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Japan's Economy: Monthly Review

Outlook Beyond the Planned Consumption Tax Hike

Japan's economy to continue growing; four risk factors warrant watch

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Summary

- **Economic outlook reviewed:** In light of the second preliminary Apr-Jun GDP release (Cabinet Office), we have reviewed our economic growth outlook. We now forecast real GDP growth of +3.0% y/y for FY13 (previous forecast: +3.0%) and +1.2% for FY14 (+1.2%). We have assumed the formation of the FY13 supplementary budget of around Y3 trillion (new spending basis).

- **Main scenario—Japan's economy to continue growing:** After hitting bottom in November 2012, Japan's economy has entered a recovery phase. We believe it will continue to expand steadily. Economic policies of the Abe administration (so-called "Abenomics") represent an appropriate set of policies with the potential of jump-starting the revival of the Japanese economy and monetary policy measures in particular are yielding marked results. We anticipate that the economy will continue to expand, supported by (1) the expansion of the US economy, (2) persistent reconstruction demand related to the 2011 Great East Japan Earthquake and the formation of a large-scale supplementary budget, and (3) the ongoing yen depreciation and the ascent in stock prices accompanying the Bank of Japan's bold monetary easing. When we compare the current recovery with past recoveries, it is distinguished by a robust household sector that is being supported by a recovery in consumer confidence from a rising stock market. While the improvement in the income environment, exports, and capex was somewhat slow in relative terms, these categories are not faring all that poorly compared to past recoveries in Japan and the US. With regard to criticisms against Abenomics such as (1) it will have an adverse impact on the economy if long-term interest rates rise and (2) employee income will fail to increase as inflation progresses, and living standards will fall, we believe these criticisms have little basis. Going forward, the Abe administration will need to actively engage in measures such as (1) maintaining fiscal discipline through fundamental reforms to the social insurance system and (2) strengthening comprehensive growth strategies through deregulation and the reduction of the effective corporate tax rate.

- **Four risk factors**: Risks that will need to be kept in mind regarding the Japanese economy are: (1) turbulence in emerging economies, (2) China's shadow banking problem, (3) a reigniting of the European sovereign debt crisis, and (4) a surge in crude oil prices stemming from geopolitical risk.

1. Main Scenario: Japan's economy on a steady path towards recovery

Abenomics represents an appropriate set of economic policies in accordance with global standards

Supported in part by Abenomics, Japan's economy is on a path towards recovery. After hitting bottom in November 2012, the economy has entered a recovery phase and we believe the economy will continue to expand steadily. This expansion will be supported by (1) the expansion of the US economy, (2) persistent reconstruction demand related to the 2011 Great East Japan Earthquake and the formation of a large-scale supplementary budget, and (3) the ongoing depreciation of the yen and the ascent in stock prices accompanying the Bank of Japan (BOJ)'s bold monetary easing.

Abenomics consists of three "arrows" (three priority areas): (1) bold monetary policy (2) flexible fiscal policy and (3) growth strategies to stimulate private-sector investment. We have argued from the beginning that Abenomics has the potential of jump-starting the revival of the Japanese economy and that its basic direction is set on the right course.

Bold monetary policy, in particular, has made a smooth start

Of the three "arrows", the first arrow, bold monetary policy, has made a particularly smooth start.

Since mid-November 2012 when the dissolution of the House of Representatives became all but certain, cumulative market capitalization in Japan has increased by around Y160 trillion. It is amazing that wealth exceeding the national government budget for a single year (around Y90 tril on an initial budget basis) was generated with the change of power. During the period, the yen has depreciated around Y18 against the dollar. According to the Daiwa short-term macroeconomic forecasting model, the yen depreciating by Y10 against the dollar would lift Japan's real GDP by around 0.3-0.5% (Y1.5-2.5 tril). To put it simply, yen depreciation accompanying the change in administration has had the effect of lifting real GDP by around Y3-5 trillion.

Going forward, the Abe administration will need to actively engage in measures such as (1) maintaining fiscal discipline through fundamental reforms to the social insurance system and (2) strengthening comprehensive growth strategies through deregulation and the reduction of the effective corporate tax rate. However as of now, we rate Abenomics extremely high.

(1) Bold monetary policy: Already yielding results

(2) Flexible fiscal policy: Uncertainty remains

Issue: Maintaining fiscal discipline

—Strengthening resilience of nation's infrastructure: Risk of public spending bloating under the guise of protecting lives and assets of citizens

—Risk of expanding budget deficit leading to triple weakness in the form of plunge in JGBs (rise in long-term interest rate), weaker yen, and lower stock prices

(3) Growth strategy: Uncertainty remains

Issue: Improving/restructuring economic structure over medium/long term

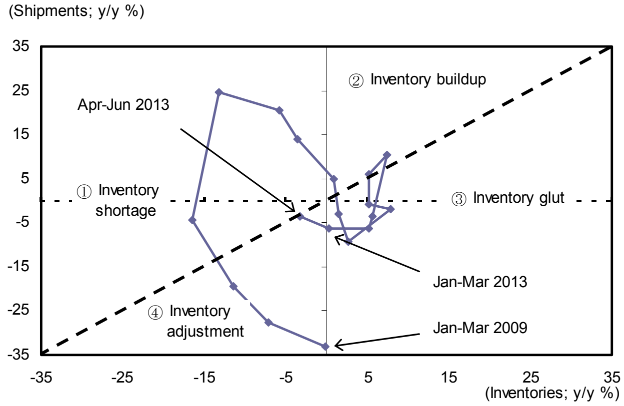
—Need to tackle issues like deregulation and lowering effective tax rate for corporations

Signs of a recovery in the corporate sector

Supported in part by Abenomics, Japan's economy is on a path toward recovery. In Chart 1, three economic indicators suggest that the corporate sector is signaling a recovery. First, a graph of the inventory-shipment cycle, with the y/y change in shipments plotted along the vertical axis and that in inventories along the horizontal axis, shows that this cycle is currently approaching the 45-degree line. This suggests the possibility that the phase of inventory adjustment is coming to an end. Second, the diffusion index for overseas supply-demand conditions for products (large manufacturers) in the BOJ Tankan survey of corporate sentiment, which displays a close relationship with Japan's export volume index, is steadily improving. Third, the revision rate for fixed investment projection in the Tankan, which leads capex by about one year, continues to improve. Thus, it is reasonable to conclude that the environment for Japan's corporate sector is steadily improving.

