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Japan's Economy: Monthly Review

The Spring of Wage Hikes Has Arrived!

The virtuous circle brought on by Abenomics is providing Japan's economy with underlying support

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Summary

- **The Spring of Wage Hikes Has Arrived!:** The virtuous circle brought on by Abenomics is accelerating. According to the Keidanren's initial calculations of April 16, the rate of wage increase coming out of the 2015 annual spring labor offensive (the total of pay-scale increase and annual wage hike) is 2.59%. This represents the highest growth wages have seen in the last seventeen years. The pay-scale increase is seen at around 0.7%, and according to DIR calculations, promises to push personal consumption up by around Y1.4 tril. We expect Japan's economy to gradually recover in 2015 due to the following factors: (1) Continuation of the virtuous circle brought on by Abenomics, and (2) The gradual firming up of exports centering on the US, leading to a moderate recovery trend.

- **Four risk factors facing Japan's economy:** Risks factors for the Japanese economy are (1) The *Triple Weaknesses* – a weak bond market, weak yen, and weak stock market stemming from fears that Japan could lose its fiscal discipline, (2) China's shadow banking problem, (3) tumult in the economies of emerging nations in response to the US exit strategy, and (4) a worldwide decline in stock values due to geopolitical risk.

1. The Spring of Wage Hikes Has Arrived!

Wage hikes (Keidanren initial calculations) coming out of this year's annual spring labor offensive are highest in 17-yrs

The virtuous circle brought on by Abenomics is accelerating. According to the Keidanren's initial calculations of April 16, the rate of wage increase coming out of the 2015 annual spring labor offensive (the total of pay-scale increase and annual wage hike) is 2.59%. This represents the highest growth wages have seen in the last seventeen years. The pay-scale increase is seen at around 0.7%.

Japan's favorable corporate sector is bringing improvements in the employment and income environments, thereby bringing positive effects to the personal sector. Looking at the big picture, there is an undercurrent in Japan's economy as hypothesized by Abenomics. This is the virtuous circle of production → income →consumption, which is currently making step-by-step forward movement.

Japan's Economic Scenario

As we have indicated in our previous outlook, Japan's economy is now seen as having entered a recession since having peaked in January 2014. However, the downtrend appears to have ended fairly quickly as of around August. We expect Japan's economy to gradually recover due to the following factors: (1) Continuation of the virtuous circle brought on by Abenomics, and (2) The gradual firming up of exports centering on the US.

