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# Japan's Economy: Monthly Outlook (Aug 2017)

## Domestic demand becomes driving force

Economic Research Dept.  
**Shunsuke Kobayashi**

### Summary

- In light of the 1<sup>st</sup> preliminary Apr-Jun 2017 GDP release we have revised our economic growth outlook. We now forecast real GDP growth of +1.9% in comparison with the previous year for FY17 (+1.5% in the previous forecast), +1.2% in comparison with the previous year for FY18 (+1.1% in the previous forecast). Overseas demand centering on exports to the US is expected to mark time, but Japan's economy is expected to continue growth led by domestic demand in the future due to the following factors: (1) growth in consumption due to improved employment environment, and (2) investment in improving productivity.
- Japan's economy in FY2017 is expected to see three factors which were the cause of stagnation in personal consumption in the past dissipate. These include (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. Meanwhile, incentive to carry out capital expenditure oriented toward dealing with the worsening manpower shortage is growing stronger. Overall capital expenditure will likely gain support from investment in rationalization & labor saving for the purpose of improving productivity, as well as investments in research & development, and upgrading & renovation for the purpose of improving of earnings. However, by FY2018 the effect this will have in helping to increase consumption is expected to fall away, and the environment for capex is expected to mature. Hence the pace of growth will likely slow down gradually at that time.

## Economic Outlook Revised: +1.9% in FY2017, and +1.2% in FY2018

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### Overseas Demand Cedes Leadership Role in Growth at Least for the Time Being

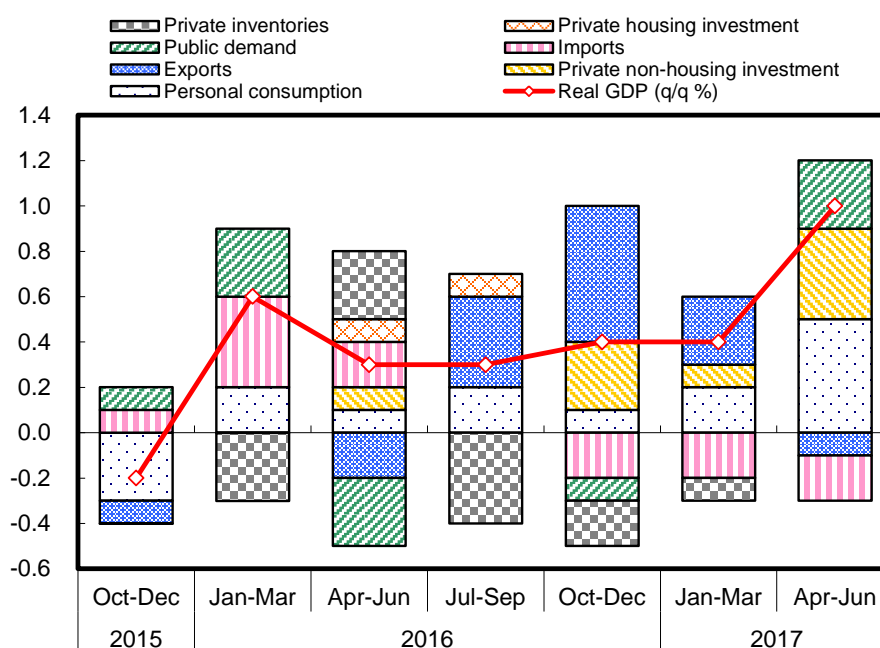
#### *Exports to US slack off while exports to China continue to expand, causing some anxiety*

Japan's economy is shifting increasingly from growth led by overseas demand toward growth led by domestic demand.

As is indicated in Chart 1, in FY2016 the larger portion of Japan's growth came from growth in exports. Looking at trends in exports by destination, we see that although exports to the US appeared to be close to peaking out, they still maintained favorable performance. Meanwhile, exports to the EU and Asia also notably show recovery and expansion. Exports bottomed out for the following reasons: (1) US demand for consumer goods was favorable due to improvements in the employment environment, (2) pent up demand rose to the surface in the EU last year after a period in which domestic demand was inhibited due to lagging recovery, and (3) emerging market economies bottomed out, centering on China where the tendency toward slowdown worsened due to capital outflows.