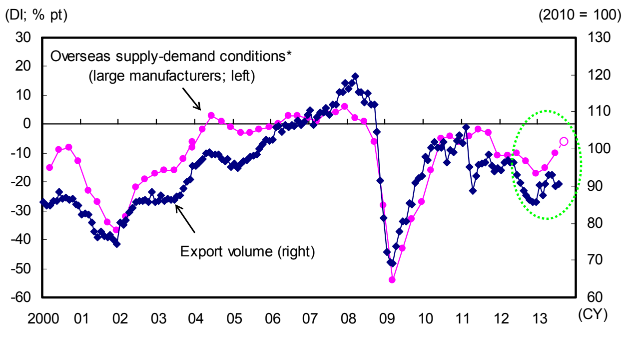
Corporate Sector Trends **Chart 1**

Inventory-shipment cycle



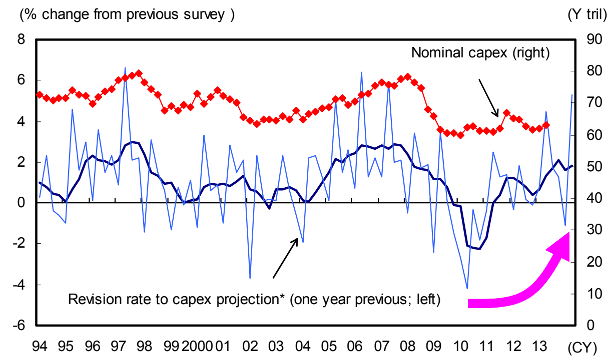
Source: Ministry of Economy, Trade and Industry; compiled by DIR.

Overseas supply-demand conditions vs. exports



Source: Bank of Japan (BOJ), Cabinet Office; compiled by DIR.
*BOJ Tankan survey of corporate sentiment; "excess demand" minus "excess supply"; latest quarter=forecast.

Capex: Revision rate vs. actual



Source: Bank of Japan (BOJ), Cabinet Office; compiled by DIR.
*BOJ Tankan survey of corporate sentiment; bold line=4Q MA.

An improved income environment likely to support personal consumption

There are also positive signs for the household sector. Chart 2 portrays the disposable income trend of workers' households. Disposable income has been increasing since the start of 2013 due to higher overtime pay mostly in the manufacturing sector and the increase in summer bonuses from improved corporate results.

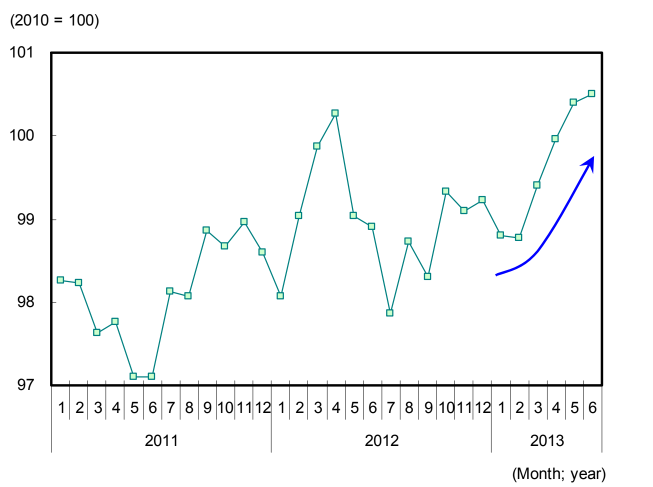
As consumers loosen their purse strings, average purchase price rises

Chart 3 illustrates the trend of percentage share of items seeing faster growth in purchase price than CPI.* In the chart, we can see that consumers tend to shift to lower-price goods during economic downturns and to higher-price goods during economic recoveries. We also learn from the chart that (1) during the so-called mini-recession from April to November 2012, consumers tended to shift to cheaper goods and that (2) since the start of 2013, they have gradually shifted to luxury goods. This development is consistent with households increasingly eating out and sales of high-end luxury goods increasing.

Will consumption lead the next cycle of recovery?

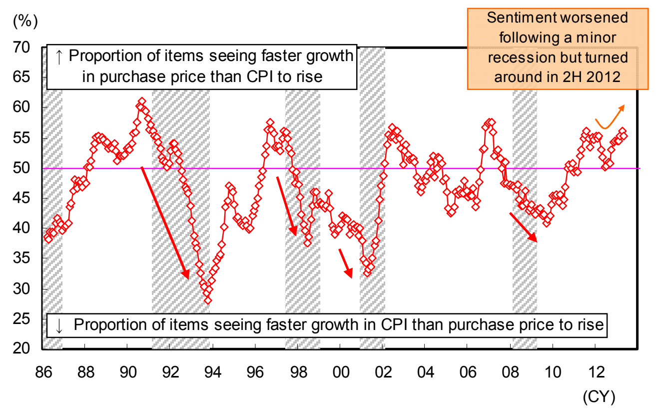
Thus, it is reasonable to think that the current strength of consumption is being supported by an improved income environment and by households loosening their purse strings. The strong growth in consumption supported by improvement in the labor market is expected to become the main engine of growth in the current economic recovery.

Household Disposable Income
Chart 2



Source: Ministry of Internal Affairs and Communications: compiled by DIR.
Note: SA 3M MA.

Comparison of Average Purchasing Price vs CPI*
Chart 3



Source: Ministry of Internal Affairs and Communications: compiled by DIR.
*Proportion of items seeing faster growth in purchase price than CPI; 6MMA.
Note: Shaded areas denote economic downturns.

For CPI to rise steadily at 2%, higher inflation expectations will be indispensable

In the final analysis, will the BOJ be able to achieve an inflation target of 2%?

Chart 4 illustrates the Phillips curve factoring in inflation expectations, where the GDP gap is plotted along the horizontal axis and the year-on-year change in core CPI along the vertical axis. The standard Phillips curve is the approximate curve between these two variables. When inflation expectations are factored in, their changes will be expressed as a shift in the level of the Phillips curve (change in the intercept). In other words, when inflation expectations increase (decrease), the Phillips curve will shift upward (downward).

