Daiwa
Daiwa Institute of Research

20 October 2017 (No. of pages: 10)

Japanese report: 20 Oct 2017

Japan's Economy: Monthly Outlook (Oct 2017)

Pointers to guide through this political season; Light and shadow of the "cherry-picking" economy

Economic Research Dept.
Shunsuke Kobayashi

Summary

- The season for politics has arrived. The House of Representatives election is now the major focus in Japan. With election surveys predicting that Abe's LDP will retain a majority, we do not expect any major changes in economic or fiscal policy for some time to come, other than a change in how the consumption tax is applied in the future.

- Other major events attracting interest around the same time as Japan's House of Representatives election is the meeting of the National Congress of the Communist Party in China, and the naming of a new chairman to the US FRB. The following effects of both these factors are of vital importance in predicting the future of the global economy: first there is the question of how long the appreciation of the Chinese Yuan and acceleration of China's economic growth (both of which originally developed as side effects of suppressing capital outflow) will last. Then there is the question of whether the newly appointed FRB chairman will continue the current direction of monetary policy, whose purpose has been to keep overheating of the asset market under control as opposed to a policy which would be dependent only on economic variables such as employment and prices.

- Despite a number of unknown factors remaining, the global economy managed to perform well in 2017, manifesting acceleration of economic growth. Behind acceleration of growth are (1) inventories, centering on the US, have recently recovered and have moved into the inventory accumulation phase, (2) expansionary fiscal policy has come into effect centering on the EU (the pace of austerity policy has slowed), and (3) acceleration of the Chinese economy ahead of the meeting of the National Congress of the Communist Party this fall. However, the possibility that these factors may begin to lose their influence in 2018 and beyond is unavoidable.

- As in the case of the global economy, the Japanese economy has also been moving ahead with factors producing accelerated economic growth which have a limited shelf life. One factor is the inventory cycle, which echoes that of the US, while the other is replacement demand for durables. Replacement demand for durables is currently driving the acceleration of Japan's economic growth, yet at the same time it may also be a factor in suppressing consumption of goods other than durables. To put it in another way, once replacement demand has run its course, the economic growth rate will likely slow overall, while at the same time, consumption of goods other than durables may then head toward recovery

1. The Season for Politics

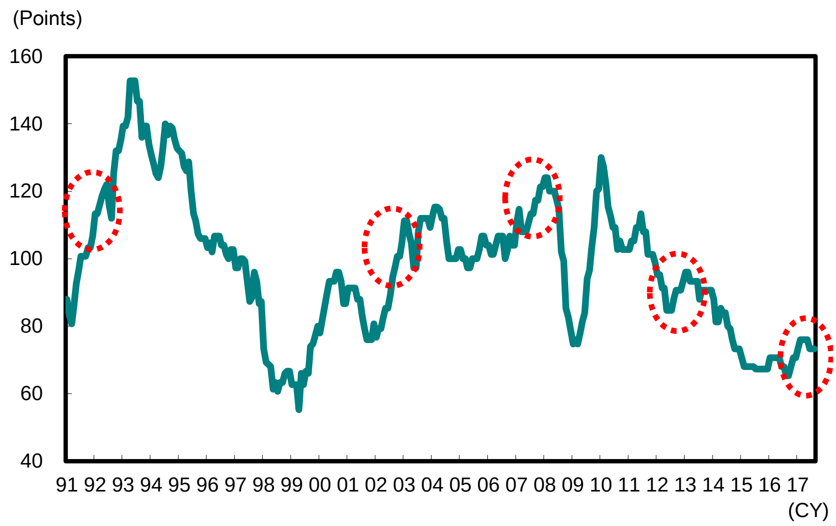
The season for politics has arrived. The House of Representatives election to be held on October 22 is of course now the major focus in Japan. It was assumed that the ruling party might lose its majority when dissolution of the House of Representatives was declared at the beginning of the current extraordinary session of the Diet on September 28. However, at this point in time election surveys predict that Abe's LDP will retain a majority. As far as we can see based on election surveys, we do not expect any major changes in economic or fiscal policy for some time to come. The major issue which has come up in the campaign is the question how the increased budget from the next consumption tax hike is used (debt payment or fiscal expansion for redistribution policies). This will require that we partially revise our economic outlook for economic and fiscal policy from the latter part of FY2019 and beyond.