Contribution to Real GDP (% pt; seasonally adjusted basis)

Chart 1

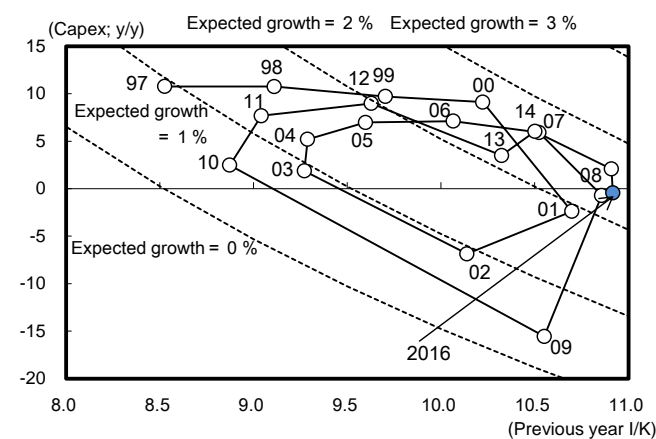


Source: Cabinet Office; compiled by DIR.

However, the assumptions behind this kind of expansion in exports are beginning to crumble. 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 2). 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. However, this acts only as a short-term factor in speeding up growth. There is not much of a chance that it can continue. As a result, Japanese exports to the US, especially their main export product, automobiles, now show signs of peaking out. Moreover, exports of parts and accessories to Asia (with the exception of China) for the manufacturing of products whose final destination is the US are also beginning to suffer from a slowdown.

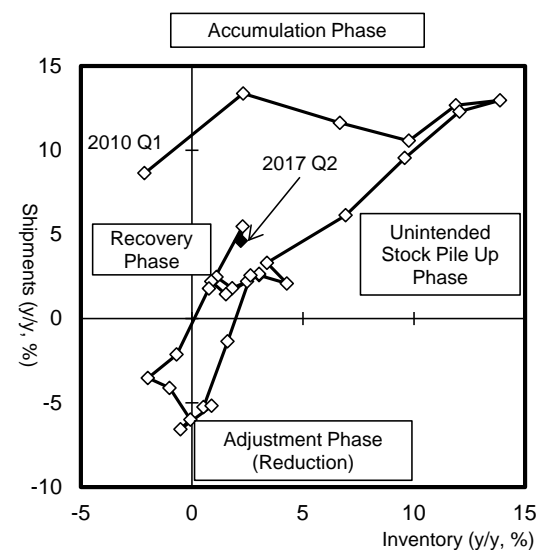
We also must take a careful look at china. One of the factors behind the resurgence of China's economy is the strengthening of rules restricting the movement of capital. This has inhibited capital outflows. Finally, capital which has been left to stagnate in domestic China, is put to use in real estate development and other investments. This activity brings risk of a reactionary decline or adjustment in the future. If these policies restricting movement of capital were merely put in place to please the National Congress of the Communist Party of China which meets this fall, then there is a good possibility that they will not continue, hence leaving open the possibility of a reactionary decline occurring in 2018 or later. Meanwhile, if the Fed further accelerates its monetary tightening policy, it could become a factor in slowing down the emerging nation economies even further due to the encouragement of capital outflows centering on China.

**US Capital Stock Cycle Chart 2**



Source: BEA, Haver Analytics; compiled by DIR.

**US Inventory Cycle Chart 3**



Source: US Dept. of Commerce; compiled by DIR

## Domestic Demand Becomes Driving Force

Overseas demand will mark time temporarily while domestic demand takes the role of providing underlying support for growth. In this section, we examine personal consumption, the most important component of domestic demand. In conclusion, personal consumption is expected to continue moderate expansion throughout the period covered by our outlook (FY2017-FY2018). However, the source of growth in domestic demand differs for each of these years. In FY2017, the main factor driving growth in personal consumption is expected to be the falling away of negative factors which inhibited consumption in the past. On the other hand, in FY2018 consumption is expected to continue to expand with improvements in employee compensation.

