Section 2
The Japanese Economy: Recent Developments and Short-Term Forecasts

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1. A Retrospective of the Japanese Economy in FY2023 and the First Half of FY2024

(1) A Gradual Recovery in Global Trade

Global trade is showing signs of recovery. According to the CPB Netherlands Bureau for Economic Policy Analysis' World Trade Monitor, in September 2024 global trade (volume basis; 2021=100) decreased for the first time in two months, down -0.9% MoM (previous month: +1.7% MoM). On a quarterly basis, it increased by +0.8% QoQ in Q3 2024. Global trade turned positive (+0.2% QoQ) for the first time in five quarters in Q4 2023, and since then has expanded and accelerated for four consecutive quarters (+0.9% QoQ in Q2 2024). By region, advanced economies grew by +0.9% in Q3 2024 (previous quarter: +0.6%), and emerging economies grew by +0.6% (previous quarter: +1.3%). This is the second consecutive quarter of growth for advanced economies and the seventh consecutive quarter of growth for emerging economies. It can be said that global trade is gradually recovering (Figure 2-2-1).

According to CPB, the global industrial production index (2021=100) for

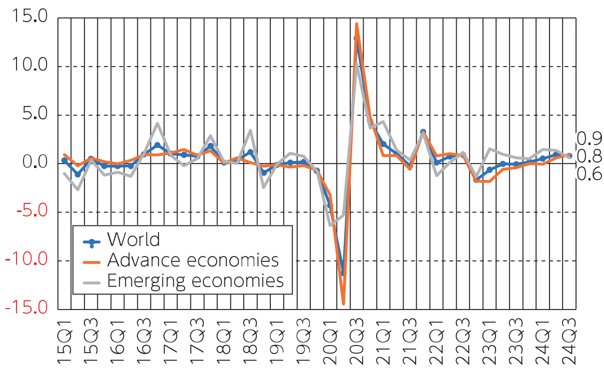

Figure 2-2-1 Changes in world trade volume (Units: QoQ, %)

Source: CPB Netherlands Bureau for Economic Policy Analysis, "World Trade Monitor, November 2024"

Q3 2024 rose QoQ by +0.6% for the second consecutive quarter (previous quarter: +0.6%). Of this, industrial production in emerging economies rose by +1.1% for the ninth consecutive quarter (previous quarter: +0.6%), while industrial production in advanced economies fell by -0.1% for the first time in two quarters (previous quarter: +0.6%). Industrial production in advanced economies has been fluctuating after falling for four consecutive quarters since Q4 2022. This is not good news for Japan, which has a high export weight to advanced economies.

According to the IMF (World Economic Outlook -Policy Pivot, Rising Threats-, October 2024), the global economy is expected to grow by +3.2% in both 2024 and 2025, roughly the same level as in 2023 (+3.3%). The growth rate for 2024 has been left unchanged from the July forecast, but the 2025 figure has been revised downward by -0.1%pt. The average growth rate for the next five years is +3.1%, which is mediocre compared to the pre-COVID-19 average. This is due to structural factors - population aging and low productivity - that are pushing down the potential growth rate.

The US economy is forecast to grow at +2.9% in 2023, +2.8% in 2024, and +2.2% in 2025, while the EU economy is forecast to grow at +1.1% in 2024, and +1.6% in 2025. Meanwhile, the Chinese economy is forecast to grow at +4.8% in 2024, and +4.5% in 2025. The growth rate for the US has been revised upwards by 0.2%pt in 2024 and 0.3%pt in 2025, respectively, from the July forecast. The EU rate has been revised downwards by 0.1%pt in 2024 and 0.2%pt in 2025, respectively. On the other hand, the rate for China has been revised downwards by 0.2%pt in 2024, but the forecast for 2025 has been left unchanged. In addition, the growth rate of real global trade (goods and services) is expected to recover from +0.8% in 2023 to +3.1% in 2024 and +3.4% in 2025, but in both cases, it will be lower than the average growth rate of +4.1% for the period 2006-2015.

According to the World Semiconductor Trade Statistics, global semiconductor sales (3-month moving average) in September 2024 were up +23.2% YoY, marking the 11th consecutive month of growth. In November 2023, sales increased by +5.7% YoY, the first increase in 16 months, and have recorded double-digit growth since December. Global semiconductor sales are expected to recover, partly due to the expansion of AI-related demand. Looking at sales by region, sales in Asia in September increased by +20.8% YoY, while sales in the US increased by +46.3% YoY, both marking the 11th consecutive month of growth. Sales in Japan increased by +7.7% YoY, recording an increase for the second consecutive month. On the other hand, sales in Europe decreased by -8.2% YoY, recording a decrease for the ninth consecutive month (Figure 2-2-2). Thus, the extent of the recovery varies by region.

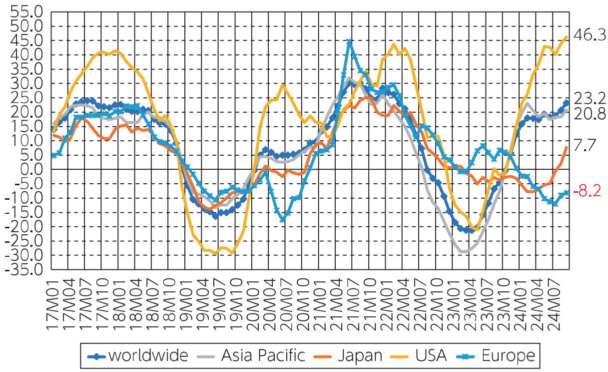

Figure 2-2-2 Changes in global semiconductor sales: 3-month moving average (Units: YoY, %)

Source: World Semiconductor Trade Statistics, November 2024

(2) The Current State of the Japanese Economy

[Second preliminary estimate of Q3 2024 GDP: positive growth for 2 consecutive quarters, but a slowdown from the previous quarter]

According to the Q3 GDP 2nd preliminary report released on December 9, 2024, the real GDP growth rate was +1.2% QoQ, a slight upward revision from the 1st preliminary report (+0.9% QoQ). Although there was a slowdown from Q2 (+2.2% QoQ), this was the second consecutive quarter of positive growth (Table 2-2-1). According to the annual estimates announced at the same time, the real GDP growth rate for FY2023 was revised downward from +0.8% to +0.7%, and for FY2022 from +1.6% to +1.4%.

