Daiwa
Daiwa Institute of Research

30 May 2017 (No. of pages: 11)

Japanese report: 24 May 2017

Japan's Economy: Monthly Outlook (May 2017)

Growth expected to accelerate throughout FY2017; economy seen moving toward balanced growth in FY2018

Economic Research Dept.
Shunsuke Kobayashi

Summary

- In light of the 1st preliminary Jan-Mar 2017 GDP release (Cabinet Office) we have revised our economic growth outlook. We now forecast real GDP growth of +1.5% in comparison with the previous year for FY17 (+1.4% in the previous forecast), +1.1% in comparison with the previous year for FY18 (+1.1% in the previous forecast). Japan's economy is expected to see growth accelerate throughout FY2017 due to the following factors: (1) favorable overseas demand, and (2) support provided by inventory investment.

- However, accelerated growth supported by these positive factors could prove to be only temporary. According to our main economic scenario, we expect Japan's growth rate to slow gradually in FY2018. On the other hand, Japan's economy is expected to move toward balanced growth in FY2018 driven equally by both domestic and overseas demand thanks to (1) genuine improvement in the employment environment, and (2) growth driven by investments in improving productivity.

- Personal consumption is expected to continue moderate growth throughout the period covered by our outlook (FY2017 – FY2018). However, the driving force behind growth will differ for each of those years. The major factor behind growth in consumption in FY2017 will be the falling away of negative factors which inhibited growth in the past. On the other hand, in FY2018, genuine improvement in the employment environment affecting even regular employees is expected to result from the worsening manpower shortage. This is also expected to become the driving force behind growth in consumption.

- Capital expenditure is also expected to continue moderate expansion. Investment in various means of dealing with the worsening manpower shortage is expected to strengthen. Capex is expected to gain support from investments in labor-saving and rationalization associated with improving productivity, as well as research & development aiming toward improving earnings, and investments in upgrading and renovation.

In light of the 1st preliminary Jan-Mar 2017 GDP release (Cabinet Office) we have revised our economic growth outlook. We now forecast real GDP growth of +1.5% in comparison with the previous year for FY17 (+1.4% in the previous forecast), +1.1% in comparison with the previous year for FY18 (+1.1% in the previous forecast). Japan's economy is expected to continue balanced growth in the future due to the following factors: (1) favorable overseas demand, and (2) inventory investment providing support for accelerated growth throughout FY2017, leading to genuine improvement in the employment environment and growth driven by investments in improving productivity in FY2018.

We expect Japan's economy to continue in a moderate expansion phase. Domestic demand is expected to maintain favorable performance despite ups and downs, while overseas demand is expected to expand due to recovery in the world economy, providing major support for Japan's economic growth. However, downside risk remains for overseas demand requiring caution due to US trade policy and rising geopolitical risk. Meanwhile, we also urge caution regarding rising interest rates accompanying the slowdown of the US economy, and the problem of capital outflows from the emerging nations.

Personal consumption is expected to continue in a moderate expansion phase. The supply of labor remains tight, and this should provide underlying support for personal consumption through growth in employee compensation. However, the one worrisome point is that the CPI has been on the rise due to growth in the price of crude oil. If real wages stagnate due to the influence of prices, personal consumption could also be suppressed. Meanwhile, the government is encouraging corporations to increase base salary rates during the annual spring labor offensive in 2017. However, many corporations, which are becoming worried about future business performance, are taking the stance that they will raise annual salaries but not monthly wages. Housing investment is expected to gradually slow down. Interest on housing loans remains low, and therefore should provide continued underlying support. However, housing starts, which had rapidly expanded with the expectation that there would be a rush to purchase homes before the additional increase in consumption tax originally planned for April 2017, are expected to decrease in the future, especially for condominiums in urban areas, and housing investment is also expected to begin declining after that point.

Capex is expected to see moderate growth. Operating rates in the manufacturing sector have been on the rise since the latter part of last year due to the expansion of exports thanks to the recovery in the world economy. However, if uncertainty grows regarding the future of the world economy, corporations are likely to lose their willingness to invest in capex, hence caution is required. On the other hand, research & development which is in growth phase, is expected to continue pushing up overall capex figures in the future. Meanwhile, investment in labor-saving and rationalization due to the continuing labor shortage is expected to continue its growth trend centering on the non-manufacturing industries. As for public investment, we expect a gradual to accompany implementation of the government's second and third supplementary budgets.

As for exports, with overseas economies continuing moderate growth, we can expect exports to maintain a firm undertone. US exports appear to be about to peak out, while exports to the EU and Asia are maintaining a firm undertone. Exports of construction equipment and electronic parts to China are expected to maintain favorable orders. Exports to China are expected to be the driving force of exports overall.