### *Three positive factors encouraging personal consumption in FY2017*

Japan's economy in FY2017 is expected to see three factors which were the cause of stagnation in personal consumption in the past dissipate. These include (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 consider (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, the government implemented a special measure so that pensions were not cut and instead left as is until FY2012. This also meant that pension amounts were higher than normal. 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, but income tax also grew by around Y2.6 tril due to the growth in income, then the raising of the maximum tax rate brought total growth in income tax to Y4 tril. In addition, social burden (employee's share of social insurance contribution) also grew by around Y3 tril. 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 expected to peak out in FY2017. 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.

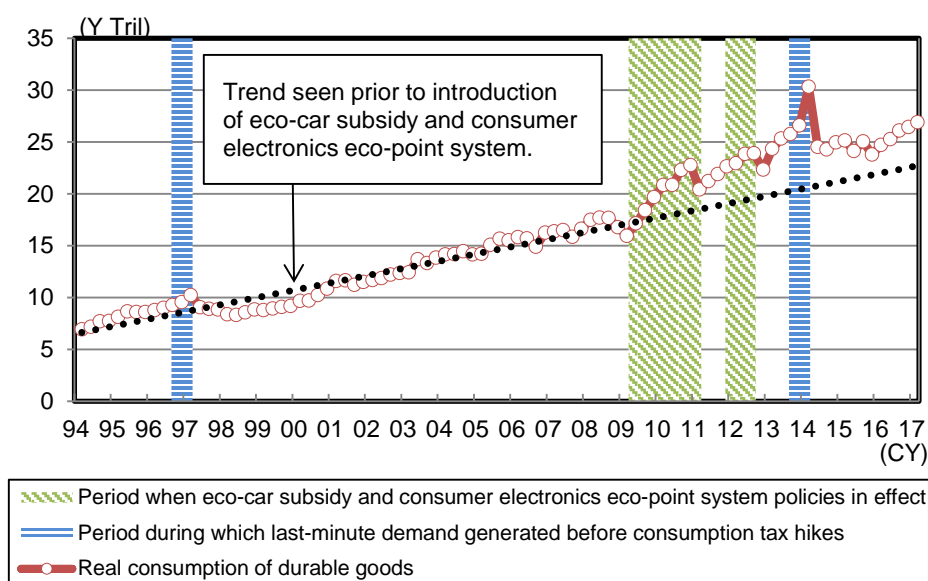
Finally, we take into consideration positive factor (3) reactionary decline following past economic stimulus measures. The past economic stimulus measures discussed here are mainly Eco-car related tax breaks and the Ecopoint program effecting household electronics, which were implemented since the year 2009 after the global financial crisis hit in 2008. Chart 4 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. At the same time, however, Chart 4 indicates that during the most recent six 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 over 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 as negative factors which have held down personal consumption until 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, run their course.

Variations in Real Consumer Expenditure on Durable Goods

Chart 4



Source: Cabinet Office; compiled by DIR.

### Countdown to Wage Inflation

Throughout FY2018 the consumption expansion effect due to the falling away of negative factors inhibiting consumption mentioned in the previous section is expected to disappear. In this section we consider the pace of improvement in employee compensation expected in the future. In conclusion, though there are localized incidents of wage inflation beginning to appear, there are still factors which offset this effect. We therefore are of the opinion that more time will be required before genuine improvement in the employment environment to the extent that a virtuous circle driven by domestic demand is triggered can begin.