[Trends in Q3 GDP components]

Private final consumption expenditure increased for the second consecutive quarter, up +0.7% QoQ (+0.4%pt contribution to real GDP growth). Nominal employee compensation increased for the fifth consecutive quarter, up +0.5% QoQ (previous quarter: +1.7% QoQ), and real employee compensation increased for the fourth consecutive quarter, up +0.2% QoQ (previous quarter: +0.7% QoQ). In addition, the impact of the income tax and resident tax cuts that have been in effect since June has led to a significant increase in household disposable income, contributing to a rise in household final consumption expenditure.

Looking at domestic household final consumption expenditure (QoQ +0.5%, contribution: +0.3%pt) by type, real durable goods increased for the second consecutive quarter, up +2.7% (contribution: +0.1%pt) due in part to the impact of increased production of passenger cars. Real non-durable goods such as food

Table 2-2-1 Changes in real GDP and its demand-side components (Units: QoQ %, % points)

	Annualized GDP	GDP	Domestic demand	Private demand	Private final consumption expenditure	Private residential investment	Private non-residential investment	Private inventory changes	Public demand	Government final consumption expenditure	Public investment	Public inventory changes	Net exports	Exports	Imports	GDI
			Contribution	Contribution				Contribution	Contribution			Contribution	Contribution			
20Q4	7.2	1.7	1.4	1.2	1.8	0.1	1.8	-0.1	0.2	0.9	0.4	0.0	0.4	8.4	5.8	1.9
21Q1	1.3	0.3	0.0	0.0	-1.5	1.7	1.5	0.5	0.0	-0.1	-0.7	0.0	0.4	4.6	2.4	-0.5
21Q2	2.5	0.6	1.0	0.6	0.4	1.6	2.2	0.0	0.3	2.2	-2.6	0.0	-0.3	2.5	4.8	0.1
21Q3	-1.9	-0.5	-0.6	-0.7	-1.1	-1.2	-1.5	0.2	0.1	0.7	-1.7	0.0	0.2	-0.8	-1.9	-1.1
21Q4	4.9	1.2	1.3	1.6	3.0	-0.5	0.3	0.0	-0.3	-1.0	-1.3	0.0	-0.1	-0.6	0.1	0.7
22Q1	-2.4	-0.6	-0.5	-0.4	-1.2	-0.8	0.4	0.3	-0.1	0.6	-4.2	0.0	-0.1	3.9	4.5	-1.1
22Q2	4.5	1.1	1.2	1.1	2.0	-2.3	2.0	-0.1	0.0	0.9	-3.3	0.0	-0.1	1.0	1.4	0.3
22Q3	-1.7	-0.4	0.2	0.3	0.0	0.3	2.1	0.0	-0.1	-0.5	0.7	-0.1	-0.6	1.7	4.9	-1.1
22Q4	1.5	0.4	0.0	-0.2	0.2	0.8	-1.2	-0.2	0.3	0.7	0.7	0.1	0.3	0.9	-0.8	0.8
23Q1	5.0	1.2	1.2	1.0	1.1	0.9	1.8	0.1	0.2	0.1	3.0	0.0	0.1	-1.6	-1.5	1.8
23Q2	2.1	0.5	-0.9	-0.6	-0.7	1.5	-1.9	0.1	-0.3	-1.5	0.2	0.0	1.5	2.3	-3.9	1.3
23Q3	-4.1	-1.0	-1.0	-1.0	-0.6	-0.9	-0.3	-0.6	0.0	0.5	-2.1	0.0	-0.1	0.6	0.7	-0.8
23Q4	0.7	0.2	0.0	0.1	-0.1	-0.9	2.0	-0.1	-0.1	0.0	-1.7	0.0	0.1	3.0	2.1	0.1
24Q1	-2.2	-0.6	-0.2	-0.1	-0.6	-2.7	-0.4	0.4	-0.1	0.2	-2.1	0.0	-0.4	-4.1	-2.4	-0.5
24Q2	2.2	0.5	1.0	0.5	0.6	1.2	1.1	-0.1	0.5	1.0	5.2	0.0	-0.4	1.5	3.3	0.8
24Q3	1.2	0.3	0.5	0.5	0.7	0.4	-0.1	0.2	0.0	0.1	-1.1	0.0	-0.2	1.1	1.8	0.3

Note: Domestic demand, private demand, private inventory change, public demand and net exports are contributions. Others are QoQ changes.

Source: National Accounts, Economic and Social Research Institute, Cabinet Office; "Preliminary Quarterly GDP Estimate for Q3 2024 (2nd Preliminary Figures)"

increased by +0.9% (contribution: +0.1%pt) for the third consecutive quarter. Real service spending increased by +0.2% (contribution: +0.1%pt) for the first time in two quarters. On the other hand, real semi-durable goods such as clothing decreased by -2.3% (contribution: -0.1%pt) for the first time in two quarters.

Of fixed capital formation, real private residential investment increased for the second consecutive quarter, rising +0.4% QoQ (contribution: +0.0%pt). The private residential investment deflator fell for the first time in five quarters (-0.0% QoQ), but the underlying tone of housing investment remains weak due to the continued high cost of materials.

Real private non-residential investment decreased QoQ by -0.1% (contribution: -0.0%pt), the first decrease in two quarters. The underlying trend of recovery is continuing, as corporate capital investment plans are firm and profits are at a high level, but the impact of factory shutdowns due to natural disasters was significant in Q3 2024.

The contribution of real change in private inventories to real GDP growth was +0.2%pt QoQ, the first positive contribution in two quarters.

Real public demand decreased QoQ by -0.1% (contribution: -0.0%pt), the first decrease in two quarters. Of this, real government final consumption expenditure increased QoQ by +0.1% (contribution: +0.0%pt), the third consecutive quarter of growth. Conversely, real public fixed capital formation experienced a 1.1% contraction QoQ (contribution: -0.1%pt), the first decrease in two quarters.

This was a reaction to the high growth rate in the previous quarter (+5.2% QoQ).

