

March 14, 2024

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.

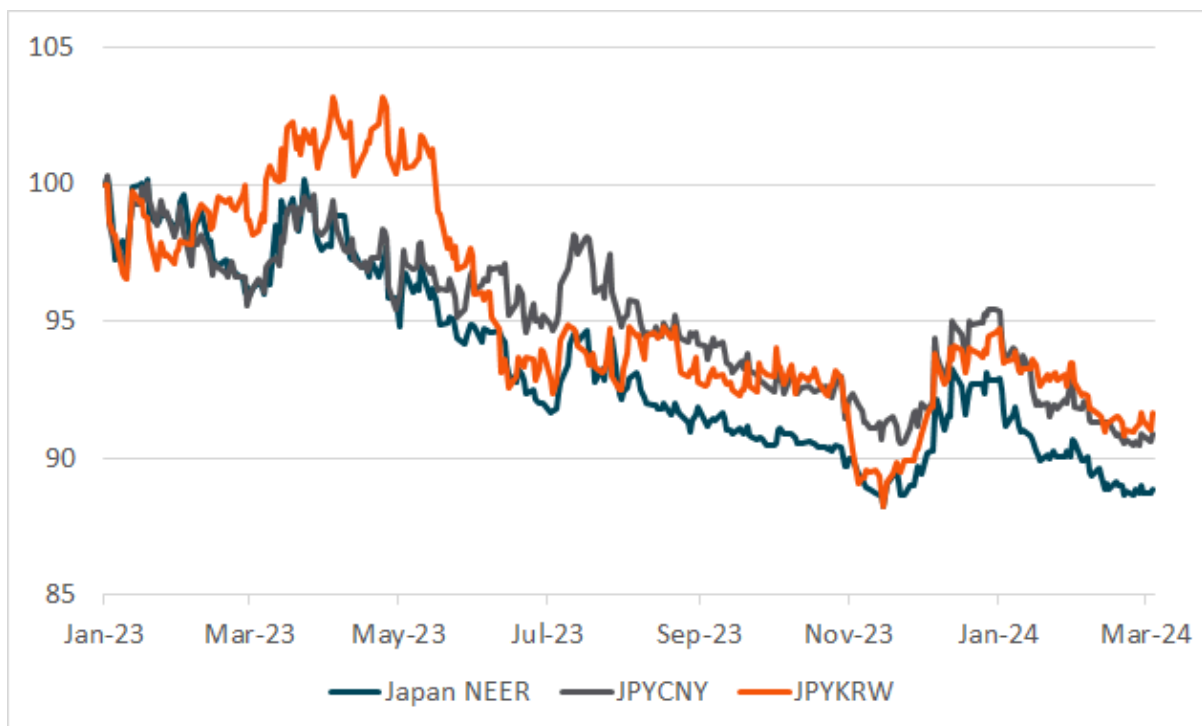
As much of Asia continues to try stay at the top of, or move up, the manufacturing value chain, the importance of productivity growth in a strong nominal wage environment will likely rise in Japan. Its companies appear highly valued, but maintaining recent gains may prove more difficult. There is a high 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 be seen as a stimulus option for low growth.

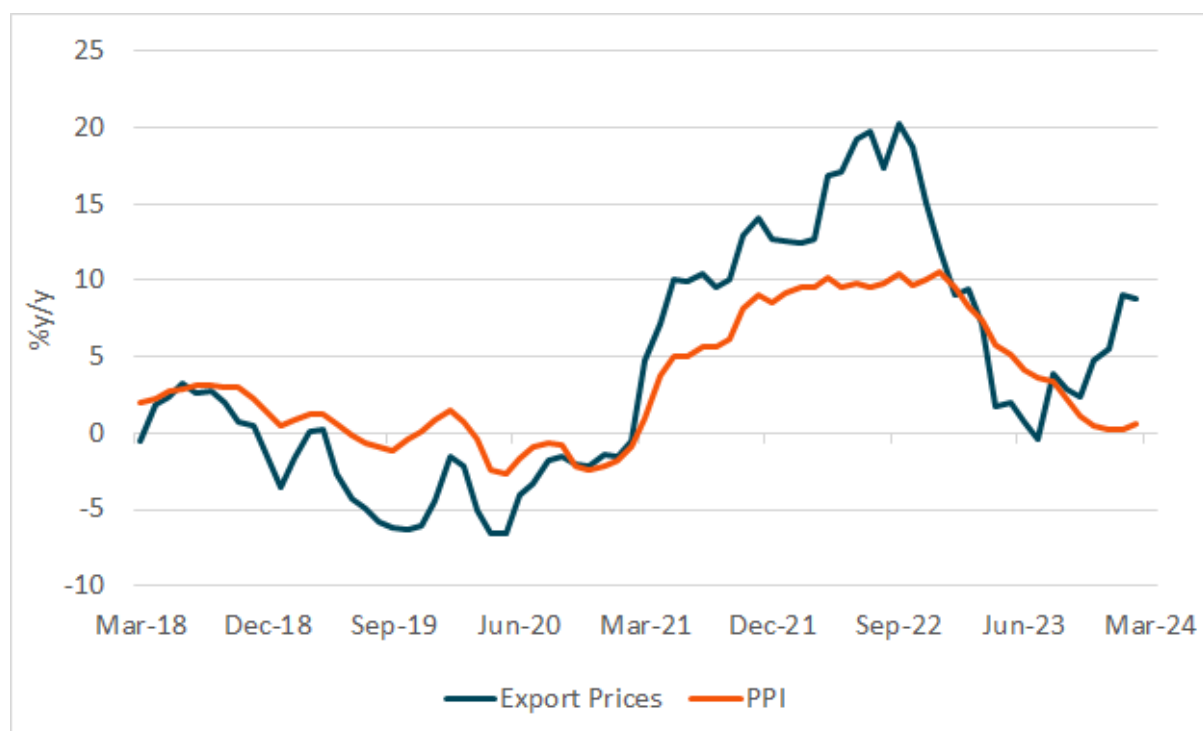
To be clear, we are not calling for broad-based appreciation amongst APAC currencies. China is showing tentative signs of deflation but would likely not want strong pass-through, as that could once again push up real rates. For other currencies such as KRW and TWD, it would seem in their home economies' 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



