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Japan's Economy: Monthly Review

Why Has Personal Consumption Remained Stagnant?

Though domestic factors are responsible for holding down economic performance, global economic factors continue to bring downside risk

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Summary

- **Downside risk remains for the Japanese economy due to global economic factors:** In light of the 2nd preliminary Jan-Mar 2016 GDP release (Cabinet Office) we have revised our economic growth outlook. We now forecast real GDP growth of +0.7% in comparison with the previous year for FY16 (+0.8% in the previous forecast), and +0.7% in comparison with the previous year for FY17 (-0.1% in the previous forecast). Japan's economy remains in a lull, but we expect it to recover gradually due to the following domestic factors: (1) growth in real wages, (2) low price of crude oil and improvement in terms of trade, and (3) the supplementary budget. However, caution is needed regarding downside risk in the global economy, especially that of China. Furthermore, it should be noted that in our previous outlook we assumed that the increase in consumption tax planned for April 2017 would ultimately take place. However, Prime Minister Abe announced on June 1st that the increase in consumption tax would be postponed, hence our current outlook assumes that the tax hike will be postponed. (More detail on this subject can be found in *Japan's Economic Outlook No. 189*, *Update (Summary)*, June 17, 2016, by Mitsumaru Kumagai.)

- **Why Has Personal Consumption Remained Stagnant?:** It would not be an exaggeration to claim that the most important challenge currently facing Japan's economy is to get personal consumption back on the road to recovery from its recently stagnant condition. In this report we consider possible prescriptions for the revitalization of personal consumption, looking at consumers by age group and income after first examining trends in personal consumption since the introduction of Abenomics. Quantitative results provide fundamental support for the implementation of income support policies directed toward the young and persons with low-income, who did not contribute to the upsurge in personal consumption after the introduction of Abenomics. However, in order to encourage consumer spending amongst younger people in the mid to long-term, it is essential that improvements be made in the employment and income environment through various means, including a reform of the labor market.

1. Downside Risk Continues for the Global Economy

Japan's economic outlook revised

In light of the 2nd preliminary Jan-Mar 2016 GDP release (Cabinet Office) we have revised our economic growth outlook. We now forecast real GDP growth of +0.7% in comparison with the previous year for FY16 (+0.8% in the previous forecast), and +0.7% in comparison with the previous year for FY17 (-0.1% in the previous forecast). Japan's economy remains in a lull, but we expect it to recover gradually due to the following domestic factors: (1) growth in real wages, (2) low price of crude oil and improvement in terms of trade, and (3) the supplementary budget. However, caution is needed regarding downside risk in the global economy, especially that of China. Furthermore, it should be noted that in our previous outlook we assumed that the increase in consumption tax planned for April 2017 would ultimately take place. However, Prime Minister Abe announced on June 1st that the increase in consumption tax would be postponed, hence our current outlook assumes that the tax hike will be postponed. (More detail on this subject can be found in *Japan's Economic Outlook No. 189, Update (Summary)*, June 17, 2016, by Mitsumaru Kumagai.)

Real GDP growth rate revised upwards to +1.9% q/q annualized (+0.5% q/q)

The real GDP growth rate for Jan-Mar 2016 (2nd preliminary est) was revised upwards slightly to +1.9% q/q annualized (+0.5% q/q) in comparison to the 1st preliminary report (+1.7% q/q annualized and +0.4% q/q). Results were in accordance with market consensus (+1.9% q/q annualized and +0.5% q/q). Results brought only a small upward revision, but were in accordance with market consensus and hence no surprise. All in all, results went according to the DIR outlook, with Japan's economy remaining in a lull.