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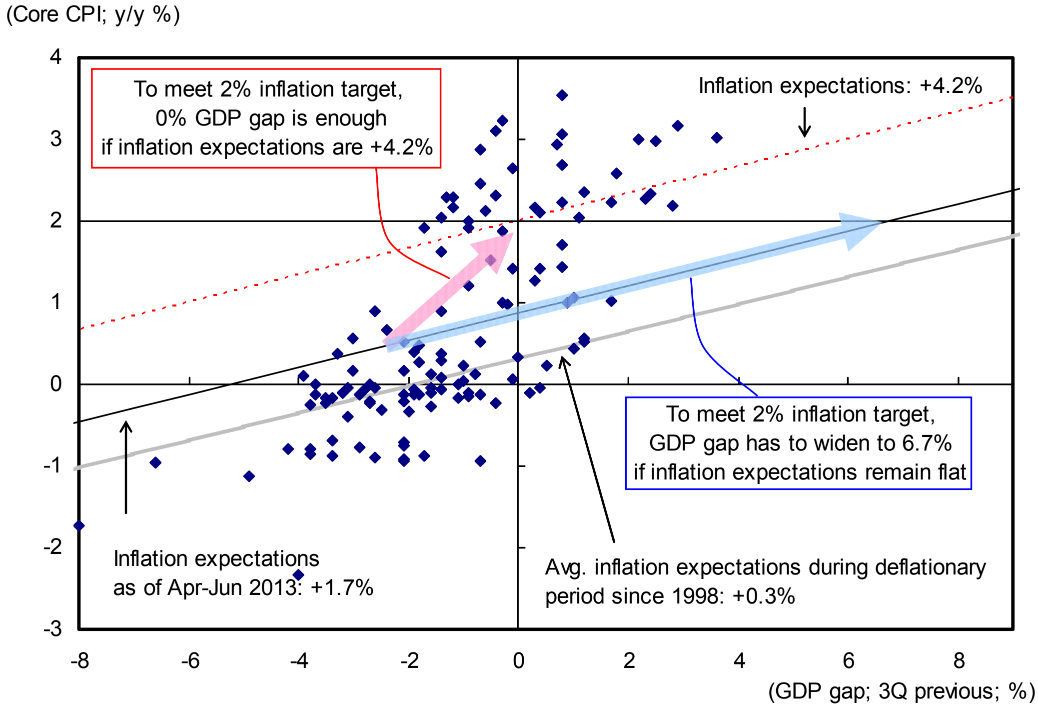
*Since consumer prices are determined by surveying prices of certain goods at certain stores, they show changes in prices when quality is unchanged. In contrast, the average purchase price is calculated by dividing the amount of expenditures spent by the number of items purchased. Thus, it reflects changes in prices as well as changes in where they were bought and what was bought. In other words, growth rate of the average purchase price exceeding that of consumer prices can be interpreted as households loosening their purse strings and shifting their purchases to more expensive items (an increase in the quality of goods purchased).

The chart indicates that, should the currently observed inflation expectations (+1.7% in Apr-Jun 2013) remain flat, the GDP gap would have to rise to +6.7% for the CPI growth rate to meet the BOJ's inflation target of 2%. Since the GDP gap is currently around –1.9%, GDP would have to increase by around 9% to meet the inflation target, an extremely high hurdle to surmount in short order.

In a case where inflation expectations rise, should the rate increase to +4.2%, the GDP gap needed to meet the CPI growth rate of 2% would narrow to 0%.

The above analysis underscores that it will be essential as a practical matter not only to narrow the GDP gap but to see an increase in inflation expectations if CPI is to steadily grow at 2%.

Phillips Curve Adjusted for Inflation Expectations **Chart 4**



Source: Cabinet Office, Ministry of Internal Affairs and Communications; compiled by DIR.
Equation: CPI = 0.15 + 0.44 x INFEX + 0.17 x GDP gap (-3),
where CPI=y/y CPI excl. fresh food (adjusted for consumption tax hikes), INFEX= inflation expectations, and the figure in parentheses=quarterly lag; adjusted R^2=0.84.
Estimation period: Oct-Dec 1980 to Jan-Mar 2013.
Inflation expectations through Jan-Mar 2004 based on Carlson-Parkin method; thereafter weighted average of inflation expectations (Cabinet Office survey) adjusted for discontinuity.

2. Characteristics of the Current Recovery

Characteristics of the recovery since November 2012

Japan's economy slipped into a recession after peaking in April 2012 and likely bottomed out in November 2012. When we compare the current recovery with past recoveries in Japan and the US, what are the similarities and differences? We examined this question in terms of (1) market trends, (2) household-sector trends, and (3) corporate-sector trends.

1) Market trends

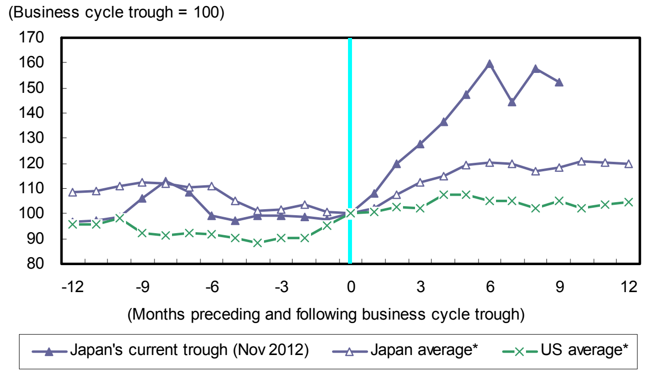
First, we analyzed market trends (Chart 5). Stock prices have surged since November 2012 based on market expectations toward Abenomics. Compared with past recoveries in the US, the current recovery in Japan is distinguished by stock prices rising at an extremely fast pace. While we will examine this development in greater detail later, the surge in stock prices has contributed to the improvement in the household sector environment by increasing consumer confidence.

Similar to the case for stock prices, foreign exchange rates are showing a distinct trend. The yen has depreciated sharply based in part on expectations toward bold monetary easing promoted by Prime Minister Abe. The depreciation of the yen combined with firm domestic demand has greatly improved corporate profits.

The long-term interest rate has been quite volatile since the introduction of the quantitative and qualitative monetary easing, but it is gradually stabilizing. While interest rates are currently rising at a pace that is slightly faster than previous recoveries, the pace remains moderate compared to past recoveries in the US.

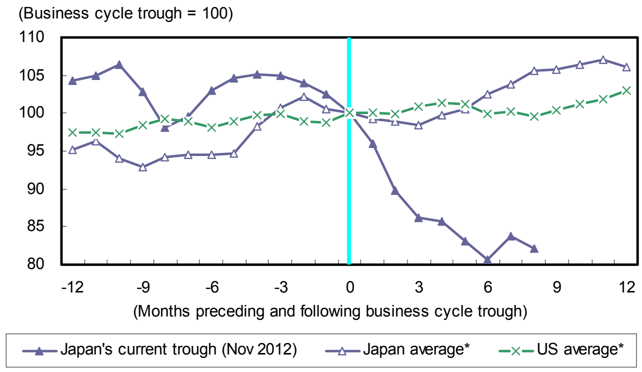
Market Trends during Economic Recovery **Chart 5**

Stock prices



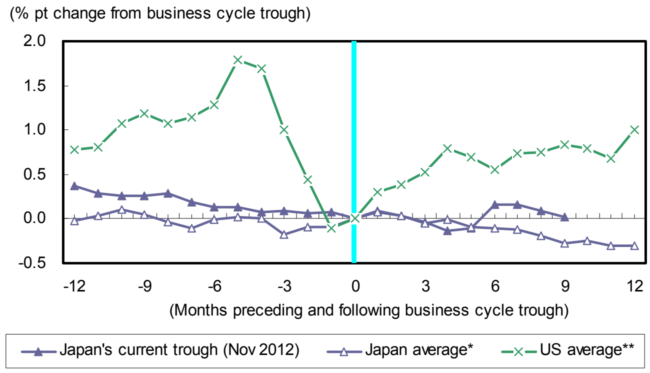
Source: Tokyo Stock Exchange, Haver Analytics; compiled by DIR.
*Average since 1980 excl. Lehman crisis.
Note: TOPIX for Japan; S&P500 for US.