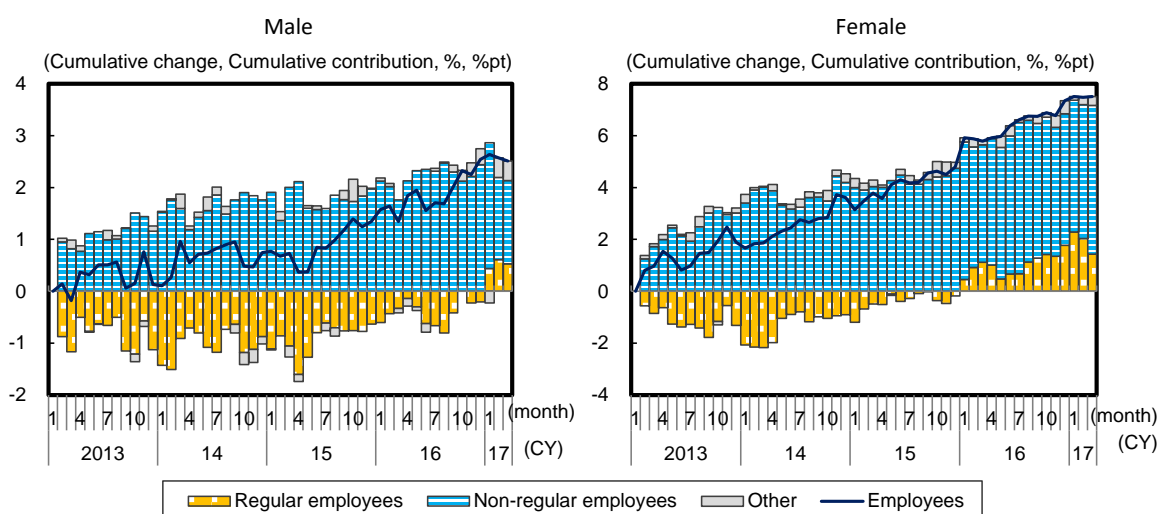
Japan's economic growth has continued to exceed its potential growth rate, while at the same time corporate earnings have expanded to reach the highest levels recorded in the past, but hourly wages of regular employees have remained stagnant. On the other hand, part-time workers have seen improvements 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 5 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 as much room left for further growth in women's labor participation rate as there has been in the past.

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 a result, the effective opening-to-application ratio for regular employees hit a historic high of 1.01x in June 2017, exceeding 1x for the first time. These developments may indicate that the countdown to wage inflation is already underway.

Factor Analysis of Employment

Chart 5



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

### ***Improvements in productivity are essential before a virtuous circle driven by domestic demand can be triggered***

However, there is still quite a bit of distance to cover before said wage inflation reaches the point of triggering a virtuous circle brought about by domestic demand. As was mentioned earlier, as growth in overseas demand comes to a temporary halt, possibilities are great that momentum of improvement in corporate earnings, which is the source of employee compensation and capital investment, will also enter a temporary lull.

First of all, simple wage inflation from the viewpoint of corporations is not only a factor bringing negative pressure on earnings, but could even lead to scaling down their business or to the hollowing out effect. Sustainable wage inflation depends on IT investment, research & development, or in some



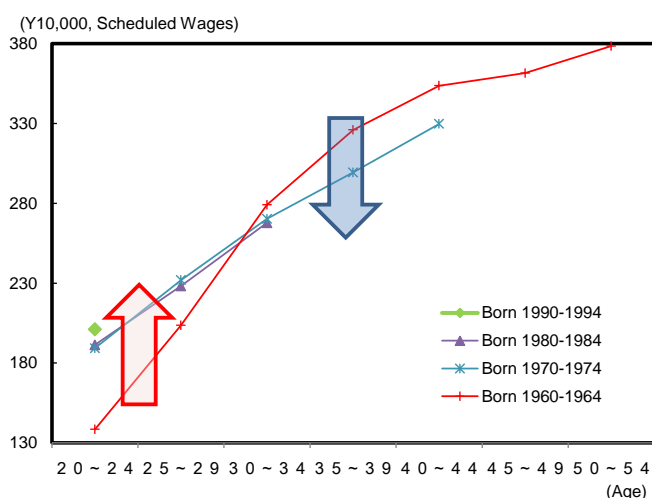
cases carrying out mergers & acquisitions, as well as whether or not corresponding labor productivity can also be attained in tandem. Meanwhile, since labor productivity such as this can take time to achieve, companies suffering from rising unit labor costs (nominal wages ÷ productivity) may very likely have to keep total labor costs under control by flattening the wage curve and placing restrictions on overtime, rationalizing the latter by dressing it up as “workstyle reform.” The practice of increasing the hourly wage at which new regular employee hires are taken on (both new graduates and non-regular employees who have gained the status of regular employees), and then holding down the total salaries of existing regular employees may likely continue for some time.

There is nothing new about this type of corporate behavior. Chart 6 illustrates the wage curve and how it is generally applied by birth year. Here we can see how starting salaries are raised, while mid-level and senior salaries are depressed. The chart reveals how flattening the wage curve continues to be practiced by corporations.

