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MACRO MORNING BRIEFING

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Reflating Japan Can Lift Many Boats

BoJ normalization and yen strength likely to have a global impact

- Policy space can open for APAC central banks to hike or allow currency strength
- Japanese companies with export exposures will look to offset earnings erosion
- Productivity improvements essential, outbound FDI to India and ASEAN could rise

Strong wages round opens way to policy changes

Despite more pushback yesterday from Bank of Japan Governor Ueda, there has been sufficient media reporting in recent days to suggest policy changes at next week's meeting. Clearly, the results from the spring wage rounds are starting to focus minds at the BoJ with inflation expectations likely to build as a consequence of the wage agreements.

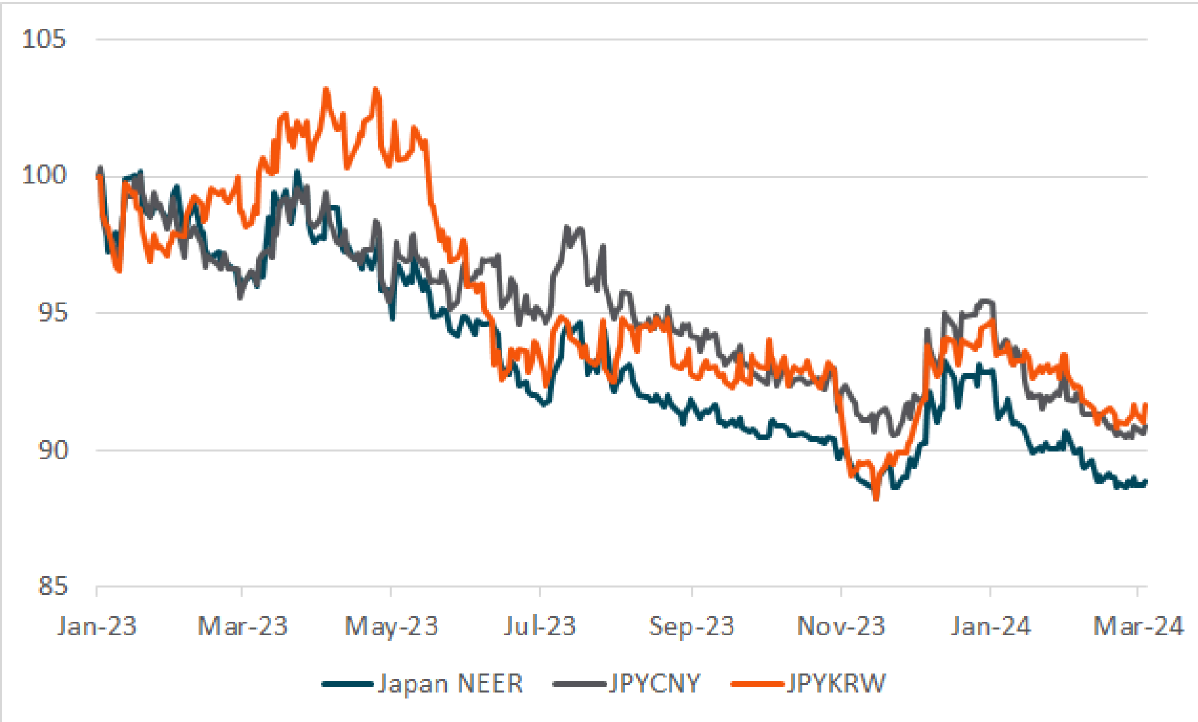
The experience of G10 economies in recent years points to the necessity of getting ahead of the curve when the labour component of inflation begins to assert. Supply-chain issues may not be as acute as in 2021-22, but higher costs due to recent pass-through will have a similar effect and contribute to the risk of a wage-price spiral. Governor Ueda may not be explicit about this, but it may prove beneficial to the economy to generate some overshoot in wages if there is better productivity growth down the line to compensate. However, some in corporate Japan may not be so confident, or keen about waiting for it.

As much of Asia continues to try stay at the top of, or move up, the manufacturing value chain, the importance of productivity growth in a strong nominal wage environment will likely rise in Japan. Its companies appear highly valued, but maintaining recent gains may prove more difficult. There is a high risk to earnings through adverse translation from a stronger yen, and higher wages also contribute to margin compression. Domestic firms will react accordingly, but one part of the productivity discussion, especially regarding costs, will be to look offshore. We have previously noted that Japan’s normalisation of policy will have material implications for wider APAC. The immediate transmission will be through monetary policy, but other factors could come in play, such as a renewed outbound FDI push by Japanese firms as the yen strengthens, and to offset domestic cost pressures.