Nominal effective exchange rates



Source: BIS; compiled by DIR.
*Average since 1980 excl. Lehman crisis.

Long-term interest rates



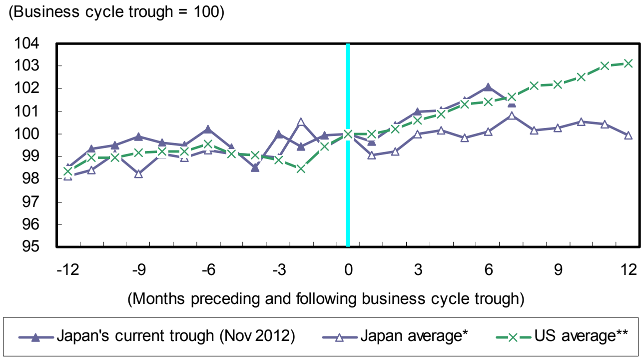
Source: Japan Bond Trading, Haver Analytics; compiled by DIR
*Average since 1999 excl. Lehman crisis.
**Average since 1980 excl. Lehman crisis.

2) Household sector trends

The improvement in the market environment contributed to the improvement in the household sector environment through strengthening consumer confidence (Chart 6). The household activity DI (*Economy Watchers Survey;* Cabinet Office [CAO]) and the Consumer Confidence Index (CAO) have both climbed sharply since end-2012. This suggests that the turnaround of the stock market may have contributed to the improvement in consumer sentiment. With the improvement in such sentiment, the Synthetic Consumption Index (CAO) is rising more rapidly than in past recoveries. Given such examples that the economy is improving in a similar manner to personal consumption-led recoveries in the US, it is reasonable to conclude that personal consumption is driving the current recovery in Japan. Housing starts, reflecting in part a surge in demand ahead of a likely consumption tax hike, are also improving more rapidly than in past recoveries in Japan.

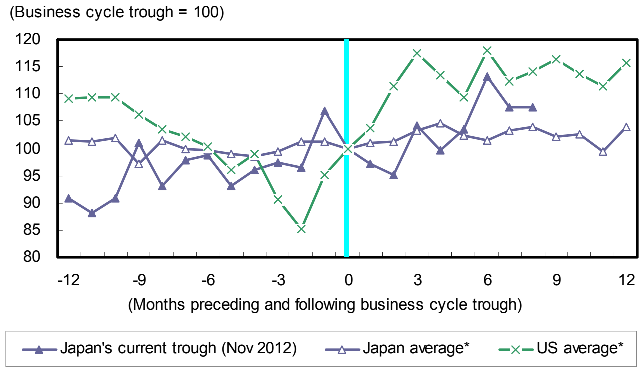
Household Sector Trends during Economic Recovery **Chart 6**

Synthetic Consumption Index



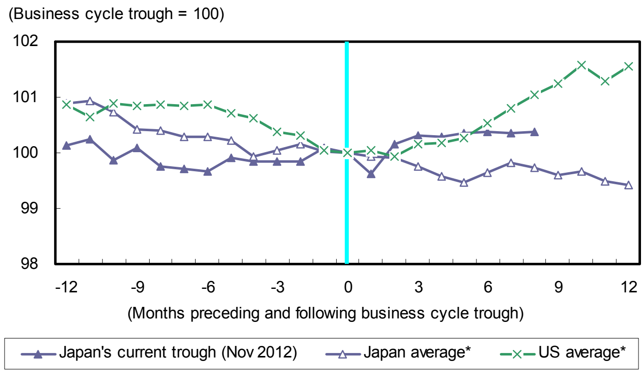
Source: Cabinet Office, Haver Analytics; compiled by DIR.
*Average since 1999 excl. Lehman crisis.
**Average since 1980 excl. Lehman crisis.
Note: Seasonally adjusted.

Number of housing starts



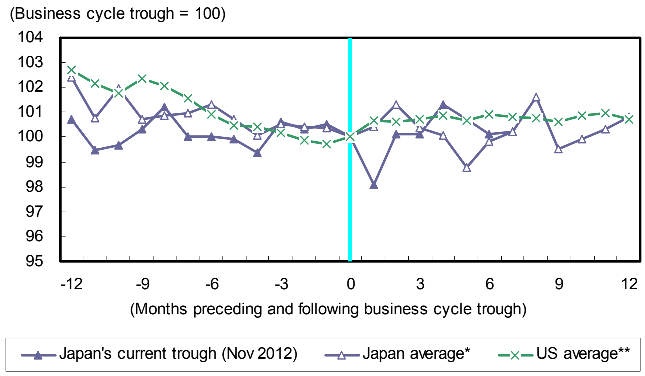
Source: Ministry of Land, Infrastructure, Transport and Tourism; Haver Analytics; compiled by DIR.
*Average since 1980 excl. Lehman crisis.
Note: Seasonally adjusted.

Number employed



Source: Ministry of Internal Affairs and Communications, Haver Analytics; compiled by DIR.
*Average since 1980 excl. Lehman crisis.
Note: Seasonally adjusted.

Real wages



Source: Ministry of Health, Labour, and Welfare; Haver Analytics; compiled by DIR.
*Average since 1990 excl. Lehman crisis.
**Average since 1980 excl. Lehman crisis.
Note: Seasonally adjusted.

The income environment is not as bad as popular opinion would suggest. While the number employed is currently treading water, this is better than in past recoveries where the number continued to decline even after the economy bottomed out. The real wage trend is following a pattern similar to past recoveries, and it is undeniable that this statistics is slow to recover relative to other indicators. Real employee compensation (GDP basis) however, has risen 0.5% q/q, the second quarterly increase in a row, and it is reasonable to conclude that the income environment is steadily improving.

