, people are becoming aware of the risk of stagnation in the global economy as the effects of inflation and increased interest rates from last year accumulate. Concern over a possible economic recession is particularly strong in the US and the Eurozone.

On the other hand, Nomura believes that Japan's economy will likely remain steady. However, this does not mean that the issues facing Japan have been resolved. We hope that Japan will draw on its advantageous position in the economic cycle to proactively work to resolve its issues in 2023.

Economic implications of global politics without a stabilizing force

The global political and economic landscape altered by geopolitical tensions



Russia's invasion of Ukraine in 2022 went beyond the bounds of heightened regional geopolitical tension to weaken political mediation and consensus-building functions on a global scale, exemplified by the struggles evident among the G20 in forming a consensus. This can be seen as the loss of a stabilizing force in global politics.

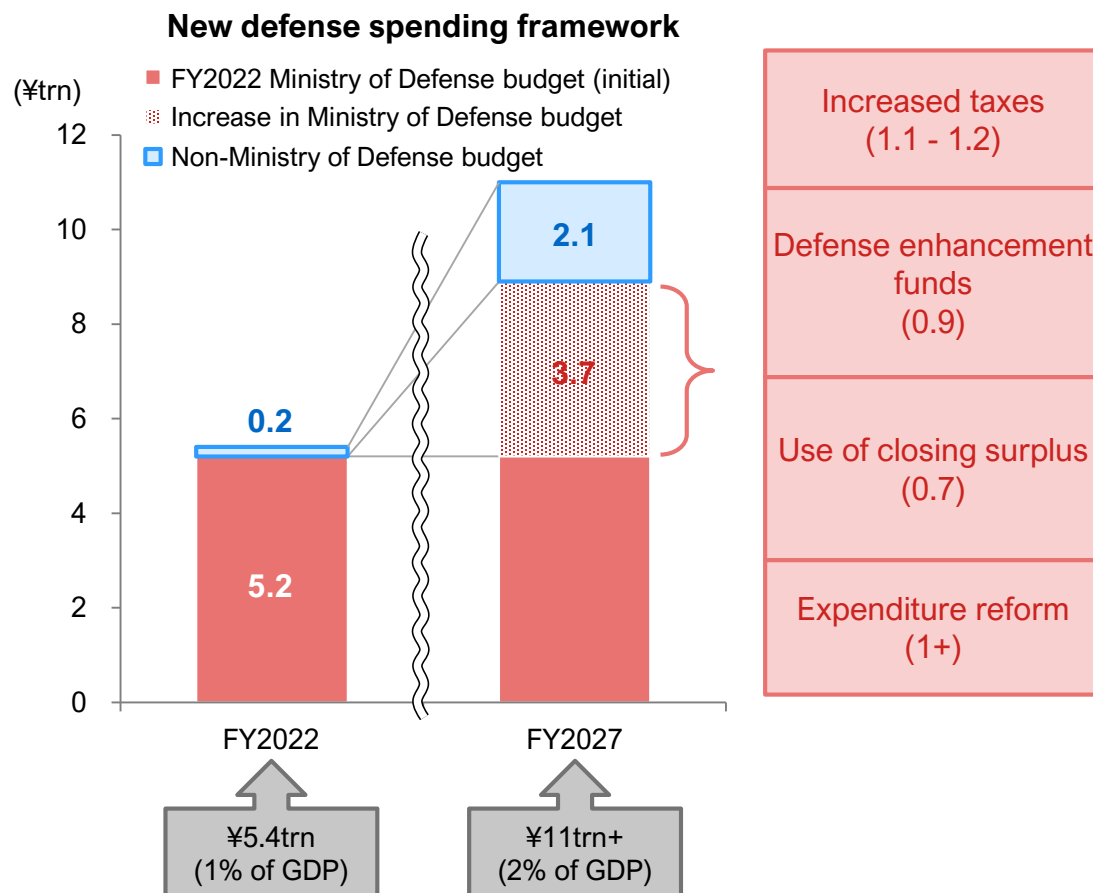
The absence of a mediator in global politics will naturally mean that national security will take on greater importance in each individual country.

The emphasis on national security by individual countries is changing the state of the global economy. The effects of this are seen in (1) the transition from streamlining of production activities on a global basis to a focus on regional economic security among countries with political and economic affinities and (2) a transition from trade based on rules laid out by the post-war World Trade Organization (WTO) to trade based on arbitrary sanctions.

The first raises concerns of a drop in the efficiency of economic activities, while the second may reduce the predictability of economic activities.

A drastic change in Japan's national security policy after a half century

Japan's defense spending to rise to 2% of FY2027 GDP



On December 16, 2022, the Cabinet of Prime Minister Kishida approved three national security-related documents (National Security Strategy, National Defense Strategy, and Defense Buildup Program) containing an increase in defense spending to 2% of GDP by FY2027.

The defense budget has been roughly 1% of GDP since 1976, when the cabinet of then Prime Minister Takeo Miki decided to limit defense spending to 1% of gross national product (GNP). The Kishida administration is overseeing drastic change to the budgetary framework of post-war national security that has lasted for close to half a century.

However, Prime Minister Kishida's drive to increase defense spending may be the spark that destabilizes his administration, which is ironic, given the political capital he has expended. The potential bone of contention is funding: While 1.1 to 1.2 trillion yen is to be raised through higher taxes, the ruling Liberal Democratic Party's tax revision plan for FY2023 does not clearly state the timing for such a tax increase, since there is as yet little consensus among members of government and the ruling party on this issue.