Other major events attracting interest around the same time as Japan's House of Representatives election are (1) the meeting of the National Congress of the Communist Party in China, (2) US President Trump's tour of Asia, and (3) the naming of a new chairman to the US FRB. As for the first two items mentioned here, the sense is that these two political events will likely determine how the US and China heads of state handle the issues surrounding the North Korean situation in the future, and hence they are attracting much attention. However, it is still unpredictable at this time, and the uncertainty factor requires that we keep a close watch on developments. Meanwhile, as for the economic implications in the near future, factors (1) and (3) have the most importance. These include the question of how long the anomalous economic situation that usually occurs in years when the National Congress of the Communist Party meets will last, and whether or not the current US monetary policy, which is so influential on the global economy, will continue.

Years in which the National Congress of the Communist Party meets are usually anomalous as far as the economy goes: how long will this effect last?

First we take a look at China. Once every five years, the National Congress of the Communist Party meets and chooses its political leader. The general understanding amongst China-watchers is that this often provides political incentive to shore up the economy with governmental means. Chart 1 shows China's business cycle signal index with red circles around years in which the National Congress of the Communist Party has met. We can easily observe that these periods have all been ones in which the economy picks up speed. The only exception during the 1990s up to the present is 1997, the year of the Asian currency and financial crisis. At the same time, we can also say that China's economy held up pretty well during this time despite the extremely negative external environment.

China's Business Cycle Index **Chart 1**

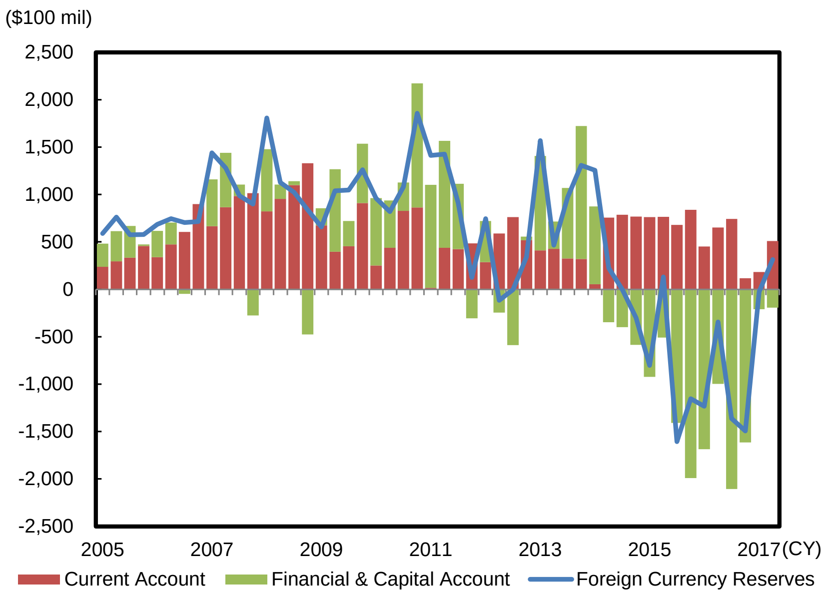


Source: National Bureau of Statistics of China, People's Bank of China, CEIC; compiled by DIR.

This year too is no exception, as China's economy again accelerates during a year in which the National Congress of the Communist Party meets. But of course, not everyone agrees with this opinion. China's economy has been accelerating since early in 2017 supported by domestic demand centering on consumption. Looking at this data in simple terms it appears that the economy just happens to be doing well this year. Some may take the view that this growth has not necessarily been supported by political means.

However, the fact is that the Chinese government has had capital outflow almost completely under control since the beginning of 2017. It seems this should overturn the above counter-argument. In August of 2015, the Chinese government devalued the yuan, causing expectations that the currency could further weaken in the future. Along with the rise in US interest rates, this led to net capital outflows from China totaling $640 bil in 2016. Then during the first half of 2017, net capital outflows from China came to only $42.3 bil (Chart 2).

China's Balance of International Payments **Chart 2**



Source: Haver Analytics; compiled by DIR.