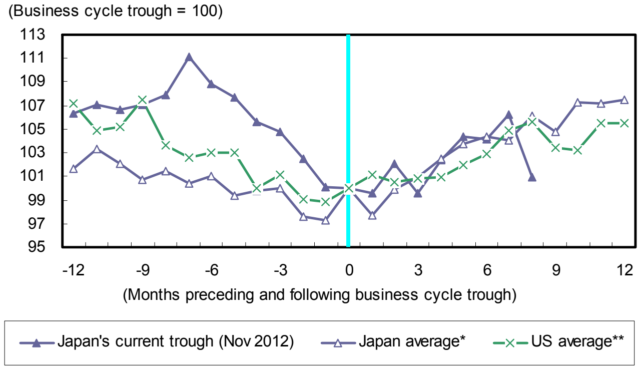
3) Corporate sector trends

Finally, we examine corporate-sector trends (Chart 7). The real export trend is following a pattern similar to past recoveries in Japan and in the US. On a GDP basis, real exports grew 3.0% q/q in Apr-Jun 2013, the second quarterly gain in a row. Going forward, exports are likely to continue to rise, supported by positive developments such as the effect of yen depreciation since end-2012 materializing with a lag, the firm growth of the US economy, and signs that European economies are bottoming out.

It deserves emphasizing that capex is not faring all that poorly compared to past economic recoveries in Japan and in the US. In the second preliminary estimate of Apr-Jun GDP report (CAO), real private non-residential investment increased 1.3% q/q, the first gain in six quarters. Going forward, we expect capex to continue to grow steadily. In past recoveries, capital good shipments firmed up a few months after the economy bottomed. In the current recovery, however, such shipments firmed up at the same time when the economy bottomed. In addition, according to a survey on planned capital spending for FY12, FY13, and FY14 published by the Development Bank of Japan, capex by manufacturers and non-manufacturers is foreseen to experience double-digit y/y growth in FY13. It is quite clear that such improvement in corporate profits is spurring companies' interest in increasing capital expenditures.

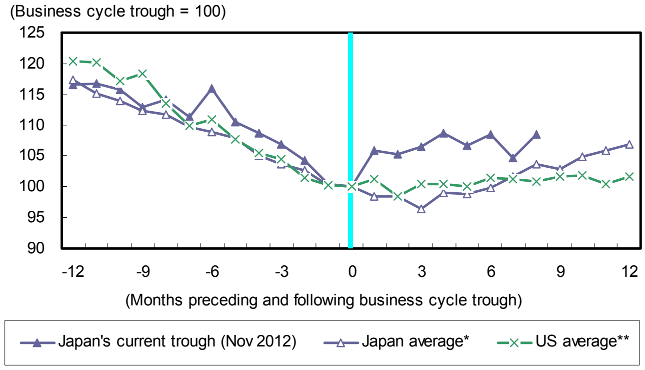
Corporate Sector Trends during Economic Recovery **Chart 7**

Real exports



Source: Bank of Japan, Haver Analytics; compiled by DIR.
*Average since 1980 excl. Lehman crisis.
**Average since 1990 excl. Lehman crisis.
Note: Seasonally adjusted.

Shipments of capital goods (excl. transportation equipment)



Source: Bank of Japan, Haver Analytics; compiled by DIR.
*Average since 1980 excl. Lehman crisis.
**2001 and 2009 trough average.
Note: Seasonally adjusted.

Summary

Summarizing the above, when we compare the current recovery with past economic recoveries in Japan and in the US, the current recovery is distinguished by a robust household sector that is being supported by the recovery of consumer confidence accompanying rising stock prices. While the improvement in the income environment, exports, and capex was seen to be somewhat lagging in relative terms, these categories are actually not faring all that poorly compared to past recoveries in Japan and in the US.

3. Two Criticisms Against Abenomics Not Well-founded

Two criticisms against Abenomics

As the final point of this report, we wish to reaffirm that Abenomics represents an appropriate set of economic policies in accordance with global standards. Two criticisms are frequently made against Abenomics. First, it is argued that Abenomics will have an adverse impact on the economy if long-term interest rates rise. Second, it is asserted that employee income will fail to increase as inflation progresses and living standards will fall. We believe, however, that neither of these criticisms is well-founded. Our reasons for thinking so are explained below.

Two Criticism against Abenomics **Chart 8**

Criticism 1: Higher long-term interest rate will have an adverse impact on the economy

Counterargument 1: What is occurring now is not a "bad" increase in interest rates ensuing from the growth of budget deficit but a "good" increase accompanying ascent of stock prices and expectations for economic recovery

Counterargument 2: Real interest (nominal interest rate minus expected inflation rate) negative.

Counterargument 3: Positive effect of weaker yen and higher stock prices far greater than adverse effect of increase in long-term interest rate

Criticism 2: Employee income will fail to increase as inflation progresses

Counterargument 1: Increase in sales followed by higher wages and higher prices in Japan

Counterargument 2: Labor's share has not moved downward in Japan

Counterargument 3: J-curve effect accompanying yen depreciation felt in Japan

Source: Compiled by DIR.

Criticism 1: Higher long-term interest rate will have adverse impact on the economy

The first criticism against Abenomics is that it will have a negative effect overall if the long-term interest rate rises. Three counterarguments can be made against this criticism.

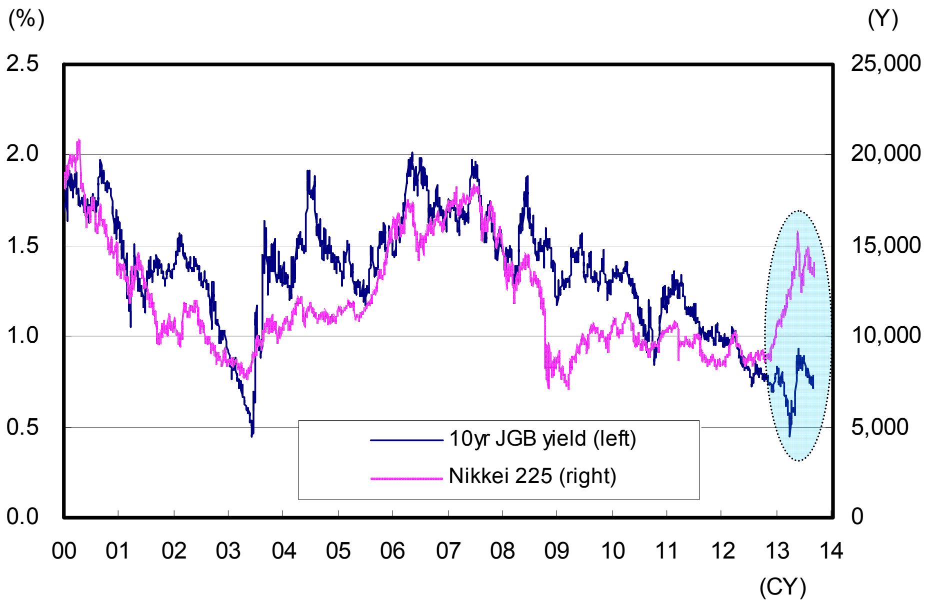
Counterargument 1: What is occurring is a "good" rather a "bad" increase in interest rates

According to the first counterargument, what is currently occurring is not a "bad" increase in interest rates ensuing from a growing budget deficit but a "good" increase accompanying the ascent of stock prices and expectations for the economy's recovery.