Japan's economy continues to face risk of possible downturn

There are no major changes to our main economic scenario for Japan. Although personal consumption is expected to continue its underlying strength due to improvements in the employment and income environment, the absence of a clearly driving force in the economy colors our basic economic scenario, which sees Japan's economy continuing to face risk of a possible downturn in the future. We urge caution regarding lingering risk factors which could have a negative impact on Japan's economy, especially the downturn in the Chinese economy, turmoil in the global financial markets in response the US exit strategy, and a strong yen / weak stock market situation brought on by risk-off behavior of investors. In addition, one should keep in mind the possible fluctuations in the economy which could occur due to the effects of the recent earthquake in Kumamoto. Prime Minister Abe announced at a press conference held on June 1st that the increase in consumption tax originally planned for April 2017 would be postponed. The main influence this decision has on the outlook for the real GDP growth rate (based on the fiscal year) is as follows: (1) FY2016 GDP will be revised downwards due to the absence of last minute demand which occurs prior to an increase in consumption tax, (2) Reactionary decline which usually occurs after the last minute demand phenomenon will be avoided, along with the effects of decline in real income which would have occurred if a tax hike had taken place, which also means that FY2017 GDP will be revised upwards, and (3) Overall GDP for FY2016-FY2017 will be revised upwards.

Personal consumption is likely to continue its downturn due to the reactionary decline following the initially positive effects of the leap year, and the effects of the Kumamoto earthquake. However, with the exception of these special factors, there is an overall positive note due to improvements in the employment and income environment. Hence we see personal consumption remaining flat. As for the question of income, real wages according to the monthly labour survey are beginning to make a comeback, and with the number of employees increasing, real employee compensation (real wages x employment) in the macro sense is exhibiting major growth. Meanwhile, the positive employment environment and the shortage of manpower in certain areas of the non-manufacturing industry will

likely lead to the gradual increase in part-timer pay. In addition, the effect of a slower growth rate in the consumer price index promises to continue pushing up real wages, and this should be a factor in providing underlying support for personal consumption. Factors to keep in mind are worsening consumer confidence due to falling stock prices and increasing uncertainty in regard to how personal income will be effected in the future as a result of fears of worsening corporate earnings associated with the strong yen. This could likely be a drag on personal consumption. Other developments to keep in mind are the pension revision rate which was raised in Fiscal 2015 for the first time in sixteen years, and which the government has decided to leave unchanged in Fiscal 2016, and the spring labor offensive in 2016, which may very possibly bring a smaller wage revision rate than in 2015 (final tally results +2.20%). In addition, regarding durable goods, it is quite possible that sales volume of smartphones may suffer a major decline as a result of changes in carrier rates and sales prices.

As for housing investment, signs of an increase are seen in new housing starts, a leading indicator for housing investment, and a gradual comeback is expected. Housing starts were recently held back by an increase in construction costs and sales prices. However, improvements in the employment and income environment, along with the historic lows in interest on housing loans are expected to work together in encouraging a gradual increase in the number of households considering purchase of a new home. Housing starts should also gradually increase. Housing investment is expected to recover to a growth trend in the future, though there is expected to be a time lag between the expected increase in housing starts and the subsequent recovery in housing investment.

As for capex, the gradual recovery is seen continuing, despite some ups and downs, due to the high level of corporate earnings, which provide underlying support for replacement and renovation investment. Favorable corporate earnings and the manpower shortage are expected to encourage replacement investment, labor saving, and energy saving, especially in the non-manufacturing industries. Meanwhile, restoration and reconstruction of production facilities lost or damaged in the recent Kumamoto earthquake are expected to contribute to growth in capital expenditure. However, as was stated earlier in our outlook, the manufacturing industries are still at risk of a downturn in the future, and caution is urged. Factors include the slowdown in the world economy, weakness in the corporate sectors of overseas economies leading to stagnation for exports, and the slow pace of recovery in personal consumption. Additional downward pressure on earnings is brought on by the strong yen, meaning that corporations delaying capex spending may increase in the future, especially amongst manufacturers.

Public investment is expected to continue to be weighed down by the shedding the effects of economic policy which provided support in the past, but progress is being made on the FY2015 supplementary budget and the FY2016 budget, so gradually the situation should bottom out. After that, the new focus on reconstruction associated with the Kumamoto earthquake should bring a gradual return to a growth trend. It should be noted that contracts and orders received, which provide the leading indicators for this area, are showing signs of a comeback.