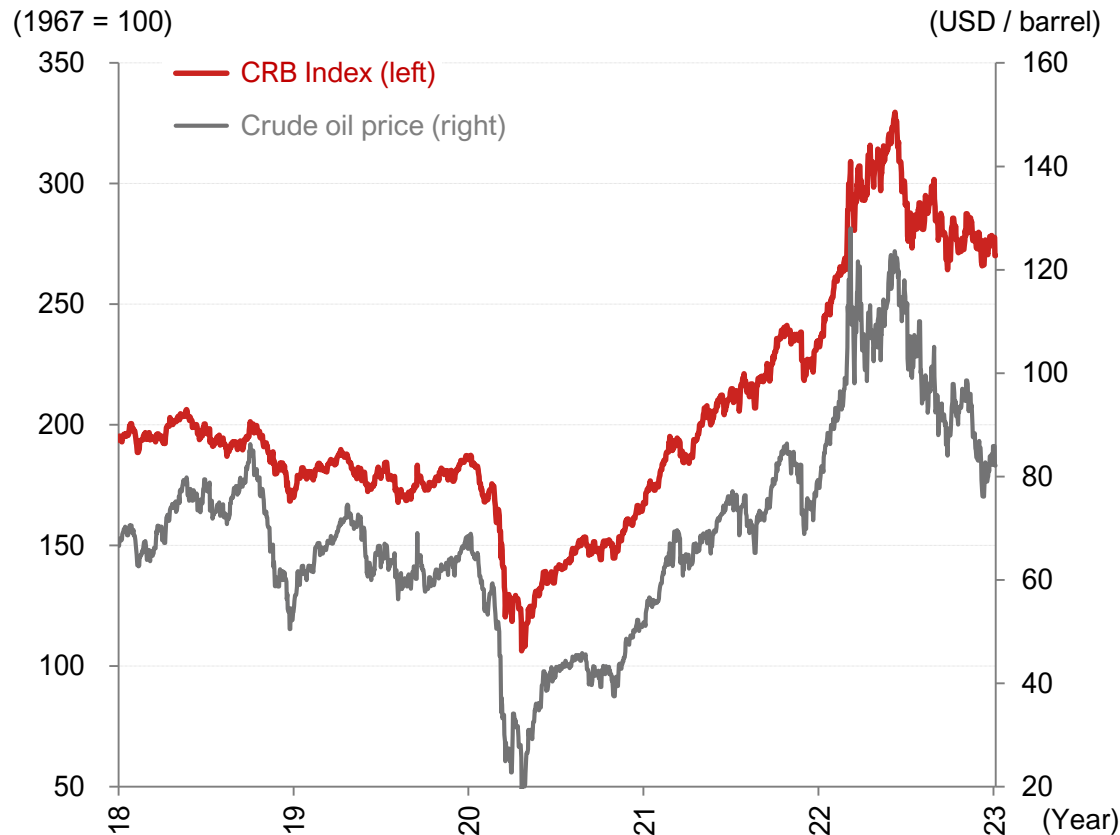
It remains to be seen whether these political ripples will grow into a massive wave that threatens the Kishida administration in 2023 and beyond. At the April 2023 Nationwide Local Elections and the next LDP Presidential Election in September 2024, we may look back on Prime Minister Kishida's political decision in 2022 as a major turning point.

Note: Defense enhancement funds will draw from non-tax revenue, etc. and will be included in the FY2023 general account as special funds for defense spending

Source: "Defense Buildup Program" (approved by the Cabinet on December 16, 2022), The Nikkei Shimbun (December 17, 2022)

The awakening of global inflation

Soaring commodity prices (global upstream prices)



There is a risk of continued heightening, expansion, multi-polarization, and multiplication of geopolitical tensions. The 2022 global economy taught us that geopolitical tensions engulfing regions producing resources or food can result in inflation increasing at unforeseeable speed. These events have left us with the impression that inflation has awakened from a deep slumber.

Once inflation awakens, there is a risk that it may take root in the collective memory and the formation of expectations of companies and households, the agents of the economy. Moreover, should inflation take root in such expectations, it may drive us into a self-fulfilling process in which expected inflation triggers actual inflation.

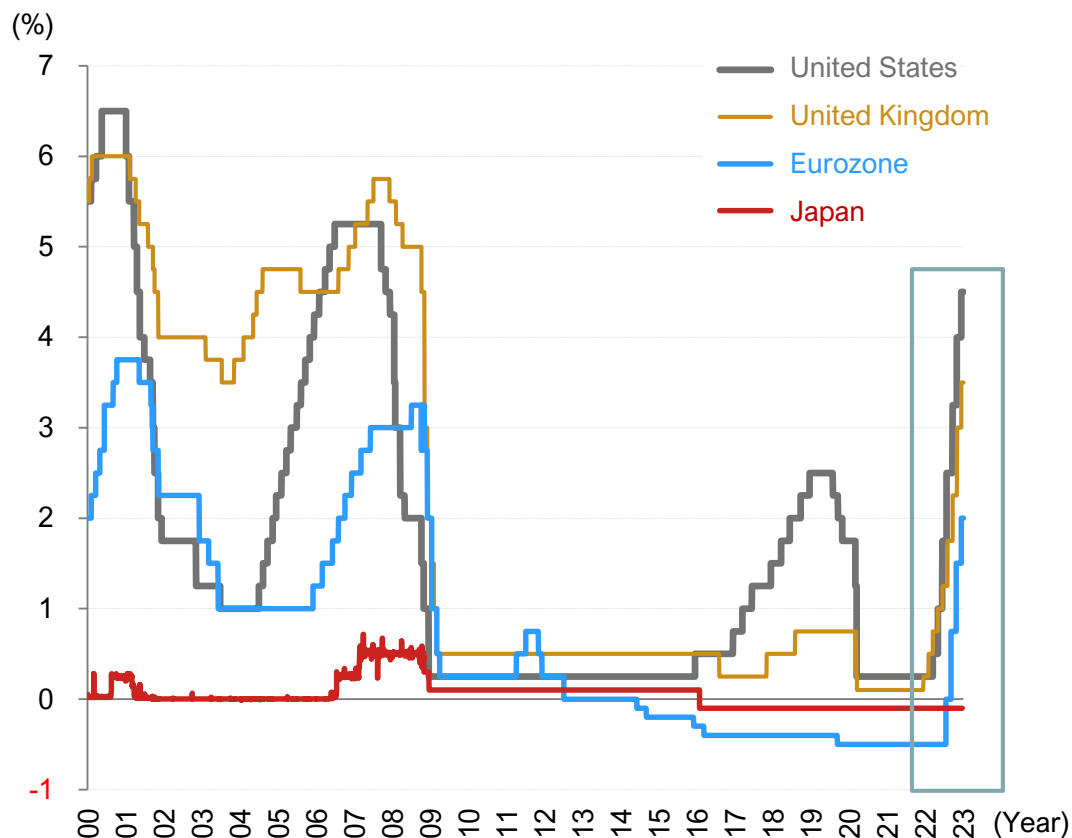
Thus, many central banks have turned to monetary tightening, raising interest rates to limit the inflation expectations of economic agents.