However, caution is required regarding overseas demand due to possible downside risk. As for the US, the Fed implemented an interest rate increase in March 2017, and may raise rates multiple times during the rest of the year. Other issues include geopolitical risk such as rising tensions in North Korea. All of these risks require caution. Our main scenario sees the world economy continuing its moderate growth. However, if uncertainty grows regarding the future of the world economy, Japan's exports are likely to decline, bringing the risk of causing downward pressure on Japan's economy.

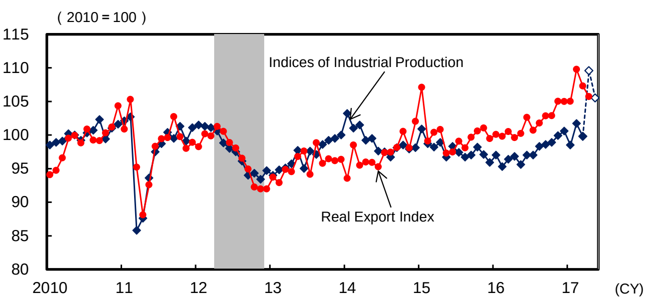
Growth Expected to Pick Up Pace throughout FY2017

Favorable overseas demand and inventory investment to become driving force

Japan's economy is expected to see accelerated growth throughout FY2017 with support from (1) favorable overseas demand, and (2) inventory investment. Japan's economy has recently moved into a major recovery and expansion phase. Chart 1 shows Japan's real exports and trends in the indices of industrial production. Industrial production continued in a trend of gradual decline since the beginning of CY2016, but then in the latter half of the year real exports bottomed out, and since then on average production has been expanding. Looking at trends in exports by destination, we see that exports to the US are maintaining favorable performance despite the sense that they are about to peak out. Meanwhile, exports to the EU and Asia are recovering and heading toward expansion. Behind the bottoming out of exports can be seen (1) favorable demand for consumer goods in the US due to improvements in the employment environment, (2) pent-up domestic demand rising to the surface in the EU as a result of the ECB's monetary easing, which lagged behind the US in its implementation, and (3) the emerging economies appear to be near bottoming out, centering on China whose economy had strengthened its downward trend as a result of capital outflows associated with the US monetary tightening.

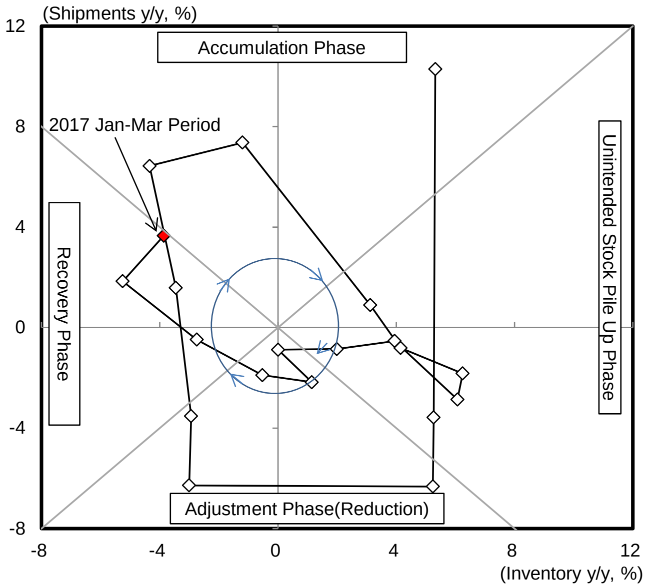
Of the above listed factors, (3) requires serious monitoring for the foreseeable future. China's economic comeback depends in part on the resurgence of real estate development which has again become the destination funds which have been retained in the domestic market as a result of suppression of capital outflows associated with the strengthening of restrictions on mobility of capital. This tendency can lead to recoil and adjustment risk in the future. Meanwhile, it appears that public investment is being used to shore up the economy with the meeting of the National Congress of the Communist Party of China just around the corner. There is a very good chance that this factor will no longer be contributing to the economy in CY2018 and beyond. Moreover, if the Fed further accelerates its tight money policy, capital outflows from the emerging nations including China could recommence, creating yet another factor leading to economic downturn.

Japan's Real Exports and Industrial Production
Chart 1



Source: BOJ, METI, and Cabinet Office; compiled by DIR
Notes: 1) Shaded areas represent periods of economic slowdown.
2) Values shown for most recent two months of industrial production are in accordance with METI's production forecast survey.