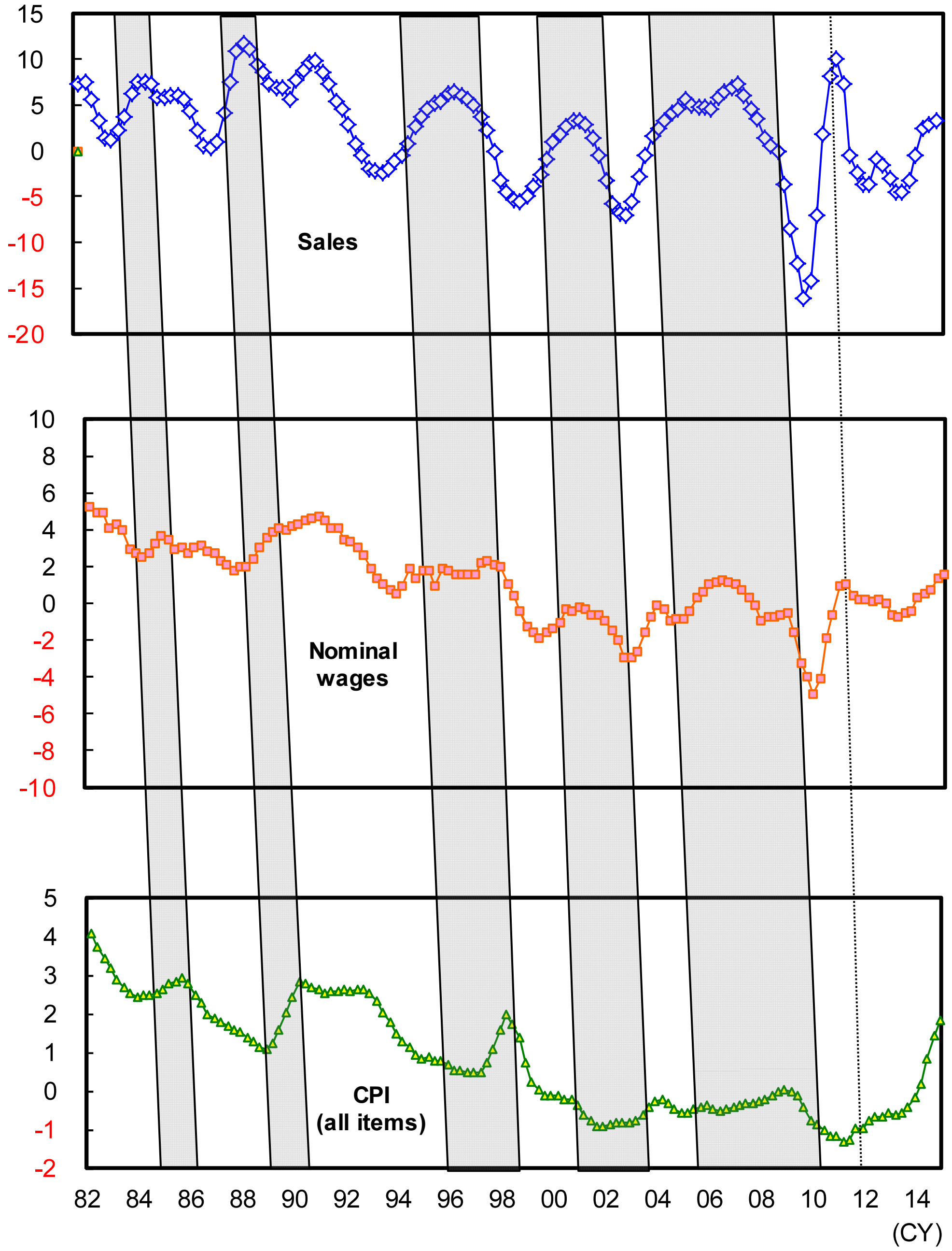
Virtuous circle brought on by Abenomics to continue

Japan's economy is expected to be supported by the virtuous circle brought on by Abenomics.

Criticisms have been voiced by the opposition parties and the mass media claiming that employee compensation has failed to increase despite the progress of inflation, and that Abenomics will only cause the people more pain. However, as is shown in Chart 1, historical data reveals that there is a recurring economic cycle in Japan moving from sales growth to wage growth and then to price increases. In other words, wage hikes in Japan tend to occur six months to a year after growth in sales, and then another six months later the consumer price index tends to rise.

With this in mind we can see that the BOJ's monetary easing policy and the government's pro-business policy have been designed to encourage growth in sales. In this sense, the basic thinking behind Abenomics is right on target in understanding that the starting point for shaking off deflation is to induce sales growth.

Sales, Wages, and Prices (y/y %) **Chart 1**



Source: Ministry of Finance, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications; 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.

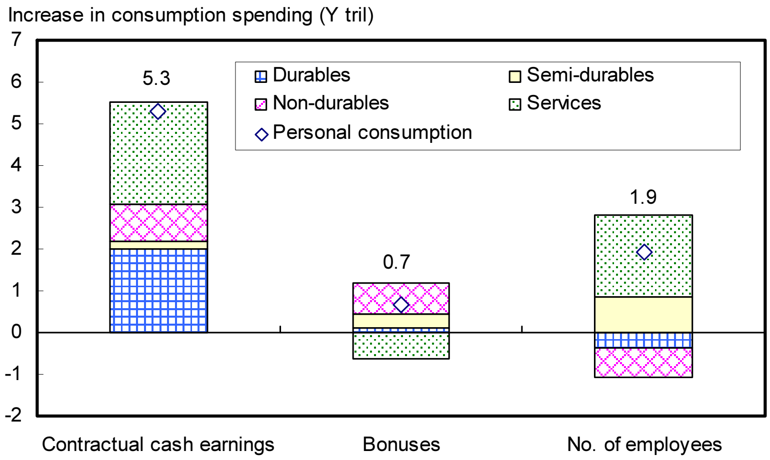
Increases in contractual earnings will stimulate personal consumption, especially of durables

Next we would like to point out that wage increases promise to have a certain "pump-priming effect" on the economy by stimulating an increase in personal consumption. An increase in contractual cash payments would especially have a positive effect by stimulating personal consumption in the area of durables. This has the added effect of helping to avoid a "fallacy of composition". Corporations with enough financial leeway should accelerate the increase of base-pay.

