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Japan's Economy: Monthly Review

Challenges facing Abenomics

In this report we examine two aspects of the growth strategy: (1) the move from savings to investment and (2) measures to counter the declining birthrate

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Summary

- **Economic outlook revised:** We revised our Jan-Mar 2014 outlook for Japan's economy based on the 2nd preliminary GDP estimate. We now forecast real GDP growth of +1.1% in comparison with the previous year for FY14 (+1.0% in the previous forecast) and +1.5% in comparison with the previous year for FY15 (+1.5% in the previous forecast). (See Japan's Economic Outlook No. 181 Update (Summary), (June 23, 2014), by Mitsumaru Kumagai et al.). Japan's economy is expected to decline temporarily in the Apr-Jun 2014 period due to the effects of the increase in consumption tax, but then to get back on track and head toward recovery during the Jul-Sep period. Japan's economy is expected to firm up in the near future due to the following positive factors: (1) The negative factors associated with the increase in consumption tax are believed to be limited, and (2) Firming up of exports due to US economic recovery.
- **Challenges facing Abenomics:** As we have mentioned before on a number of occasions, the biggest challenges faced by *Abenomics* are (1) maintaining fiscal restraint, and (2) strengthening its growth strategy. The arguments supporting this outlook focus especially on the following themes.
 - (1) **Speed up the move from savings to investment:** The effects of Abenomics are expected to lead to inflation, and the move from savings to investment must be encouraged.
 - (2) **Halt the decline in birthrate:** Halt the decline in the birthrate, which has plagued Japan for many years now, by aggressively promoting more contribution from women in the workforce.

1. Japan's Economic Scenario

Main scenario: Japan's economy to continue growing

We revised our Jan-Mar 2014 outlook for Japan's economy based on the 2nd preliminary GDP estimate. We now forecast real GDP growth of +1.1% in comparison with the previous year for FY14 (+1.0% in the previous forecast) and +1.5% in comparison with the previous year for FY15 (+1.5% in the previous forecast). (See Japan's Economic Outlook No. 181 Update (Summary), (June 23, 2014), by Mitsumaru Kumagai et al.). Japan's economy is expected to decline temporarily in the Apr-Jun 2014 period due to the effects of the increase in consumption tax, but then to get back on track and head toward recovery during the Jul-Sep period. Japan's economy is expected to firm up in the near future due to the following positive factors: (1) The negative factors associated with the increase in consumption tax are believed to be limited, and (2) Firming up of exports due to US economic recovery.

Real GDP growth rate revised upwards from 1st preliminary estimate

The real GDP growth rate for Jan-Mar 2014 (2nd preliminary est) was revised upwards from the preliminary est, recording +6.7% q/q annualized (+1.6% q/q) as compared to the preliminary figures (+5.9% q/q annualized, +1.5% q/q). The 2nd preliminary figures also exceeded market consensus (up 5.6% q/q annualized and up 1.4% q/q), due mainly to the upward revision of capex, which exceeded earlier expectations – all in all a positive report.

Capex revised sharply upwards

Looking at the upward revision since the 1st preliminary, capex was revised considerably upwards to +7.6% q/q (+4.9% on the 1st preliminary) as a result of the announcement of corporate statistics. Even at the stage of the 1st preliminary estimate, capex had exceeded previous performance, which was a major factor in GDP exceeding market expectations as of that point, and it has again been revised upwards even further in the current estimate. Meanwhile, personal consumption was also revised upwards somewhat in comparison to the 1st preliminary figures.

At the same time, private sector inventories were revised downwards considerably from the 1st preliminary estimate in reaction to corporate statistics (q/q real GDP contribution ratio -- 1st preliminary: -0.2% pt → 2nd preliminary: -0.5% pt). However, the sharp decline in inventories was due to last minute demand prior to the increase in consumption tax, hence these figures should not be taken negatively. Figures for public sector fixed capital formation were also revised downward (1st preliminary: -2.4% → 2nd preliminary: -2.7%) in response to the March 2014 synthetic construction indices (a basic statistic).

The GDP deflator was also revised downwards slightly to -0.1% y/y (0.0% on the 1st preliminary.)

Capex achieves considerable growth with help of last minute demand

Looking at the extent of contribution of domestic and foreign demand to real GDP growth rate during the Jan-Mar 2014 period (q/q basis), we see contribution from domestic demand at +1.9% pt (+1.7% pt on the 1st preliminary) and foreign demand at -0.3% pt (-0.3% pt on the 1st preliminary report).

The primary cause in the growth of domestic demand was last minute demand prior to the increase in consumption tax, which led to a major jump in personal consumption (+2.2% q/q) – results which were pretty much expected. Within this context, the major upward revision of capex in the current estimate due to high growth in this area is an especially positive factor. It is hard to believe that positive capex performance is due only to the emergence of large scale growth in last minute demand alone. It makes

much more sense to see growth in capex as connected to recent improvement in corporate earnings and the resolution of the recent sense that capex was in excess.

Contribution of foreign demand to GDP has seen minus figures for the past three quarters. This is due to the fact that the expansion of domestic demand led to growth in imports exceeding that of exports. While revision of the international balance of payments indicates an upward trend, but even without that, exports are definitely showing signs of coming out of a slump.

On the other hand, public investment, which had been in a continuous growth trend in recent months, suffered its first decline in five quarters. Ever since 2013, public investment continued to grow in due to the effects of implementation of the FY 2012 supplementary budget, but it appears that the effects of that budget period are gradually wearing thin. We recommend keeping an eye on future trends in this area.

Japanese economy back on growth track by Jul-Sep 2014 period

As for the outlook for the Japanese economy, the period of Apr-Jun 2014 is likely to see declines in personal consumption and housing investment for the first time in 7 quarters. However the reactionary decline occurring after the last minute demand prior to the increase in consumption tax is seen as having hit bottom in April, and are expected to begin easing up, supported by increases in base wages by major corporations feeling pressured to raise wages due to the stringent supply and demand situation for labor. Therefore possibilities are good that personal consumption will enter a growth trend in q/q terms by the Jul-Sep quarter.