Controlling capital outflows with the use of government policy moved forward after the beginning of the year 2017. There is nothing odd about the sense that the Chinese government should implement policies to protect against the risk of a collapse in the yuan rate ahead of the meeting of the National Congress of the Communist Party. It is quite possible that as a result of the stimulus produced by policy guidance, capital which no longer had anywhere to go flowed back into the domestic market in the form of investment and consumption. Other developments during the same time may also have been an indirect result of the same policy, including the skyrocketing of the virtual currency market and real estate prices which were supposed to have been brought under control in 2016. We should also not ignore the stimulus of domestic demand in China through the asset effect brought on by developments in the asset market. In other words, it is possible that China's economy has sped up during the year 2017 as a side effect of placing controls on capital outflow.

The question now is how much longer will the effects of controlling capital outflow last, and how much longer will the side effects remain active as a factor in the acceleration of China's economy? That of course remains unclear. However, it is quite possible that once the meeting of the National Congress of the Communist Party has ended, the effects of stimulating the economy will begin to wane. In the first place, the policy to control capital outflow is one that is necessarily accompanied by side effects. And as mentioned previously, it also comes at the cost of having asset prices skyrocket, and the decline in international competitiveness accompanying the appreciating yuan. In addition, overseas investment opportunities are lost.

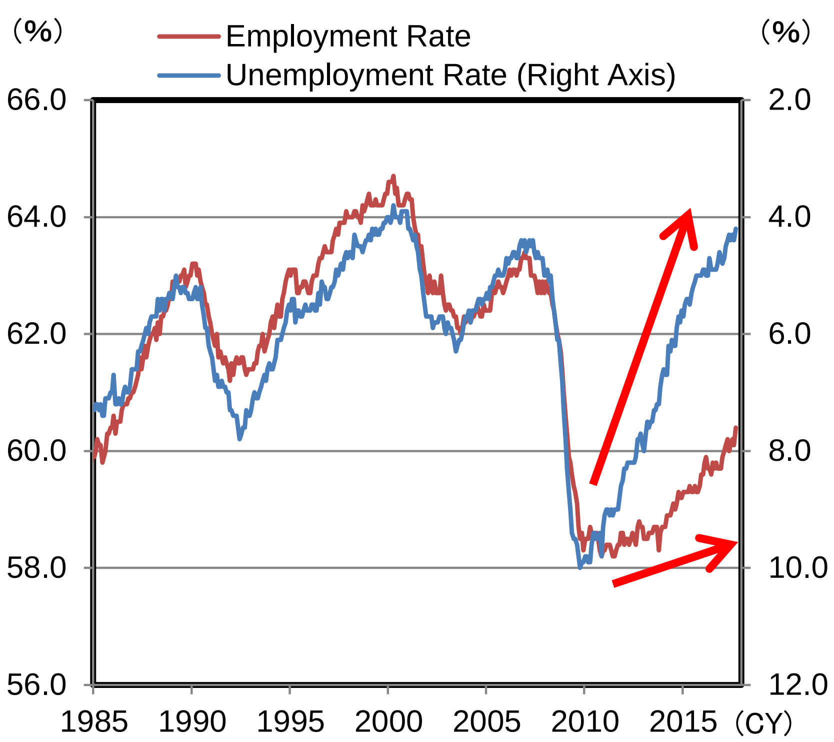
Of course, the restarting of capital outflows will not immediately lead to China's economic meltdown or to a recession. However, it is still necessary to keep in mind the possibility that the Chinese Yuan could reverse its recent appreciation trend and begin to weaken, while the economy could fall back from its accelerating trend and begin to slow down.

Will the new FRB Chairman continue in Yellen's footsteps?

Next we consider what may happen when a new FRB chairman takes hold of the reins. The FRB has been in rush to carry out its exit strategy since the beginning of 2017, which includes raising the policy interest rate and reducing quantitative easing (tapering). However, it is difficult to justify this policy in light of the FRB's original policy targets of maximizing employment and stabilizing prices.