Meanwhile, exports are expected to remain flat for a while longer, and then make a gradual comeback as overseas economies improve. The US and the EU economies are showing a firm undertone and should provide underlying support for exports. However, industrial sectors the world over are suffering from stagnant raw materials prices and excess production capacity. Overseas shipments of electronic parts and devices for smartphones are expected to continue to be sluggish. Considering this fact, the expected shift back into a growth trend for exports of goods will likely not come until after summer. In addition, the export of services, which had been favorable up to now, will be effected by the following factors: (1) The Chinese government has increased customs duty on goods purchased in foreign countries, causing fears that the “explosive buying” trend by Chinese tourists will likely take a rest, and (2) The number of tourists visiting Japan may decrease due to the recent Kumamoto earthquake. Looking at the current situation by region, we see that a firm undertone continues in US economic expansion centering on the household sector, bringing expectations for a recovery in Japanese exports centering on durables. As for the EU, the economy is expected to move gradually toward a comeback

due to the effects of the collapse of crude oil prices and additional monetary easing on the part of the ECB. Exports to the EU are expected to gradually recover to a growth trend. As for the Asian economy, electronic parts and devices for smartphones as mentioned above, as well as iron & steel and materials are expected to be a drag on performance due to China's excess production capacity. Asian exports are expected to continue on the weak side. As for China, whose economic slowdown continues, monetary easing and promotion of automobile sales are helping to lift the real economy, and the effects are beginning to show up in personal consumption and the service sector. There is a good possibility that further declines in consumption can be avoided in the area of consumer goods.

Risk factors facing Japan's economy

Risk factors for the Japanese economy are: (1) The downward swing of China's economy, (2) Tumult in the economies of emerging nations in response to the US exit strategy, (3) A strong yen / weak stock market situation brought on by risk-off behavior of investors due to geopolitical risk, and (4) The threat of UK exiting the EU (*Brexit*), and uncertainty regarding Greece. Our outlook for China's economy is optimistic in the short-term and pessimistic in the mid to long-term. Looking at China's economic situation in a somewhat reductive way, the fact is that China's government holds treasury funds totaling between 600 to 800 tril yen with which it is standing up to over 1,000 tril yen in excessive lending and over 400 tril yen in excess capital stock. China is expected to be able to avoid the bottom falling out of its economy for a little while, but in the mid to long-term, there is risk of a massive capital stock adjustment.

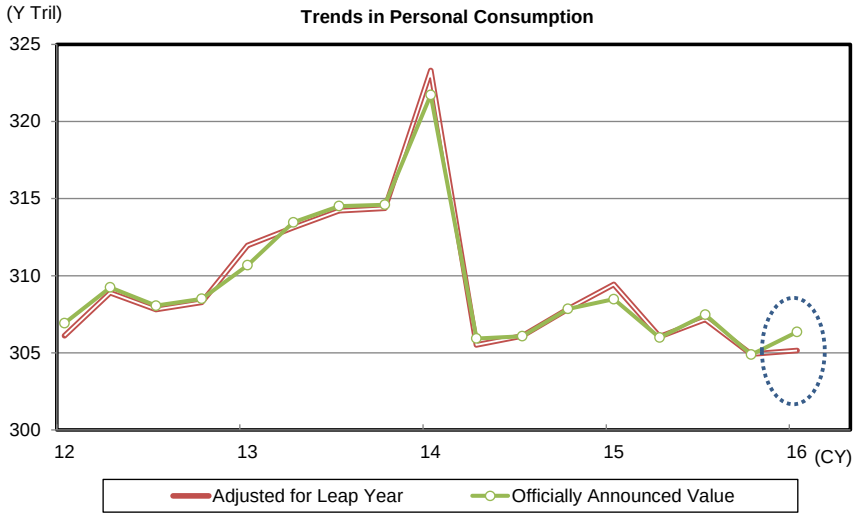
2. Why Has Personal Consumption Remained Stagnant?