Note: 1. CRB Index = Thomson Reuters/Core Commodity CRB Index, an international commodities index calculated from commodities futures prices at exchanges in US and the UK
2. Crude oil price is the Brent Crude Futures price on the Intercontinental Exchange (ICE)

Source: Bloomberg

Simultaneous hikes in interest rates around the world – the Bank of Japan is an exception

Policy interest rates in major countries and regions



- Note:
1. Values for the US are the upper limit of the federal funds target rate
 2. Values for Japan are the uncollateralized overnight call rate until February 15, 2016 and the interest rate on the Policy-Rate Balance, part of the Bank of Japan's current account balance, from February 16, 2016 (however, from April 2013 to January 2016, there was no policy rate; rather, monetary policy was conducted solely on the Bank of Japan's current account balance as a quantitative indicator)
 3. Values for the Eurozone are the ECB Deposit Facility Interest Rate
 4. Values for the UK are the Bank Rate

Source: Bloomberg

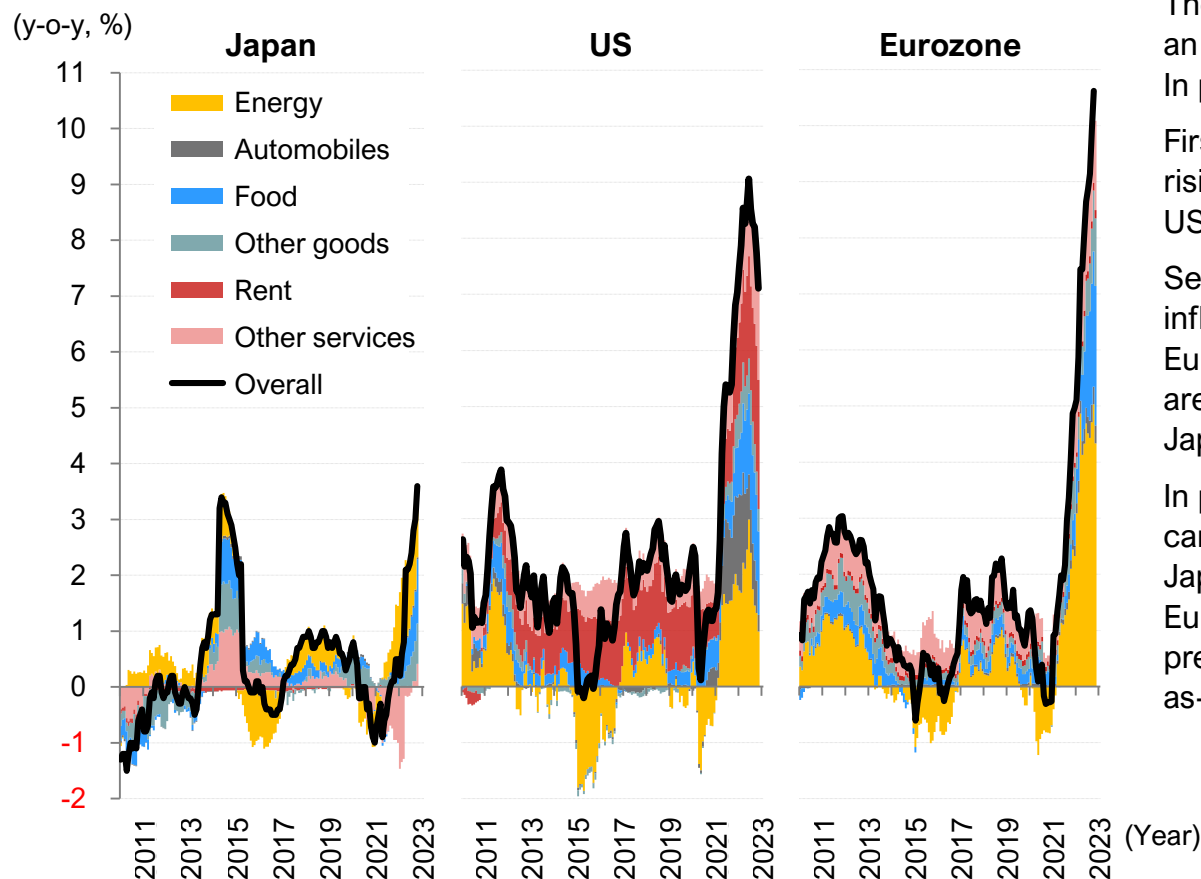
Changes to the global economic environment must necessarily include the previously mentioned geopolitical tensions and awakened inflation, as well as changes in monetary policy. The US Federal Reserve Board (FRB), European Central Bank (ECB), and Bank of England (BoE) have all pivoted to rapid increases in interest rates with the aim of preventing the inflation expectations of economic agents (companies and households) from taking root at a high level.

Occasionally it is said that raising central bank interest rates will not have an effect on inflation rooted in the supply side, such as soaring resource and food prices. However, no matter whether the cause is on the supply side or the demand side, central banks need to tighten monetary policy if there is a risk of rising and solidifying inflation expectations among economic agents (companies and households).

The Bank of Japan (BoJ) stands out in this environment. The BoJ has been keeping interest rates low based on the yield curve control (YCC) framework.

Japan's inflation differs from the US and the Eurozone

Comparison of inflation in G3 economies



The Bank of Japan is keeping YCC steady on the back of an inflation rate that differs from US and Eurozone rates. In particular, the following two differences are important.

First, Japan's inflation is relatively slow. Japan's CPI is rising at roughly one third to one half of the speed of the US and the Eurozone.

Second, the base of inflation is relatively narrow. While inflation rates are being driven up in the US and the Eurozone, such a trend is not clearly visible in Japan in the areas of rent and service prices, which account for half of Japan's CPI.

In particular, the slow pace of increase for service prices can be seen as a symptom of the difference between Japan's inflation rate and those of the US and the Eurozone. Different symptoms call for different prescriptions. This is the reason the BoJ is keeping YCC as-is.