Real exports of goods & services increased for the second consecutive quarter, but only slightly, by +1.1% QoQ (contribution: +0.2%pt). Exports of goods increased for the first time in three quarters, by +2.1% QoQ (contribution: +0.3%pt), after falling in the previous quarter (-0.8% QoQ). Exports of services (including direct purchases in Japan by non-resident households) fell -1.8% (contribution: -0.1%pt), the first negative growth in two quarters. Of this, due in part to the impact of natural disasters, direct purchases in Japan by non-resident households, which is inbound tourism demand, fell -3.5% (contribution: +0.0%pt), the first decrease in nine quarters.

Meanwhile, real imports of goods and services exhibited an uptick for the second consecutive quarter, with a +1.8% QoQ rise (contribution: -0.4%pt). Of this, imports of goods increased for the second consecutive quarter, up +2.1% QoQ (contribution: -0.4%pt). Meanwhile, imports of services (including direct purchases overseas by resident households) increased for the third consecutive quarter, rising +0.9% QoQ (contribution: -0.1%pt).

Looking at the deflator, the domestic demand deflator rose +0.2% QoQ, marking the 15th consecutive quarter of positive growth (previous quarter: +1.0%). Of these, the deflator for private final consumption expenditure rose by +0.2% QoQ for the 15th consecutive quarter, but the inflation rate slowed for the second consecutive quarter (previous quarter: +0.7%). The deflator for private residential investment fell by -0.0% for the first time in five quarters. The deflator for private non-residential investment rose by +0.4% for the 16th consecutive quarter. In the external demand deflator, the exports of goods & services deflator fell by -1.2% for the first time in 6 quarters, and the imports of goods & services deflator fell by -1.1% for the first time in 5 quarters. The terms of trade deteriorated for the first time in 3 quarters. As a result, the GDP deflator rose by +0.1% QoQ for the 8th consecutive quarter (previous quarter: +1.4% QoQ).

As a result, nominal GDP in Q3 2024 increased for the second consecutive quarter, rising +0.5% QoQ (annualized +1.8%; previous quarter: annualized +7.8%). Nominal GDP also exceeded JPY 600 trillion for the second consecutive quarter, reaching JPY 610.2 trillion. As a result, nominal GDP in FY2023 recorded a positive growth of +4.9% for the third consecutive year.

[Adjustment process from the COVID-19 pandemic]

In Q3 2024, real GDP (JPY 557.1 trillion) recorded positive QoQ growth for two consecutive quarters, but due to revisions to past values, it was below the pre-Corona pandemic peak (in Q3 2019: JPY 557.4 trillion) for five consecutive quarters. This suggests a weak recovery trend in the Japanese economy. However, due in part to the impact of rising prices, nominal GDP has exceeded the pre-Corona peak (JPY 561.4 trillion) for eight consecutive quarters.

Looking at the recovery situation for each component of GDP, at present the recovery of private final consumption expenditure (-2.1%) and private capital formation (-1.8%) is still lagging behind, but due to the rapid recovery of inbound tourism, service exports (+22.4%) have recovered for seven consecutive

Table 2-2-2 Adjustment process from the COVID-19 pandemic: real GDP and its components (2019Q3=100)

	GDP	Goods imports	Services imports	Private final consumption expenditure	Private investment	Government spending	Goods exports	Services exports	Nominal GDP
19Q3	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
19Q4	97.1	98.4	96.2	96.6	94.8	100.2	97.5	100.2	98.0
20Q1	97.7	94.1	94.9	97.4	95.1	100.2	96.1	88.2	98.8
20Q2	90.3	95.0	88.9	89.4	91.6	101.9	78.2	76.4	91.5
20Q3	95.1	87.2	84.5	94.2	88.4	103.1	88.8	73.0	96.2
20Q4	96.7	93.8	84.7	96.0	89.3	103.8	97.6	74.3	97.8
21Q1	97.1	96.5	85.5	94.5	93.4	103.6	101.9	78.6	98.2
21Q2	97.7	99.7	93.9	94.9	95.5	104.9	104.8	79.6	98.7
21Q3	97.2	98.3	90.8	93.8	95.0	105.2	103.5	80.7	98.1
21Q4	98.4	98.2	91.4	96.6	95.0	104.1	103.0	79.7	99.1
22Q1	97.8	103.1	93.8	95.4	96.4	103.8	108.2	78.5	99.2
22Q2	98.9	105.3	92.7	97.3	96.9	104.0	107.9	84.4	99.9
22Q3	98.5	106.4	110.6	97.3	98.5	103.5	108.7	89.4	99.2
22Q4	98.8	106.8	105.9	97.5	97.0	104.5	108.4	95.1	101.1
23Q1	100.0	103.7	110.4	98.6	98.9	105.1	104.9	100.0	103.9
23Q2	100.5	99.3	107.4	97.8	97.9	103.9	106.3	106.1	105.8
23Q3	99.5	98.4	115.0	97.3	95.1	103.8	105.8	110.4	105.7
23Q4	99.7	101.7	112.5	97.2	96.0	103.5	105.8	124.9	106.3
24Q1	99.1	97.5	116.7	96.6	96.8	103.3	103.1	114.3	106.2
24Q2	99.6	99.9	123.7	97.2	97.6	105.1	102.2	124.6	108.2
24Q3	99.9	102.0	124.8	97.9	98.2	105.0	104.4	122.4	108.7

Source: Authors' calculations based on the National Accounts, Economic and Social Research Institute, Cabinet Office, Government of Japan, and the "Preliminary Estimate of Quarterly GDP (Second Preliminary Estimate) for Q3 2024" quarters to the pre-Corona pandemic peak. On the other hand, service imports (+24.8%), which are a deduction item in GDP, have also excelled for nine consecutive quarters, while net exports of services are making a negative contribution (Table 2-2-2).

2. Japan's Economic Outlook: FY2024-2026

(1) Assumptions about Exogenous Variables

Let's look at the assumptions for domestic policies (exogenous variables). In Q3 2024, real public fixed capital formation decreased by -1.1% QoQ, the first decrease in two quarters (previous quarter: +5.2% QoQ). According to the Ministry of Land, Infrastructure, Transport and Tourism's General Construction Statistics (volume basis), public works (nominal, seasonally adjusted) in Q3 fell -0.5% QoQ, the first decline in two quarters (previous quarter: +9.8% QoQ). Reflecting the recent trend, we assume that real public fixed capital formation will grow by +1.8% in FY2024, +0.7% in FY2025, and +1.6% in FY2026.

