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Japan’s Economy: Monthly Review

Three Issues Regarding Abenomics

Maintaining fiscal discipline, strengthening growth strategies, and increasing employee income

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Summary

- **Economic outlook reviewed:** In light of the second preliminary Jan-Mar GDP release (Cabinet Office), we have reviewed our economic growth outlook. We now forecast real GDP growth of +3.1% y/y for FY13 (previous forecast: +3.1%) and +0.7% for FY14 (+0.7%).

- **Three issues regarding Abenomics:** In this report, we examine three issues regarding Abenomics. First, there is the risk that the government failing to maintain fiscal discipline will invite the triple blow of falling JGB prices, falling stock prices, and a falling yen. Second, criticism is being widely voiced that medium- to long-term improvements in the nation’s economic foundation and structural reforms are currently insufficient. Third, there is concern that employee income will not grow as inflation progresses. Thus, going forward, the Abe administration will need to actively engage in: (1) the maintenance of fiscal discipline, such as by making fundamental reforms to the social insurance system, (2) the strengthening of comprehensive growth strategies, such as through deregulation, participation in the Trans-Pacific Partnership (TPP), and the reduction of the effective tax rate borne by corporations, and (3) the achievement of higher employee income where the pain is shared among the government, business, and labor.

- **Main scenario for Japan’s economy:** Japan’s economy slipped into recession after peaking in March 2012. It now appears to have hit bottom in November 2012 and to have bottomed out. It is expected to continue expanding, supported by (1) the recovery of the US and Chinese economies, (2) the continuation of reconstruction demand and a large-scale supplementary budget, and (3) the ongoing depreciation of the yen and the ascent of stock prices accompanying the Bank of Japan (BOJ)’s bold monetary easing. With regard to the last, we anticipate that the yen will gradually weaken against the US dollar. Also, in comparison to the real economy, it still cannot be said that stock prices are overvalued at their current levels.

- **Risks facing Japan’s economy:** Risks that will need to be borne in mind regarding Japan’s economy are (1) a reigniting of the European sovereign debt crisis, (2) the worsening of Japan-China relations, (3) the US fiscal issue, and (4) a surge in crude oil prices stemming from geopolitical risk.

1. Economic Outlook

In light of the second preliminary Jan-Mar GDP release (Cabinet Office), we have reviewed our economic growth outlook. We now forecast real GDP growth of +3.1% y/y for FY13 (previous forecast: +3.1%) and +0.7% for FY14 (+0.7%).

Main scenario for Japan's economy

Japan's economy slipped into recession after peaking in March 2012. It now appears to have hit bottom in November 2012 and to have bottomed out. Japan's economy is expected to continue expanding, supported by (1) the recovery of the US and Chinese economies, (2) the continuation of reconstruction demand and a large-scale supplementary budget, and (3) the ongoing depreciation of the yen and the ascent of stock prices accompanying the BOJ's bold monetary easing. With regard to the last, we anticipate that the yen will gradually weaken against the US dollar. Also, in comparison to the real economy, it still cannot be said that stock prices are overvalued at their current levels.

Risks facing Japan's economy

Risks that will need to be borne in mind regarding Japan's economy are: (1) a reigniting of the European sovereign debt crisis, such as from political instability in Italy or Spain, (2) the worsening of Japan-China relations, (3) the US fiscal issue, and (4) a surge in crude oil prices stemming from geopolitical risk.

2. Three Issues Regarding Abenomics

Three issues worrying Japanese citizens

(1) Fiscal discipline, (2) growth strategies, and (3) employee income

In this report, we examine three issues regarding Abenomics, which, according to media reports, Japanese are concerned about. First, there is the risk that the government failing to maintain fiscal discipline will invite the triple blow of falling JGB prices, falling stock prices, and a falling yen. Second, Abenomics is currently centered on such stimulus measures as monetary policy and public works spending, and criticism is being widely voiced that medium- to long-term improvements in the nation's economic foundation and structural reforms are insufficient. Third, there is concern that employee income will not grow as inflation progresses.

Thus, going forward, the Abe administration will need to actively engage in: (1) the maintenance of fiscal discipline, such as by making fundamental reforms to the social insurance system, (2) the strengthening of comprehensive growth strategies, such as through deregulation, participation in TPP, and the reduction of the effective tax rate borne by corporations, and (3) the achievement of higher employee income where the pain is shared among the government, business, and labor.