Meanwhile, exports are expected to grow as overseas economies, led by the U.S., continue to expand, and as Japan improves its global competitiveness thanks to the weak yen. Increasing exports will lead to production growth and improved earnings, and this is expected to trigger more capex. Hence we believe the Japanese economy will be back on the growth track by the Jul-Sep 2014 period.

Four risk factors facing Japan's economy

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.

First, to examine turbulence in emerging economies, we analyze the world economic cycle. In the past, advanced economies led by the US drove emerging economies. However, a decoupling is currently occurring—advanced economies are performing well but emerging economies are stagnating. We believe that this decoupling is occurring for three reasons: (1) the dwindling amount of loans from European financial institutions to emerging economies in light of the European debt crisis, (2) the sluggishness of the Chinese economy, and (3) concerns that money will be taken out of emerging economies based on worries that the FRB will adopt a hasty exit from quantitative easing. We anticipate that a further deterioration of emerging economies will be avoided as the US economy continues to expand. Nevertheless, we think the state and the future direction of the Chinese economy will continue to require close monitoring.

BOJ's monetary policy

We expect additional monetary easing measures by the BOJ to carry over beyond the 2015 Jan-Mar period. While there is still a chance that the BOJ might reach its price target, our outlook as of this point in time is that the growth rate in consumer prices will not reach 2%.

2. Challenges Facing Abenomics

Challenges Facing Abenomics

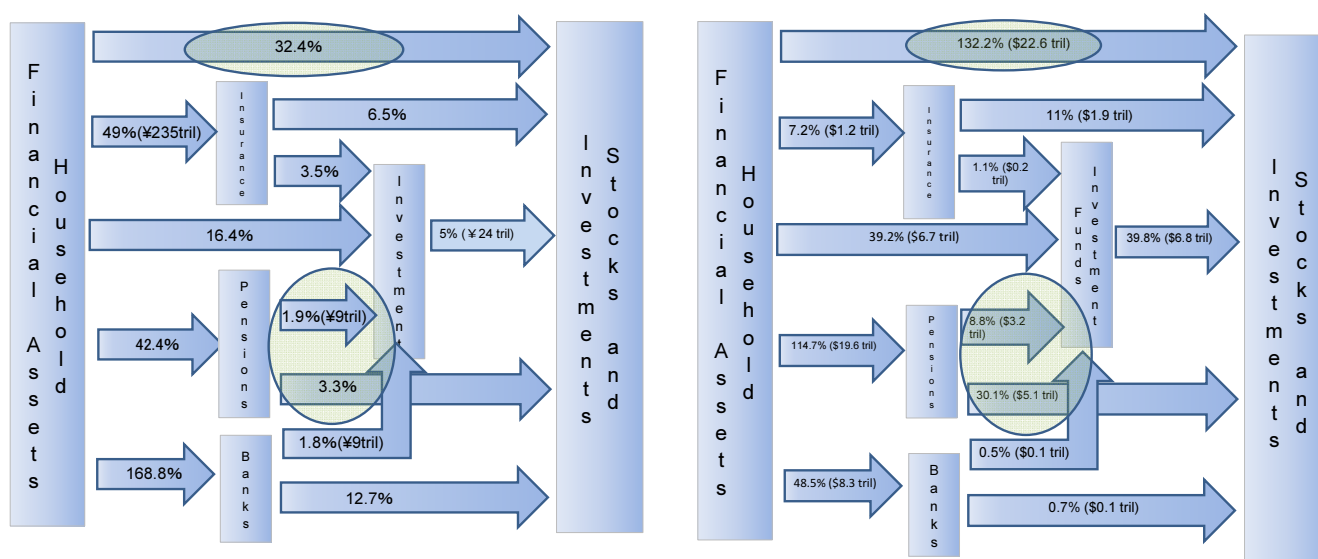
As we have mentioned before on a number of occasions, the biggest challenges faced by *Abenomics* are (1) maintaining fiscal restraint, and (2) strengthening the growth strategy. (See Japan's Economic Outlook No. 177, Assessment of Abenomics: Examination of current situation and future issues (June 3, 2013), by Mitsumaru Kumagai et al.). The arguments supporting this outlook focus especially on the following themes. (1) Speed up the move from savings to investment, and (2) Halt the declining birthrate.

2.1 Challenge (1) Speed up the move from savings to investment

Money-flow of household financial assets in Japan and US differs greatly

In this section we consider the question of the need to move from savings to investment. Chart 1 shows a comparison of how financial assets are utilized by households in Japan and the US. There is a huge amount of financial assets held by private households in Japan. However, the extent to which investments in securities by household financial assets contributes to GDP (assets/GDP) is extremely small in comparison to the US. The reason for this discrepancy is that Japanese households keep most of their financial assets in cash and savings accounts. Moreover, long-term deflation in Japan only encouraged households to keep financial assets in the form of cash and savings. As a matter of fact, the real asset balance increased during this period. The economic climate that develops during a long-term period of deflation is one in which there is no risk of price fluctuation, therefore the holding of cash and savings, which have a high rate of liquidity, becomes a practical choice in the handling of assets. The same asset structure can be seen in the handling of pension funds. The Japan pension fund system holds a much smaller amount of investments in securities or investment funds when compared with the US Social Security system.

Once Japan moves into an inflation phase under *Abenomics* as is predicted, it will no longer be practical to keep such a large amount of financial assets in the form of cash and savings. Japanese individuals and pension funds will have to switch from savings to investment to prepare for the coming period of inflation which is expected. Japan's own version of *The Great Rotation* (the switch from bonds and risk-free assets to stocks and risk-assets) needs to happen, and it needs to happen soon.