In Q3, real government final consumption expenditure increased by +0.1% QoQ, the third consecutive quarter of growth (previous quarter: +1.0% QoQ). Reflecting the recent trend, we assume that real government consumption expenditure will grow by +1.6% in FY2024, +0.6% in FY2025, and +0.5% in FY2026.

For the external environment (exogenous variables), the key assumptions are for crude oil prices, world trade, and exchange rates. Crude oil prices (average of WTI, Dubai, and North Sea Brent) peaked in Q2 2022 ($109.41) and then began to fall, reaching $76.54 in Q2 2023. Prices have reversed since then and remained high (Q3 2024: $77.35). In this forecast, we expect $71.44 for Q1 2025, $65.15 for Q1 2026, and $65.15 for Q1 2027. The average annual figures are assumed to be $76.4 for FY2024, $67.48 for FY2025, and $65.15 for FY2026.

The outlook for real world trade is based on the IMF's World Economic Outlook, October 2024. The growth of world trade (goods and services) will recover gradually, from +0.8% in 2023 to +3.1% in 2024, +3.4% in both 2025 and 2026.

Regarding the Fed's reduction of policy interest rates, we assume that after the September 2024 reduction (50 basis points), there will be further reductions of 25 basis points each in November and December. Additionally, a reduction in the target policy interest rate to a range between 2.50% and 2.75% is projected by the beginning of 2026. Meanwhile, the Bank of Japan (BOJ) lifted its negative interest rate on March 19th and raised interest rates for the first time in 17 years, raising the policy interest rate to around 0.25% on July 31st. The Bank of Japan will continue to carefully maintain the phase of raising interest rates.

Based on the monetary policy stances of Japan and the US, we had assumed that the depreciation of the Japanese yen would reverse after Q3 2024 and gradually head towards appreciation, but following the outcome of the U.S. presidential election, the exchange rate exceeded JPY 150 in November. As a result, we assumed the exchange rate to be JPY 152.4 in FY2024, JPY 147.3 in FY2025, and JPY 140.3 in FY2026 (Table 2-2-3).

(2) Forecasts for Real GDP Growth: +0.3% in FY2024, +1.2% in FY2025, +1.3% in FY2026

The Japanese economy outlook for FY2024-2026 has been revised, incorporating new assumptions for exogenous variables (fiscal and monetary policy and

Table 2-2-3 Summary of forecast results

	2023	2024	2025	2026
Real GDP (%)	0.7	0.3	1.2	1.3
Private demand (contribution)	-0.6	0.5	1.1	1.1
Private final consumption expenditure (%)	-0.4	0.6	1.1	1.3
Private residential investment (%)	0.8	-2.1	-0.4	-0.1
Private non-residential investment (%)	-0.1	2.4	2.5	2.3
Private inventory changes (contribution)	-0.4	0.0	0.0	0.0
Public demand (contribution)	-0.2	0.4	0.2	0.2
Government final consumption expenditure (%)	-0.8	1.6	0.6	0.5
Public investment expenditure (%)	-0.3	1.8	0.7	1.6
Public inventory changes (contribution)	0.0	0.0	0.0	0.0
External demand (contribution)	1.4	-0.6	0.0	0.0
Exports of goods and services (%)	2.8	1.4	2.3	2.3
Imports of goods and services (%)	-3.3	4.5	2.4	2.1
Nominal GDP (%)	4.9	2.8	3.0	2.8
GDP deflator (%)	4.2	2.4	1.8	1.5
Domestic corporate price index (%)	2.4	2.7	0.7	0.4
Core consumer price index (%)	2.8	2.6	2.0	1.6
Industrial production index (%)	-1.9	-0.7	1.9	1.4
New housing starts (%)	-7.0	-1.2	-2.4	-0.6
Unemployment rate (%)	2.6	2.5	2.4	2.3
Current account balance (JPY trillion)	26.6	29.9	30.7	31.0
% of nominal GDP	4.5	4.9	4.9	4.8
Crude oil price (USD/barrel)	80.7	76.4	67.5	65.2
USD/JPY exchange rate	144.5	152.4	147.3	140.3
USA real GDP (%, calendar year)	2.9	2.7	2.0	2.1

Note: % change from the previous year, others are notes variables related to the overseas economy) and adding the second preliminary GDP figures for Q3 2024. This time, we forecast real GDP growth of +0.3% for FY2024, +1.2% for FY2025, and +1.3% for FY2026 (Table 2-2-3), and -0.3% for 2024, +1.1% for 2025, and +1.4% for 2026 on a calendar year basis.

Looking at the contribution to the forecast real GDP growth rate by major item, in FY2024, private demand and public demand will contribute +0.5%pt and +0.4%pt, respectively, to the growth rate. However, net exports are projected to subtract -0.6%pt from the growth rate. In FY2025, private demand and public demand are expected to contribute to an increase in the growth rate by +1.1%pt and +0.2%pt, respectively. Public demand is projected to increase by +0.2%pt, while net exports are estimated to decrease by -0.0%pt. In FY2026, private demand is predicted to rise by +1.1%pt, public demand by +0.2%pt, and net exports by +0.0%pt. In FY2025-2026 period, domestic demand will be the primary driver of growth (Figure 2-2-3).

Looking at the contribution of private demand by category, in FY2024 real private final consumption expenditure contributed +0.3%pt, real private residential investment contributed -0.1%pt, real private non-residential investment contributed +0.4%pt, and real private inventory change contributed +0.0%pt, with private final consumption expenditure and private capital investment making positive contributions. In FY2025, real private final consumption expenditure contributed +0.6%pt, real private residential investment contributed +0.0%pt, real non-residential investment +0.4%pt, and real private inventory change +0.0%pt, with all items contributing positively. In FY2026, real private final consumption expenditure +0.7%pt, real private residential investment +0.0%pt, real