The Inventory Cycle
Chart 2

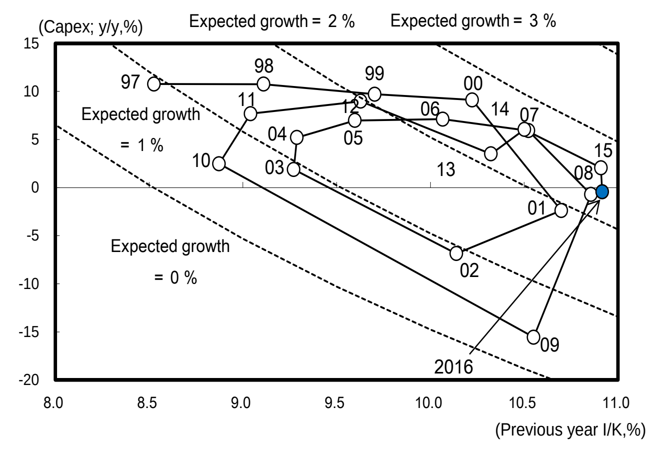


Source: METI; compiled by DIR

Meanwhile, the US itself is not immune to the risk of economic slowdown. First of all, judging from the Juglar Cycle, the mid to long-term cycle of the US economy, the six years lasting from 2010 to 2015 represent a capital stock accumulation phase, during which the economy is driven by growth in capital expenditure (Chart 3). However, as a result, no more margin is left for further expansion of capital expenditure. The US economy has entered the maturation phase. On the other hand, judging from the Kitchin Cycle (the short-term economic cycle), the US economy has just recently been in the inventory accumulation phase, which promises to act as a factor encouraging economic growth for the time being (Chart 4). However, this acts only as a short-term factor in speeding up growth. There is not much of a chance that it can continue beyond CY2018. In other words, both China and the US are currently performing favorably. However, it would be difficult to assume that either can keep up that growth in the long-term.

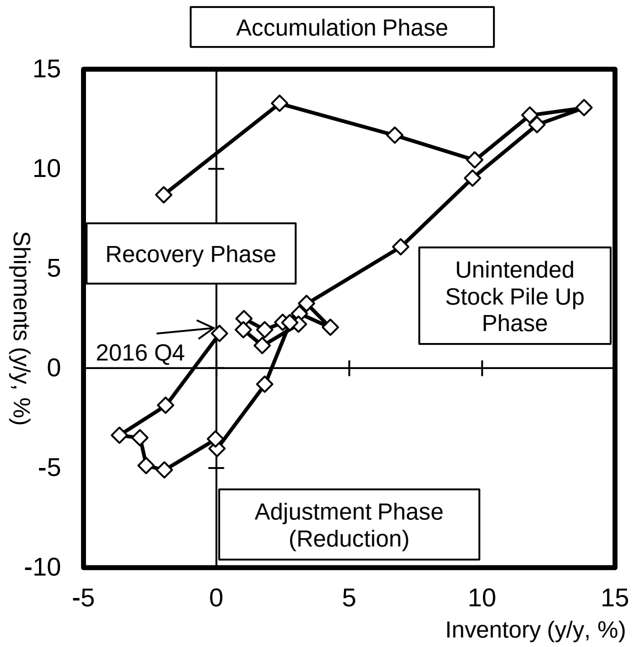
Next we take a look at the inventory cycle shown in Chart 2 above. Inventory adjustment was in the inventory reduction phase until the middle of CY2016. Then it reached the end of its cycle, and moved into the recovery phase, then back into the inventory accumulation phase. However, as mentioned above, this merely represents the short-term economic growth cycle. Therefore, most likely acceleration of growth supported by the two previously mentioned factors, (1) favorable overseas demand and (2) inventory investment, will only be a temporary phenomenon. According to our main economic scenario, Japan's economic growth rate will reach a peak during FY2017, and then head toward a gradual slowdown during FY2018.

US Capital Stock Cycle **Chart 3**



Source: BEA, Haver Analytics; compiled by DIR.

US Inventory Cycle **Chart 4**



Source: US Dept. of Commerce; compiled by DIR

Moving toward Balanced Growth in FY2018 Driven Equally by Domestic and Overseas Demand

Personal consumption to continue gradual expansion

As was mentioned in the previous section, Japan's economic growth will no longer be led by overseas demand. Instead, domestic demand will take over the role of providing support for growth. However, this may also result in uneven distribution of economic growth in terms of the extent to which growth spreads to regional economies. In this section we consider the question of personal consumption, the most important component in domestic demand. Our conclusion is that personal consumption will continue to gradually expand during the period covered by our outlook (FY2017 – FY2018). However, expansion of domestic demand will exhibit different patterns in FY2017 and FY2018. The major factor behind growth in consumption in FY2017 will be the falling away of negative factors which inhibited growth in the past. On the other hand, in FY2018, genuine improvement in the employment environment affecting even regular employees is expected to result from the worsening manpower shortage, and this will drive growth in consumption.

Three positive factors affecting personal consumption in FY2017

The major factor behind growth in FY2017 is expected to be the falling away of negative factors which inhibited growth in the past. The following three factors caused personal consumption to become stagnant in the past: (1) elimination of the special case pension category, (2) increased tax and insurance burden for the working-age generation, and (3) reactionary decline following past economic stimulus measures. These factors will lose their negative effects in the near future, bringing in their stead positive factors for the outlook for personal consumption.