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

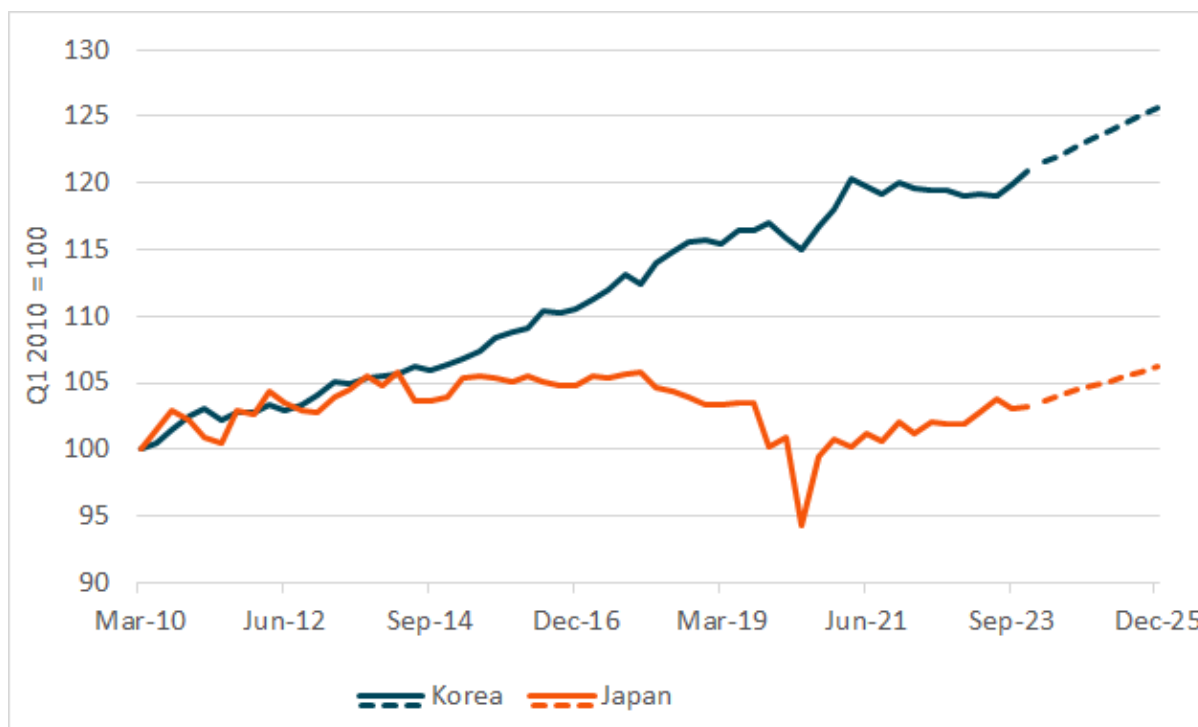


Source: Bloomberg, BNY Mellon

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

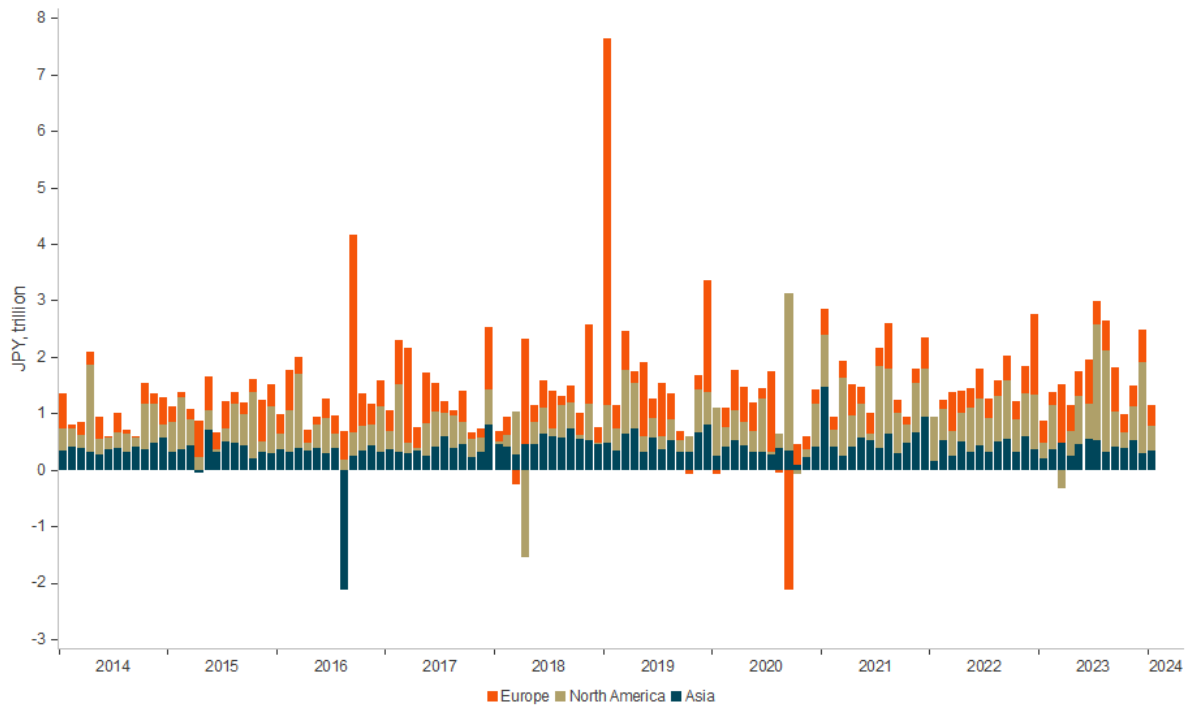


Source: Bloomberg, BNY Mellon

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

Please direct questions or comments to: iFlow@BNYMellon.com



Geoff Yu
EMEA MACRO STRATEGIST

CONTACT GEOFF



bnymellon.com

BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation and may be used as a generic term to reference the corporation as a whole and/or its various subsidiaries generally. This material and any products and services may be issued or provided under various brand names in various countries by duly authorized and regulated subsidiaries, affiliates, and joint ventures of BNY Mellon, which may include any of the following. The Bank of New York Mellon, at 225 Liberty St, NY, NY USA, 10286, a banking corporation organized pursuant to the laws of the State of New York, and operating in England through its branch at One Canada Square, London E14 5AL, UK, registered in England and Wales with numbers FC005522 and BR000818. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the US Federal Reserve and authorized by the Prudential Regulation Authority. The Bank of New York Mellon, London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV, a Belgian public limited liability company, with company number 0806.743.159, whose registered office is at 46 Rue Montoyerstraat, B-1000 Brussels, Belgium, authorized and regulated as a significant credit institution by the European Central Bank (ECB), under the prudential supervision of the National Bank of Belgium (NBB) and under the supervision of the Belgian Financial Services and Markets Authority (FSMA) for conduct of business