To better understand these differences on a quantitative basis, we divided employee income into regular payments (regular payments plus overtime payments), bonuses, and the number of employees to estimate how each change would influence personal consumption (Chart 2). Our estimates show that an increase in regular payments would have the greatest effect in increasing personal consumption. If an increase in regular payments boosts total employee income by 2%, personal consumption would increase Y5.3 trillion, mainly through more consumption of durable goods and services. The effect of an increase in the number of employees would be Y1.9 trillion, less than half that of higher regular payments, and the effect of an increase in bonuses would be an even smaller, at Y0.7 trillion.

We estimated the impact of a 1% rise in contractual earnings (approximately Y2.4tril) on personal consumption (see Chart 3). According to the Keidanren's initial calculations of April 16, the pay-scale increase is seen at around 0.7%, and according to DIR calculations, promises to push personal consumption up by around Y1.4 tril. The breakdown is around Y0.5 tril for durables, Y0.1 tril for semi-durables, and around Y0.2 tril for non-durables. Services expect to see an increase of around Y0.7 tril in consumption.

Impact of 2% Rise in Employee Compensation on Personal Consumption **Chart 2**



Source: Cabinet Office, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Employee compensation expressed as "total cash payments multiplied by no. of employees". If employee compensation rises 2%, regular payments would be up 2.4%, bonuses up 12.0%, and no. of employees up 2.0%. If this is the case, personal consumption would increase as shown in the chart. Estimation period: Jan-Mar 1994 to Apr-Jun 2013.

Impact of 1% (Approx. Y2.4 tril) Rise in Contractual Earnings on Personal Consumption **Chart 3**

	Personal Consumption				
		Durables	Semi-Durables	Non-Durables	Services
Actual Value (Ytril)	2.04	0.78	0.07	0.34	0.94
Growth Rate (%)	0.78	3.49	0.37	0.49	0.62

Source: Cabinet Office, Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Amount of growth in personal consumption if contractual earnings (regular salaries) grow by 1%. The estimation period is between 1994 1Q and 2013 2Q.

2. Four Risk Factors Facing Japan's Economy

Four risk factors facing Japan's economy

In this section we examine the four risk factors facing Japan's economy.

Risk factors for the Japanese economy are: (1) The *Triple Weaknesses* – a weak bond market, weak yen, and weak stock market stemming from fears that Japan could lose its fiscal discipline, (2) China's shadow banking problem, (3) tumult in the economies of emerging nations in response to the US exit strategy, and (4) a worldwide decline in stock values due to geopolitical risk.

2.1 Risk (1): The *Triple Weaknesses* – a weak bond market, weak yen, and weak stock market stemming from fears that Japan could lose its fiscal discipline

Postponement of the additional consumption tax hike triggers a host of new problems

The first risk we examine here is The *Triple Weaknesses* – a weak bond market, weak yen, and weak stock market stemming from fears that Japan could lose its fiscal discipline

Implementing monetary easing measures while at the same time forfeiting fiscal discipline is indeed an action tinged with monetization. If the bond market were to suddenly drop (which means a major increase in the long-term interest rate), there would be danger of a situation occurring where a malignantly weak yen and rising import prices would go unchecked, and which would in turn run into stagflation.