As indicated in Chart 9, a moderate correlation is found between the Nikkei stock average and the yield on 10-year JGBs. As a rule of thumb shared by many market participants, multiplying the yield (%) on 10-year JGBs by 10,000 is roughly the same as the Nikkei stock average. For example, a yield on 10-year JGBs that is consistent with the current level of stock prices at 14,000 would be around 1.4%.

Moreover, while there is a risk that Japan's long-term interest rate will surge in the future, the BOJ will maintain its aggressive stance toward JGB purchases and we anticipate that the upside risk for the long-term interest rate is limited for the time being.

Long-term Interest Rate and Nikkei 225 **Chart 9**



Source: Ministry of Finance, *Nikkei*; compiled by DIR.

Counterargument 2: Real interest rate (nominal interest rate minus expected inflation rate) negative

As our second counterargument, real interest rate is negative. Ultimately, it is the real interest rate (nominal interest rate minus expected inflation rate) that has an impact on the economy. Currently, the nominal interest rate (yield on 10-year JGBs) is around 0.8%. Since the expected inflation rate is around 1.7%, real interest rate is negative by about 1%, which can be viewed as an extremely accommodative monetary environment.

Counterargument 3: Positive effect of weaker yen and higher stock prices far greater than adverse effect of increase in long-term interest rate

As our third counterargument, it is highly likely that the positive effect of a weaker yen and higher stock prices is far greater than the adverse effect of an increase in the long-term interest rate.

In quantitative terms, if the long-term interest rate were to rise sharply and adversely affect Japan's economy, to what degree would this offset the positive effects of a weaker yen and higher stock prices?

Chart 10 shows the impact of changes in the yen exchange rate, stock prices, and the long-term interest rate on Japan's economy as annual averages. Our estimation indicates that the impact of the yen depreciating by 10% and TOPIX rising by 200 points would nearly be offset by the impact of the long-term interest rate increasing by 2 percentage points.

In other words, in terms of its impact on the economy for at least the next year or so, the likelihood is strong that the adverse effect of a higher long-term interest rate will be less than the positive effect of higher stock prices and a weaker yen. Should the yen and stock prices remain at their current levels (roughly corresponding to the scenario of 20% depreciation of the yen against the dollar and 400-point rise in TOPIX from the base scenario in the chart), the impact on

Japan’s economy will continue to be positive as long as the long-term interest rate does not rise around 4 percentage points.

Adverse impact of higher long-term interest rate over the medium-/long-term warrants attention

Our estimation above, however, indicates the average impact the economy would sustain in one year after the occurrence of the shock. Over the medium to long term, the contraction of capex accompanying a higher long-term interest rate would give way to the retrenchment of domestic production sites, raising concern that the hollowing out of Japan’s economy would accelerate further. It is also worth recalling that, in the wake of the European sovereign debt crisis, financial markets and the real economy suffered adverse and discontinuous blows from plunging bond prices.

To conclude, while the adverse impact of a higher long-term interest rate on Japan’s economy will be limited for the time being, the possibility should be entertained that, in the medium to long term, it will have a larger adverse impact than estimation results based on our short-term macroeconomic model.

Impact of Further Depreciation of Yen, Rise in Stock Prices, and Rise in Long-term Interest Rate
(% pt deviation from base scenario) **Chart 10**

GDP	Base scenario	Long-term interest rate to rise by			
		1% pt	2% pt	3% pt	4% pt
Base scenario	0.00	-0.21	-0.42	-0.63	-0.84
10% depreciation of yen against dollar + 200pt rise in TOPIX	0.38	0.17	-0.04	-0.25	-0.46
20% depreciation of yen against dollar + 400pt rise in TOPIX	0.76	0.55	0.34	0.13	-0.08
30% depreciation of yen against dollar + 600pt rise in TOPIX	1.15	0.94	0.73	0.51	0.30

Capex	Base scenario	Long-term interest rate to rise by			
		1% pt	2% pt	3% pt	4% pt
Base scenario	0.00	-1.39	-2.79	-4.18	-5.57
10% depreciation of yen against dollar + 200pt rise in TOPIX	1.13	-0.26	-1.65	-3.04	-4.44
20% depreciation of yen against dollar + 400pt rise in TOPIX	2.27	0.87	-0.52	-1.91	-3.30
30% depreciation of yen against dollar + 600pt rise in TOPIX	3.40	2.01	0.61	-0.78	-2.17

Personal consumption	Base scenario	Long-term interest rate to rise by			
		1% pt	2% pt	3% pt	4% pt
Base scenario	0.00	-0.04	-0.09	-0.13	-0.18
10% depreciation of yen against dollar + 200pt rise in TOPIX	0.20	0.16	0.12	0.07	0.03
20% depreciation of yen against dollar + 400pt rise in TOPIX	0.41	0.36	0.32	0.28	0.23
30% depreciation of yen against dollar + 600pt rise in TOPIX	0.61	0.57	0.52	0.48	0.44

CPI (y/y)	Base scenario	Long-term interest rate to rise by			
		1% pt	2% pt	3% pt	4% pt
Base scenario	0.00	-0.00	-0.00	-0.01	-0.01
10% depreciation of yen against dollar + 200pt rise in TOPIX	0.21	0.21	0.21	0.21	0.20
20% depreciation of yen against dollar + 400pt rise in TOPIX	0.43	0.43	0.42	0.42	0.42
30% depreciation of yen against dollar + 600pt rise in TOPIX	0.64	0.64	0.64	0.64	0.63

Nominal employee compensation	Base scenario	Long-term interest rate to rise by			
		1% pt	2% pt	3% pt	4% pt
Base scenario	0.00	-0.08	-0.16	-0.25	-0.33
10% depreciation of yen against dollar + 200pt rise in TOPIX	0.36	0.28	0.20	0.12	0.03
20% depreciation of yen against dollar + 400pt rise in TOPIX	0.72	0.64	0.56	0.48	0.40
30% depreciation of yen against dollar + 600pt rise in TOPIX	1.09	1.00	0.92	0.84	0.76

Corporate earnings	Base scenario	Long-term interest rate to rise by			
		1% pt	2% pt	3% pt	4% pt
Base scenario	0.00	-2.05	-4.10	-6.14	-8.19
10% depreciation of yen against dollar + 200pt rise in TOPIX	6.45	4.41	2.36	0.31	-1.74
20% depreciation of yen against dollar + 400pt rise in TOPIX	12.91	10.86	8.81	6.76	4.71
30% depreciation of yen against dollar + 600pt rise in TOPIX	19.36	17.31	15.26	13.22	11.17

Source: Compiled by DIR.