Money-Flow of Household Financial Assets (Left: Japan, Right: US) (as of end 2013) Chart 1


Source: Bank of Japan, compiled by DIR
 Note: Comparison with Nominal GDP

Source: FRB, compiled by DIR
 Note: Comparison with Nominal GDP

Seen from an international perspective, the asset effect in Japan is small

Chart 2 shows how the balance of household stock ownership influences personal consumption in the OECD member nations. This is called the “asset effect.”¹ We can see by the results of estimates that the asset effect is not observed in some countries, but in Japan it measures significantly. This is essentially what happened when the stock market highs in Japan which accompanied the rapid weakening of the yen starting at the end of 2012 also led to an increase in personal consumption.

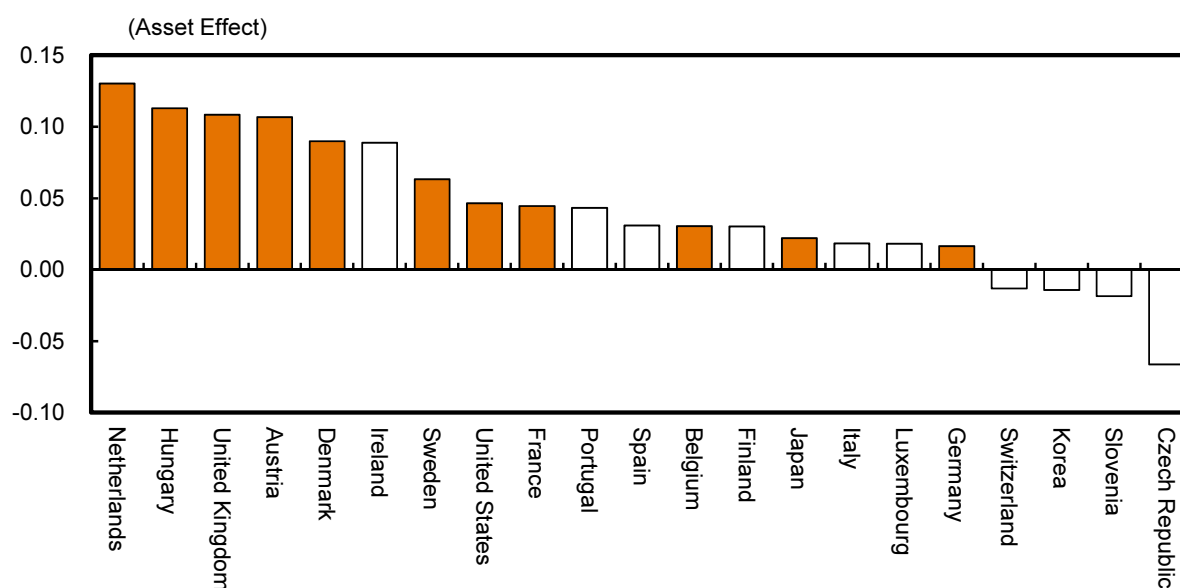
However, when the size of the asset effect (the elasticity value of the balance of stocks held by households in comparison to real personal consumption) measured at that time is compared with that of other countries, Japan was the second smallest of those countries in which an asset effect occurs. In other words, Japan’s asset effect is small when seen from an international perspective.

Of course, the asset effect is not a simple phenomenon. In other words, when we look at countries like the US, we cannot necessarily say in simple terms that in countries where there is a large asset effect there is also a large percentage of household financial assets that are invested in securities. But at least one of the factors which is a cause of Japan’s small asset effect is unquestionably the fact that, seen from an international perspective, the percentage of household financial assets in Japan that are invested in securities is small.

¹ Data used in estimates are not necessarily national averages, hence results should be interpreted broadly.

Comparison of Asset Effect Amongst OECD Member Countries

Chart 2



Source: OECD; compiled by DIR.

Note: Equation use to obtain estimates: $\ln(\text{CP}) = \alpha \times \ln(\text{YDH}) + \beta \times \ln(\text{STOCK}) + \gamma \times \ln(\text{NFA})$

CP: Real Personal Consumption, YDH: Real Household Disposable Income

STOCK: Balance of Stocks Held by Households, NFA: Net Financial Assets Other than Stocks

Data in the chart corresponds to the estimated value β in the above formula. Uncolored bars mean that the coefficient is insignificant.

Household stock ownership has a loose correlation with personal consumption. There is no correlation with income gap.