Five structural changes in Japan's economy

The Japanese government must steadily work toward fiscal reconstruction, keeping in mind the dramatic changes in the environment Japan will find itself in further up the road. As shown in Chart 4, the economic environment influencing Japan will likely see the following five structural changes: (1) an expanding fiscal deficit, (2) a dwindling current account surplus, (3) the shift from a strong yen to a weak yen, (4) the move from deflation to inflation, or stagflation, and (5) a change in the declining long-term interest rate to rising interest rates. The danger is that these five factors could suddenly occur all at once, upsetting Japan's entire economy. These structural changes would cause a huge shock to the system.

Japan's population is now aging faster than any other country in the world and this brings greater risk of a major increase in the fiscal deficit.

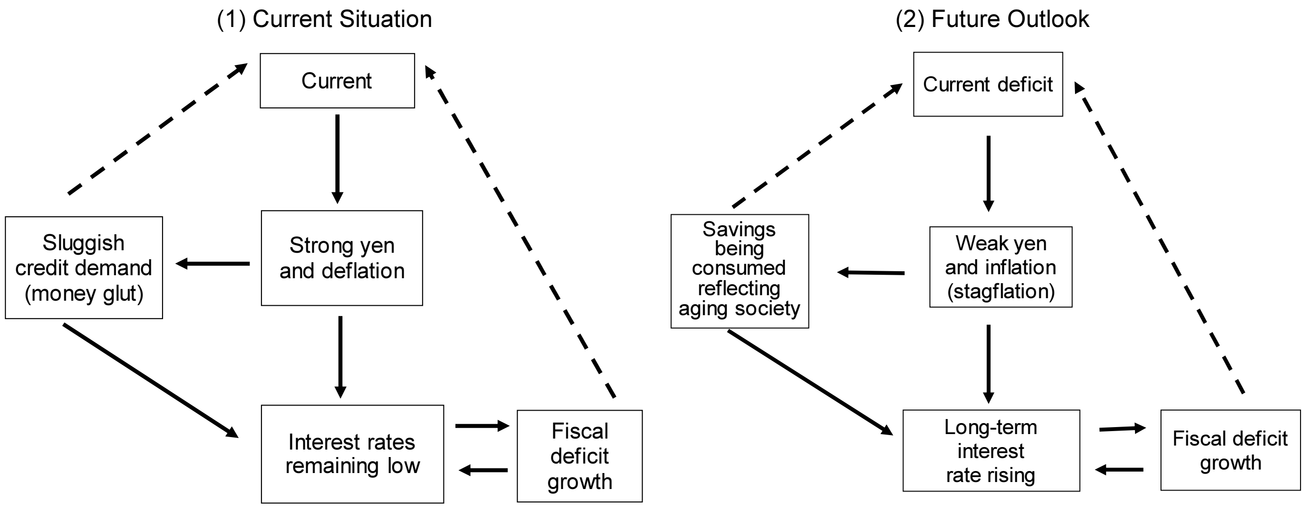
Then the increase in fiscal deficit would bring with it a decline in current account surplus as the public sector's condition worsens, causing the investment-savings balance to crumble, meaning the public sector would lose the capital surplus it needs. (In macro-economics the desirable equation to achieve is current account balance (excess savings in international trade) = fiscal balance (excess savings in the public sector) + excess savings in the private sector.

Meanwhile, the yen would continue to weaken on the foreign exchange markets if the following were to occur: (1) the timing of the BOJ's shift to monetary restraint is seen as being too far behind similar actions of central banks in other countries and (2) Japan's current account surplus shrinks.

As a result of the BOJ's qualitative and quantitative monetary easing measures, Japan is now moving quickly to the point where it will experience a shift from deflation to inflation. The danger here is that if fiscal discipline is lost, the yen rate could diverge from Japan's economic fundamentals and fall considerably against other currencies, aggravating imported inflation pressure and putting the squeeze on Japanese pocketbooks.

Finally, there would be an increasing risk of Japan's government bond bubble bursting if the above issues all came to a head at once. In this environment, the collapse of the government bond market is always there, hovering nearby.