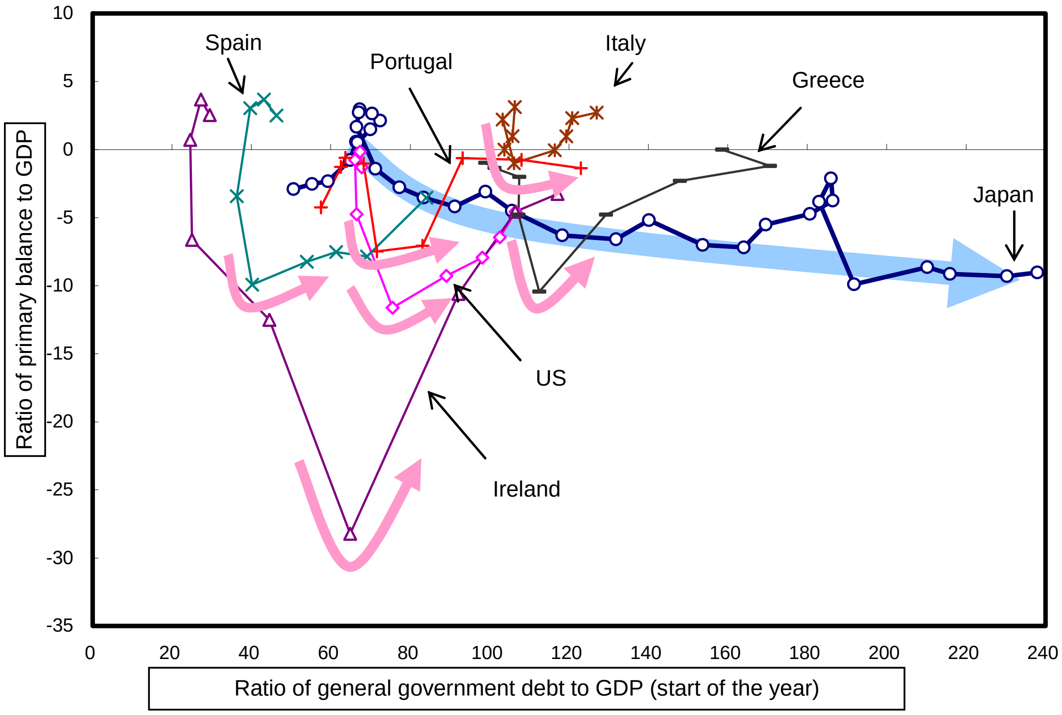
Issue 1: Maintaining fiscal discipline

Japan risks forfeiting the sustainability of government finances

The first issue that Japanese are concerned about with respect to Abenomics is the risk that the government failing to maintain fiscal discipline will invite the triple blow of falling JGB prices, falling stock prices, and a falling yen.

It hardly needs mentioning that government finances are facing a crisis in Japan. Chart 1 examines conditions for the sustainability of budget balances as formulated by Henning Bohn, professor of economics at the University of California.

Primary Balance and General Government Debt (% of GDP) Chart 1



Source: IMF; compiled by DIR.
Note: 1981-2013 for Japan and 2005-13 for others; IMF outlook for Japan and Portugal from 2011 and others from 2012.

Clearly, Japan's situation is far worse than that facing southern European nations. In the chart, the vertical axis shows the ratio of the primary balance to GDP and the horizontal axis the ratio of general government debt to GDP at the start of the year. In simple terms, a line graph rising to the right indicates that budget balances are sustainable, and a line graph falling to the right indicates that such balances are unsustainable. In other words, nations with line graphs rising to the right are those where the ratio of general government debt to GDP at the start of the year (budget balance on a stock basis; horizontal axis) is problematic, but, at the same time they are nations that are just about managing government finances in a way that promises improvement with respect to the ratio of the primary balance to GDP (budget balance on a flow basis; vertical axis). In contrast, nations with line graphs falling to the right are those where the ratio of general government debt to GDP is problematic, and, despite this situation, are also managing government finances in a reckless manner that will further worsen the ratio of the primary balance to GDP.

Southern European nations are positioned to the left of Japan in the chart, positioning clearly lower than Japan's place along the horizontal axis (ratio of general government debt to GDP at the start of the year). Also, the line graph for Japan is basically trending toward the lower right, which casts serious doubt on the sustainability of its budget balance. In contrast, European nations are generally trending to the upper right, and it is possible to say that their budget balances are sustainable, albeit only just.

The prospect of the European sovereign debt crisis spreading to Japan and giving way to a sharp decline in JGBs is not by any means remote. It will be important for the Japanese government to accept European sovereign risk as a valuable lesson and to work toward rebuilding government finances such as by raising the consumption tax.

Reducing social security costs will be key to achieving sound government finances in Japan

Increasing the consumption tax alone will be insufficient to achieve sound government finances in Japan and a substantial reduction in social security costs will be essential. Chart 2 presents simulation results for the medium- to long-term fiscal balance. We developed seven scenarios comprising varying pairs of nominal and real GDP growth rates in Japan and then simulated the fiscal balance for different growth rates in social security costs under respective scenarios. The results are shown in terms of ratio of the primary balance to nominal GDP as of FY20. According to simulation results, even in Scenario 1 (optimistic one with nominal growth of 3.0% and real growth of 2.0% for the medium- to long-term trend), social security costs will have to be reduced at an annual pace of 4% if the primary balance is to turn positive in FY20. Considering social security costs have been on an uptrend in recent years, a very high hurdle stands in the way of achieving a balanced primary balance in FY20.