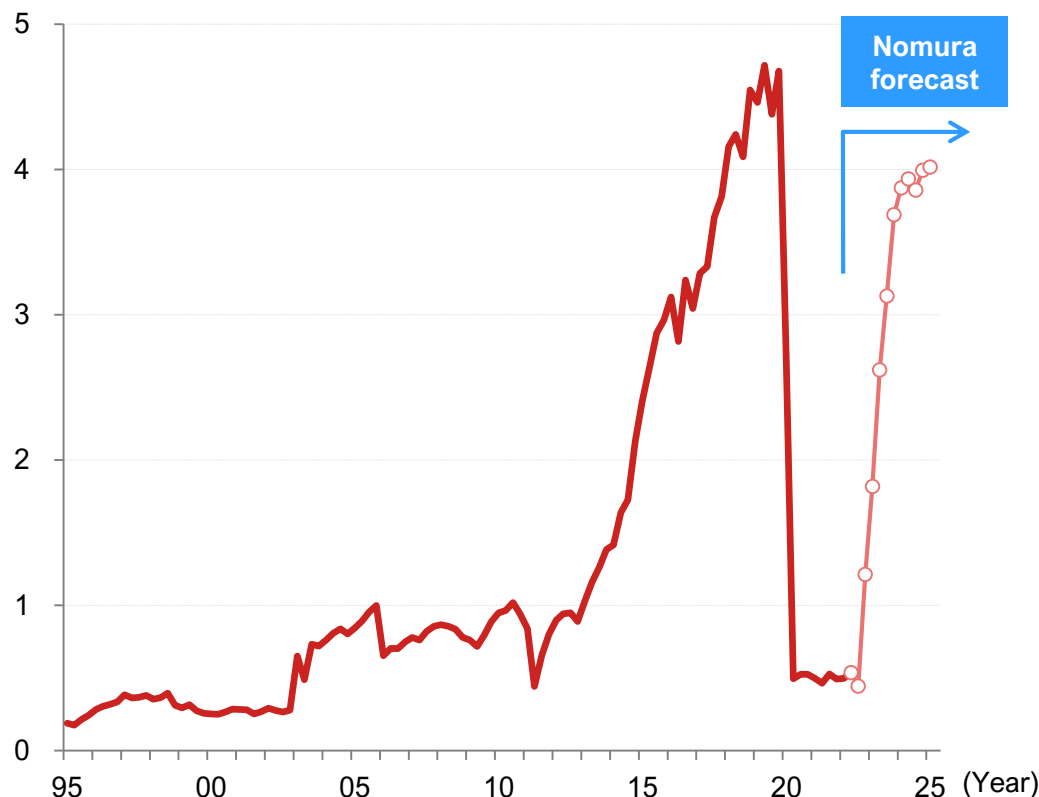
Note: Overall values exclude fresh foods for Japan, differs from US and Eurozone

Source: Ministry of Internal Affairs and Communications, U.S. Bureau of Labor Statistics (BLS), European statistics (Eurostat), and Haver

Support for the Japanese economy (1): Inbound demand

Historic results and forecasts for inbound demand

(Annual, ¥trn)



Three factors can be expected to support the Japanese economy in 2023: (1) an increase in inbound demand, (2) reopening of the economy from COVID-19 and an increase in personal consumption on the back of increased savings during the pandemic, and (3) an increase in capex spurred by gradual relaxation of constraints on the supply of semiconductors, etc., and decarbonization and digital transformation.

For the first factor of inbound demand, demand had grown to c.¥4.5trn per year (0.9% of annual GDP) before COVID-19, but plummeted to ¥0.5trn during the pandemic. However, with the easing of border control measures such as removal of limits on foreign arrivals in October 2022, inbound demand is starting to increase.

Nomura, under the assumption that the Chinese government will ramp up the pace of easing its zero COVID policy following the March 2023 National People's Congress, predicts that annual inbound demand will rebound to c.¥4trn per year by the end of 2023.

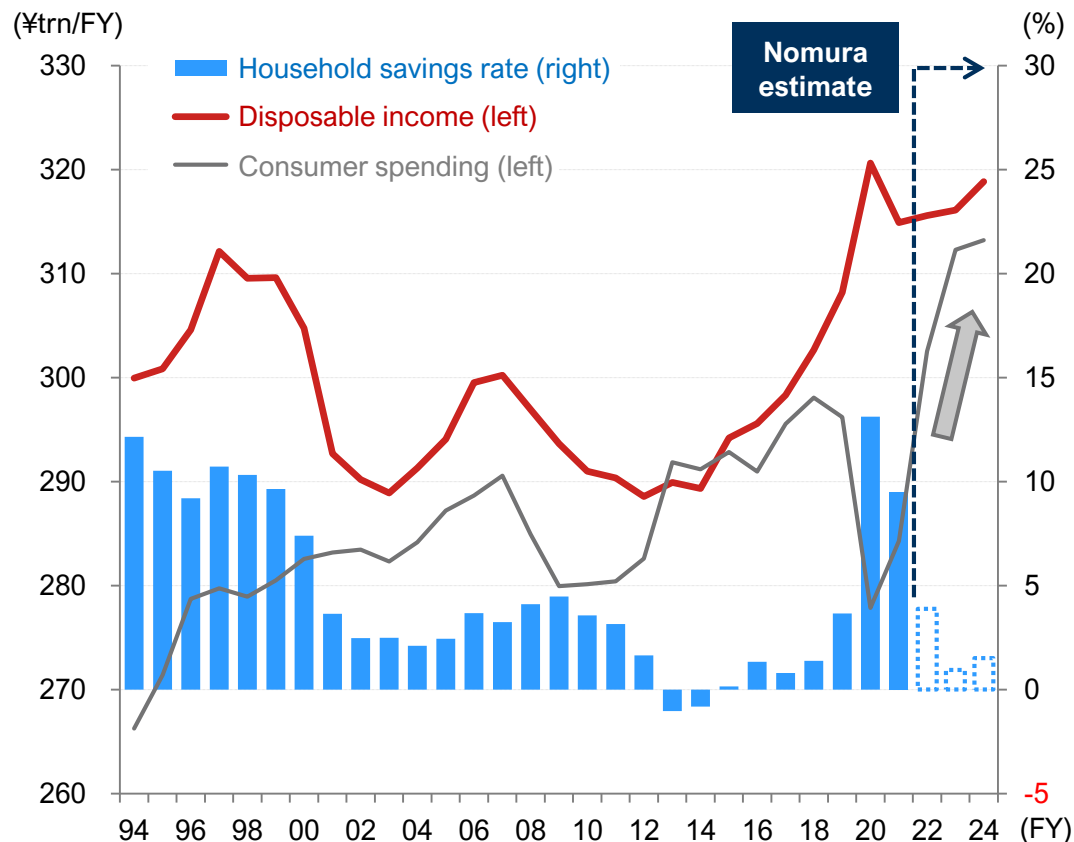
However, a lack of workers is an issue for the hotel sector, for which the creation of a more liquid labor market is essential.