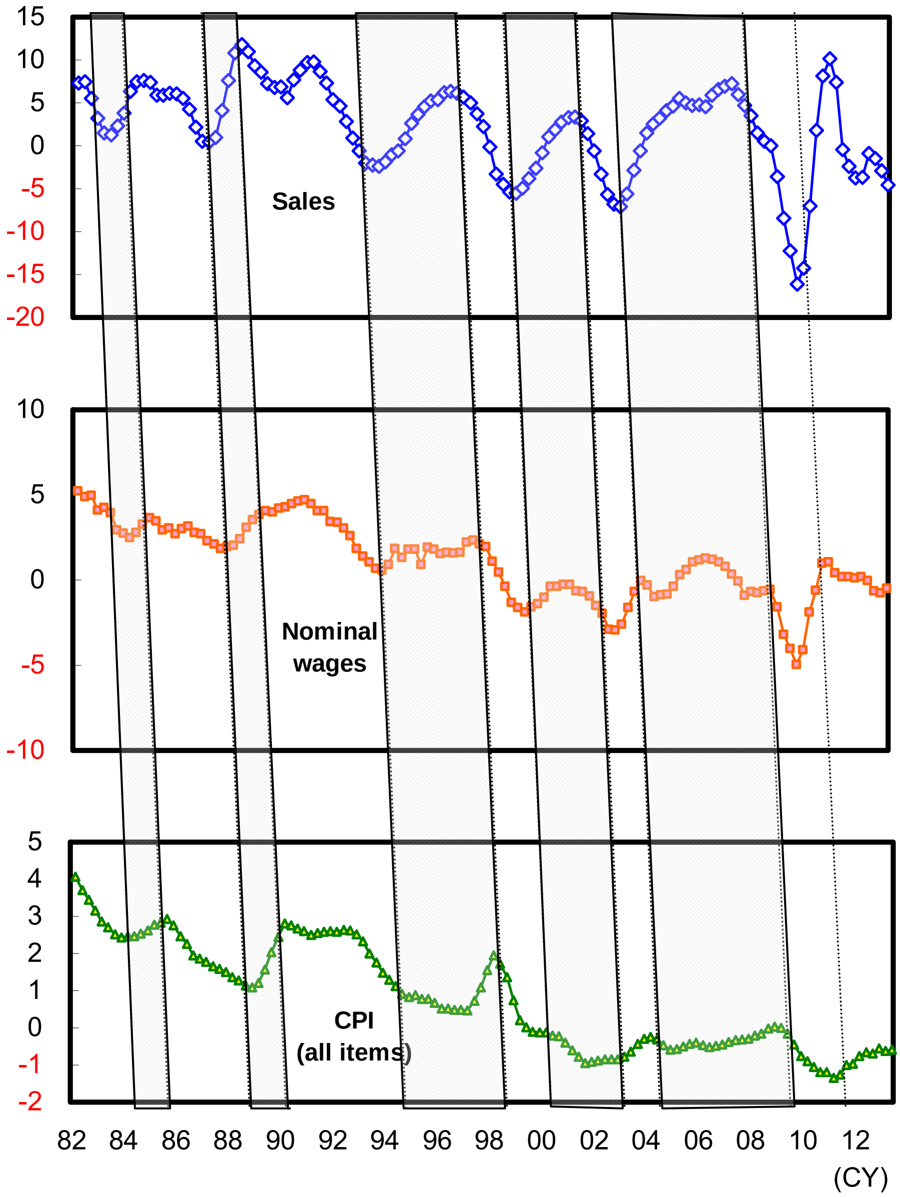
Criticism 2: Employee income will fail to increase as inflation progresses

The second criticism against Abenomics is that employee income will fail to increase as inflation progresses, and living standards will fall. Three counterarguments can also be laid against this criticism.

Counterargument 1: Increase in sales followed by higher wages and higher prices in Japan

As shown in Chart 11, an examination of the historical record discloses the existence in Japan of a cycle where an increase in sales is followed by higher wages and higher prices. In other words, about six to 12 months after sales increase, wages rise, followed by CPI after another six months. In its basic philosophy, Abenomics views the expansion of sales through monetary easing by the BOJ and through the pro-business policies of the government as the best approach for overcoming deflation. Bearing the above cycle in mind, it is safe to say that Abenomics has chosen precisely the right target to aim for.

Sales, Wages, and Prices (y/y %) **Chart 11**



Source: Ministry of Finance, Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.
Notes: 1) Y/y comparison of four-quarter moving average.
2) Shaded bars denote periods when sales were on uptrend. Bars tilted in order to show roughly 6-month lag from sales graph to nominal wages graph and from there to CPI graph, respectively.

Policies sought that will support transfer of income from corporate to household sector

Nevertheless, with the progress of globalization since the 2000s there is some concern that sales have lost some of its leading character relative to wages. In other words, as global competition intensifies, there is a tendency among companies to accelerate the increase or decrease in employee wages in advance of the sales trend. There is no doubting the need in policy terms to strengthen a transmission mechanism that will enable higher sales to propagate appropriately to wage increases.

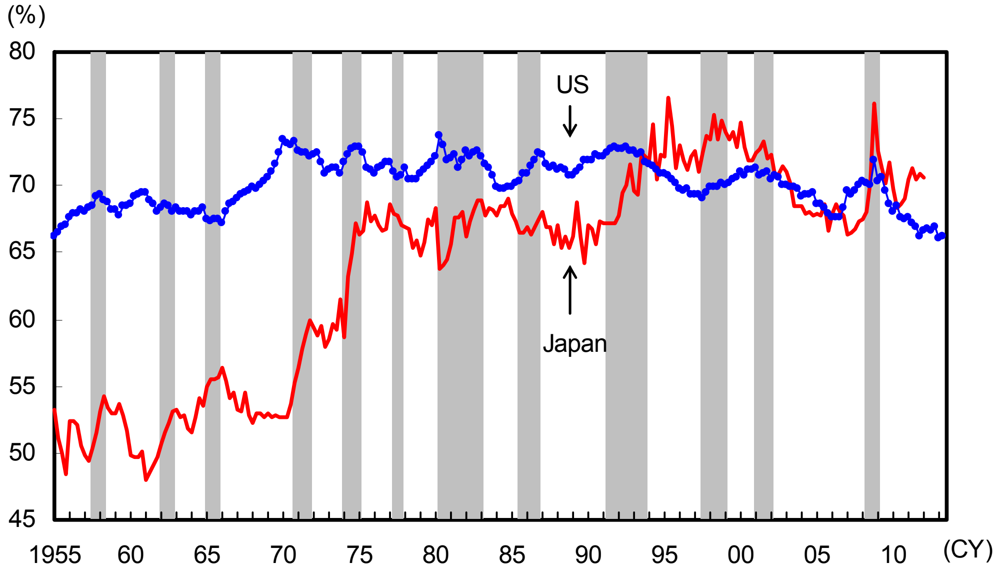
The Abe administration is planning to provide tax breaks to companies that increase the allocation of income to workers. While this policy can be commended to a certain degree, what is needed to strengthen the transfer of income from the corporate to household sector is a broader approach where higher wages are achieved by sharing the pain among government, business, and labor.