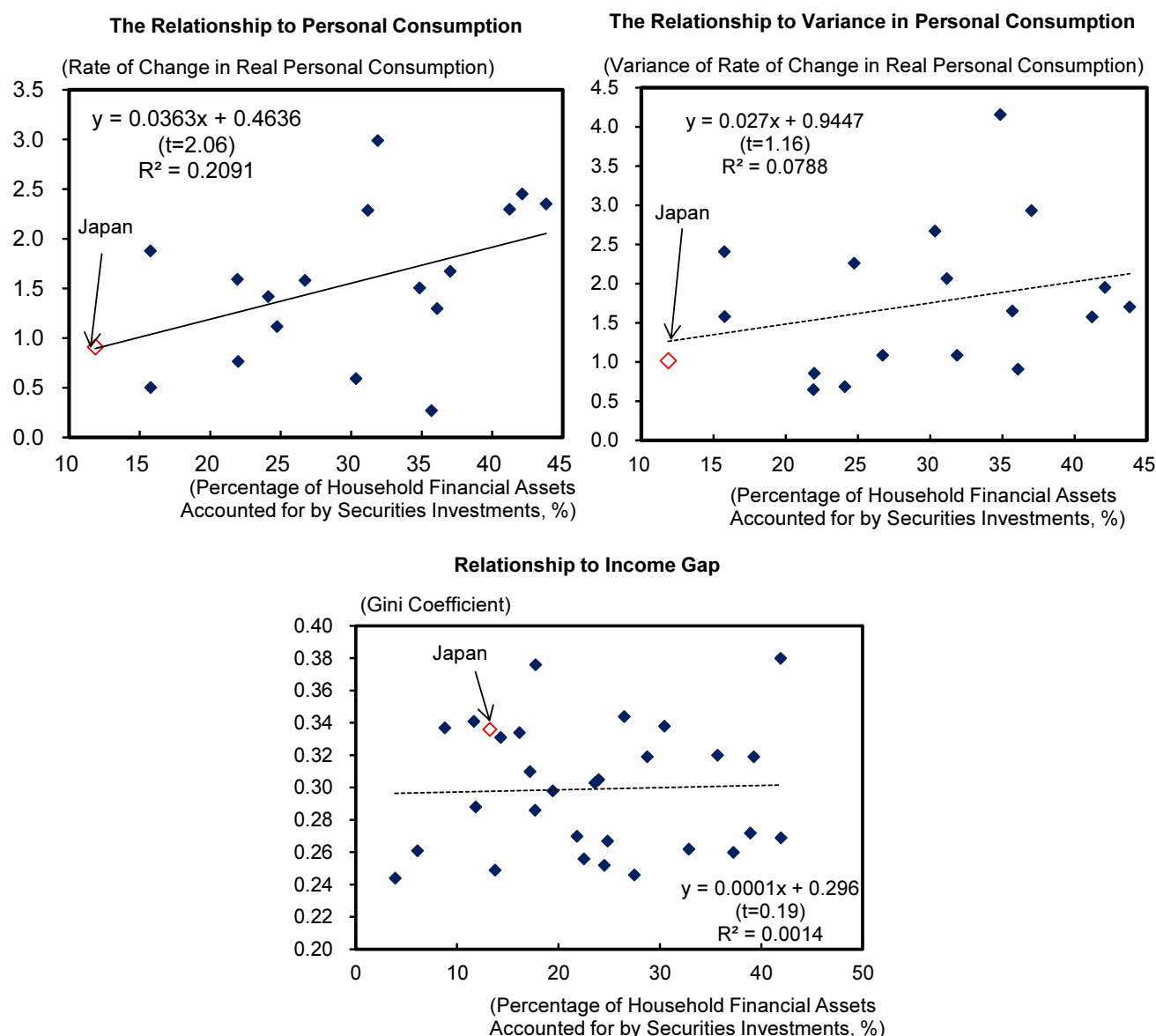
Earlier it was pointed out that the asset effect as related to personal consumption encouraged by stock ownership is not necessarily measurable in all countries. However, in examining the relation between the percentage of household stock ownership and the rate of change in real personal consumption on an international level, it is possible to confirm that there is a loose correlation (see Chart 3, top left). In other words, countries where investment in risk-assets is advanced tend also to have higher growth in personal consumption.

When the proportion of stock ownership is high, it contributes to growth in personal consumption due to the asset effect as long as stock prices are on the way up. When stock prices fall, there is a reverse asset effect which brings downward pressure on personal consumption. Is it possible that when the proportion of stock ownership grows that personal consumption can also grow more volatile? In Chart 3 (top right) we examine the variance of personal consumption. Here, we do not find that countries with a higher percentage of stock ownership necessarily exhibit wider variance in personal consumption. This is because ultimately, the factor having the greatest influence on fluctuation in personal consumption is income, and changes in income and stock ownership are not necessarily linked.

Finally, we examine the relationship between the percentage of household stock ownership and income gap (see bottom of Chart 3). Here again, we find no meaningful correlation. At least in an international comparison, we see no increase in income gap as a result of the shift of household financial assets to investment in stocks.

Relationship of Household Stock Ownership to Personal Consumption and Income Gap in OECD Member Countries

Chart 3



Source: OECD; compiled by DIR.

Note: Data in top left and top right charts is the annual average between the year 2000 and 2012. The bottom chart uses data from the year 2012.

Savings will become less attractive once Japan's economy sheds deflation

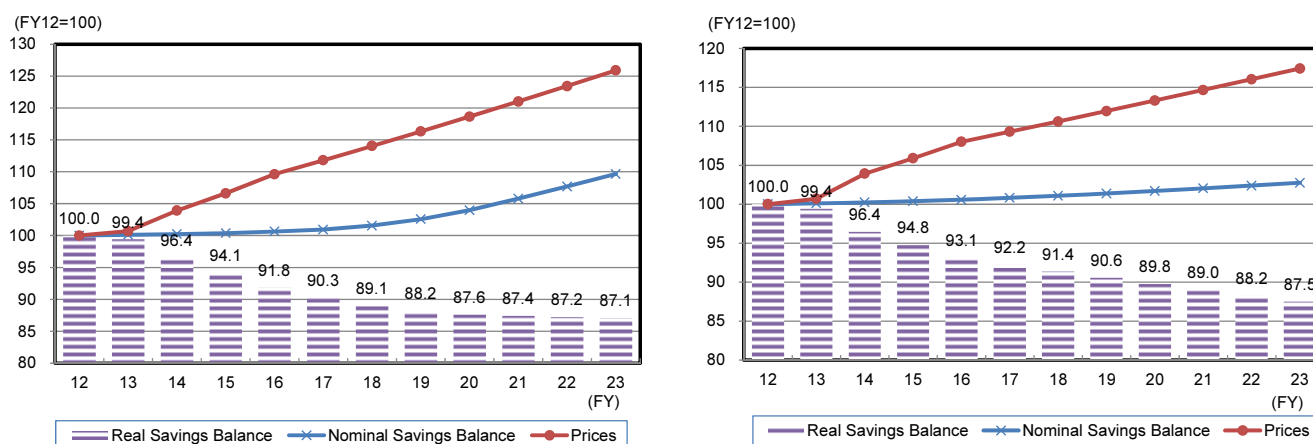
In this section we consider whether there is a danger that the value of cash and savings might decline under *Abenomics*, and if so to what extent. Chart 4 shows the results of a simulation which considers what might happen to the real balance of household savings assuming that the government's economic outlook made public in January 2014 becomes a reality. (The simulation utilizes calculations regarding the government's mid to long-term economic policy.)