2.1 Leap Year Factor Pads Personal Consumption

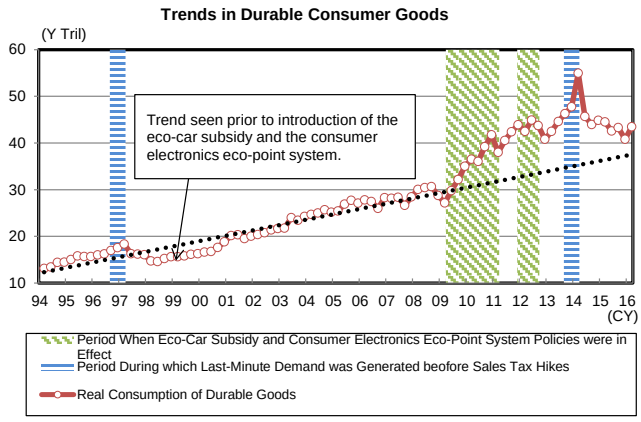
It would not be an exaggeration to claim that the most important challenge currently facing Japan's economy is to get personal consumption back on the road to recovery from its recently stagnant condition. Personal consumption on a GDP basis during the Jan-Mar period of 2016 increased in q/q terms for the first time in two quarters. However, the leap year effect had major influence on these results. When personal consumption is recalculated subtracting the extra days gained from the leap year, we see that it has continued to crawl along the bottom since the consumption tax hike of 2014 (Chart 1). It is our opinion that behind sluggish personal consumption lies two factors – that of increased adjustment in durable consumer goods due to various economic policies in the past, and the downtrend in non-essential services due to a decline in income confidence. (See *Japan's Economic Outlook No. 188, April 1, 2016*, by Mitsumaru Kumagai.)

On the other hand, when we look at personal consumption from a viewpoint other than categories such as goods and services, we find that there are other implications. In this chapter we examine personal consumption by age group and income level, and survey trends in personal consumption since the advent of Abenomics. In this way we hope to suggest prescriptions for reviving personal consumption.

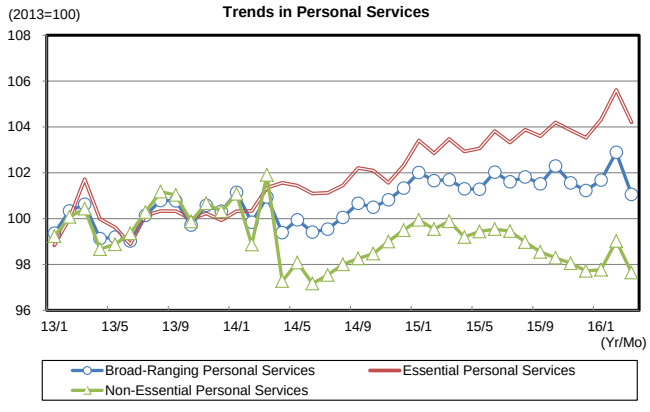
Overview of Trends in Consumption **Chart 1**



Source: Cabinet Office; compiled by DIR.



Source: Cabinet Office; compiled by DIR.



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

2.2 Trends in Consumption by Age Group and Income Level

Young adults and low-income bracket reap few benefits from Abenomics

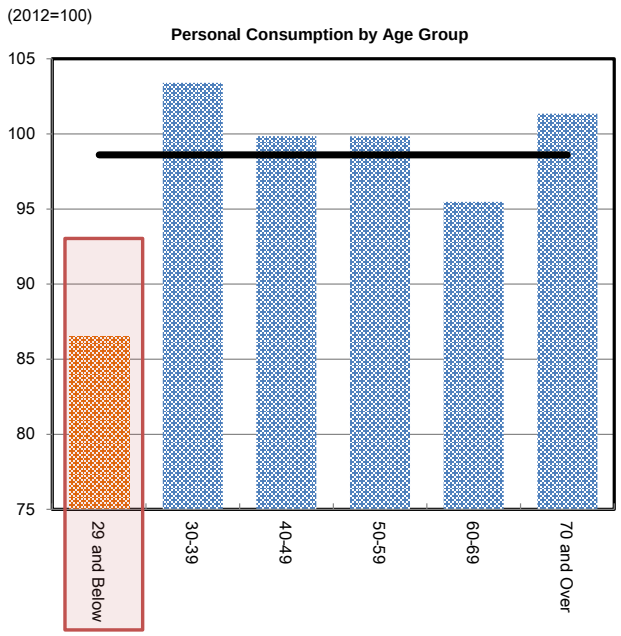
The initial effect of economic recovery through Abenomics was the increase in personal consumption as a result of the asset effect. However, the benefits from this improvement were not felt equally amongst the entire populace.