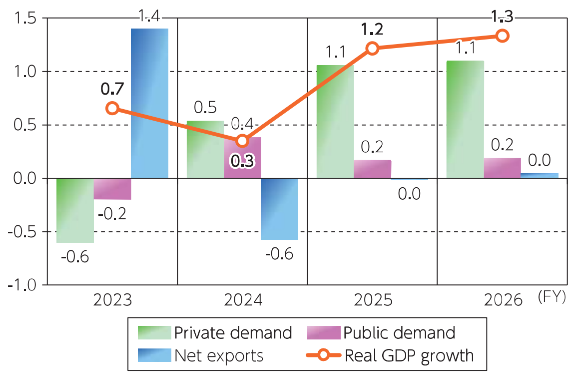

Figure 2-2-3 Real GDP growth rate and contribution by item (Units: QoQ %, %pt)

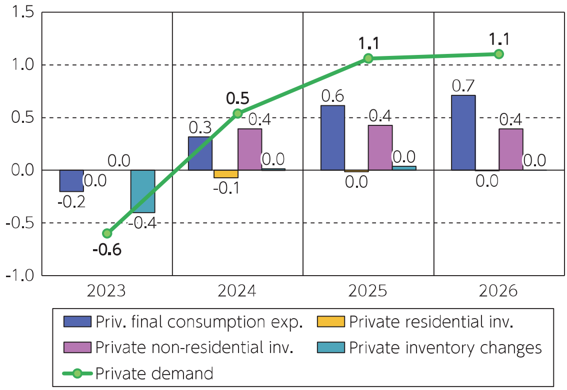

Figure 2-2-4 Contributions to real GDP growth by the components of private demand (Units: YoY %, %pt)

non-residential investment +0.4%pt, and real private inventory change +0.0%pt (Figure 2-2-4).

If we look at real GDP (actual and forecast) on a quarterly basis, the growth rate in FY2024 will remain low because the temporary boost to household final consumption expenditure from the flat-amount tax cut will wear off in the second half of FY2024. In FY2025, wage growth will be comparable to that in the previous year, and in the second half of the year, when consumer price inflation slows down, the increase in real wages will gradually expand, and GDP growth rate will continue to exceed the potential growth rate. However, there is a high risk of a downturn in net exports (see Box "The fallout of President Trump's Policies"), and in FY2025-2026, there will be a gradual recovery centered on domestic demand (Figure 2-2-5).

Box: The Fallout of President Trump's Policies

If we organize the information we have so far, the policies of U.S. President-elect Donald Trump, who will take office in January 2025, will have the following effects on the global economy

(1) Higher tariffs (universal tariffs) will reduce global exports and force a reorganization of the global supply chain. (2) High tariffs will cause inflation to accelerate in the U.S., which will delay the cycle of monetary easing. (3) This will lead to a weakening of each country's currency against the dollar.

These will be serious risks to the recovery of the global economy. For this reason, there is little hope for net exports in the Japanese economy in FY2025-2026.

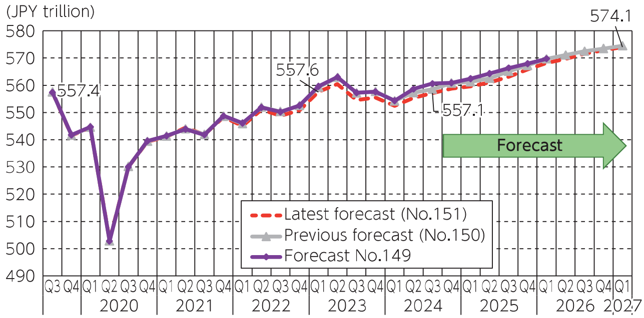

Figure 2-2-5 Quarterly real GDP: actual and forecast

Note: Actual figures through Q3 2024, projected figures thereafter

(3) Household Sector: FY2025 Private Final Consumption Expenditure on Track to Recovery Due to Gradual Increase in Real Wages

According to the preliminary figures for household disposable income and the household savings rate (Figure 2-2-6), in Q1 2024 the household savings rate turned positive for the first time in four quarters. In addition, due in part to the temporary flat-amount tax cut that has been in effect since June, real household disposable income in Q2 returned to the level of Q1 2019 for the first time in nine quarters. After decreasing for four consecutive quarters since Q2 2023, real household consumption expenditure expanded for two consecutive quarters in Q3 2024. The impact of the flat-amount tax cut continued to contribute to the increase in private final consumption expenditure in Q3.

According to the Ministry of Health, Labour and Welfare's Monthly Labour Survey (final figure, all industries, establishments of 5 or more employees), total cash earnings in September 2024 increased by +2.5% YoY, marking the 33rd consecutive month of growth. Real cash earnings (real wages), calculated by dividing total cash earnings by the Consumer Price Index (CPI) excluding imputed rent of owner-occupied dwellings, decreased by -0.4% YoY, marking the second consecutive month of decline.

As a result, nominal wages in Q3 were up +2.9% YoY, the 14th consecutive quarter of growth (previous quarter: +3.0% YoY), but real wages were down -0.2% YoY, the 10th consecutive quarter of decline (previous quarter: -0.2% YoY).

As the effects of the flat-amount tax cut are only temporary, real private final consumption expenditure in FY2024 is expected to increase only slightly by +0.6%, but in FY2025, real wages are expected to expand gradually, and real

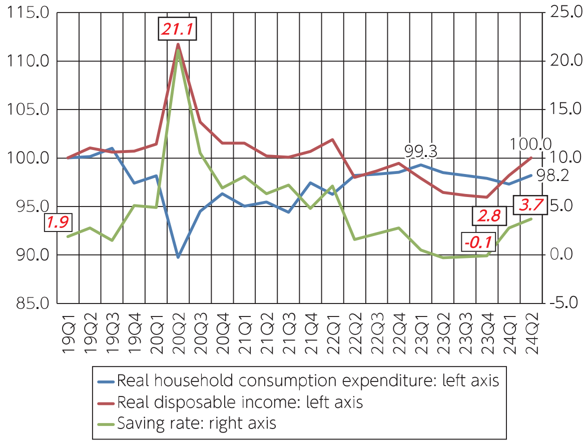

Figure 2-2-6 Real household consumption expenditure, real disposable income, saving rate (Units: 2019Q1=100, %)

Source: Cabinet Office, "Quarterly Estimates of Household Disposable Income and Household Saving Ratio"

private final consumption expenditure is expected to increase by +1.1%, and by +1.3% in FY2026.