Assuming that *Abenomics* produces results and the revival of the economy so often spoken of by the Abe administration actually comes to pass, the real balance of savings in Japan may decline by around 10%. The Bank of Japan is expected to raise interest rates in incremental steps at a pace that is predicted to be gradual. Therefore, interest available from savings accounts is expected to grow at a rate slower than that of inflation. Hence the economic revival scenario sees the real balance of savings declining in tandem with the progression of inflation.

Next we use a reference case produced by the Cabinet Office to look at what happens if the economy actually grows. The conclusion here as well is that the real balance of savings will decline. Our reference case sees inflation progressing at a fairly mild rate of less than 2%. If this is the case, then the BOJ would be expected to stabilize the situation by setting the call rate at a low level for the long-term in hopes of attaining its target for an increase in prices of 2%. For this reason, interest on savings accounts would feel mild upward pressure from inflation, but since the low interest policy would still continue, it is expected that interest on savings would stay at a low level. Therefore, our reference case also sees a decline in the real balance of savings. The results of the simulation mentioned earlier in this section assumes economic growth spurred on by *Abenomics*. This means that cash and savings would become significantly less attractive in comparison to a period when deflation is the norm. In order for the real asset balance either to maintain the same level or to grow, a portion of savings must be channeled into stocks and similar investment assets which provide a hedge against inflation.

To sum up the above argument, inflation is expected to progress in the future due to the effects of *Abenomics*, hence it is necessary to speed up the shift from savings to investment.

Real Balance of Household Savings (Left: Economic Revival Case, Right: Reference Case) Chart 4



Source: Cabinet Office, BOJ; compiled by DIR.

2.2 Challenge (2) Halt the decline in birth rate

The main cause of the decline in birth rate is the decline in the marriage rate

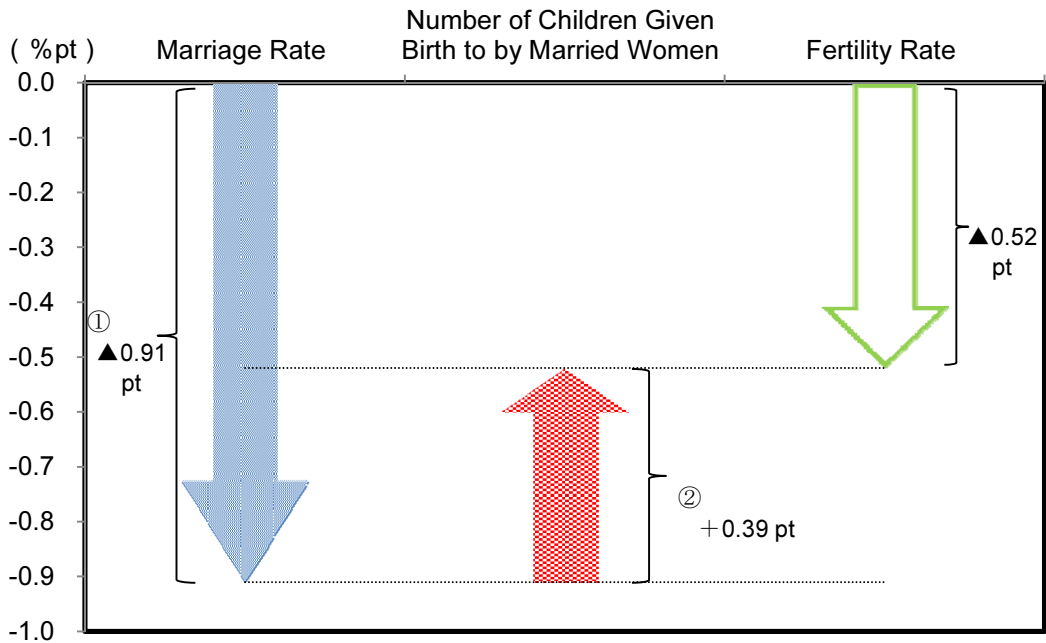
In order for Japan's economy to attain long-term growth, the decline in birth rate must of course be halted. But to begin with, what is the main cause of the decline in the birth rate?

Chart 5 and 6 present a factor analysis of Japan's total fertility rate. Between 1975 and 2010, total fertility rate fell by 0.52 pt. The major factor was by far the decline in the marriage rate, meaning of course a decline in the percentage of married persons. In contrast, the average number of children given birth to by married women actually grew.

Chart 7 compares the percentage of married persons by age group during various 5-year periods. Looking at this chart, it becomes evident that the tendency to marry late has been growing, while the overall marriage rate has been in decline.

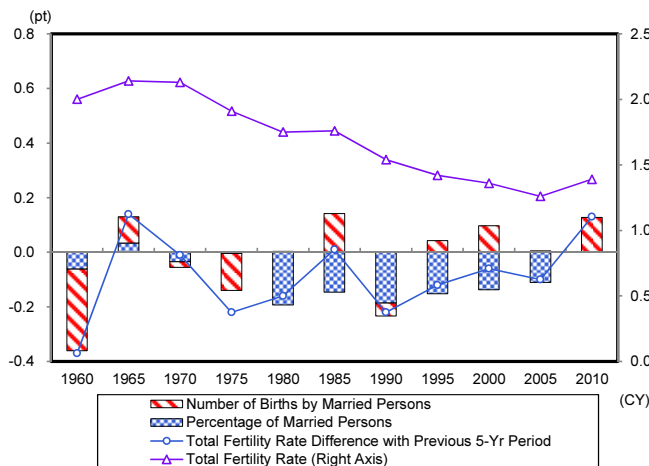
Factors Contributing to Fluctuation in Birth Rate **Chart 5**

$$\text{Fertility Rate} = \text{Marriage Rate} \times \text{Number of Children Given Birth to by Married Women}$$