First of all, the problem right now is that the inflation rate is not rising. The growth rate in wages is also sluggish, and there are no signs of overheating. The only reason they can come up with to rush into monetary tightening is that the fact that the unemployment rate is low means that the US has reached full employment and it is therefore possible that wages and prices will rise sharply in the near future. But this logic contains a major pitfall. As is shown in Chart 3, this is the fact that despite the decline in the unemployment rate, the employment rate is at a historic low. What is indicated by the deviation between the unemployment rate and the employment rate is that the US is progressing in non-working or non-labor force population. In plain language this means that the number of people who have given up looking for a job and are now classed as "NEET" (not in education, employment or training) has increased to over ten-million since the global financial crisis of 2008. Or to put it in yet another way, the fact that the unemployment rate has declined does not mean that the employment environment has improved. Rather, it means merely that the ratio of non-working people has become quite large. Behind the unemployment rate in the US lurks a major slackening.

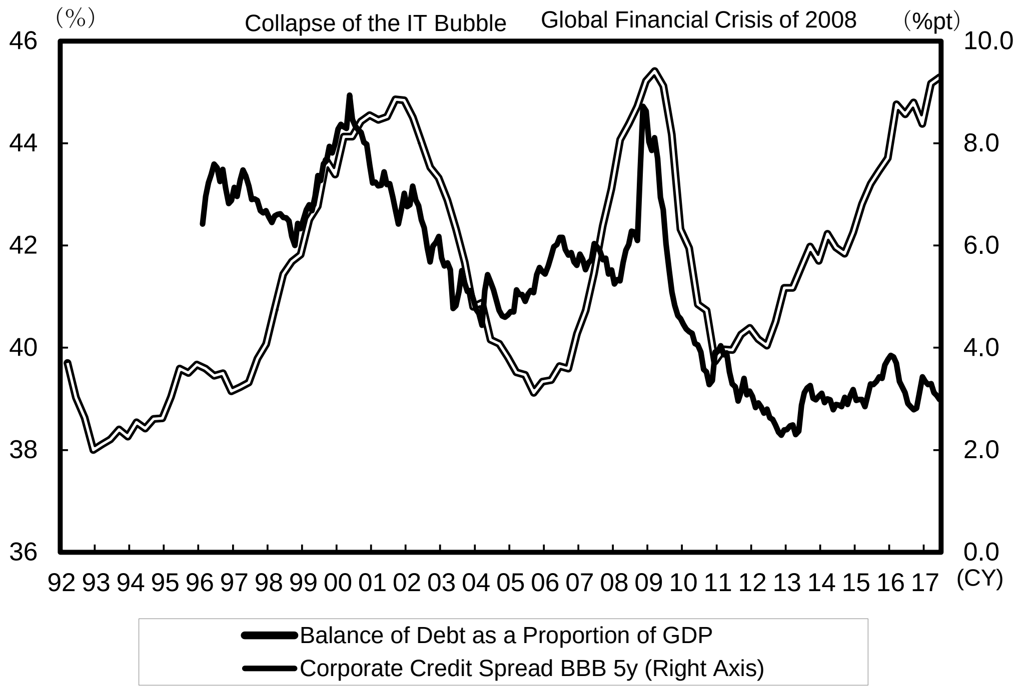
The US Labor Market **Chart 3**



Source: BLS; compiled by DIR.

So why is the FRB so eager to implement monetary tightening when there is major slack leading to a sluggish growth rate in wages and prices? As is shown in Chart 4, this is not unrelated to the fact that debt leveraging by US corporations was already at a level comparable to that seen just before the collapse of past economic bubbles. In the past, the cost of issuing corporate bonds and the cost of borrowing was kept under control by the low interest policy and quantitative easing. As a result of these costs continually falling below that of the cost of capital stock, corporations were especially aggressive in share buybacks and corporate buyouts. In other words, corporate debt leveraging continued to build up over time. If the FED's purpose is to release some of the pressure produced by this credit bubble, then perhaps the current exit strategy or an even more rapid one is justifiable.

US Corporate Debt to GDP Ratio, and Corporate Bond Spreads **Chart 4**



Source: FRB, Haver Analytics; compiled by DIR.