Chart 2 shows the difference between consumption expenditure in 2012 before the stock price highs due to Abenomics appeared, and recent consumption expenditure by age group and income level. The chart on the left is a comparison with other age groups. Especially notable is the decline in consumption expenditure amongst households in the 29-years-old-and-below bracket.

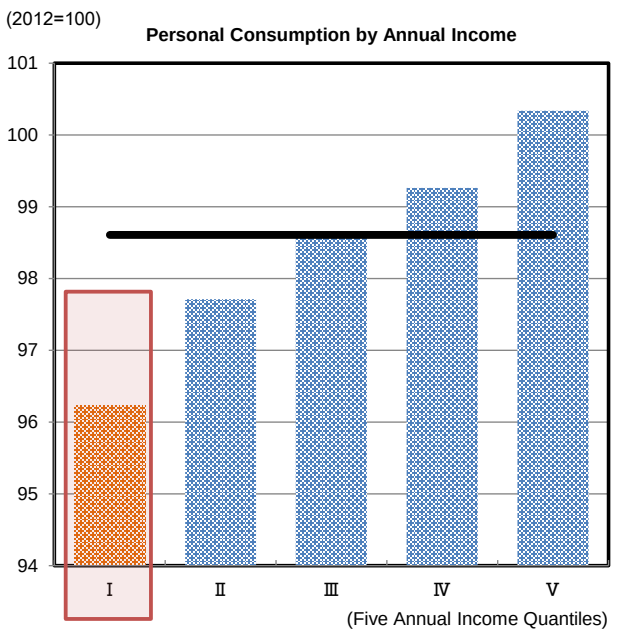
When the same analysis is performed on income brackets, we see that consumer expenditure amongst households in the first quantile is sluggish. The general understanding is that the higher the income the more financial assets held, hence there will be more cases in which a higher income household will have been able to reap the benefits of the asset effect. Since the year 2012, the higher the income bracket the more consumer expenditure has tended to expand. Meanwhile, looking at consumer confidence around the time of the last consumption tax hike by income level, we see that the higher income bracket maintained a steady undertone in consumer confidence, while consumer confidence in the low income bracket began to worsen before the consumption tax hike and continued at a low ebb for some time after the tax increase. This difference in consumer confidence suggests that consumers in the low income bracket may have experienced an increasing sense of resistance to the tax increase.

According to this analysis personal consumption was revitalized during the initial period of Abenomics due to the asset effect as seen from an overall macro-economic viewpoint. However young adults and persons in the low income bracket did not reap many benefits. It therefore follows that the key to getting personal consumption back on the road to recovery is for the government to give more attention to the young adult and lower income brackets, including the forming of an income support policy.

Personal Consumption by Age Group and Income Bracket (2016 Jan-Mar Period) **Chart 2**



Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Seasonal Adjustment by DIR. Thick bold line indicates average of all households.



Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Seasonal Adjustment by DIR. Thick bold line indicates average of all households.

2.3 Economic Effect of Income Support Policy for Young Adults and Low-Income Bracket Would be Large

Effectiveness of income support policy for young adults and low-income bracket backed up by quantitative data

Next we examine the question of whether or not an income support policy directed towards young adults and the lower income bracket can be rationalized not only from the viewpoint of providing aid for the socially disadvantaged, but from that of producing a positive economic effect. In this section we estimate consumption functions for age groups and income brackets and evaluate the characteristics of consumer behavior for each category.