Changes in Japan's Economic Environment **Chart 4**



Source: Compiled by DIR

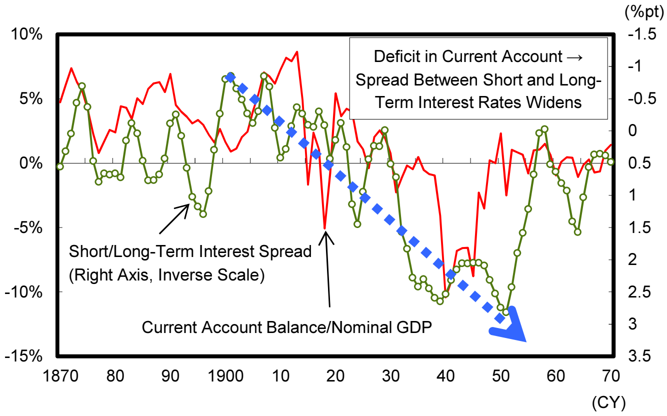
Spread between short and long-term interest rates widens when current account balance worsens

Historical data tells us that when the current account balance worsens, the spread between short and long-term interest rates tends to widen.

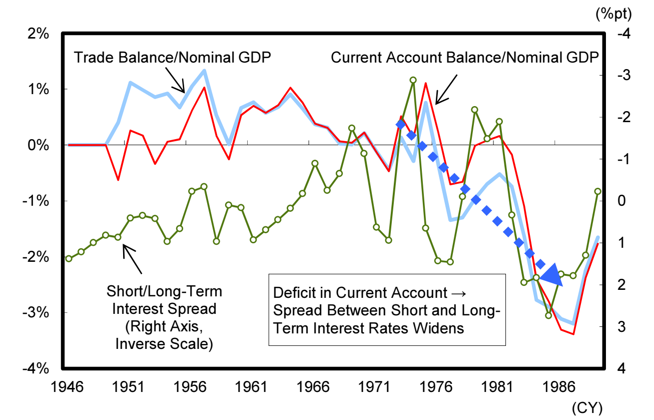
Chart 5 shows changes in the spread between short and long-term interest rates during periods when there were deficits in current account in the UK and the US (UK: 1920-1940, US: 1970-1980). In both cases, the spread between short and long-term interest rates rapidly widened. Considering the cumulative increases Japan has already experienced in its fiscal deficit, we should remain on the lookout religiously for the possibility of a rapid increase in the spread between short and long-term interest rates as soon as signs develop of a deficit in current account in the future.

Current Account Balance and Spread Between Short and Long-Term Interest Rates (UK & US) **Chart 5**

UK



US



Source: International Historic Statistics, by Brian R. Mitchell (Palgrave Macmillan), A History of Interest Rates; compiled by DIR.
Note: Long-term interest rate expressed in terms of 3-qtr moving average.

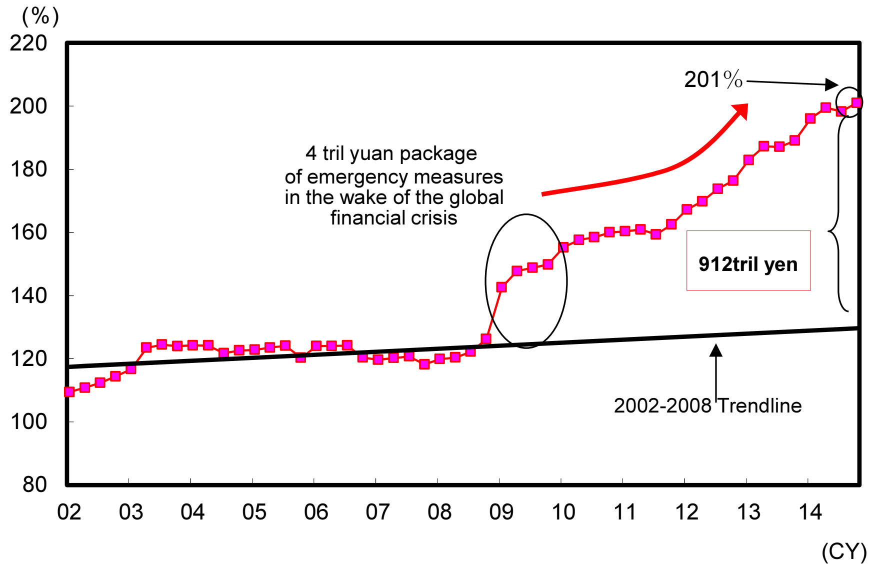
Source: Historical Statistics of the United States; compiled by DIR.