It is because the purpose of the FRB's current monetary policy is to prevent the asset market from overheating, as opposed to being dependent only on economic variables such as employment and prices that the appointment of a new chairman is so vitally important at this time. Current chairperson of the FED Janet Yellen completes her term in February 2018. If the next chairman continues the same policy direction, there is a good possibility that a balanced policy giving an eye to both the real economy and the asset market will continue to be implemented. However, if the next chairman focuses more on the hidden slack in the labor market and low inflation and leans more toward monetary easing, then it is possible that the asset market might overheat. On the other hand, if policy takes a more fundamentalist, rule-based approach (such as the Taylor rules with a heavy dependence on the unemployment rate), or if there is a quick exit from quantitative easing based on the desire to manifest small government, then the risk of dampening the expansion of the real economy will be unavoidable.

2. Light and shadow of the "cherry-picking" economy

Despite a number of unknown factors remaining, the global economy managed to perform well in 2017, manifesting acceleration of economic growth. Both the US and the Eurozone recorded growth rates of 2.1% during the first half of 2017. Meanwhile, even China, which dragged the world economy during the China Shock (China's economic slowdown and collapse of the yuan), increased its growth rate to 6.9% during the first half of the year (6.8% was recorded in the Jul-Sep period).

Favorable growth has continued recently, leading to optimistic outlooks from economists. The IMF's economic outlook as of October 2017 sees global economic growth at 3.6% as compared to 3.2% in 2016 and 3.4% in 2015 (Chart 5). The IMF sees growth accelerating even more in 2018 at 3.7%. But to what extent can we trust these optimistic outlooks for the global economy?

IMF Global Economic Outlook (as of October 2017) **Chart 5**

	Estimate		Projections		Difference	
	2015	2016	2017	2018	2017	2018
World Output	3.4	3.2	3.6	3.7	0.1	0.1
Advanced Economies	2.2	1.7	2.2	2.0	0.2	0.1
United States	2.9	1.5	2.2	2.3	0.1	0.2
Euro Area	2.0	1.8	2.1	1.9	0.2	0.2
Japan	1.1	1.0	1.5	0.7	0.2	0.1
Emerging Market and Developing Economies	4.3	4.3	4.6	4.9	0.0	0.1
Commonwealth of Independent States	–2.2	0.4	2.1	2.1	0.4	0.0
Emerging and Developing Asia	6.8	6.4	6.5	6.5	0.0	0.0
China	6.9	6.7	6.8	6.5	0.1	0.1
Emerging and Developing Europe	4.7	3.1	4.5	3.5	1.0	0.3
Latin America and the Caribbean	0.1	–0.9	1.2	1.9	0.2	0.0
Middle East, North Africa, Afghanistan, and Pakistan	2.7	5.0	2.6	3.5	0.0	0.2
Sub-Saharan Africa	3.4	1.4	2.6	3.4	–0.1	–0.1

Source: IMF; compiled by DIR.

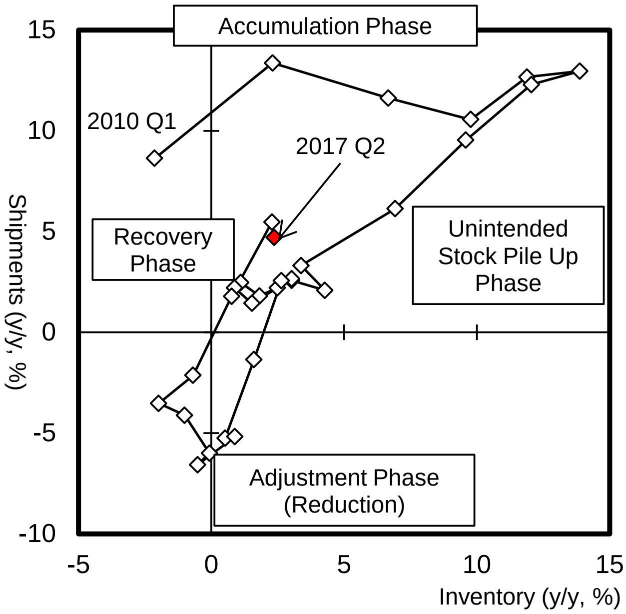
Three factors supporting acceleration of growth in 2017

Before moving on to the outlook for the future, let us review developments in the recent past. Until recently there were three major short-term factors speeding up growth in the global economy. These were (1) inventory recovery and beginning of inventory accumulation centering on the US (2) expansionary fiscal policy centering on the EU (pace of austerity policy slows), and (3) acceleration of the Chinese economy ahead of the National Congress of the Communist Party (covered in the previous chapter).