The top portion of Chart 3 shows the estimation results of consumer expenditure for each age group. Here we see that the disposable income parameters for households in the 29 and under and 30-39 age groups are remarkably high. What this tells us is that an income support policy directed toward these two age groups in particular would have a much greater effect on increasing consumption expenditure through an increase in disposable income than would one directed toward other age groups. However, excessive dependence on an income support policy is to be avoided. This is because when it comes to the factor of anxiety regarding the future, the age 29 and below category has parameters well into the negative numbers. It will be several decades before this age group needs to make use of social security benefits such as pensions. There is a strong tendency in this age group to respond to anxiety regarding the future by holding down its consumption behaviors (or in other words increasing savings). Hence, though a short-term income support policy directed toward young adults may be valid, it would be necessary to design a clear-cut policy with a time limit in order to avoid this group's tendency to hold down consumption as a means of dealing with anxiety regarding the future.

Next we look at the bottom portion of Chart 3. Here we see that the low income bracket also has large parameters when it comes to disposable income, meaning that an income support policy for this group would be especially effective in revitalizing personal consumption. At the same time we see that the financial asset parameters of the high income group are also quite large. The high income group holds more financial assets such as stocks than any other group, indicating how large the asset effect has been. An income support policy directed toward the low income bracket could gain a positive reaction on the stock market causing stock prices to rise, thereby indirectly benefiting the high income bracket as well, due to the asset effect.

The above considerations suggest that an income support policy directed towards young adults and the lower income bracket, both groups which did not contribute much to the increase in personal consumption which occurred after the advent of Abenomics, would be economically effective, and that there is quantifiable data to support this hypothesis.

Consumption Function Estimation Results by Age Group and Income Bracket **Chart 3**

	Estimation of Consumption Functions by Age Group					
	Age 29 and Below	30-39	40-49	50-59	60-69	Age 70 and Over
Disposable Income	0.91***	0.97***	0.67***	0.79***	0.49***	0.46***
Financial Assets	0.08	-0.04	-0.05	0.16***	0.11	0.54***
Anxiety Regarding the Future	-0.32***	-0.11***	-0.15***	-0.06*	0.00	0.11
Trend Term	0.00	0.00**	0.00	0.00*	0.00***	0.00**

	Estimation of Consumption Functions by Income Bracket		
	Low Income	Middle Income	High Income
Disposable Income	0.85***	0.84***	0.75***
Financial Assets	0.15***	0.17***	0.26***
Anxiety Regarding the Future	-0.01	-0.02**	-0.07***

Source: Produced by DIR.
Notes: 1) The asterisks *, **, *** indicate that the coefficients are statistically different from zero at the 1%, 5%, and 10% levels.
2) The factor of anxiety regarding the future is Japan's outstanding obligations as a percentage of GDP.

2.4 Improvement in Employment & Income Environment for Young Adults through Labor Market Reform is Key

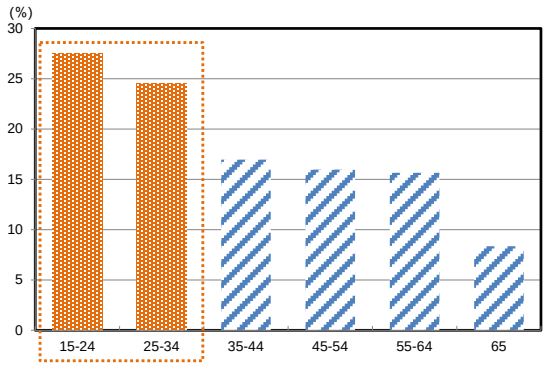
Labor market reform is essential in the mid to long-term

In order to encourage consumption expenditure amongst young adults in the mid to long-term, it is essential to bring about improvements in the employment and income environment. This is best done by implementing labor market reforms.