Meanwhile, Chart 7 shows the technique of flattening the wage curve from a different angle. In another development which will become more prominent by the latter part of the 2000s, the proportion of workers in their 40s who have moved into managerial positions is decreasing. In other words, corporations appear to be delaying the promotion of workers in their 40s, while also decreasing the number of workers who are promoted to management positions. Members of Japan’s second-generation baby boom are now just entering their 40s, hence this age group accounts for a large proportion of overall personnel expenses. By delaying the promotion of employees who form the “volume zone” in terms of age-group, corporations hope to cut back on personnel expenses. The possibility of a similar phenomenon occurring in the future is also a factor which cannot be ignored.

Wage Curve by Birth Year and Age Group

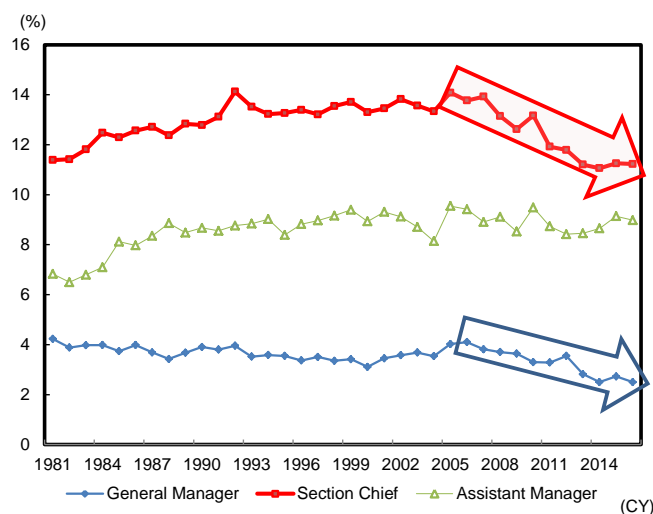
Chart 6



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

Proportion of Workers in Their 40s in Managerial Positions

Chart 7



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

### ***Overtime pay could decline by up to Y8.5 tril as a result of workstyle reforms***

Caution is required regarding factors which bring risk of offsetting the effects of wage inflation. Amongst the various workstyle reforms is the adoption of a rule limiting the amount of overtime an employee is allowed to work. This type of rule includes a penalty if the rule is not followed. This type of rule has been adopted by some companies as a corrective to the tendency to work overly long hours. However, the existence of this rule carries with it the risk of bringing downward pressure on overall employee compensation by virtue of reducing overtime pay.

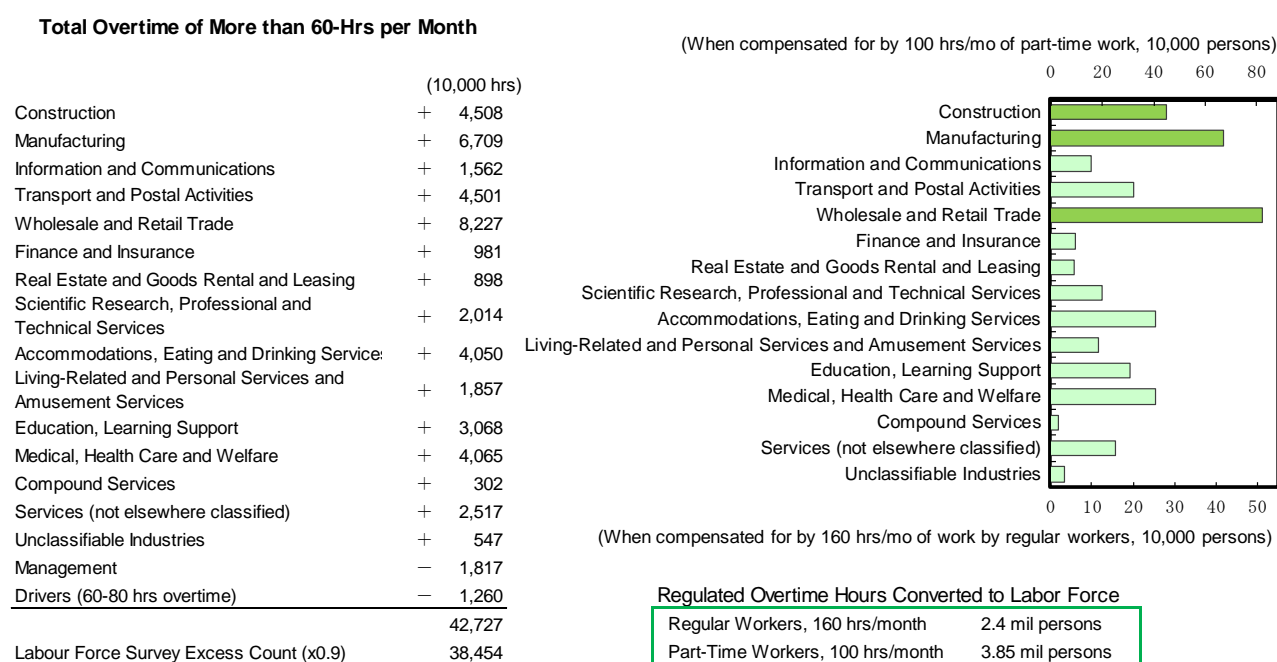
In some cases the rule limiting overtime with penalty includes some exceptions, but in general, overtime is restricted to 45 hours per month or a total of 360 hours per year. If labor and management