According to the Ministry of Land, Infrastructure, Transport and Tourism, the number of new housing starts (seasonally adjusted) in September increased by +3.0% MoM, marking the third consecutive month of growth. As a result, Q3 saw a -4.4% QoQ decrease, the first negative growth in two quarters. Meanwhile, the planned construction expenditure (1 x residential construction + 0.7 x combined residential-industrial construction), which is a good indicator of private residential investment on a GDP basis, increased by +10.9% MoM in September, the first increase in two months. Consequently, Q3 saw a QoQ decrease of -6.0%, the first negative growth in two quarters.

With no significant improvement expected in the income environment, we forecast that real private residential investment will slump in FY2024, decreasing by -2.1% YoY, -0.4% in FY2025, and -0.1% in FY2026.

(4) Corporate Sector: All-Time High Corporate Profits and a Strong Potential for Investment Expansion Amid Concerns About Future Risks

According to the Ministry of Economy, Trade and Industry (METI)'s Indices of Industrial Production (final figures), the seasonally adjusted Industrial Production Index for October rose by +2.8% MoM, the first rise in two months (Figure 2-2-7). As a result, October production was up +2.7% compared to

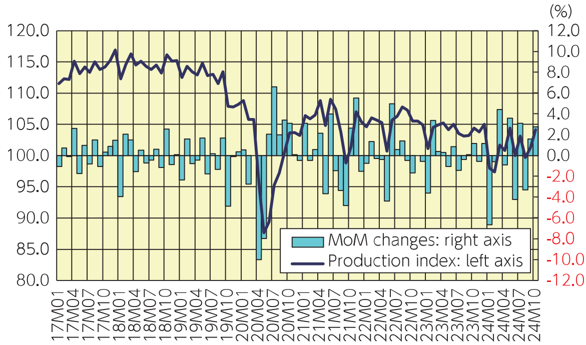

Figure 2-2-7 **Indices of Industrial Production (2020=100, seasonally adjusted)**

Source: Ministry of Economy, Trade and Industry, “Indices of Industrial Production”

the average of July-September (Q3: -0.4% QoQ). METI left its assessment of the underlying tone of production in October unchanged from the previous month, saying that it was “up and down.” According to the Survey of Production Forecast, manufacturing output is expected to decrease MoM in both November (-2.2%) and December (-0.5%). If the forecast figures are realized, Q4 will see a QoQ increase in production for the first time in two quarters (+1.0%).

Reflecting these factors, the Indices of Industrial Production for FY2024 are forecast to be -0.7% compared to the previous year, +1.9% in FY2025, and +1.4% in FY2026. The impact of the decline in production due to natural disasters was significant in FY2024.

The Tertiary Industry Activity Index (seasonally adjusted) for October rose +0.3% MoM, the first increase in three months (Figure 2-2-8). As a result, October fell -0.2% from the average of July-September (Q3: +0.5% QoQ). METI left its assessment of the economy unchanged from the previous month, saying that the economy was “moving back and forth.”

According to the Ministry of Finance’s Corporate Statistics Survey for Q3 2024, ordinary profit (seasonally adjusted, excluding the finance and insurance industries) for all industries in the same period fell by -10.6% QoQ, the first decrease in three quarters (Figure 2-2-9). Of these, manufacturing profits fell by -19.9% and non-manufacturing profits fell by -5.5%, both of which were the first quarterly declines in three quarters. Although corporate profits in Q2 were the highest ever, they remained at a high level in Q3. As a result, there is strong potential for expansion, centered on investment in DX and addressing the shortage of labor.

According to the Cabinet Office, the core machinery orders (private

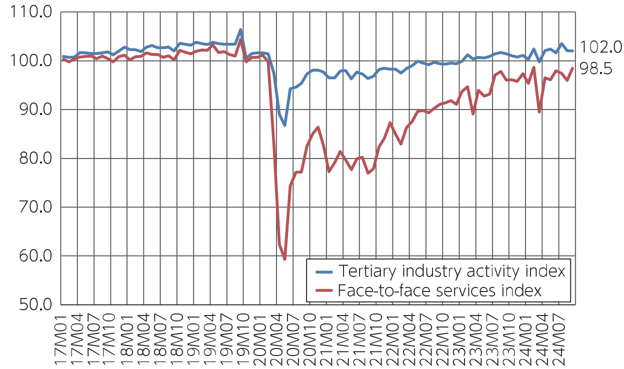

Figure 2-2-8 Face-to-face services vs. tertiary industry activity index (Seasonally adjusted, 2015=100)

Note: The face-to-face services index is a weighted average of the transportation, accommodation, restaurants, food services, other lifestyle-related services, and entertainment industry indexes; the tourism-related index is a weighted average of the face-to-face services index. 2015 average =100
Source: Ministry of Economy, Trade and Industry, "Tertiary Industry Activity Index"

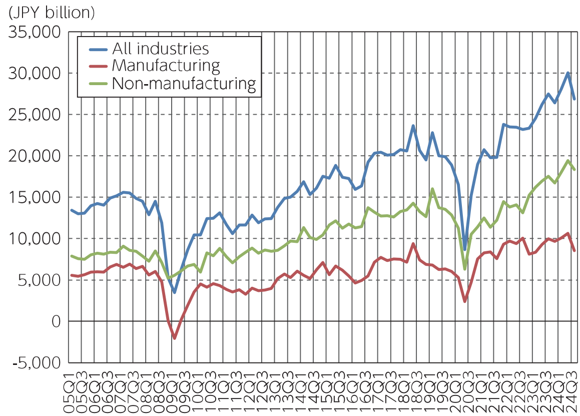

Figure 2-2-9 Ordinary profit by sector (Seasonally adjusted)

Source: Ministry of Finance, "Quarterly Survey of Corporate Business Enterprises (July-September 2024)"

demand excluding ships and electricity; seasonally adjusted), which is a leading indicator of private capital investment, increased by +2.1% MoM in October for the first time in four months. As a result, October saw an increase of +0.9% compared to the average of July-September (Q3: -1.3% QoQ). According to a survey conducted at the end of September, the outlook for core machinery orders in Q4 was +5.7% QoQ. The Cabinet Office left its assessment of the trend in machinery orders unchanged from the previous month, saying that “there are signs of a pause in the recovery.”

Looking at investment-related indicators from METI, the capital goods shipment index (final figures, seasonally adjusted) rose +9.1% MoM in October, the second consecutive monthly increase. As a result, in October, the index rose by +2.7% compared to the average for July-September (Q3: -4.7% QoQ).

