Preface: Will Japan Be Back?

HONDA, Yuzo

The stubbornly high inflation seems to have started cooling off in the US, standing at 3.1% in November 2023. Industrial production has virtually levelled off throughout 2022 and 2023. Both prices and production suggest that the US economy is decelerating, although the third-quarter GDP growth remains at the respectable 3.0%, and the unemployment rate at a low 3.7% in November.

To cope with the outbreak of the Covid-19 pandemic in 2020, the US government and the Federal Reserve Board (FRB) took bold expansionary fiscal and monetary policies, respectively. This, together with the global surge in energy and food prices, has induced the current high inflation in the US. The switch to contractionary monetary policy by the FRB since the beginning of 2022 has pushed up the short-term interest rate (the 3-month Treasury Yield) roughly from 0.1% to 5.4%, and the long-term interest rate (the 10-year Treasury Yield) from 1.6% to 3.9%. The rise in interest rates and the reduction in the monetary base have led to the current slowdown in real spending in the US.

Now, the question is whether or not the slowdown of the US economy will turn into a recession in the beginning of 2024. I believe even if that should happen to be the case, the recession would be mild, with the appropriate management by the FRB. Overall, the US economy seems to be on a right track.

The rise in interest rates in the US has not only curbed spending, but it has also had a huge economic impact all over the world, including Japan. More specifically, the widening interest rate differential between Japan and the US has led to the depreciation of the yen against the US dollar from 115 yen per dollar at the beginning of 2022 to 143 yen on December 21, 2023, a depreciation of approximately 24%. The yen depreciation, together with the global surge in energy and food prices, has reduced the purchasing power of people in Japan through the rising prices of imported goods. As a result, domestic consumption has decreased, which has had a negative impact on the Japanese economy.

With some time lag (called “J curve effect in macroeconomics”), however, the yen depreciation has produced a favorable environment for Japanese business firms, exporting manufacturers in particular, generating handsome profits in 2023. The improved performance of those businesses has enabled them to make new investments and raise wages. According to the Nihon Keizai Shinbun Survey from December 16, 2023, the 874 leading Japanese companies are going to make total fixed investments worth 32 trillion yen for the 2023 fiscal year, which is an impressive 17.3% increase from the previous year. Indeed, there is a possibility that the expansionary monetary policy, which has been implemented by the Bank of Japan (BOJ) for more than a decade, might have helped to lay the basic foundations needed to rebuild the Japanese economy, which has been stagnating since the bubble burst in 1990.

Whether or not Japan will be back is yet to be seen, but at least there seem to be some structural changes happening in recent exports and foreign direct investment. Japanese firms have been putting more weight on the US both as a trading partner and as a destination for direct investment. For example, Japanese direct investments in North America amounted to 9.0 trillion in 2021 and 8.1 trillion yen in 2022, significantly exceeding the 5.6 trillion yen in the pre-pandemic 2019. Also, Japan's exports to the US exceeded those to China in 2023, in contrast to the previous year.

In order for the Japanese economy to get back on a steady growth path, two factors seem to be indispensable. The first one is investment by private businesses: with the necessary funds at hand, firms need to make new investment, which embodies the technological innovation, so that their products and services may become more competitive on the global market.

Second, it is essential for the BOJ to take an appropriate monetary policy to support the real sector. There has been constant and strong upward pressure on the Japanese long term interest rate through arbitrage since the FRB began to take a contractionary monetary policy at the beginning of 2022. This upward pressure on the long term interest rate from the US has collided with the BOJ's monetary policy to keep the rate around the zero percent, leading the Nikkei 225 Index to exceed its highest peak of 38,915 yen recorded at the end of 1989 for the first time in 34 years, and also the yen-dollar exchange rate to hover around 150 yen per dollar in February 2024. In general, it takes some time for exogenous shocks on financial (asset price) variables (like stock prices and exchange rates) to have full impacts on income (flow) variables (like consumption and investment), and we have to wait and see how this will happen in the near future. In the meantime, however, the recent violent behavior of financial variables is now posing a difficult problem on whether the BOJ should keep or modify the current yield curve control (YCC) policy in the future.

Part I of this year's Economic Outlook discusses the economic status quo in the major countries along the Pacific Rim surrounding Japan. Part II outlines the performance of the Japanese economy in general, and that of the Kansai area in particular. Given that the Osaka-Kansai Expo will be held in 2025, and that international tourism in Japan is resurging, we have added two chronologies - an EXPO 2025 Chronology and a Tourism Chronology - in Part III for your convenience. Part IV contains a Statistical Annex. Although this Economic Outlook is an abridged English-language version of the original Economic Outlook 2023 published by APIR in Japanese, some of the authors have updated their manuscripts in order to provide readers with the latest information.