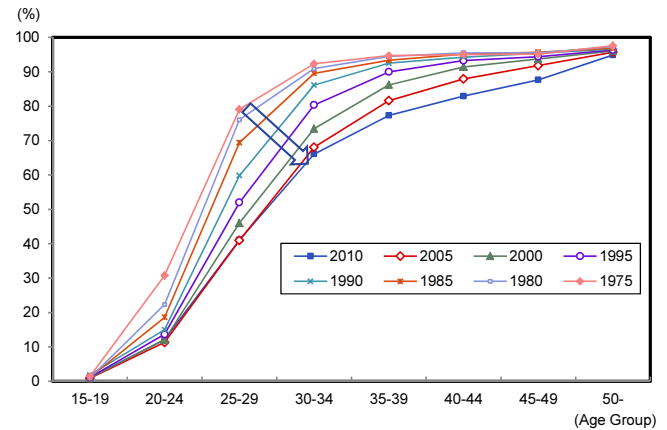
Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications; compiled by DIR

Factor Analysis of Change in Total Fertility Rate
Chart 6



Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications; compiled by DIR.

Change in Percentage of Married Women by Age Group
Chart 7



Source: Ministry of Internal Affairs and Communications; compiled by DIR.

Anxiety about the future and poverty may be behind the decline in the marriage rate

It can be inferred that one of the issues behind the decline in the marriage rate is people's anxiety about their economic future and poverty. As is indicated in Chart 8, growth in the ratio of non-regular employees amongst men in the 25-34 age bracket is concurrent with the decline in the marriage rate.

The following measures are suggested as a means of halting the decline in the marriage rate.

First of all, it is important to more actively promote women's contribution in the work force and speed up women's social advancement. This would increase the number of double income families in the future, as well as encourage a change in the marriage rate.

Secondly, decreasing the sense of uneasiness many people feel about their economic future through the introduction of reforms in the social security and welfare system will also be key. Japan's fiscal structure is now moving away from "mid-range benefits-low burden" and nearing the point of "high-range benefits-low burden". The basic direction of future reforms in Japan's social security system will be towards introduction of a framework which maintains a balance between insurance premiums and benefit payout no matter what happens with the economic climate and the birth rate.

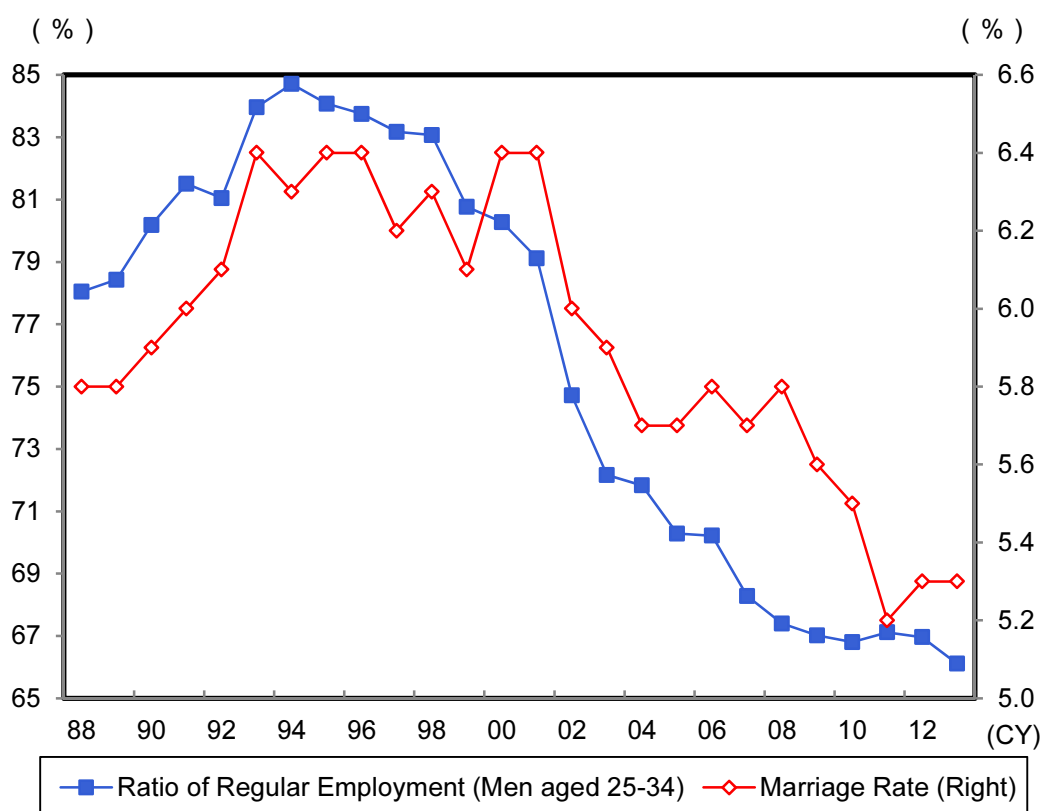
Practically speaking, this will likely lead to consideration of the following issues: (1) a raising of the age at which pensions become payable, (2) setting in motion a "macroeconomic slide" in which growth in pension amounts will be controlled rather than wages and prices, thereby reducing the amount in pension payouts, and (3) increasing the amount of tax payable on income from pensions.

Thirdly, the need to resolve the gap between regular and non-regular workers is a pressing issue. An important perspective to consider here is that of "equal pay for equal value work". At the same time, forcing companies to change all non-regular workers to regular worker status would encourage companies to outsource more jobs to overseas locations, causing even more suffering for non-regular workers.