As for factor (1), we take a look back at recent history. Charts 6&7 show the inventory cycle in the US and Japan. Growth rate in shipments is shown on the vertical axis (growth is on top and decline is on the bottom). Then inventory growth is shown on the horizontal axis (growth is on the right and decline is on the left). The inventory cycle diagram moves clockwise and has four phases: inventory reduction phase, inventory recovery phase, inventory accumulation phase, and unintended stock pileup phase. Passing through all four of the phases brings you once through the entire cycle. Taking a look at US shipments and inventory based on this cycle, we see that in 2015 the US was in the inventory reduction phase. In 2016 it entered the recovery phase, and then in 2017 began the accumulation phase.

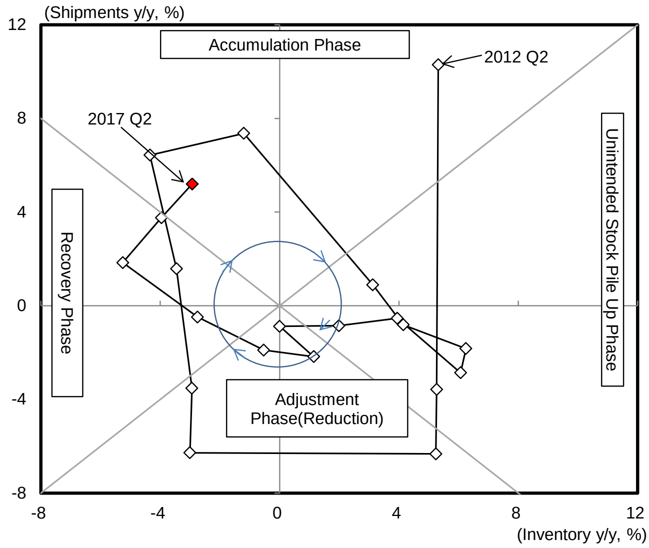
When US inventory was in the accumulation phase, the China shock occurred, and then as shipments declined business sentiment worsened, and in 2015 US corporations began reducing inventory. However, throughout 2016, as China's economy regained some calm, the US presidential election took place, and coupled with expectations regarding fiscal policy, business sentiment improved, and then throughout 2017 inventory accumulation again took place. Japan's inventory cycle during this time is very similar to that of the US.

US Inventory Cycle **Chart 6**



Source: Dept. of Commerce; compiled by DIR

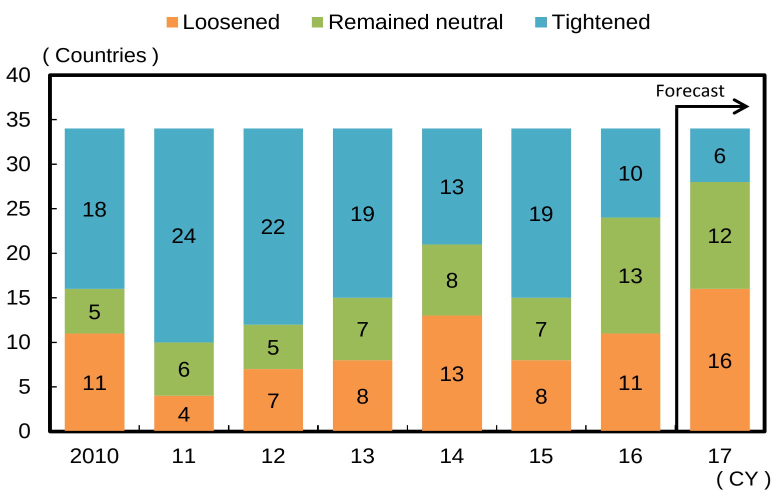
Japan Inventory Cycle **Chart 7**



Source: Ministry of Economy, Trade and Industry; compiled by DIR

In the case of factor (2), the Greek fiscal crisis was reignited around 2015, and it became difficult to absorb sovereign bonds, especially in the southern European countries. As yield rose, the number of countries feeling forced to implement austerity measures grew. The ECB provided support though its monetary easing policy, but properly dealing with the problem was put off in the end. By 2017 the number of countries able to carry out an expansionary fiscal policy or to slow the pace of austerity measures had grown.