2.2 Risk (2): China's shadow banking problem

The second major risk facing Japan's economy is China's shadow banking problem

Excessive lending has become a problem in China in the wake of its response to the global financial crisis in 2008. Chart 6 provides an estimate of total social financing in China as a proportion of China's GDP. Such financing jumped from its long-term trend in 2009 and has continued to expand, reaching 201% of nominal GDP at the end of December 2014. Comparing current levels to the long-term trend, we estimate excessive lending in China to be around Y912 trillion. Should part of these assets become non-performing, this could cause major turbulence in China and global financial markets. Risk scenarios that should be kept in mind include (1) China drawing down its foreign currency reserves (around $3.9 tril) to deal with non-performing debt, causing long-term interest rates to surge in the US, and (2) the yen appreciating from a global flight to quality.

China's Total Social Financing (% of GDP) **Chart 6**



Source: People's Bank of China, National Bureau of Statistics of China; compiled by DIR.
Assumption: Outstanding balance of total social financing as of end-Dec 2001 to be 1.1 times bank lending.

2.3 Risk (3): Tumult in emerging markets in response to the US exit strategy

The US exit strategy will be a plus for the Japanese economy

The third risk factor facing Japan's economy is the question of whether or not the US exit strategy will cause tumult in the emerging markets.
In this section we contemplate how the global financial markets have been evaluating the US exit strategy since 2013.

We believe that the US exit strategy will hold many beneficial points for the Japanese economy. Possibilities are good that the US long-term interest rate will rise gradually in a mirroring of the recovery in the actual economy. Chart 7 shows changes in the US long-term interest rate and TOPIX. Movements of these two indices have fairly close linkage.

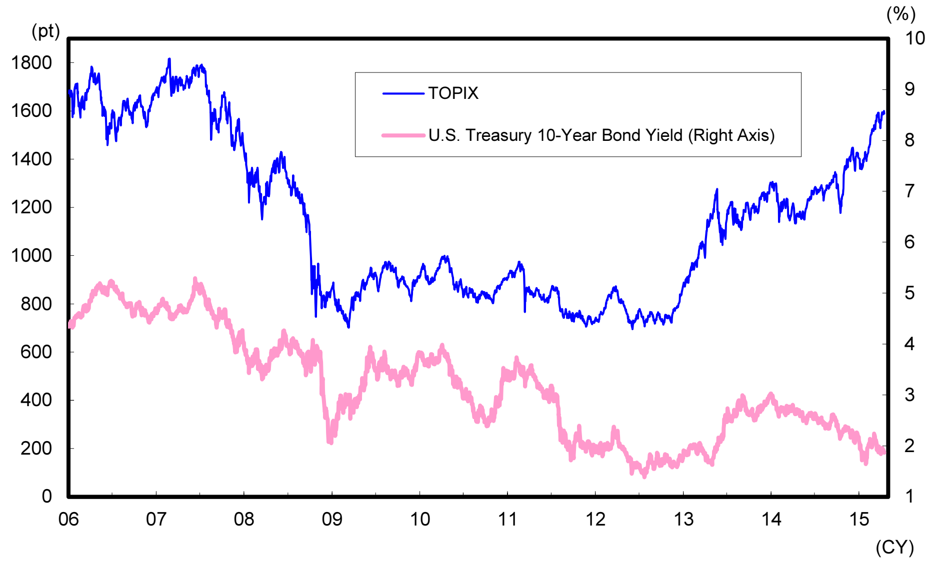
The question is why are the US long-term interest rate and Japanese stocks so closely linked?

The first reason is that the difference between US and Japan interest rates widens the more the US long-term interest rate rises, and this becomes a factor in the current weak yen/strong dollar relationship. As yen depreciation progresses, the amount of exports that Japan's corporations can achieve grows.

The second reason is that when the US long-term interest rate is tending upwards, it is usually because the US economy is strong. A favorable US economy provides fundamental support for Japan's overall exports.