Finally, the fourth issue is that, despite the difficult budgetary situation, in terms of fiscal policy, providing support for measures to halt the decline in birth rate is an effort which cannot be ignored. If we take the Swedish and French examples where success was achieved in halting the decline in birth rate, we can see that in order to do so, budgetary measures equal to around 2% of nominal GDP were provided.

Rate of Regular Employment for Men Aged 25-34 and Marriage Rate

Chart 8



Source: Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.
 Note: Ratio of regular employment = number of regular employees / total population.

Growth of women in the workforce will ease manpower shortage

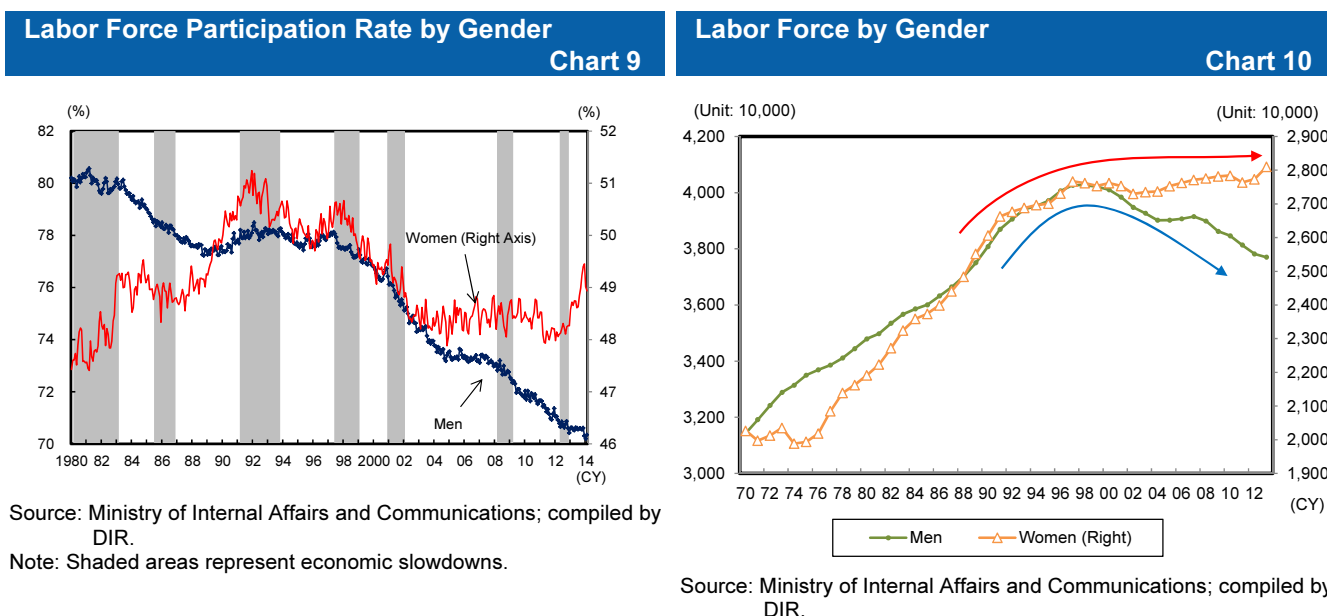
The shortage of manpower is expected to become increasingly serious as the population continues to age, but growth in the number of women in the workforce (labor force participation rate) adds a positive factor to this situation.

Chart 9 shows the labor force participation rate by gender. Japan's Equal Employment Opportunity Law went into effect in the late 1980s, and subsequently women's labor force participation rate grew rapidly. After that point the labor force participation rate of both men and women grew pretty much in tandem. However, after the year 2000 men's labor force participation rate began to decline, while women's labor force participation rate remained flat. The labor force population itself also reflects these developments. Looking at Chart 10 we see that men's labor force population has been in decline, while that of women has been flat.

In recent years women's labor force participation rate has grown sharply

This trend has become especially prominent in more recent years. Since 2013, women's labor force participation rate has grown sharply. This is because not only has the employment rate of women in their 20s and 30s been growing, but women in their 40s and 50s have returned to the work force as well. In fact, work force participation has been activated amongst women in many age groups.

During the peak years of the 90s, women's labor force participation rate was at around 51%, meaning that there is still plenty room for continued growth in women's labor force participation rate in the future. Women's participation in the labor force will likely continue to progress in the future, especially if more advances are made in government policy to encourage a more active role for women in society, as well as the efforts of private corporations raise the status of women workers. In addition, this also promises to have the effect of easing the manpower shortage Japan now suffers from.



Growth in women's employment rate will have a major impact on change in industrial structure