Fiscal Policies of Advanced Nations **Chart 8**



Source: IMF; compiled by DIR.

As a result, the number of countries which are able to implement monetary easing has increased since that time. Chart 8 shows that 19 out of the total of 34 advanced countries were implementing austerity measures in 2015, while in 2016 there were only 10, with this number expected to drop further in 2017 to 6 countries. Conversely, there were 8 countries on the low side implementing fiscal expansion in

2015, with this number rising to 11 countries in 2016, and growing further to an expected 16 countries in 2017. These developments are thought to be one of the factors behind the EU's current economic acceleration.

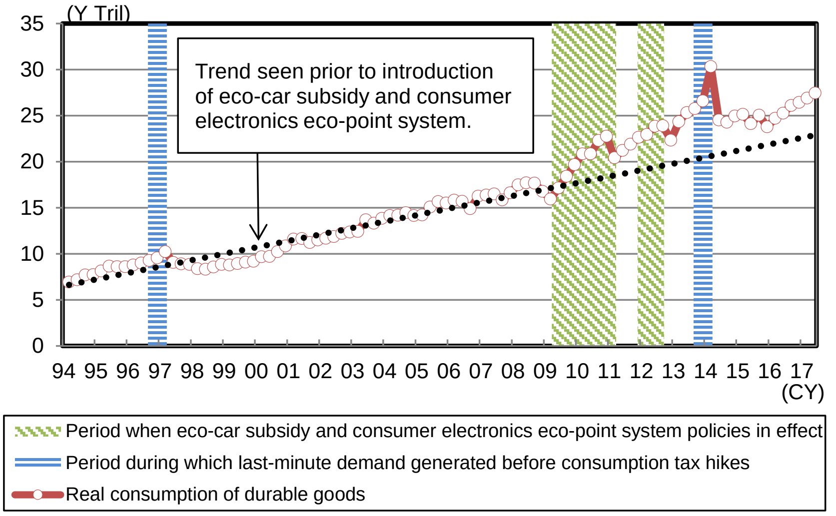
The three factors supporting growth in the global economy in 2017 are strong points that were focused on. However, there are doubts that this can continue into 2018 and beyond, and there is plenty of margin left for doubt. For one thing, the inventory cycle is merely a short-term factor, and even considering the possibility that a recovery and accumulation phase may sometimes be on the long side, it still has to end sometime. Meanwhile, it is almost certain that the ECB will announce its plan to reduce quantitative easing within the year. It is therefore questionable whether expansionary fiscal policy in the EU can maintain its momentum. There is a good chance that the factors bringing upward pressure on the US and EU economies will gradually disappear. As for China, details have already been covered in an earlier chapter. All in all, the short-term factors expected to encourage acceleration of the global economy in the near future will very likely fall by the wayside further up the road.

Light and shadow of replacement cycle for durables in Japan

As in the case of the global economy, the Japanese economy has also been moving ahead with factors producing accelerated economic growth which have a limited shelf life. One factor is the inventory cycle, which echoes that of the US, while the other is replacement cycle for durables.

Chart 9 shows changes in the real amount of consumption of durables in Japan since 1994. Immediately after the global financial crisis of 2008, Eco-car related tax breaks were introduced in order to provide underlying support for personal consumption, and the Ecopoint program effecting household electronics was implemented after 2009. During this time and the period lasting until the Jan-Mar period of 2014 in which last minute demand occurred due to the increase in the consumption tax, consumption of durables vastly exceeding past trends.