Considering recent orders and shipments, we forecast that real private non-residential investment will recover +2.4% in FY2024, +2.5% in FY2025, and +2.3% in FY2026.

(5) External Sector: Trade Deficit Narrows Somewhat, Improvement in Services Deficit Delayed, but Current Account Balance Remains High Due to Strong Income Balance

According to the preliminary figures in the Trade Statistics released by the Ministry of Finance, the trade balance for November was JPY -117.6 billion, marking a deficit for the fifth consecutive month, but the deficit was down -85.5% YoY. The seasonally adjusted figure was JPY -384.2 billion, a deficit for the 42nd consecutive month, and expanded for the second consecutive month, up 67.6% MoM. As a result, the average trade deficit for October-November was down -29.4% compared to the average for July-September (Q3: -27.5% QoQ).

The value of exports (seasonally adjusted) increased +0.2% MoM, the first increase in two months. Imports (seasonally adjusted) increased by +1.9% MoM, the first increase in four months. Comparing the average for October-November with the average for July-September, exports decreased by -0.8% and imports decreased by -2.1%.

In terms of volume (seasonally adjusted, APIR estimate), the export volume index for November decreased by -3.1% MoM, the first decrease in three months. The import volume index fell by -9.6% MoM, the first fall in three months. Comparing the average of October and November with the average of July and September, the export volume index rose by +1.0%, while the import volume index fell by -1.7%. The contribution of net exports of real goods to GDP growth in the October-November period was positive.

A review of the regional trends for November (seasonally adjusted, APIR estimate) reveals a decline in exports to Asia, with a decrease of -1.1% compared to the previous month. Exports to China were down -2.3%, while exports to the U.S. and the EU showed respective -6.8% and -7.4% declines. Comparing the average for October and November with the average for July-September, exports to Asia increased by +3.8%, to China by +4.6%, but to the U.S. decreased

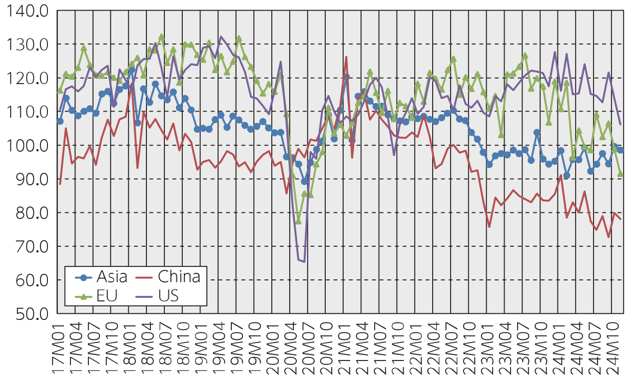

Figure 2-2-10 Export volume index by region (2020=100)

Source: Ministry of Finance, "Trade Statistics," seasonally adjusted values are APIR estimates

by -5.4%, and to the EU by -10.2%. Exports to Asia and China increased (Figure 2-2-10). On the other hand, imports from Asia in November exhibited a -9.2% MoM decline, imports from China experienced a -9.1% decrease, imports from the U.S. decreased by -14.0%, and imports from the EU were down -16.3%. Comparing the average for October and November with that for July-September reveals an increase of +0.3% in imports from Asia, +5.3% from China, +0.2% from the U.S., and a -9.3% decrease from the EU.

Taking these underlying factors into account, we forecast that real exports of goods & services will increase by +1.4% in FY2024, +2.3% in FY2025, and +2.3% in FY2026. Meanwhile, we forecast that real imports of goods & services will increase by +4.5% in FY2024, +2.4% in FY2025, and +2.1% in FY2026. In terms of nominal value, the trade balance deficit is expected to narrow due to falling crude oil prices. Meanwhile, the travel balance will continue to be in surplus, driven by a robust inbound tourism demand, but the digital deficit will steadily increase, thereby delaying the improvement in the services balance deficit. Furthermore, the current account balance is expected to be JPY 29.9 trillion in FY2024, JPY 30.7 trillion in FY2025, and JPY 31.0 trillion in FY2026, as the high level of the primary income balance is anticipated to continue.

(6) Price Trends: Consumer Prices Heavily Influenced by Government Policy

According to the Bank of Japan, the Domestic Corporate Goods Price Index (2020 average=100) was up +0.3% MoM in November, the third consecutive month of positive growth. Looking at the contribution to the MoM change by

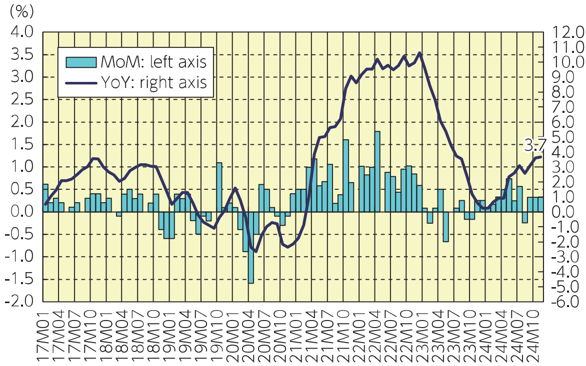

Figure 2-2-11 Changes in domestic corporate goods price index (2020=100, MoM and YoY)

Source: Bank of Japan, "Domestic corporate goods price index"

category, electricity, city gas, and water; agricultural, forestry, and fishery products; plastic materials; food and beverages; and other industrial products, etc. contributed to the increase. On the other hand, production equipment and metal products, etc. contributed to the decrease in the Domestic Corporate Goods Price Index, which was up +3.7% YoY, the 45th consecutive month of increase (Figure 2-2-11).

The dollar exchange rate (monthly average) in November was JPY 153.72, which was up +2.7% MoM and +2.6% YoY, representing the second consecutive month of yen depreciation. As a result, the yen-based export price index rose for the second consecutive month, increasing by +2.2% YoY. On the other hand, the yen-based import price index fell for the third consecutive month, decreasing by -1.2% YoY. As a result, the terms of the trade index (export price index/import price index*100) for November rose (improved) for the first time in two months, increasing by +0.1 pt from the previous month. It also rose by +2.8 pt YoY, representing the fourth consecutive month of improvement (Figure 2-2-12).