rules, and a subsidiary of The Bank of New York Mellon. The Bank of New York Mellon SA/NV operates in England through its branch at 160 Queen Victoria Street, London EC4V 4LA, UK, registered in England and Wales with numbers FC029379 and BR014361. The Bank of New York Mellon SA/NV (London Branch) is authorized by the ECB and subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of our regulation by the Financial Conduct Authority and Prudential Regulation Authority are available from us on request. The Bank of New York Mellon SA/NV operating in Ireland through its branch at 4th Floor Hanover Building, Windmill Lane, Dublin 2, Ireland trading as The Bank of New York Mellon SA/NV, Dublin Branch, is authorised by the ECB and is registered with the Companies Registration Office in Ireland No. 907126 & with VAT No. IE 9578054E. The Bank of New York Mellon, Singapore Branch, subject to regulation by the Monetary Authority of Singapore. The Bank of New York Mellon, Hong Kong Branch, subject to regulation by the Hong Kong Monetary Authority and the Securities & Futures Commission of Hong Kong. If this material is distributed in Japan, it is distributed by The Bank of New York Mellon Securities Company Japan Ltd, as intermediary for The Bank of New York Mellon. If this material is distributed in, or from, the Dubai International Financial Centre ("DIFC"), it is communicated by The Bank of New York Mellon, DIFC Branch, regulated by the DFSA and located at DIFC, The Exchange Building 5 North, Level 6, Room 601, P.O. Box 506723, Dubai, UAE, on behalf of The Bank of New York Mellon, which is a wholly-owned subsidiary of The Bank of New York Mellon Corporation. This material is intended for Professional Clients only and no other person should act upon it. Not all products and services are offered in all countries.