agree, this amount can be extended to up to 720 hours per year. This is expected to become law in Japan by April 2019 at the earliest.

According to our risk scenario, if overtime hours which have been reduced are not redistributed to other workers and new workers, total overtime pay of workers in Japan could undergo downward pressure of Y8.5 tril annually. This is the equivalent of 3% of employee compensation. Meanwhile, in order to compensate for reduced overtime hours, 2.4 million new fulltime workers would be required in order to make up for those lost hours. However, due to the limited margin available for increasing the labor force participation rate in Japan, there is not much hope of a major increase in the number of employees. The one thing that can be said is that the question of increasing labor productivity as was discussed earlier is an urgent one.

### Estimated Effects of Restriction on Overtime (Risk Scenario)

Chart 8



**Overtime Pay -8.5 tril yen/yr = Downward Pressure of 3% on Employee Compensation**

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

Note: The term "Management" refers to all jobs with a managerial function. The term "Drivers" includes operation of all kinds of transport equipment and machinery. This includes the operation of trains and airplanes. According to the Labour Force Survey, there is a chance that in the case of many of these jobs, unpaid overtime and break time may in some cases be counted as work time. Therefore 10% is subtracted from the estimate with reference to the difference between the Labour Force Survey and the Monthly Labour Survey.

### Capex expected to maintain underlying strength focusing on rationalization & labor saving

Despite the advice of caution in the previous section, the incentive to carry out investments oriented toward rationalization & labor saving in the face of the worsening labor shortage is actually stronger than it has been in the past, and few have any doubts about whether or not this is a wise move. But if serious wage increases including those affecting regular employees occur in the future, unit labor cost will increase as well, bringing pressure on corporate earnings, unless labor productivity or profitability can be raised to the degree that they can offset wage increases. For this reason, investments in research & development, and upgrading & renovation with an aim to improve earnings in addition to investment in rationalization and labor-saving directly linked to improving productivity will likely continue to achieve moderate growth in the future.