FY20 Primary Fiscal Balance (% of GDP) **Chart 2**

Scenario		1	2	3	4	5	6	7
Nominal GDP		+3.0%	+2.0%	+1.5%	+1.0%	+0.0%	-1.0%	-2.0%
Real GDP		+2.0%	+2.0%	+1.0%	+1.3%	+0.6%	-0.1%	-0.7%
Social security expenditure	+4%	-3.0	-3.4	-3.9	-4.1	-4.8	-5.6	-6.4
	+3%	-2.5	-3.0	-3.4	-3.6	-4.3	-5.0	-5.8
	+2%	-2.1	-2.5	-3.0	-3.1	-3.8	-4.5	-5.2
	+1%	-1.6	-2.1	-2.5	-2.7	-3.3	-4.0	-4.7
	+0%	-1.2	-1.6	-2.1	-2.2	-2.8	-3.5	-4.1
	-1%	-0.8	-1.2	-1.6	-1.8	-2.4	-3.0	-3.6
	-2%	-0.5	-0.8	-1.2	-1.4	-1.9	-2.5	-3.1
	-3%	-0.1	-0.4	-0.8	-1.0	-1.5	-2.1	-2.7
	-4%	0.3	-0.1	-0.5	-0.6	-1.1	-1.7	-2.2

Source: Compiled by DIR based on various materials.

Major assumptions

1) Consumption tax to rise by 3% pt in April 2014 and 2% pt in Oct 2015.
2) Figures in the table on central/local government basis; figures used for calculation are general government basis for employee compensation and central/local government basis for other.
3) Nominal and real GDP growth rates through FY15 estimated by DIR; thereafter as described in scenarios.
4) Elasticity of tax revenue vs. nominal GDP assumed to be 1.1.
5) Real revenues other than taxes extended based on nominal GDP growth rate.
6) Growth rate of social security expenditure through FY15 estimated by DIR based on “Estimation of Impact of FY13 Budget on Revenue and Expenditure in Following Years” (Ministry of Finance; in Japanese).
7) Public gross fixed capital formation through FY14 estimated by DIR and assumed to grow at the same rate as nominal GDP thereafter.
8) Interest payment = outstanding balance of public debt (previous FY) x effective interest rate (previous FY) + increased portion of public debt x long-term interest rate.
9) Other expenditure extended based on nominal GDP growth rate.

Issue 2: Strengthening growth strategies

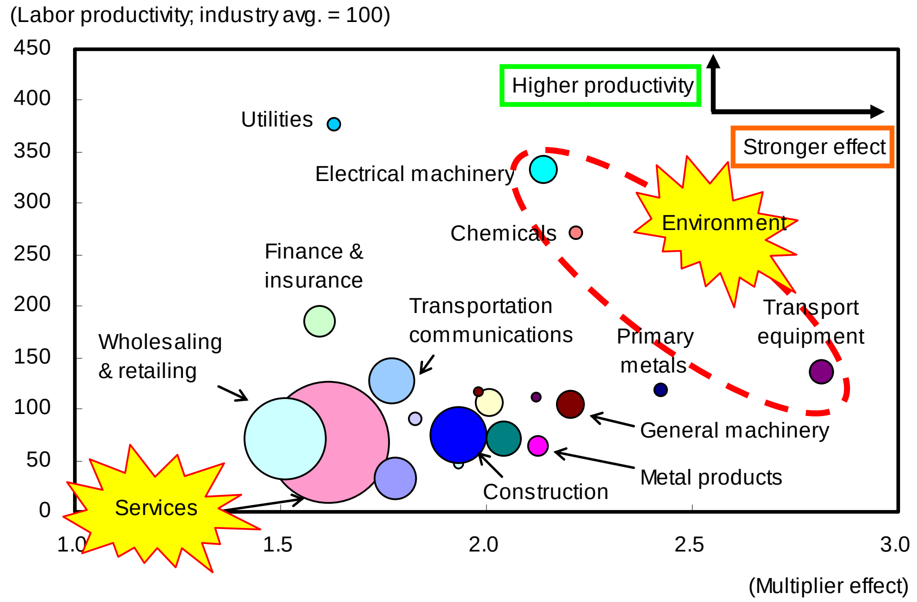
Efforts such as deregulation and corporate tax reduction currently insufficient

The second issue that Japanese are concerned about with respect to Abenomics is that medium- to long-term improvements in the nation’s economic foundation and structural reforms are insufficient at the present moment. Abenomics mainly consists of stimulus measures like public works spending and monetary policies. However, if growth strategies to stimulate private sector investment (one of the three thrusts of Abenomics) are to be strengthened in the medium to long term, structural reform such as deregulation to topple vested interests (which is like drilling into bedrock) will be necessary. Other essential steps will be reducing the corporate tax, tax breaks for investing in growth sectors, and establishing an environment that promotes entrepreneurship. If Japan’s economic foundations are not improved through such measures, there is concern that the ascent of share prices and depreciation of the yen will come to be just passing phenomena.