Note: 1. Inbound demand is defined as direct purchases made in Japan by non-resident individuals
2. Historic results through the April-June 2022 period; subsequent values are Nomura forecasts

Source: Historic results from Cabinet Office GDP statistics, forecasts by Nomura

Support for the Japanese economy (2): Consumer spending

Increased savings during the pandemic will support consumption going forward



The second factor that will support the Japanese economy in 2023 is consumer spending.

The timing of reopening for Japan was later than for the US and the Eurozone, so the high savings rate more or less compulsory during COVID-19 has yet to drop significantly. Thus, even if wage increases are sluggish, savings may fuel consumer spending in 2023.

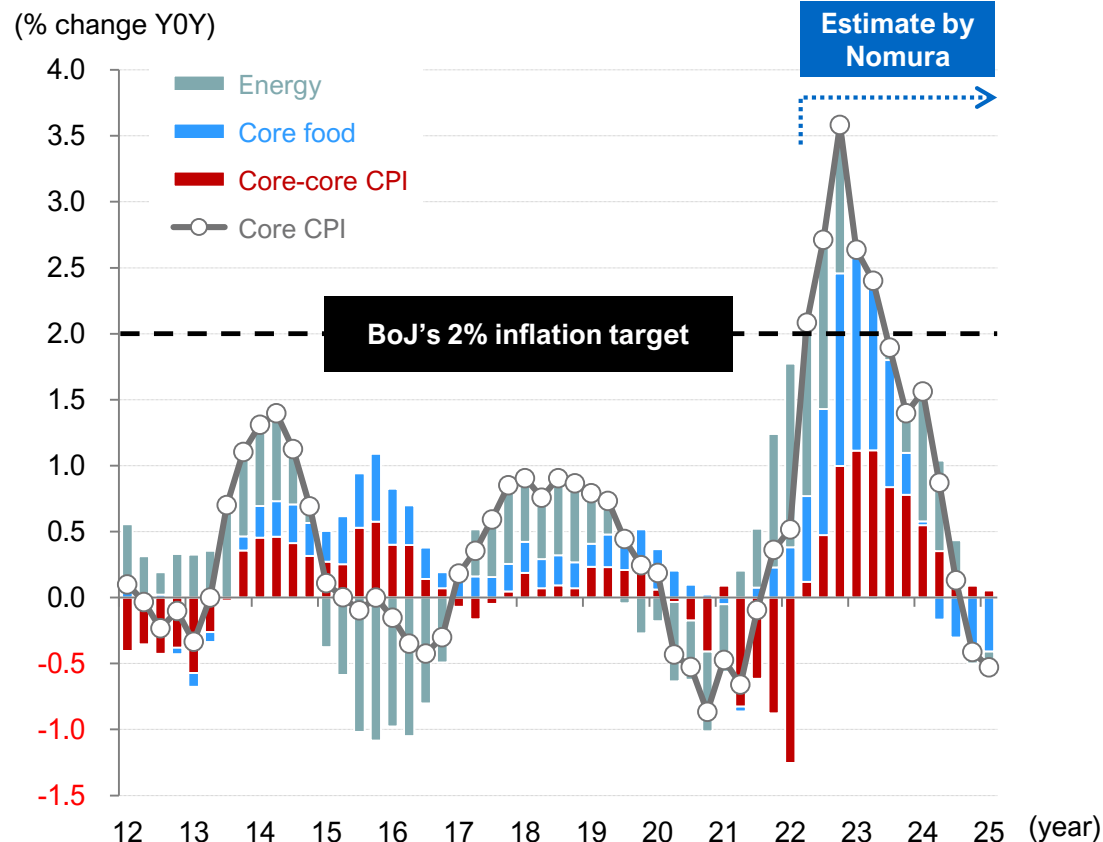
From this perspective, we would like to stay aware of the risk of excessive increase in consumer spending. In other words, we cannot eliminate the possibility of the household savings rate becoming negative (spending higher than disposable income) as a result of the expenditure of the stock of accumulated savings in addition to the flow of current savings. This is only a risk scenario; the likelihood of consumer spending, the largest component of GDP at 55%, supporting the economy is reassuring.

Note: Savings rate (%) = $(1 - (\text{Consumer spending} / \text{disposable income})) \times 100$

Source: Cabinet Office GDP statistics

However, steady 2% inflation may not be achieved

Core CPI (excluding fresh foods), actual and estimated



Nomura estimates that the inflation rate in Japan measured by core CPI (which excludes fresh foods) will decline in 2023 to 2024.

The background factors for this view are (1) the inflationary effects caused by the prices paid for commodities and foods are likely to recede from the level of the prior year, (2) while the yen weakened against the dollar in 2022, this is forecast to reverse in 2023, so that higher prices owing to the weak yen can also be expected to moderate, and (3) the comprehensive economic measures approved in October 2022 by the cabinet of Prime Minister Kishida are expected to suppress CPI by an average of 1.2 percentage points from the prior year in January through September 2023, mainly through lower energy costs.

Certainly, there have been price increases in Japan for more product categories. But the transfer of higher input costs to sales prices represents only a transfer of income from households to corporations; by no means does this establish a stable rate of inflation.