First we take a look at (1) elimination of the special case pension category. Pension payment amounts are determined annually, taking into account the trends in prices and wages. However, despite the collapse in prices in the past, which normally would have meant a decrease in pension payment, the government implemented a special measure so that pensions were not cut and instead left as is until FY2012. Then as of FY2013, the special measure was eliminated, bringing a cut in pension payment per person. The special case pension category was eliminated in FY2015, and as of FY2016 the effect is no longer operating as a factor in holding down per capita pension payments. Taking into consideration the time lag which likely exists before the propensity to consume amongst the elderly population finally recovers, it seems that by now the effect of suppressing consumption should be gradually disappearing.

Next we examine the issues surrounding positive factor (2) Increased tax and insurance burden for the working-age generation. As is the case with pensioners, factors have appeared in recent years bringing pressure on disposable income for the working-age generation. Employee compensation grew around Y9.5 tril between FY2012 and FY2015. On the other hand, income tax also grew by around Y4 tril due to the growth in income, while in addition, social burden (employee's share of social insurance contribution) also grew by around Y3 tril, placing a restraint on growth in disposable income. Even if salaries grew in terms of face value the net amount did not grow, effectively putting a damper on consumption on the part of the working-age generation. The negative effects of the income tax rate being raised are expected to have played themselves out by the end of FY2016. Meanwhile, the annual rate of increase in insurance premiums is also near its point of peaking out. Overall, our view is that negative factors holding down the growth rate of disposable income in comparison to the growth rate of employee compensation will gradually fall away. Of course, the original source of this problem, Japan's low birthrate and aging population, will continue to be an issue. Hence, as long as there is no change in the general trend toward growth in social insurance burden, this problem will continue to reignite in the future. However, we can at least declare these factors as positive ones as of this point, which are expected to bring improvements in the outlook for disposable income for the duration of the period covered by our outlook, or for around the next 2-3 years.

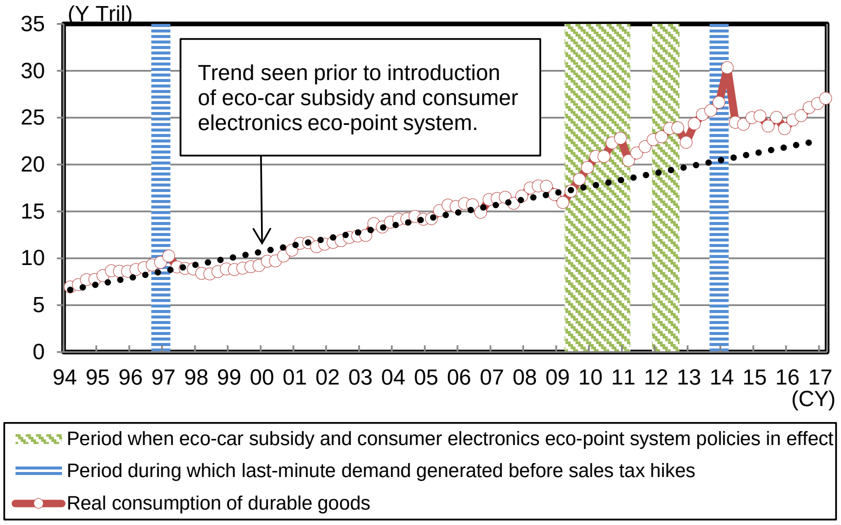
Finally, we take into consideration positive factor (3) Reactionary decline following past economic stimulus measures. The past economic stimulus measures discussed here are mainly Eco-car related tax breaks and the Ecopoint program effecting household electronics, which were implemented since the year 2009 after the global financial crisis hit in 2008.

Chart 5 shows variations in real consumer expenditure on durable goods since 1994. Looking at this chart it becomes evident that consumer expenditure on durable goods during the period covered by the Eco-car related tax breaks and the Ecopoint program, and the period lasting until the Jan-Mar period of 2014 (unrelated to economic measures) in which last minute demand occurred due to the increase in the consumption tax, recorded performance vastly exceeding past trends. On the other hand, when we consider the fact that real employee compensation was stagnant until the inauguration of the second Abe administration, we can conclude that expenditure on durable goods in contrast to income between the year 2009 up to just before the increase in consumption tax, was too high. In other words, there was preconsumption over demand in the area of durables as a result of economic measures. It is quite possible that a form of economic padding occurred. The reaction to this preconsumption over demand then appeared after the consumption tax was raised, and is thought to be related to the decline in expenditure on durable goods which occurred after that time.

At the same time, however, we can also conclude from Chart 5 that during the most recent three quarters, real consumer expenditure on durable goods has entered a recovery trend. About eight years have passed since the Eco-car related tax breaks and the Ecopoint program were first introduced, and it has been more than three years since the last increase in consumption tax. Now durable goods purchased when those economic measures were implemented are up for replacement, so it is possible that the market for durables may be on the way up again in the near future.