Reflation in Japan and a higher Real Effective Exchange Rate (REER) for the JPY could allow other economies which compete with or have trade exposure to Japan to strengthen their currencies. But there's a difference between the relative and the absolute. Exhibit 1 shows the Nominal Effective Exchange Rate changes in JPY over the past year compared with its performance against CNY and KRW – currencies of two countries with the strongest trade and competitiveness exposures to Japan in the region. Since the beginning of 2023, the JPY decline in NEER terms has been greater than its decline against CNY and KRW, though the margins are fine. Low rates across Asia have hurt all these currencies against USD, but JPY weakness has been exceptional and served to offset currencies' weakness – which particularly in China's case should been seen as a stimulus option for low growth.

To be clear, we are not calling for broad-based appreciation amongst APAC currencies. China is showing tentative signs of reflation but would likely not want strong pass-through, as that could once again push up real rates. For other currencies such as KRW and TWD, it would seem in their home economies' interest to capture immediate competitiveness gains against the JPY through the currency. There will be operational freedom nonetheless, especially as the Federal Reserve begins to cut rates and that starts to weigh on USD. There will likely be at least a stronger JPY to provide an initial offset, otherwise central banks would need to immediately assess whether rate cuts would be needed, which may or may not suit the needs of the economy outside of the export sector.