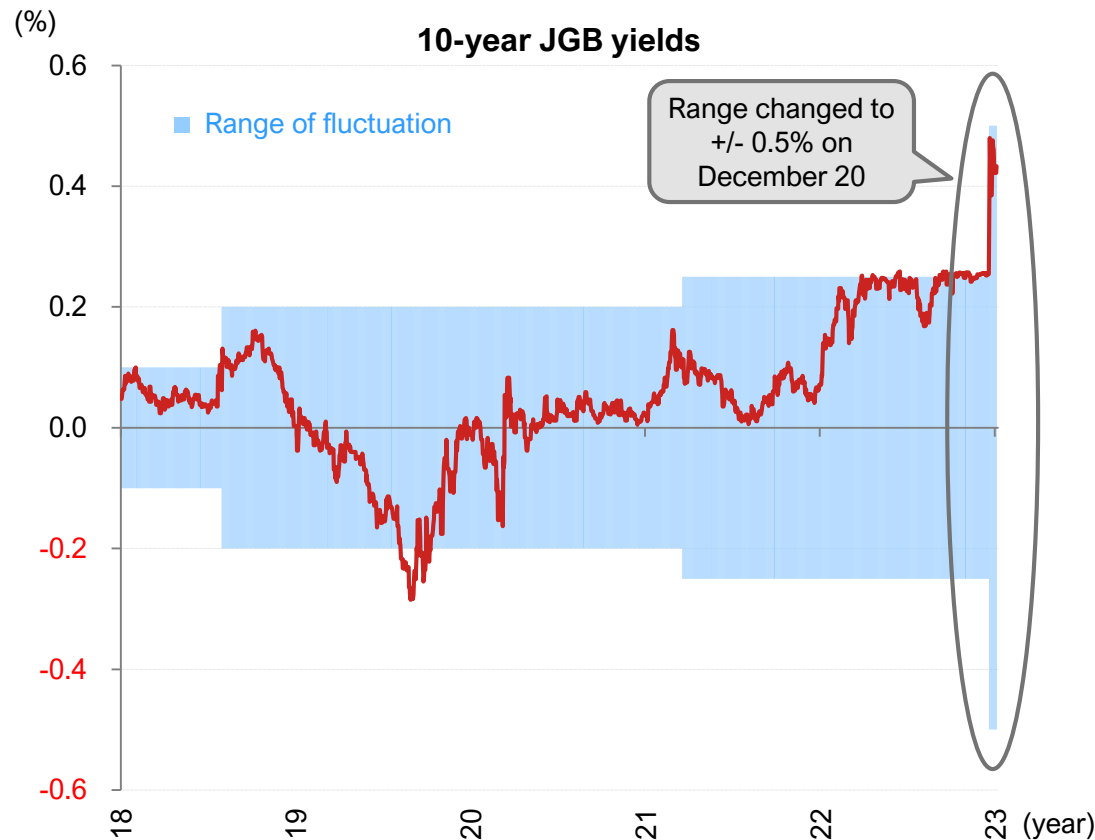
Rather, a transfer of income from corporations to households, achieved through a stable rise in wages of about 3% annually, is essential to achieve 2% inflation.

Note: "Core CPI" excludes fresh foods; "core-core CPI" excludes energy and foods (but includes alcohol)

Source: Ministry of Internal Affairs and Communications for historical data; estimates are by Nomura

A sudden revision to YCC by the Bank of Japan on December 20, 2022

The Bank of Japan widens the range of 10-year JGB yields



On December 20, 2022, the Bank of Japan (BoJ) made the following three revisions to yield curve control (YCC), ostensibly to enhance the sustainability of monetary easing.

- 1) Expansion of the range of fluctuation for the long-term policy interest rate (10-year JGB yields) from +/- 0.25% to +/- 0.5%.
- 2) Significant increase in the monthly amount of JGB purchases from ¥7.3trn to 9trn.
- 3) Flexibility in increasing purchase amounts for each bond term and fixed-rate purchase operations.

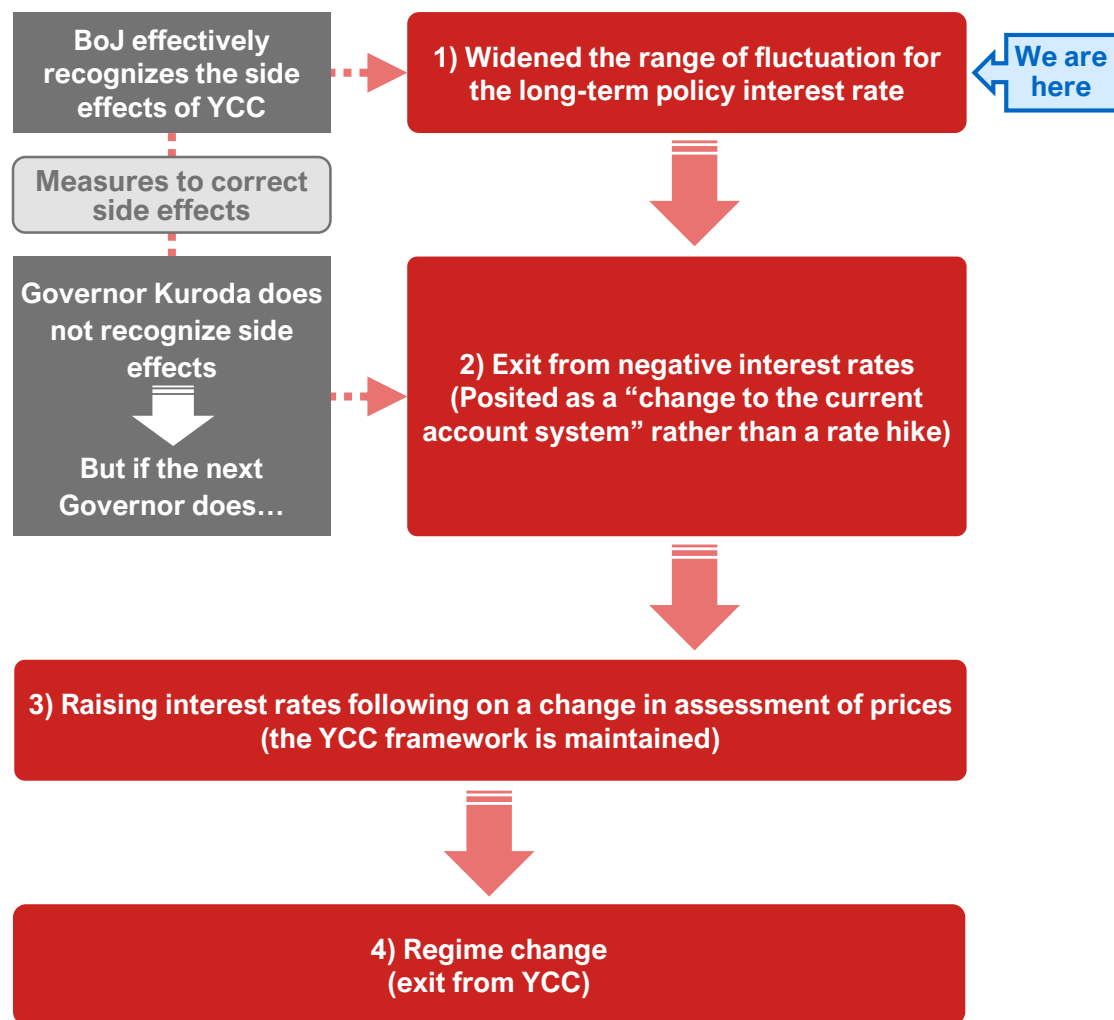
The BoJ explained that the aim of these three revisions is to correct the reduced market functionality that had been a side effect of YCC; these revisions in turn will enhance the sustainability of monetary easing.