To summarize the above arguments, it is our opinion that personal consumption will continue to record moderate growth in the future for two reasons. First, real wages are expected to maintain growth, though their growth rate will likely slow down. In addition, negative factors which have held down personal consumption until just recently, including (1) Elimination of the special case pension category, (2) Increased tax and insurance burden for the working-age generation, and (3) Reactionary decline following past economic stimulus measures, have pretty much run their course.

Variations in Real Consumer Expenditure on Durable Goods **Chart 5**



Source: Cabinet Office; compiled by DIR.

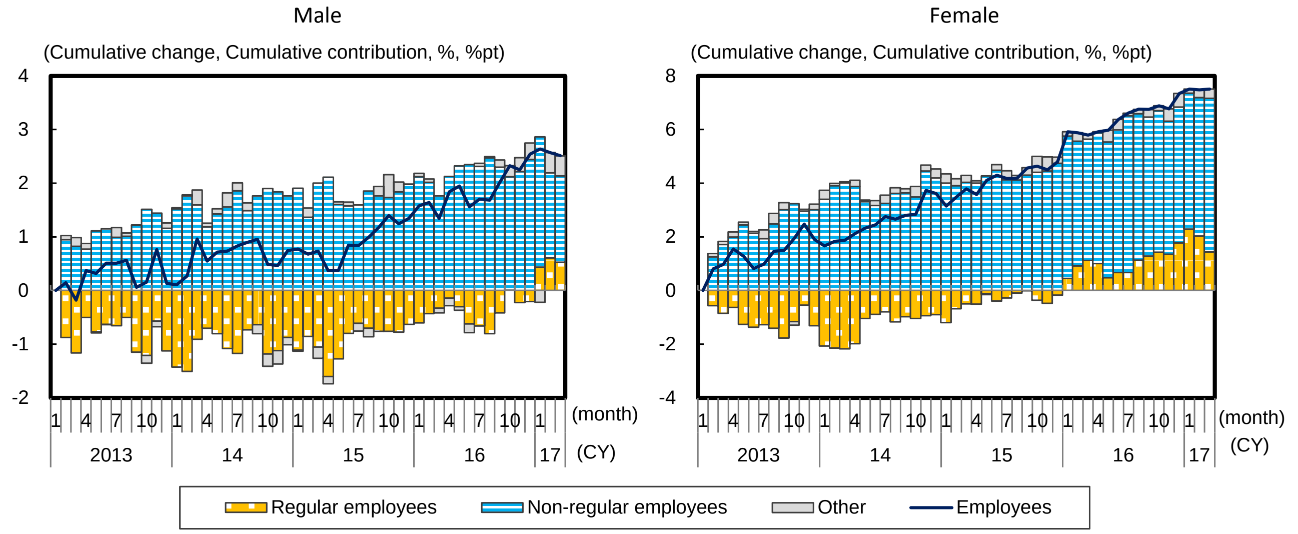
Countdown to Full-Fledged Wage Inflation

In FY2018 the consumption expansion effect due to the falling away of negative factors inhibiting consumption explained in the previous section will disappear. In its place a new factor will appear which is expected to drive expansion in consumption – that is genuine improvement in the employment environment affecting even regular employees as a result of the worsening manpower shortage.

Japan's economic growth has continued to exceed its potential growth rate, while at the same time corporate earnings have expanded to reach the highest levels recorded in the past, but hourly wages of regular employees have remained stagnant. On the other hand, part-time workers have seen improvements in hourly wage and employment. Behind this lies the fact that corporations have been cautious regarding the expansion of regular employment due to the strict regulations governing dismissal under Japan's unique lifetime employment system. Moreover, the hourly wages of part-timers have also been lower than regular employees in the past. But the tide has begun to change. Chart 6 suggests that since around the year 2016, non-regular employment has stopped growing, and instead, growth in regular employment has accelerated. One of the reasons behind this change is that the hourly wages of non-regular employees are no longer that much cheaper than regular employees. However, more importantly, this is one of the symptoms of Japan's having entered the era of chronic shortages in manpower. Over the past four years, Japan's working age population has declined by nearly four million, due to its low birthrate and aging population. Even so, the working age population has actually grown of late. The reason is that the employment rate has recorded major growth centering on women and the elderly. However, it would be difficult to expect major growth in the labor participation rate in the future. This is because the distinctive M curve associated with women's labor participation rate has disappeared after years of growth in women's employment, and has now reached about the same level as that seen in the US. We will have to accept that there is not much room left for further growth in women's labor participation rate.

In conclusion, the effective opening-to-application ratio for part-timers has reached an unprecedented level. Under these circumstances it has become difficult to find part-time workers, and hence corporations have begun, somewhat tentatively at first, to increase the number of regular employees. As corporations become more aggressive in their search for hires that will become regular employees, the effective opening-to-application ratio for regular employees also grows, having recently hit a historic high of 0.94x. If growth continues at the current pace, it would not be surprising if the figure exceeds 1x by some time during CY2017. Put in another way, these developments may indicate that the countdown to full-fledged wage inflation is already underway.