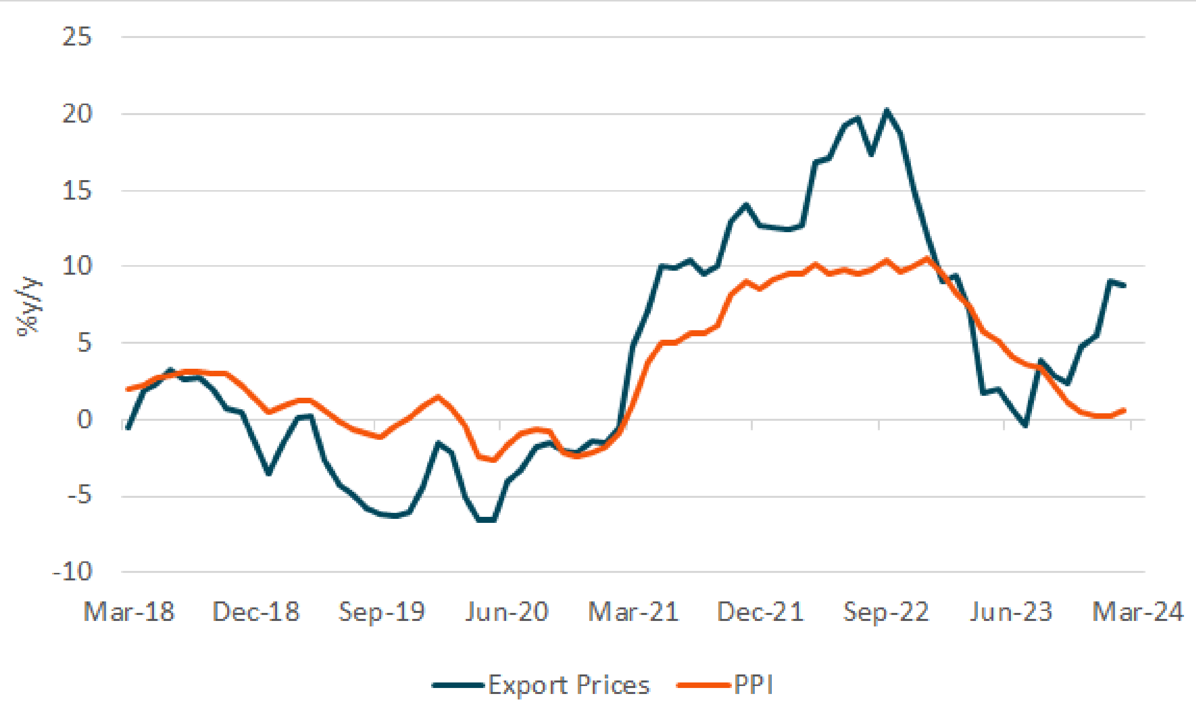
Exhibit #1: NEER/FX Performance For JPY



Source: Bloomberg, BNY Mellon

Meanwhile, Japanese exporters will need to face up to stronger headwinds. Even with a weaker JPY, export prices have been rising strongly over the past year. We suspect much of this could be due to the larger quantum of import costs being passed on, but recently we have seen divergence between PPI and export price growth (exhibit 2) after those two metrics were strongly aligned for much of the last few years. Given Japan's advantages in very high value-added goods, which are benefitting from strong global demand, this could simply be a case of a supply-demand imbalance for specific goods to the extent that even a weaker JPY cannot provide an offset. We have seen over the last few years that supply constraints in high value-added goods without immediate substitutes take time to correct. Labour supply is likely already limited (Japan's demographics alone would seem to guarantee that), but if wage gains now begin to feed back into PPI, then the risk to further acceleration in export price growth would likely be material. We note that the spring wage round has reported firmly labour-favourable settlements for the country's car manufacturers, so the high value-added manufacturing industry will feel the effects.

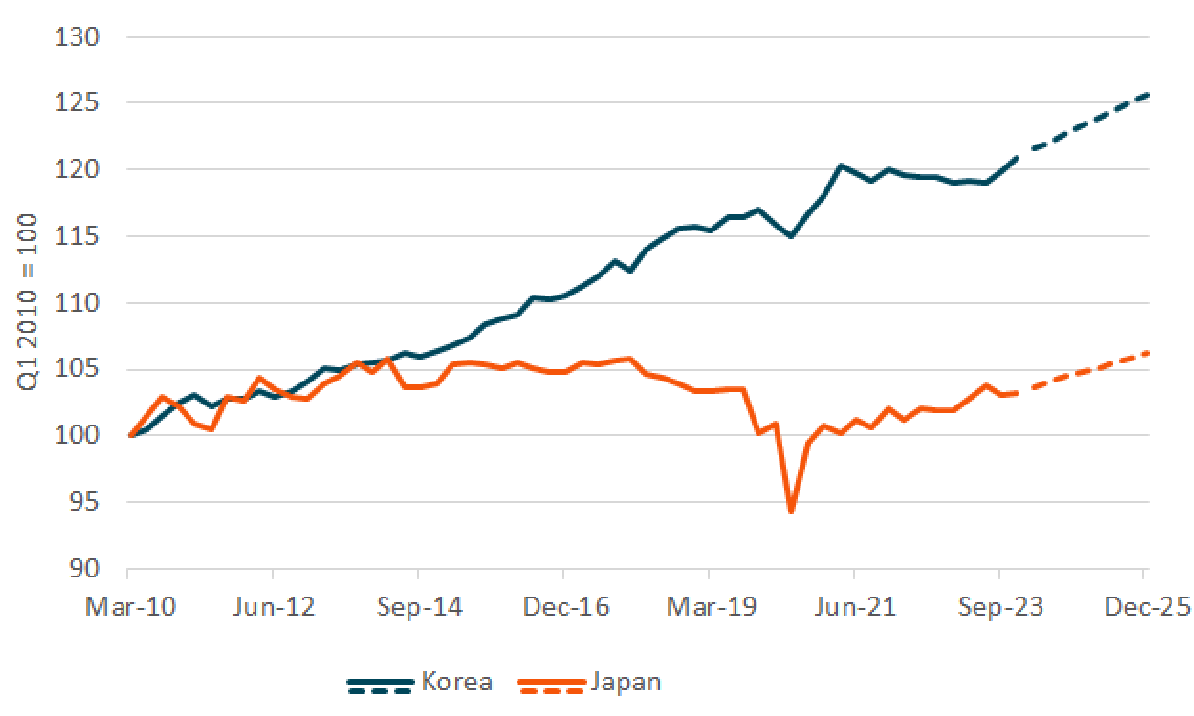
Exhibit #2: Japan Export Prices vs. PPI



Source: Bloomberg, BNY Mellon

Strong productivity gains historically have been Japanese firms' forte in managing profit risks, but the true picture over the past decade is perhaps not as rosy as reputation. Exhibit 3 compares total economy productivity trends (including forecasts) for Japan and South Korea. On this evidence, Japan's productivity growth began to stagnate around the middle of the past decade; it's not expected to recover materially over the OECD's forecast horizon. In contrast, South Korea – arguably facing even stronger demographic challenges – has sustained consistent productivity growth, even limiting losses during the pandemic when a productivity drag went global. If currency translation effects begin to improve on a relative basis as the JPY strengthens (especially for USD-based customers) and is coupled with productivity gains, the improvement in overall competitiveness could be formidable, especially in areas where Seoul and Tokyo compete directly.