Finally, if the FRB gives its official stamp to the recovery of the actual US economy, allowing for the moving ahead of a serious exit strategy, this will provide more confidence in the economy. FRB chair Janet Yellen recently announced that she would gradually move forward with an exit strategy while carefully observing the recovery in the actual economy. In conclusion, we believe that any risk of the FRB's exit strategy being too fast, hence leading to major confusion in the international markets, especially emerging nations, is extremely limited.

TOPIX and U.S. Treasury 10-Year Bond Yield **Chart 7**



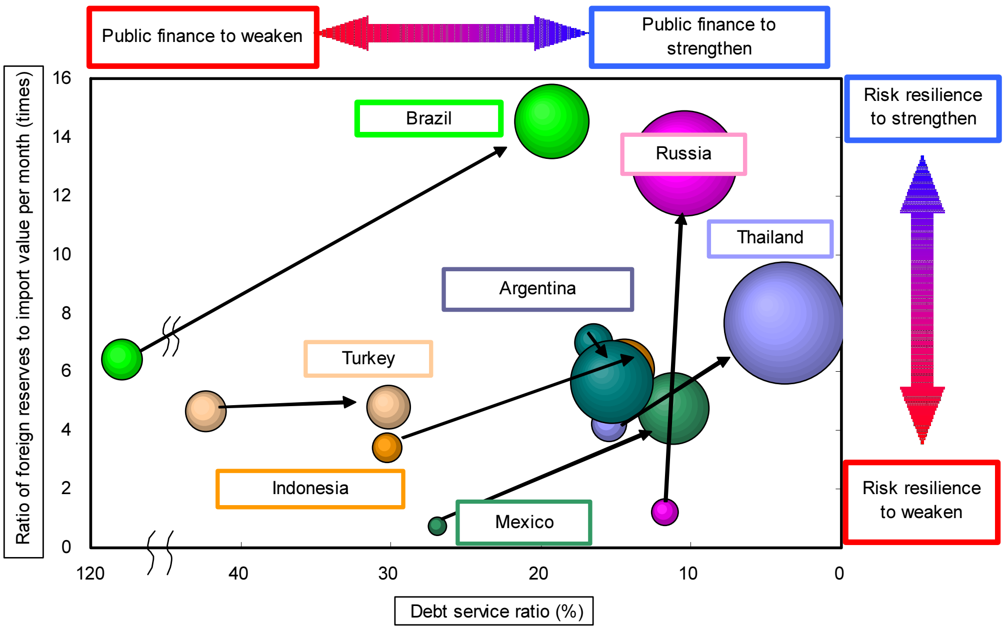
Source: Tokyo Stock Exchange and FRB; compiled by DIR.

Possibility of a serious crisis in emerging economies is limited

We believe there is a limited possibility that emerging economies will experience a serious crisis similar to the Asian currency crisis in 1997. Chart 8 depicts changes in risk resilience of emerging market nations from the year each nation experienced a financial crisis. Learning from past financial crises, these nations have amassed huge foreign currency reserves. Not only has the absolute size of such reserves increased, but the size of foreign currency reserves relative to goods and services imports (vertical axis) and that relative to short-term foreign debt (the sizes of circles) have also improved for most nations. Moreover, the debt service ratio, defined as debt service payments for external debt as a percentage share of good and service exports, a leading indicator used to determine country risk, has fallen for the most part (conditions have improved) since the financial crisis.

As far as we can see from this chart, the possibilities of turmoil occurring in the world financial markets after January 2014 are rather slim. The ignition point for the last crisis was Argentina, but it seems to be an exception. Looking at the emerging nations overall, we see steady improvement in the fundamentals.

Risk Resilience of Emerging Market Economies **Chart 8**



Source: Haver Analytics; compiled by DIR.
Notes: 1) Arrows denote shift of positions at critical moments to 2012.
2) Year of crises defined as 1994 for Mexico, 1997 for Thailand and Indonesia, 1998 for Russia, 1999 for Brazil, 2001 for Turkey, and 2002 for Argentina.
3) Size of circles shows ratio of foreign reserves to foreign debt with less than one-year maturity. The larger the circle, the greater the resilience.