Factor Analysis of Employment **Chart 6**



Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Seasonal adjustment performed by DIR.

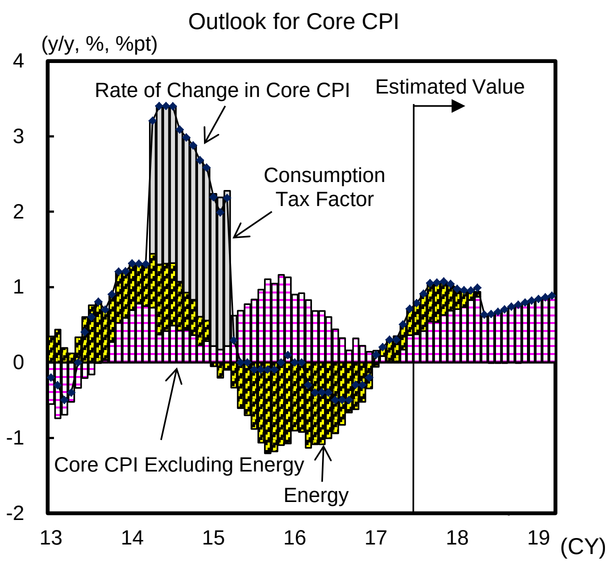
Genuine Improvement in Employment Environment Affecting Even Regular Employees to Become Factor in Accelerated Consumption in FY2018

Under these conditions, growth in employee compensation is expected to gather speed throughout FY2018. In addition, the inflation rate is expected to calm down, while real employee compensation moves toward further growth.

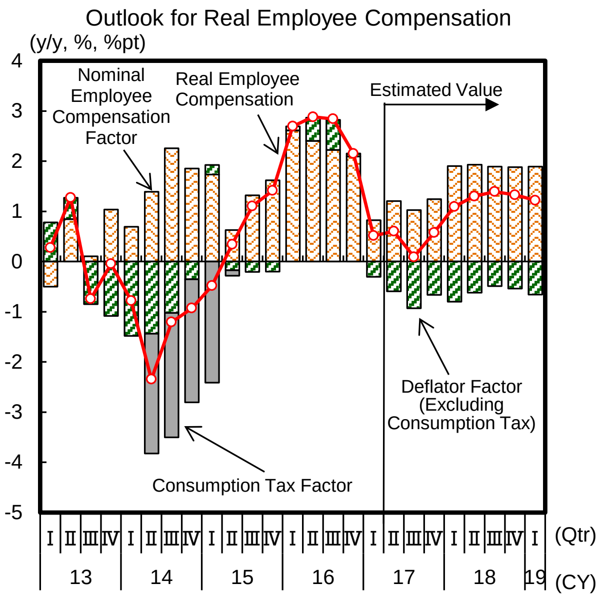
Chart 7 indicates that most recently, the pattern of growth of real employee compensation has become well-established, in which figures regularly exceed those of the same period of the previous year. This contrasts with the major declines occurring in FY2014 as a result of the increase in prices after the consumption tax was raised. This effect began to fall away once FY2015 got underway, while at the same time contributing to an increase in real wages. In addition to the positive factor of prices, nominal wages have also continued an upward trend due to the tight supply and demand situation for labor and increases in base salary. All of these factors have encouraged growth in real employee compensation. In addition to real employee compensation, the number of employees has increased regularly, reflecting corporate demand for labor centering on the non-manufacturing industry. This state of affairs has also brought upward pressure on wages in the macro sense.

As for future prospects for the employment and income environment, there is a very good possibility that the employment environment will continue to improve. In addition, upward pressure on wages will probably continue due mainly to the supply and demand situation for labor, which continues to be tight. However, as is shown in Chart 7, the price of crude oil is expected to recover in y/y terms during FY2017, and prices are expected to experience upward pressure as the yen becomes progressively weak. As a result, the growth rate for real wages is expected to gradually slow down. However, the suppression of real wages which usually accompanies rising prices is expected to disappear in FY2018. In addition, as was explained in the previous section, if genuine growth in wages begins, improvement in the capacity for households to consume will likely pick up speed.