Change in Real Amount of Consumption of Durables Chart 9

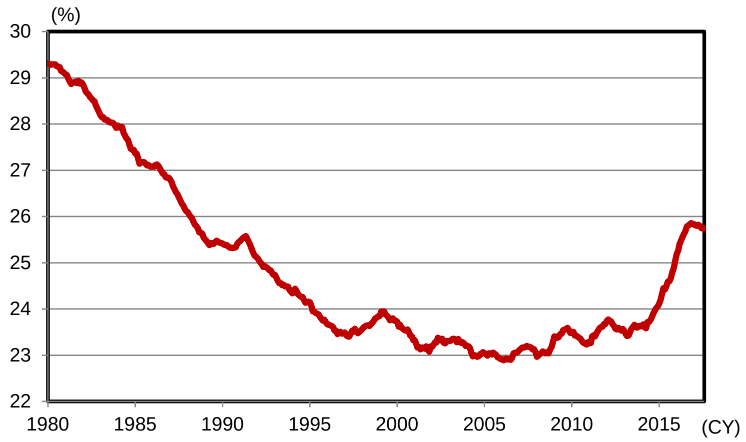


Source: Cabinet Office; compiled by DIR.

However, as is confirmed by Chart 9, the real amount of consumption of durables has been notably in a recovery phase during the most recent six quarters. Approximately eight years have passed since the Eco-car tax breaks and the Ecopoint program was introduced. It has been three years since the most recent instance of an increase in the consumption tax was implemented. Durables purchased during those periods are now again completing their replacement cycle. Hence we may see yet another increase in consumption of durables.

Of course, replacement demand can't last forever , and in this sense Japan's economy resembles that of overseas economies in that most likely, acceleration of growth which depends on inventory accumulation and replacement demand for durables will gradually disappear. On the other side, at the same time, another interesting point is the question of the side effects of replacement demand for durables. From the viewpoint of corporations, replacement demand is a factor leading to growth in earnings. However, from the viewpoint of households it is a factor which leads to an increase in expenditure. Therefore, it follows that households have an incentive to economize when it comes to expenditure on items other than durables. The Engel coefficient expresses this relationship quite well (Chart 10).

Long-Term Fluctuations in Engel's coefficient Chart 10



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

Note: 1) Engel's coefficient ＝Food consumption÷Disposable income.

2) Two-more-person households (including agricultural, forestry and fisheries households).

3) 12 months moving average.

After the 2000s Japan's Engel coefficient bottomed out and then reversed course, heading into a growth phase. This is due mainly to the following structural factors: (1) as the population ages the portion of disposable income used to purchase food increases, (2) as the ratio of households with double incomes increases, the tendency is more toward foods that are simple to prepare and eating alone, hence food products are more high value added than in the past, and this increases expenditure on foods, and (3) Japan has become relatively poor in comparison to other countries in general (especially the emerging nations), and relative purchasing power of Japanese individuals has declined.

Japan's Engel coefficient peaked out at the end of 2016, and has since been somewhat in a decline. This kind of temporary halt in the Engel coefficient has been seen before in situations such as those explained above, in other words the periods when the Eco-car tax breaks and the Ecopoint program were in effect, and the period in which last minute demand occurred due to the increase in the consumption tax. In other words, a rise in demand for durables has a recognizable tendency to suppress demand for foods and goods and services other than durables.

Replacement demand for durables is currently driving the acceleration of Japan's economic growth, yet at the same time it may also be a factor in suppressing consumption of goods other than durables. To put it in another way, once replacement demand has run its course, the economic growth rate will likely slow overall, while at the same time, consumption of goods other than durables may then head toward recovery

Economic Indicators and Interest Rates — Chart 11

Indicator	2016 Oct-Dec	2017 Jan-Mar	2017 Apr-Jun	2017 Jul-Sep	2017 Oct-Dec	2018 Jan-Mar	FY15	FY16	FY17	FY18
	Actual			DIR estimates			Actual		DIR estimates	
Real GDP										
Q/q %, annualized	1.6	1.2	2.5	1.8	1.4	1.5				
Y/y %	1.7	1.5	1.4	1.8	1.7	1.7	1.3	1.3	1.7	1.3
Current account balance SAAR (Y tril)	20.6	21.7	18.9	19.5	20.0	20.5	17.9	20.4	20.0	20.9
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	0.4	0.7	0.8	0.6	-0.0	-0.2	0.6	0.7
10-year JGB yield (period average; %)	0.00	0.07	0.04	0.05	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 Update (Summary).*