The information contained in this material is intended for use by wholesale/professional clients or the equivalent only and is not intended for use by retail clients. If distributed in the UK, this material is a financial promotion.

This material, which may be considered advertising, is for general information purposes only and is not intended to provide legal, tax, accounting, investment, financial or other professional advice on any matter. This material does not constitute a recommendation by BNY Mellon of any kind. Use of our products and services is subject to various regulations and regulatory oversight. You should discuss this material with appropriate advisors in the context of your circumstances before acting in any manner on this material or agreeing to use any of the referenced products or services and make your own independent assessment (based on such advice) as to whether the referenced products or services are appropriate or suitable for you. This material may not be comprehensive or up to date and there is no undertaking as to the accuracy, timeliness, completeness or fitness for a particular purpose of information given. BNY Mellon will not be responsible for updating any information contained within this material and opinions and information contained herein are subject to change without notice. BNY Mellon assumes no direct or consequential liability for any errors in or reliance upon this material.

This material may not be distributed or used for the purpose of providing any referenced products or services or making any offers or solicitations in any jurisdiction or in any circumstances in which such products, services, offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements.

The terms of any products or services provided by BNY Mellon to a client, including without limitation any administrative, valuation, trade execution or other services shall be solely determined by the definitive agreement relating to such products or services. Any products or services provided by BNY Mellon shall not be deemed to have been provided as fiduciary or adviser except as expressly provided in such definitive agreement. BNY Mellon may enter into a foreign exchange transaction, derivative transaction or collateral arrangement as a counterparty to a client, and its rights as counterparty or secured party under the applicable transactional agreement or collateral arrangement shall take precedence over any obligation it may have as fiduciary or adviser or as service provider under any other agreement.

Pursuant to Title VII of The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and the applicable rules thereunder, The Bank of New York Mellon is provisionally registered as a swap dealer with the Commodity Futures Trading Commission ("CFTC") and is a swap dealer member of the National Futures Association (NFA ID 0420990).

BNY Mellon (including its broker-dealer affiliates) may have long or short positions in any currency, derivative or instrument discussed herein. BNY Mellon has included data in this material from information generally available to the public from sources believed to be reliable. Any price or other data used for illustrative purposes may not reflect actual current conditions. No representations or warranties are made, and BNY Mellon assumes no liability, as to the suitability of any products and services described herein for any particular purpose or the accuracy or completeness of any information or data contained in this material. Price and other data are subject to change at any time without notice.

Rates: neither BNY Mellon nor any other third party provider shall be liable for any errors in or delays in providing or making available the data (including rates, WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates) contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees' negligence. The WM/Reuters Intra-Day Spot Rates and WM/Reuters Intra-Day Forward Rates are provided by The World Markets Company plc ("WM") in conjunction with Reuters. WM shall not be liable for any errors in or delays in providing or making available the data contained within this service or for any actions taken in reliance on the same, except to the extent that the same is directly caused by its or its employees' negligence.

The products and services described herein may contain or include certain "forecast" statements that may reflect possible future events based on current expectations. Forecast statements are neither historical facts nor assurances of future performance. Forecast statements typically include, and are not limited to, words such as "anticipate", "believe", "estimate", "expect", "future", "intend", "likely", "may", "plan", "project", "should", "will", or other similar terminology and should NOT be relied upon as accurate indications of future performance or events. Because forecast statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict. iFlow® is a registered trademark of The Bank of New York Mellon Corporation under the laws of the United States of America and other countries.

This document is intended for private circulation. Persons accessing, or reading, this material are required to inform themselves about and to observe any restrictions that apply to the distribution of this information in their jurisdiction.

Currency Administration is provided under and subject to the terms of a definitive agreement between BNY Mellon and the client. BNY Mellon exercises no investment discretion thereunder, but acts solely pursuant to the instructions in such agreement or otherwise provided by the client. Unless provided by definitive agreement, BNY Mellon is not an agent or fiduciary thereunder, and acts solely as principal in connection with related foreign exchange transactions.

All references to dollars are in US dollars unless specified otherwise.

This material may not be reproduced or disseminated in any form without the prior written permission of BNY Mellon. Trademarks, logos and other intellectual property marks belong to their respective owners.

The Bank of New York Mellon, member FDIC.

© 2020 The Bank of New York Mellon Corporation. All rights reserved.