According to the Ministry of Internal Affairs and Communications, the National Consumer Price Index (2020 average = 100) for November was up +2.9% YoY, marking the 39th consecutive month of increase. The core index, which excludes volatile fresh food, rose by +2.7% YoY, marking the 39th consecutive month of increase. The rate of inflation accelerated for the first time in three months. The core-core index, which excludes fresh food and energy, rose by +2.4% YoY, marking the 32nd consecutive month of increase. The rate of inflation accelerated for the fourth consecutive month (Figure 2-2-13).

An examination of the trends in the November general index by category reveals that energy rose +6.0% YoY, marking the eighth consecutive month of

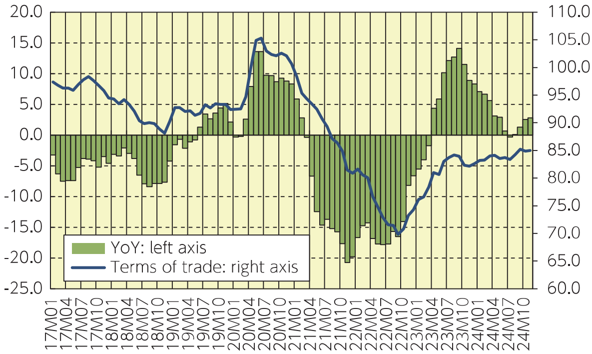

Figure 2-2-12 Terms of trade (2020=100, Unit %pt YoY)

Source: Authors' calculations based on Bank of Japan, "Domestic Corporate Goods Price Index"

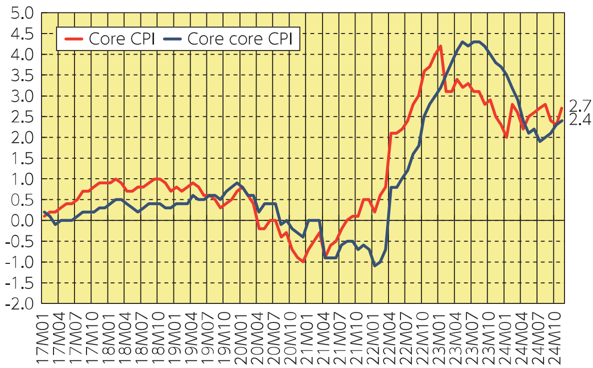

Figure 2-2-13 Changes in national consumer price index (2020=100, Unit % YoY)

Source: Ministry of Internal Affairs and Communications, "National Consumer Price Index"

increase. The rise in energy prices was larger than usual due to the government's decision to reduce the amount of subsidies for electricity and gas bills. The contribution to the overall index was +0.45%pt. Of this, electricity prices rose +9.9% YoY, marking the seventh consecutive month of increase. City gas prices rose +6.4% YoY, marking the sixth consecutive month of increase. Gasoline prices rose +1.0% YoY, marking the first rise in four months.

Non-energy prices rose +2.6% YoY, marking the 32nd consecutive month of YoY increases. The contribution to the overall increase was +2.45%pt. Of this, food prices excluding fresh food rose +4.2% YoY, marking the 41st consecutive month of increases. In addition, the rate of inflation accelerated for the fourth

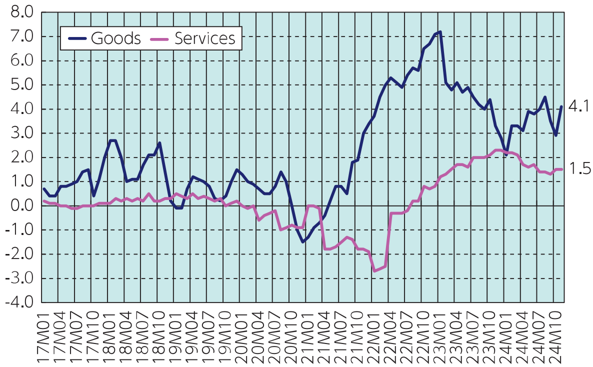

Figure 2-2-14 Changes in national consumer price index by category (Unit: % YoY)

Source: Ministry of Internal Affairs and Communications, "National Consumer Price Index"

consecutive month. The contribution to the overall increase was +1.00%pt. Of this, rice prices showed a substantial surge of +63.6% YoY, the largest increase since January 1971, when comparable data became available. The contribution of rice to this increase was +0.37%pt.

Looking at the breakdown by goods and services, goods prices rose +4.1% YoY, marking the 43rd consecutive month of increases. The contribution was +2.20%pt. The rate of increase in goods prices expanded from the previous month due to the acceleration of the rise in energy prices. Services rose by +1.5% YoY, marking the 28th consecutive month of increase. The contribution was +0.72%pt. In relation to service expenditure, accommodation charges rose by +7.7% YoY, marking the 19th consecutive month of increase. The contribution was +0.09%pt (Figure 2-2-14).

Taking into account the current situation, the Domestic Corporate Goods Price Index is forecast to be +2.7% in FY2024, +0.7% in FY2025, and +0.4% in FY2026.

The rate of consumer price inflation is heavily influenced by government policy. It is likely to remain high in the second half of FY2024, and will not fall below 2% until FY2025. As a result, we forecast the rate of inflation in the Core CPI to be +2.6% in FY2024, +2.0% in FY2025, and +1.6% in FY2026.

In addition, the GDP deflator in FY2024 is predicted to decelerate to +2.4% from the previous year (+4.2%) when the terms of trade improved substantially. It is forecast to be +1.8% in FY2025 and +1.5% in FY2026 (Figure 2-2-15).

Part I Part II Part III Part IV

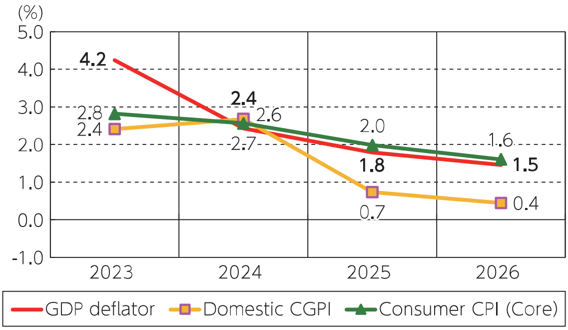

Figure 2-1-15 Changes in prices (YoY)