Exhibit #3: OECD Productivity Trends, Japan & South Korea

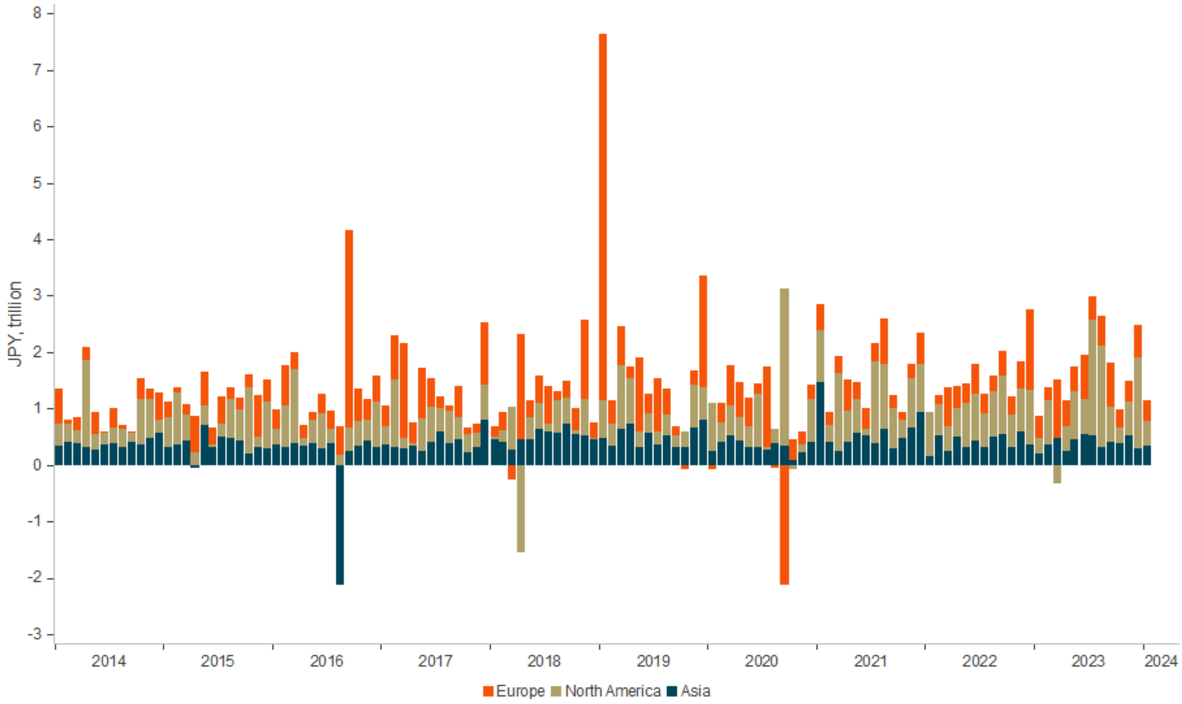


Source: Bloomberg, BNY Mellon

Compared to the golden age of globalisation, FDI flows will likely stay muted. Costs and scale alone are not enough to sway the argument – geopolitics, proximity and place in the value chain are just as important to investment decisions. Nonetheless, if the JPY begins appreciating materially, exporting excess savings could once again be in focus and contribute to resolving the competitiveness issue that Japanese corporates might face.

Exhibit 4 shows North America dominant in attracting Japanese FDI in recent years. Given the level of USDJPY, cost considerations were clearly secondary to access to technology and innovation – ultimately another case for productivity improvement. On a cumulative basis since January 2020, the US has attracted 46% of net outbound Japanese FDI. If cost becomes a more immediate issue, APAC flows could start to improve on the 28% share so far this decade. Geopolitics and valuations point to strong potential in India and ASEAN (Vietnam has been a particularly strong beneficiary in recent years). These economies would likely have benefited in any case, but an FDI race between Japan and China to tap capabilities in these markets could take economic and asset performance to the next level.

Exhibit #4: Japanese Outbound FDI



Source: Macrobond, BNY Mellon

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