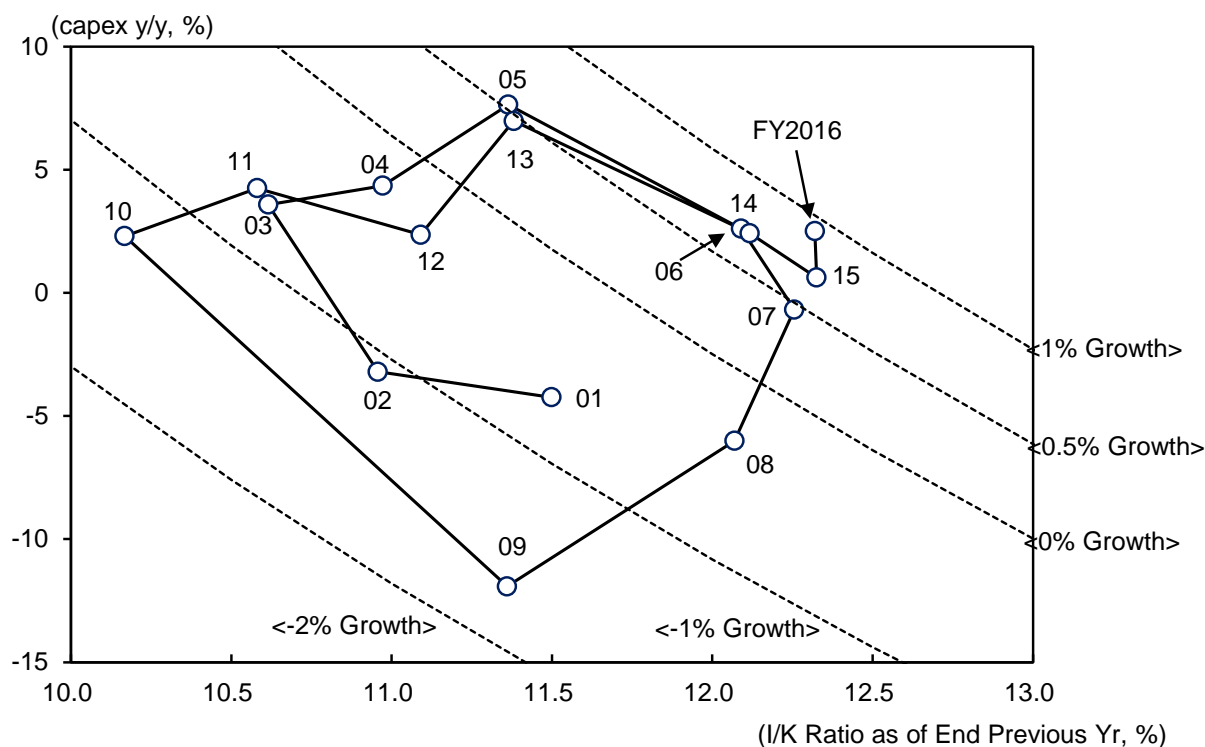
On the other hand, one problem that is often pointed out regarding recent trends in capital investment is that capex spending does not grow as much as one would have expected when compared to



favorable corporate earnings. As is shown in Chart 9, Japan's capital stock cycle is now in the maturation phase as is the US. In order to extend the stock accumulation phase, it is essential that the anticipated growth rate be increased. In addition, factory operating rates are at a lower level than they have usually been during past periods of growth in capital expenditure and this is a worrisome point. 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 production volume, factory operating rates must exceed a certain threshold and continue performing at that level.

Diagram: The Stock Cycle

Chart 9



Source: Cabinet Office, Bank of Japan.

Note: Dotted lines represent the hyperbolic curve in relation to current anticipated growth rate.

### ***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. 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, large manufacturers do not feel the shortage in employment to the same degree as small business and non-manufacturing industries. With labor's relative share at a low level, there should be limited downward pressure on capital expenditure originating in worsening of earnings.

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.

### Corporate Stance Toward Distribution of Profits

Chart 10

(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) Component percentages of total number of respondents. Respondents were asked to provide answers to at least three out of a total of ten questions.

2) Questionnaire took place in Jan-Mar 2017 period, based on FY2016 business performance.

### Economic Indicators and Interest Rates

Chart 11

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	
<b>Real GDP</b>										
Q/q %, annualized	1.7	1.5	4.0	0.6	1.1	1.6				
Y/y %	1.7	1.5	2.0	1.9	1.8	1.8	1.3	1.3	1.9	1.2
<b>Current account balance</b>										
SAAR (Y tril)	20.6	21.7	18.9	19.3	19.5	20.0	17.9	20.4	19.6	20.6
<b>Unemployment rate (%)</b>										
	3.1	2.9	2.9	2.9	2.8	2.8	3.3	3.0	2.8	2.7
<b>CPI (excl. fresh foods; 2015 prices; y/y %)</b>										
	-0.3	0.2	0.4	0.7	0.7	0.5	-0.0	-0.2	0.6	0.6
<b>10-year JGB yield</b>										
(period average; %)	0.00	0.07	0.04	0.04	0.04	0.04	0.26	-0.05	0.04	0.04

Source: Compiled by DIR.

Note: Estimates taken from DIR's *Japan's Economic Outlook No. 194*.