However, the BoJ did not change its outlook for fundamentals such as economic activity and prices. As a result, the policy interest rate level (-0.1% interest on policy-rate balances, 10-year JGB yield of around 0%) and forward guidance remained unchanged.

Going forward, analysis of both the fundamentals and side effects will be required to gain an outlook on the BoJ's monetary policy.

The four steps to exiting YCC

The four steps to regime change (exit from YCC)



An exit from YCC would be a change to the monetary policy regime that has lasted from September 2016. The process to realizing this regime change can be divided into the following four steps.

First is widening of the range of fluctuation for the long-term policy interest rate. This was the policy response taken in December 2022. The motive was to address the side effects of YCC (reduced market functionality).

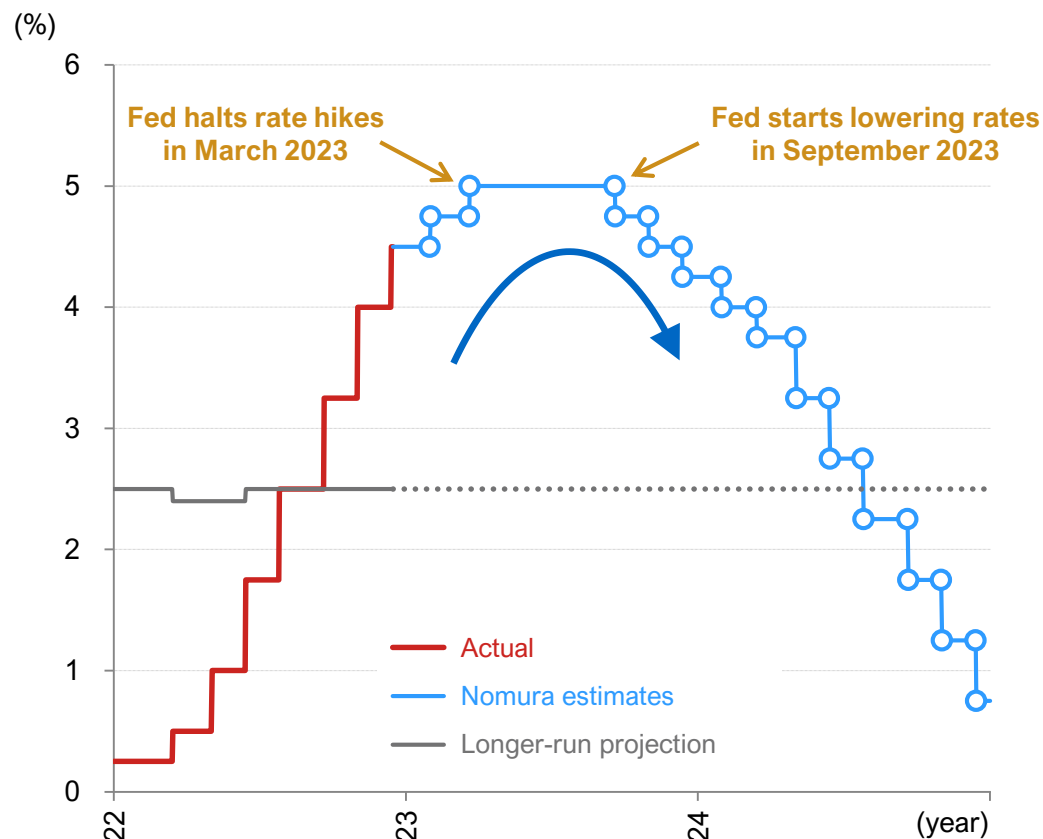
Second is an exit from negative interest rates. The motive for this will also be addressing the side effects of YCC (deterioration of financial institution revenues). Specifically, this is expected to take the form of abolishing the application of negative interest rates to certain balances in current accounts held at the BoJ (the policy-rate balances). Thus, BoJ is not likely to posit this move as a rate hike. BoJ has up to now not recognized the deterioration of financial institution revenues as a side effect of YCC. Thus, the exit from negative interest rates will likely be a topic to be taken up under the new Governor taking office in April 2023.

Third is an interest rate hike following on a change in assessment of prices, or in other words, economic fundamentals. This is likely to take place in 2024 or later.

The fourth and final step is an end to YCC.

Approaching a pivot in US monetary policy

Target federal funds rate (upper limit), actual and estimated



Through foreign exchange, US monetary policies have an impact on prices in Japan. Nomura expects the Fed to continue raising the federal funds rate, its policy interest rate, until March 2023, all the way up to 5.00% (the upper limit of a range set at 4.75% to 5.00%). We expect the Fed to begin reducing the rate in September. Rates coming down for the first time in four years will constitute a major pivot.

Needless to say, for this scenario to become a reality, the Fed will need to cool the economy sufficiently, by holding down rising prices and wages. This is why Nomura believes it will be necessary for the Fed to increase the federal funds rate to as high as 5.00%.