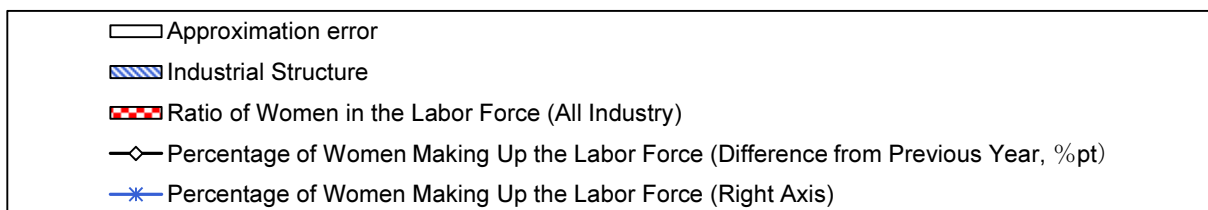
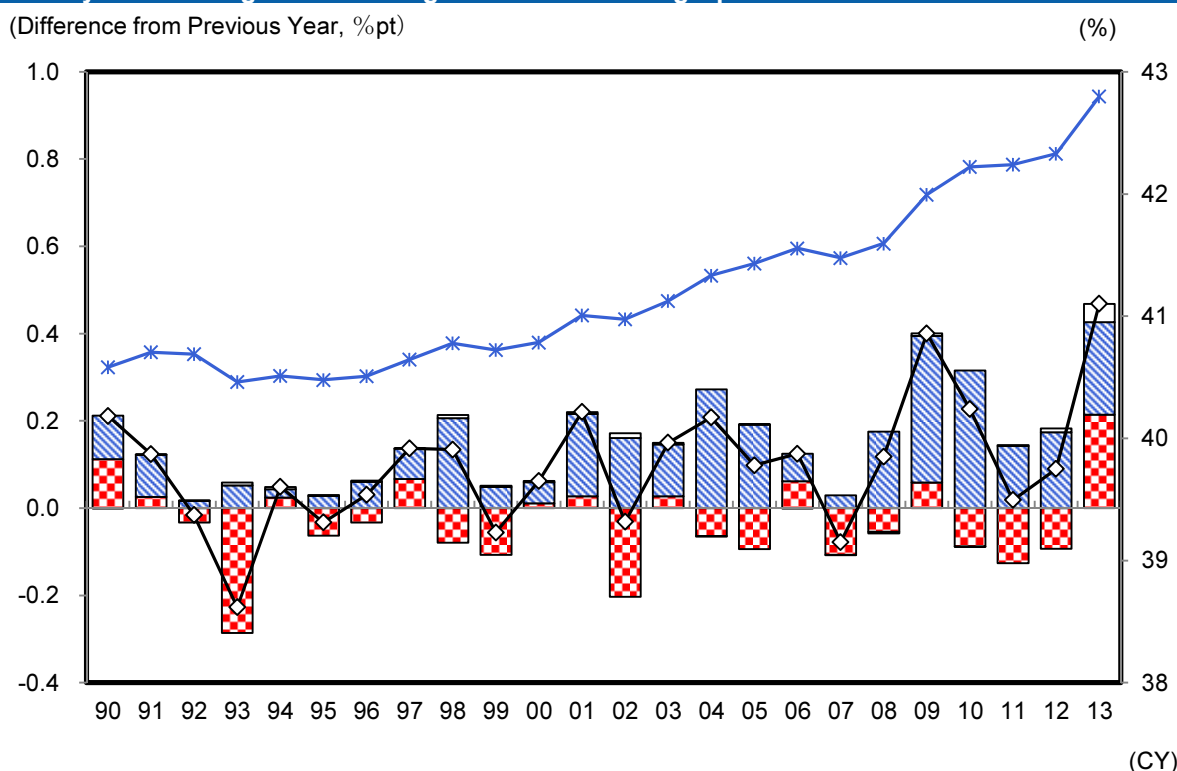
The percentage of women making up the total working population continues to grow along with the growth in women's labor force participation rate. In Chart 11, change in the percentage of women making up the work force is shown along with a factor analysis of the extent of that change. As can be seen in this chart, the percentage of women making up the work force (total employees) has been growing continuously. Furthermore, we can see that the major factor behind this growth has been industrial structure.

The percentage of women making up the work force appears to be the same for the most part in each of the various individual industries. However, another interesting fact is that those industries in which the percentage of women making up the work force is especially high tend to have a higher growth rate than those which have a lower percentage. Moreover, industries in which the percentage of women making up the work force is especially high also have a higher growth rate in the total number of employees, resulting in the fact that, overall, the number of women employees is growing.

Looking at this from the other way around, the growth in women’s presence in the labor market is due mainly to changes in industrial structure. However, this can also be interpreted as meaning that on the level of individual corporations and industries, there is actually not much progress in aggressively recruiting women.

Since men’s labor force population is expected to decline in the future, Japan’s economic situation will continue to grow dim as the shortage in manpower becomes more serious, unless women’s labor force is activated. In order to ensure that Japan can unquestionably achieve economic growth, it is essential to actively promote women’s contribution in the work force. The Abe administration has given a central place in its policy to actively promoting women’s contribution in the work force and speeding up women’s social advancement. However, it is also important to create an environment that would make it easier not only for government, but for private corporations to move aggressively to recruit more women. Decisive action is required in this area. Both the public and private sectors should make it urgent business to carry out the reforms necessary to speed women’s full and active participation the workplace and society.

Factor Analysis of Change in Percentage of Women Making Up the Labor Force **Chart 11**



Source: Ministry of Internal Affairs and Communications; compiled by DIR.

Note: Where P is the percentage of women making up the labor force, w_i is the the number of employees in industry i, and p_i is the percentage of women making up the workforce, the following expression is possible.

$$P = \sum_i w_i \times p_i \quad \Delta P \approx \sum_i \Delta w_i \times p_i + \sum_i w_i \times \Delta p_i$$

Here, the first term on the right is the factor of industrial structure, while the second term on the right is the factor of women's ratio of participation in the labor force.

Economic Indicators and Interest Rates

Chart 12

Indicator	2013	2014				2015	FY12	FY13	FY14	FY15
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
	Actual	DIR estimates				Actual	DIR estimates			
Real GDP										
Q/q %, annualized	0.3	6.7	-4.2	2.5	2.1	2.1				
Y/y %	2.5	3.0	1.0	1.3	1.7	0.5	0.7	2.3	1.1	1.5
Current account balance										
SAAR (Y tril)	0.0	-5.6	-1.9	-0.5	0.8	1.9	4.2	0.8	0.1	3.4
Unemployment rate (%)	3.9	3.6	3.6	3.6	3.6	3.6	4.3	3.9	3.6	3.5
CPI (excl. fresh foods; 2010 prices; y/y %)	1.1	1.3	3.3	3.1	3.0	3.0	-0.2	0.8	3.1	1.9
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; %)	0.64	0.61	0.65	0.70	0.75	0.80	0.78	0.69	0.73	0.90

Source: Compiled by DIR.

Note: Estimates taken from DIR's Japan's Economic Outlook No. 181 Update.