First of all it is important to decrease the number of instances where young adults find themselves in involuntary, irregular employment situations. Chart 4 shows overall irregular employees and the percentage of the total accounted for by people who are involuntarily in that type of employment. As becomes clear in looking at this chart, the ratio of young adults in involuntary irregular employment situations is extremely high – significantly more than any other age group. While irregular employment has the benefit of allowing one to work when it is personally convenient, it also has the disadvantage of being an insecure form of employment providing only a low wage. Behind this lies the fact that the introduction of the principle of equal pay for equal work in Japan has led to the polarization of the labor market into two extremes – regular employees with benefits and lifetime employment and irregular or non-regular employees who lack benefits and security, and who often work for much less. This system must be corrected. Improving the treatment of irregular employees is an urgent matter. Realizing reform and creating a situation where those now working as involuntary irregular employees can find a more satisfying work environment is expected to bring the additional benefits of removing worker anxiety regarding the future and an increase in wages and lifetime earnings. Ultimately it should also encourage the expansion of consumption expenditure.

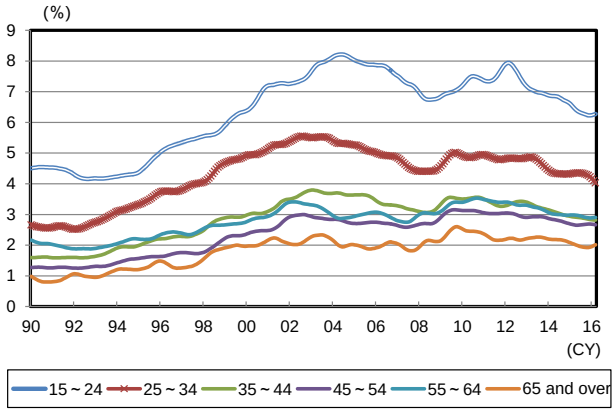
Next is the need to resolve the problem of mismatch. This is important as a means of decreasing the unemployment rate amongst young adults. Chart 5 shows structural and frictional unemployment by age group. In comparison to other age groups, young adults aged 15-24 and 25-34 have a higher structural unemployment rate. Looking at past trends as well we see that since the mid-1990s there has been rapid growth in structural unemployment amongst young adults. This gives us the impression that employment mismatch amongst young adults has been increasing over the long-term. If the problem of employment mismatch can be resolved and the longstanding unemployment rate amongst young people reduced, this should lead to an increase in income and a decrease in the sense of anxiety regarding the future in that age group. This promises to lead to the revitalization of personal consumption in that age group as well.

Involuntary Irregular Employee Ratio (2015) **Chart 4**



Source: Ministry of Internal Affairs and Communication; compiled by DIR.
Notes: 1) Number of irregular employees accounted for by individuals who became an irregular employee because there were no regular employee positions open.
2) Number of irregular employees in the 15-24 age group does not include individuals still going to school.

Structural and Frictional Unemployment Rates by Age Group **Chart 5**



Source: Ministry of Internal Affairs and Communication, Ministry of Health, Labour and Welfare; compiled by DIR.
Note: Estimated values calculated by DIR.

Economic Indicators and Interest Rates — Chart 6

Indicator	2015	2016				2017	FY14	FY15	FY16	FY17
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
	Actual		DIR estimates				Actual		DIR estimates	
Real GDP										
Q/q %, annualized	-1.8	1.9	0.4	1.1	1.3	0.6				
Y/y %	0.7	0.1	0.5	0.4	1.2	0.8	-0.9	0.8	0.7	0.7
Current account balance SAAR (Y tril)	19.2	19.8	20.2	20.4	21.0	21.4	8.7	17.7	20.7	23.0
Unemployment rate (%)	3.3	3.2	3.2	3.2	3.2	3.1	3.5	3.3	3.2	3.1
CPI (excl. fresh foods; 2010 prices; y/y %)	0.0	-0.1	-0.3	-0.1	0.2	0.7	2.8	-0.0	0.1	0.9
10-year JGB yield (period average; %)	0.29	-0.01	-0.10	-0.15	-0.20	-0.25	0.46	0.26	-0.18	-0.25

Source: Compiled by DIR.

Note: Estimates taken from DIR's *Japan's Economic Outlook No.189 Update (Summary)*.