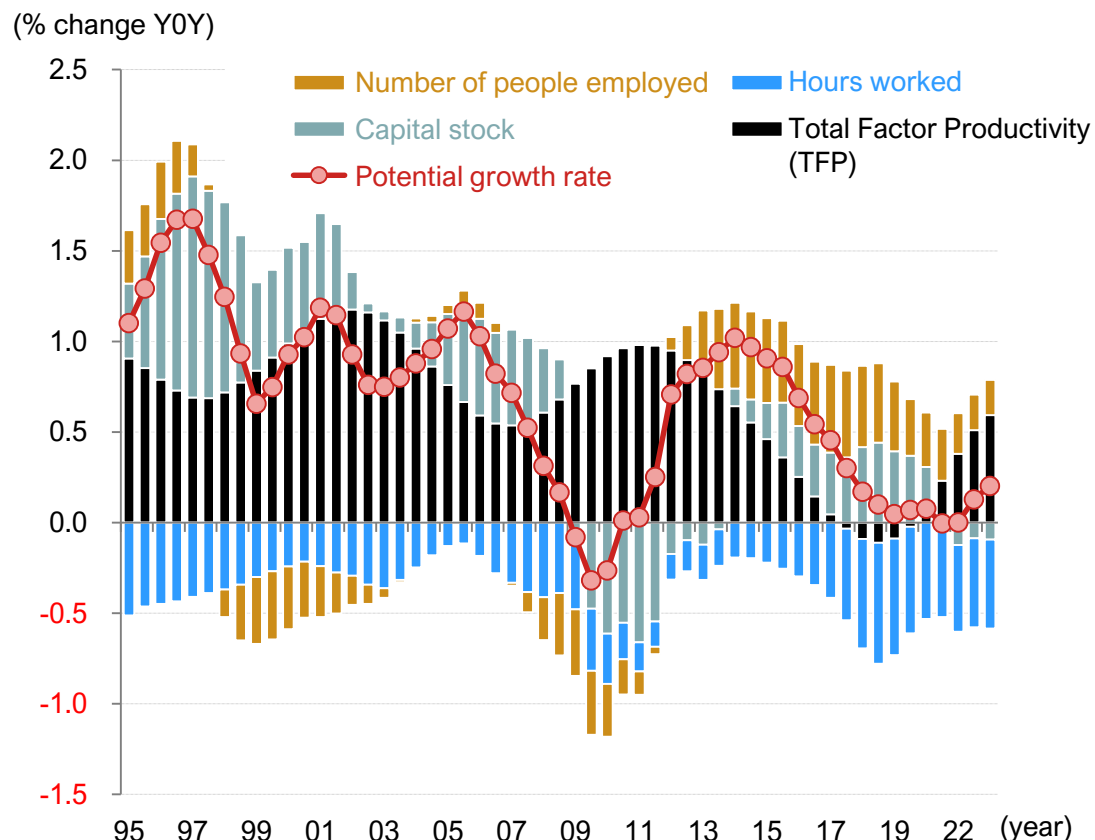
If this comes to pass, the difference in interest rates between the US and Japan, which widened precipitously in 2022, should begin to narrow towards the end of 2023. Then, we can expect the yen to strengthen against the dollar towards the end of 2023.

Note: The "longer-run projection" in the diagram above is the median figure for the longer-run FF rate among members of the Federal Open Market Committee (FOMC)

Source: Federal Reserve Board for historical data; estimates are by Nomura

To improve the potential growth rate

Japan's potential growth rate (Bank of Japan estimate)



Note: Total Factor Productivity (TFP) is one of the contributors to economic growth (GDP growth). Unlike quantitative production factors such as capital and labor, TFP refers to qualitative growth factors such as technological innovation or improvements to production efficiency. Because TFP cannot be measured directly, it is calculated by subtracting the contributions of factors other than TFP from the rate of economic growth

Source: BOJ materials

According to an estimate by the BOJ, Japan's potential growth rate has fallen to between 0% and 0.5%. Since the early 2010s, the number of women and the elderly participating in the workforce have increased, nudging the potential growth rate higher. But there is now little leeway for further growth in the workforce; any growth will now have to come from growth in total factor productivity (TFP).

At the individual level, workers are called on to improve their productivity through (1) recurrent education (organized learning by working adults) and (2) reskilling (acquiring new knowledge or skills needed to adapt to technological innovations and other changes).

In addition, there is a need to create the structures for renewal on a macroeconomic level by introducing regulations and other systems to promote the flexible reallocation of workers to industries with potential for growth.

From this standpoint, employment policies also need to shift from suppressing unemployment (which has the effect of also suppressing economic renewal) to minimizing periods of unemployment (allowing the economy to undergo renewal as well).

Biography



Kyohei Morita

Chief Economist

As Nomura's Chief Economist, Kyohei Morita analyzes macroeconomic trends across countries and regions, and financial markets across asset classes, to predict what lies ahead for Japan's economy. He is particularly well-versed in monetary policy, having written on the subject for his doctoral thesis; he received his PhD in Economics from Kyushu University in 2018.

Since joining Nomura Research Institute in 1994, he has been engaged in macroeconomic analysis and forecasting. He was at the UK head office of Nomura Research Institute Europe from 2001 to 2004, providing in-depth analysis and forecasts of the Japanese economy for Japanese equities investors in the UK, continental Europe, and the Middle East. During this period, he had opportunities to visit some 500 investors each year. Over the next 14 years, he served as Chief Economist at Barclays Securities (2008-2017) and Credit Agricole (2017-2022). He became Chief Economist at Nomura Securities in 2022.

After graduating from Kyushu University School of Economics in 1994, Kyohei continued his studies at the Graduate School of Brown University from 1998-2000, earning a Master's Degree in Economics. As non-traditional monetary policy came to be adopted around the world, he began work on a doctoral thesis to deepen his understanding of the theoretical and historical underpinnings, culminating in "A Consideration of Monetary Policies Under Low Natural Interest Rates." He received his doctoral degree in economics from Kyushu University in 2018.

As an economist, Kyohei focuses on (1) data analysis that is detailed but easy to understand, (2) generating global, rather than local, economic scenarios, and (3) central bank watching based on meticulous data analysis. Institutional investors have appreciated his insights: thanks to their votes, Kyohei placed fourth among economists ranked by Nikkei Veritas in 2022.

Kyohei has also contributed to books on economic issues: Asset Formation in an Age of Population Decline (Toyo Keizai, 2005); Modern Financial Theory, new ed. (Yuhikaku, 2016); Modern Securities Theory (Minerva Shobo, due out in 2023). He is a frequent guest on the TV Tokyo program, News Morning Satellite, and contributes regularly to Deep Dive into Market Topics by Top Economic Analysts on Diamond Online .

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Publication date: January 4, 2023

This material was created as reference material for Nomura Securities' Japan in the World event to be held in January 2023