Due to an excessive preoccupation with averting unemployment during recessions, wage cuts became prevalent in Japan, and deflation has persisted. What is needed in the future is to have workers accept a greater degree of labor flexibility and to have companies actively increase wages in exchange. To encourage such developments, the government should support vocational training and workers' efforts to get jobs, provide tax breaks like that mentioned above, and support the restructuring of companies even more than before.

Counterargument 2: Labor's share has not moved downward in Japan

As the second counter argument, the view loudly proclaimed by some economists that labor's share is trending downward in Japan is a misinterpretation of the facts.

Long-term Trend of Japan and US Labor's Share **Chart 12**



Source: US Bureau of Economic Analysis, Cabinet Office; compiled by DIR.
Notes: 1) Shaded areas denote economic downturns in Japan.
2) Japan's labor's share adjusted based on 1990 SNA for 1955-79, 2000 SNA for 1980-93, 2005 SNA from 1994, and seasonally adjusted by DIR for 1955-79.

Chart 12 portrays the long-term trend of labor's share in Japan and the US. The chart reveals that labor's share is trending upward in Japan in the medium to long term and that its current level exceeds that of the US. Because of the downward rigidity of wages, labor's share generally declines during economic expansion and advances during recession. In the years since 1990, labor's share in Japan surged temporarily when the economy worsened sharply following the collapse of an asset bubble and after the Lehman crisis but declined in subsequent economic expansion periods. It is not the case that it is on a downward trend. In other words, the sluggishness of employee income is not a problem related to the allocation of national income but is mainly the outcome of an economic pie that has not expanded.

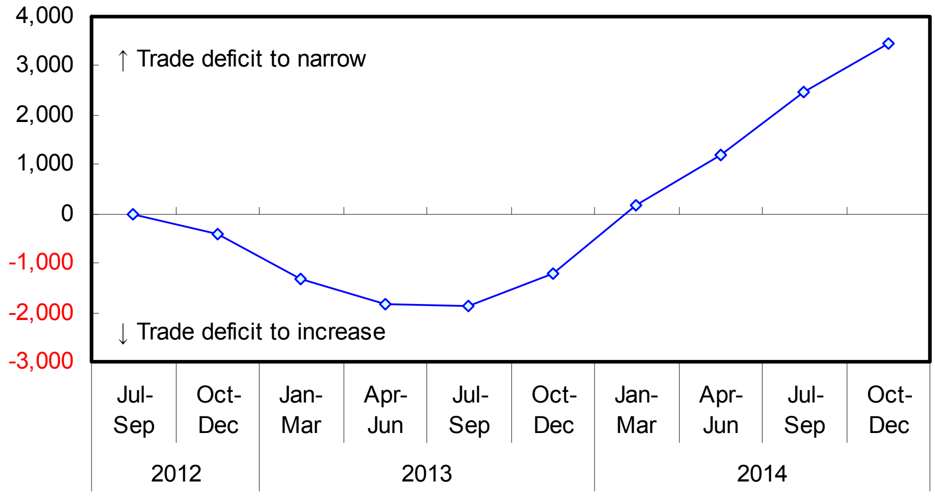
Counterargument 3: J-curve effect accompanying yen depreciation felt in Japan

As our third counterargument, it is worth noting the existence of the J-curve effect that accompanies the depreciation of the yen. Chart 13 portrays the effect of a weaker yen on the trade balance based on Daiwa short-term macroeconomic model. When the yen depreciates, the trade deficit will temporally widen due to higher import prices. Then, as export volume grows, export value will gradually increase, and the trade deficit will begin to narrow. This is the so-called J-curve effect.

As shown in the chart, the depreciation of the yen since November 2012 is estimated to first widen the trade deficit by Y200 billion at maximum. Beyond Jan-Mar 2014, however, the depreciation of the yen will work to narrow the trade deficit.

Economic observers who only draw attention to the drawbacks of a weak yen have become widespread in Japan in recent years. Such views, however, can hardly be called balanced. In the final analysis, what will be important is to compare and measure the benefits and drawbacks of a weak yen. Given Japan's export-led economic structure, it seems safe to say that the degree to which the yen has depreciated to date is having a greater positive than negative effect on the economy as a whole.

J-curve Effect of Weaker Yen on Trade Balance (Y100 mil) **Chart 13**



Source: Compiled by DIR.
Note: DIR estimate based on Daiwa short-term macroeconomic model for a case where forex moves toward a weaker yen than our assumption (Y80/$).

Outlook for Japanese Economy, Interest Rates

Chart 14

Indicator	2012 Oct-Dec	2013 Jan-Mar	2013 Apr-Jun	2013 Jul-Sep	2013 Oct-Dec	2014 Jan-Mar	FY11	FY12	FY13	FY14
	Actual			DIR estimates			Actual		DIR estimates	
Real GDP										
Q/q %, annualized	1.1	4.1	3.8	3.2	4.2	5.4				
Y/y %	0.4	0.3	1.2	3.0	3.8	4.0	0.3	1.2	3.0	1.2
Current account balance SAAR (Y tril)	4.3	3.1	8.5	8.6	9.2	9.5	7.6	4.4	8.9	14.3
Unemployment rate (%)	4.2	4.2	4.0	4.0	4.0	3.9	4.5	4.3	4.0	3.9
CPI (excl. fresh foods; 2010 prices; y/y %)	-0.1	-0.3	0.0	0.6	0.7	0.9	-0.0	-0.2	0.6	2.9
Unsecured overnight call rate (period end; %)	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
10-year JGB yield (period average; %)	0.76	0.66	0.77	0.80	0.90	0.95	1.05	0.76	0.86	1.05

Source: Compiled by DIR.
Note: Estimates taken from DIR's *Japan's Economic Outlook No. 178 Update*.