Outlook for Inflation Rate and Real Employee Compensation **Chart 7**



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



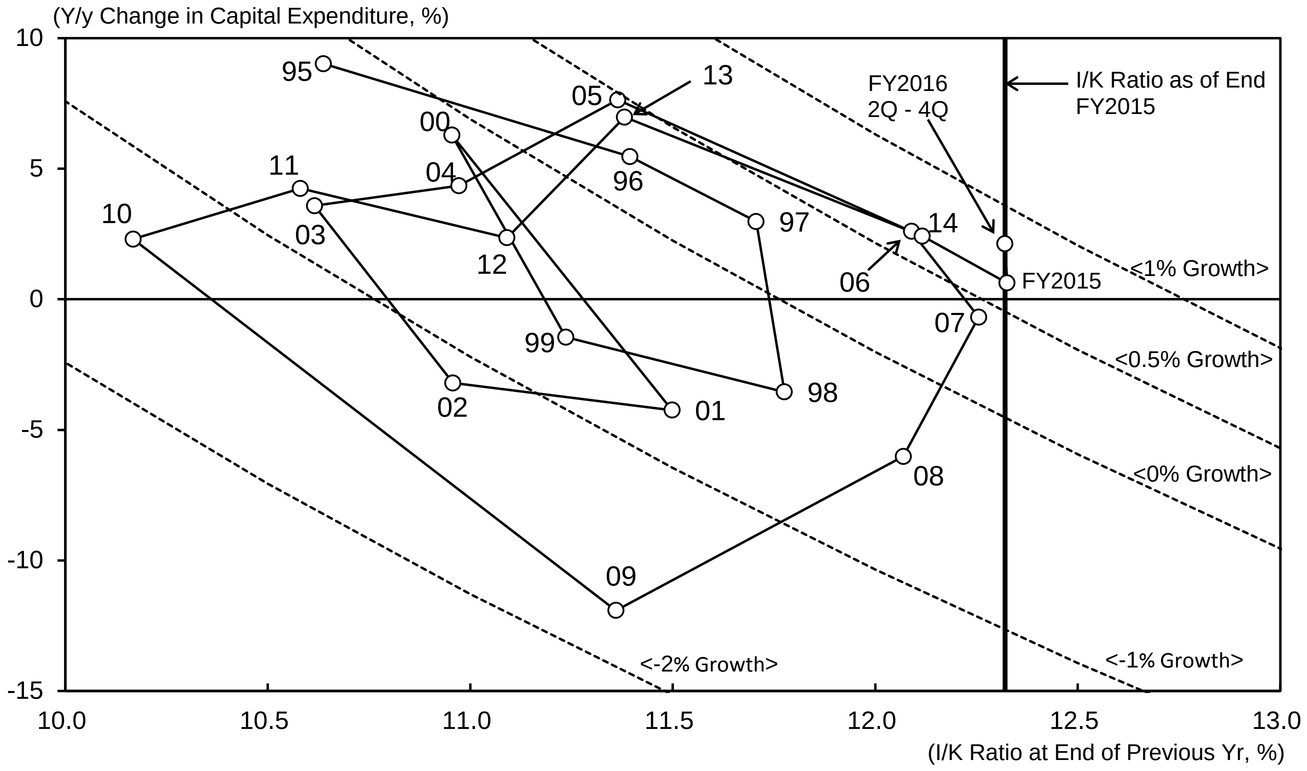
Source: Cabinet Office; compiled by DIR.

Capital Expenditure Expected to Maintain Steady Undertone Centering on Investments in Rationalization & Labor Saving

As was mentioned in the previous section, corporate incentive to carry out capital expenditure is strengthening, especially with an eye toward rationalization & labor saving investment due to the worsening labor shortage. Meanwhile, if full-fledged growth in wages occurs in the future, including improvement in wages of regular employees, unit labor cost will increase and become a factor in dragging down corporate earnings unless the increase in wages can be offset by improvements in labor productivity or by achieving more profitability. It is precisely here where investment in rationalization & labor saving finds its role in improving productivity, while investments in research & development, as well as upgrading and renovation, have as their purpose the improvement of earnings. Capital expenditure is therefore expected to continue moderate growth.

One of the problems which have been pointed out in recent trends in capital expenditure is that spending on capex has not grown as much as one might expect despite the fact that corporate earnings have been favorable. One of the aspects of this issue is illustrated in Chart 8, which indicates that, much like the situation in the US, Japan's capital stock cycle is now in the maturation phase. In addition, factory operating rates are at a lower level than they have usually been during past periods of growth in capital expenditure. In examining the correlation between components of corporate earnings and capital expenditure, we see that there is a close relationship between domestic sales volume and export sales volume. In contrast, there is not much correlation between variable costs and cost of production. In other words, while expansion of earnings attributable to the volume factor plays a major role in increasing capital expenditure, expansion of earnings attributable to the price factor does not. This tells us that in order to predict whether or not capital expenditure will move into full swing, we have to confirm that the following conditions have been met: along with growth in both domestic sales volume and export sales volume, factory operating rates must have exceeded a certain threshold and continue performing at that level.

Diagram: The Stock Cycle **Chart 8**



Source: The Bank of Japan.