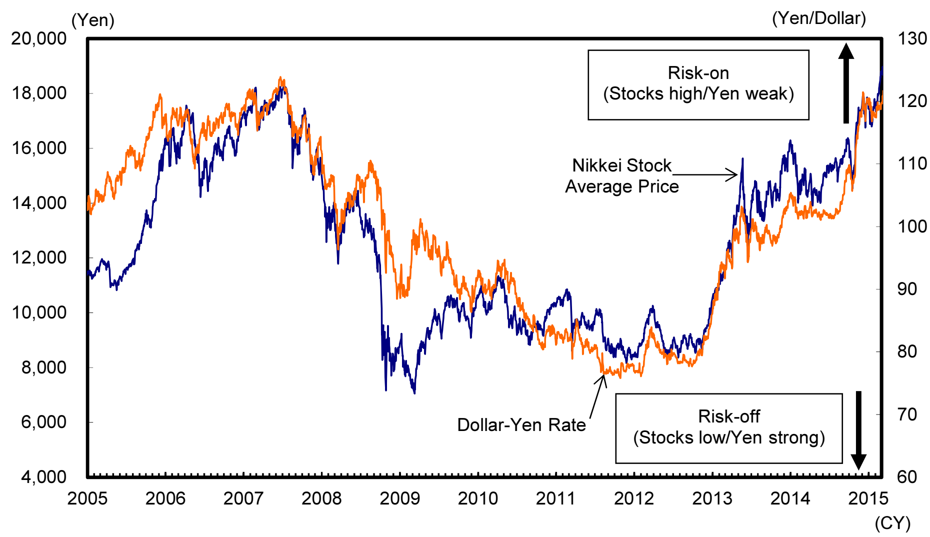
2.4 Risk (4): A worldwide decline in stock values due to geopolitical risk.

Will investors switch from risk-on to risk-off?

The fourth risk factor which the Japanese economy faces is geopolitical.

When the sense of caution increases in the business world due to geopolitical risk, the global financial markets tend to move away from risk-on to risk-off investment behavior. Chart 9 shows changes in the yen/dollar rate and the Nikkei stock average price over the last several years. In recent years, the yen exchange rate and the Nikkei average have exhibited a close linkage. As the global economy has begun to recover, investors have shown more willingness to take risks in their investments. This is called "risk-on" behavior. The Bank of Japan's bold monetary easing measures have also had an effect on investor behavior, and ever since the last part of 2012, investors have acted with a positive, risk-on behavior. The weak yen and rising stock prices have been moving in tandem since that time. In the future, caution in regard to geopolitical risk may encourage investors to switch to a risk-off approach, and the yen could strengthen again, influencing Japan's export business negatively. If this occurs, caution will also be necessary in regard to downward pressure on personal consumption due to falling stock prices.

Dollar-Yen Rate and Nikkei Stock Average **Chart 9**



Source: Bloomberg, Nikkei; compiled by DIR.

Economic Indicators and Interest Rates **Chart 10**

	2014	2015				2016	FY13	FY14	FY15	FY16
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
Indicator	Actual	DIR estimates					Actual	DIR estimates		
Real GDP										
Q/q %, annualized	1.5	2.9	2.2	1.9	1.7	1.8				
Y/y %	-0.8	-1.4	1.0	2.2	2.2	2.0	2.1	-1.0	1.9	1.8
Current account balance SAAR (Y tril)	9.9	16.4	16.9	17.5	18.2	18.7	0.8	8.1	17.8	19.0
Unemployment rate (%)	3.5	3.4	3.3	3.3	3.3	3.3	3.9	3.5	3.3	3.2
CPI (excl. fresh foods; 2010 prices; y/y %)	2.7	2.2	0.1	-0.0	0.4	0.9	0.8	2.8	0.3	1.1
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; %)	0.40	0.34	0.40	0.45	0.50	0.55	0.60	0.41	0.48	0.65

Source: compiled by DIR.
Note: Estimates taken from DIR's *Japan's Economic Outlook No.184 Update*.