Risk Associated with Fallacy of Composition

A final lingering problem is that of the possibility that we may unwittingly commit a fallacy of composition in moving from the micro to the macro. The idea that aggressive capital expenditure is required as a means of offsetting downward pressure on corporate earnings caused by wage increases originating in the shortage of manpower is one associated primarily with the labor intensive industries, mainly small and medium-sized enterprises in the non-manufacturing sector. However, the corporations which actually have more margin to become aggressive in capital expenditure are the large manufacturers.

The following provides a more detailed summary of the above issue. Small and medium-sized enterprises in the non-manufacturing sector which exhibit an especially strong sense of employment shortage are also high in labor's relative share. This means growing personnel expenses, which are thought to be a major factor holding down earnings. In addition, capital expenditure's elasticity value in comparison to corporate earnings is also great. Hence it may also be possible to deduce that capital expenditure is being held down by growth in personnel expenses since this leads to a decline in corporate earnings. On the other hand, labor's relative share in the case of large corporations in the non-manufacturing sector is low, though they also have a strong sense of employment shortage and are experiencing pressure from rising personnel costs as well. With labor's relative share at a low level, large corporations in non-manufacturing can avoid the worst of downward pressure on capital expenditure due to pressure on earnings. Meanwhile, there is not much chance that growth in personnel expenses will inhibit capital expenditure in the case of large manufacturers. The growth trend in capital expenditure in the macro sense is expected to continue, thanks to rising operating rates accompanying production growth and continued expansion of corporate earnings. This will likely center on large corporations, especially in the manufacturing industries.

Caution is advised regarding the risk involved in not carrying out improvements in labor productivity to match the increase in wages or in not carrying out capital expenditure as a result of having focused more on the macroeconomic view of spending versus income. This mistake results from the fallacy of composition, in which one naively assumes that what is true for a part is also true for the whole (micro vs. macro). Ultimately, capital expenditure is necessary in order for corporations to attain profitability. The result of not carrying out enough capital expenditure would be that if unit labor cost increases, corporations will be forced to make a choice between scaling down their business or suffering the hollowing out effect, or possibly even having to accept both. In this sense, a decline in labor input could result if work style reforms are implemented without sufficient improvements in productivity accompanying them. We advise caution here as this could cause a decline in the potential growth rate of Japan's economy.

Corporate Stance Toward Distribution of Profits **Chart 9**

(Component percentages of total number of respondents, %)

	Large Corporations			Middle-size Corporations			Small Corporations		
	All	Manufacturing	Non-Manufacturing	All	Manufacturing	Non-Manufacturing	All	Manufacturing	Non-Manufacturing
Capex	62.3	72.1	57.3	51.0	66.5	46.2	41.4	50.9	39.5
Research & development	26.6	47.0	16.2	20.5	31.3	17.1	15.7	30.4	12.8
Capitalization of associate companies, M&A	10.8	8.4	12.0	5.7	4.2	6.2	3.2	2.9	3.3
Reduce interest-bearing liabilities	19.2	21.4	18.0	22.7	26.2	21.6	26.6	27.8	26.4
Increase number of new employees	7.0	4.1	8.5	18.2	13.3	19.6	21.3	19.7	21.6
Profit-sharing with employees	27.7	24.9	29.1	41.9	40.1	42.4	54.6	56.9	54.1
Compensation, bonuses to directors	3.7	2.6	4.3	8.7	6.4	9.5	22.4	15.8	23.7
Dividend payout to shareholders	56.5	58.2	55.6	34.2	34.2	34.2	8.6	7.1	9.0
Retained earnings	55.2	42.0	62.0	58.8	48.2	62.1	58.3	48.3	60.3
Others	1.8	0.3	2.5	1.5	1.2	1.6	2.5	1.3	2.7

Source: Cabinet Office, Ministry of Finance; compiled by DIR.
Notes: 1) Questionnaire took place in Jan-Mar 2017 period, based on FY2016 business performance.
2) Component percentages of total number of respondents. Respondents were asked to provide answers to at least three out of a total of ten questions.

Economic Indicators and Interest Rates

Chart 10

Indicator	2016	2017				2018	FY15	FY16	FY17	FY18
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
	Actual		DIR estimates				Actual		DIR estimates	
Real GDP										
Q/q %, annualized	1.4	2.2	1.8	1.4	1.1	1.3				
Y/y %	1.7	1.6	1.6	1.7	1.6	1.4	1.2	1.3	1.5	1.1
Current account balance SAAR (Y tril)	20.6	18.4	20.2	21.1	21.7	22.0	17.9	20.2	21.5	23.0
Unemployment rate (%)	3.1	2.9	2.9	2.9	2.8	2.8	3.3	3.0	2.8	2.7
CPI (excl. fresh foods; 2015 prices; y/y %)	-0.3	0.2	0.5	0.9	1.1	1.0	-0.0	-0.2	0.9	0.8
10-year JGB yield (period average; %)	0.00	0.07	0.05	0.05	0.05	0.05	0.26	-0.05	0.05	0.10

Source: Compiled by DIR.