Japan's growth areas in terms of industrial structure

As illustrated in Chart 3, in view of Japan's industrial structure, priority areas are likely to be (1) the environment, which promises efficiency, ripple effects to other industries, and high growth prospects, and (2) services centering on health care and long-term care which have a large capacity to create jobs. In the chart, the size of circles indicates number employed. The capacity to create jobs is limited for environment-related industries (electrical machinery, chemicals, and transportation equipment). In addition, manufacturing industries only accounted for 18.8% of the number of employees in CY12. Therefore, to increase jobs, it will be indispensable to stimulate services, centering on health care and long-term care (located in the lower left corner in the graph) by, for example, easing regulations regarding operating "special nursing homes" (social welfare facilities for the aged).

Labor Productivity and Multiplier Effect **Chart 3**



Source: Ministry of Economy, Trade and Industry; Cabinet Office; compiled by DIR.
Notes: 1) Multiplier effect: DIR estimate for some industries.
2) Size of circles indicates number employed.

In growth strategy discussions, the pointless contest between manufacturing and non-manufacturing (services) industries or that between foreign demand and domestic demand often continues endlessly. While manufacturing industries and foreign demand promise efficiency and ripple effects to other industries, service industries and domestic demand have a large capacity to create jobs. Thus, the key to Japan's economic growth will be to first determine the potential advantages of each and then to implement strategies to fortify industries/demand on both sides as optimally as possible.

In implementing industrial policies, the government should provide funds, such as subsidies to specified areas, only on a limited basis. For example, in such areas as stem-cell research where it is difficult for the pure private sector to assume risk—areas where research periods are long and uncertainties large—some degree of government involvement to bring a pump-priming effect will be necessary. The basic approach, however, should be for the government to create an equal footing—to ease regulations to the maximum extent possible within the scope that does not cause harm and to expend maximum effort in laying the groundwork so the private sector can freely express its creative energies.

The key is increasing labor productivity of the non-manufacturing sector

A major factor behind the persistence of deflation in Japan is the low labor productivity of the non-manufacturing sector which stems from a low capital-labor ratio, centering on IT-related investments.

The capital-labor ratio of the industry is growing far more slowly than that of the manufacturing industry, and total factor productivity (a measure of technological progress) of the industry remains stagnant.

An important issue going forward will be raising labor productivity of the non-manufacturing industry such as by increasing its capital-labor ratio, centering on IT-related investments. Specifically, it will be worth considering policy incentives to promote IT-related investments in the industry. What will prove to be key are measures that will encourage the renewal of companies in the industry by fostering entrepreneurs, by developing domestic sites through the promotion of TPP, and by reforming the labor market.

Tax reform conforming to international standards

Going forward, an important task will be reforming Japan’s tax system to be in conformity with international standards. With the progress of globalization, we have entered an age where the global harmonization of tax systems has become a desirable goal. For this reason, it will be essential to examine a suitable framework for Japan’s tax system based on a thorough understanding of global tax reform trends.

The reduction of progressive tax rates (so-called flattening of tax rates) and the raising of income tax thresholds that were implemented as stimulus measures following the collapse of the asset bubble in Japan have led to a hollowing out of the income redistribution function through income tax. Japan’s tax system also has many atypical features in international terms, such as a high corporate tax rate and low consumption tax rate.

As the basic direction for tax reform, it will be important to levy taxes on Japanese citizens broadly and lightly such as by expanding the tax base of income tax, lowering income tax thresholds, and increasing the consumption tax rate. It will also become necessary to expand the tax base of corporate tax and to reduce the tax rate to maintain economic vitality.

Major transformation of agricultural policies

The major transformation of agricultural policies will have a decisive effect on the question of whether or not to participate in TPP. The global trend of agricultural policies is to end price support policies for agricultural products and to support agriculture through direct payments by the government. Agricultural policies in Japan, however, have burdened consumers with the hidden cost of protecting agriculture by means of price support policies.

Learning from the global trend of agricultural policies, Japan should replace its price support policies with direct income support policies. Needed are policies that lower the prices of agricultural products and that lead to greater consumption and higher exports in the end. Rather than being a declining industry, agriculture is a growth industry with the potential of expanding greatly in the future. It would be truly unfortunate if Japan is forfeiting a major growth opportunity through the failed policies of the government.

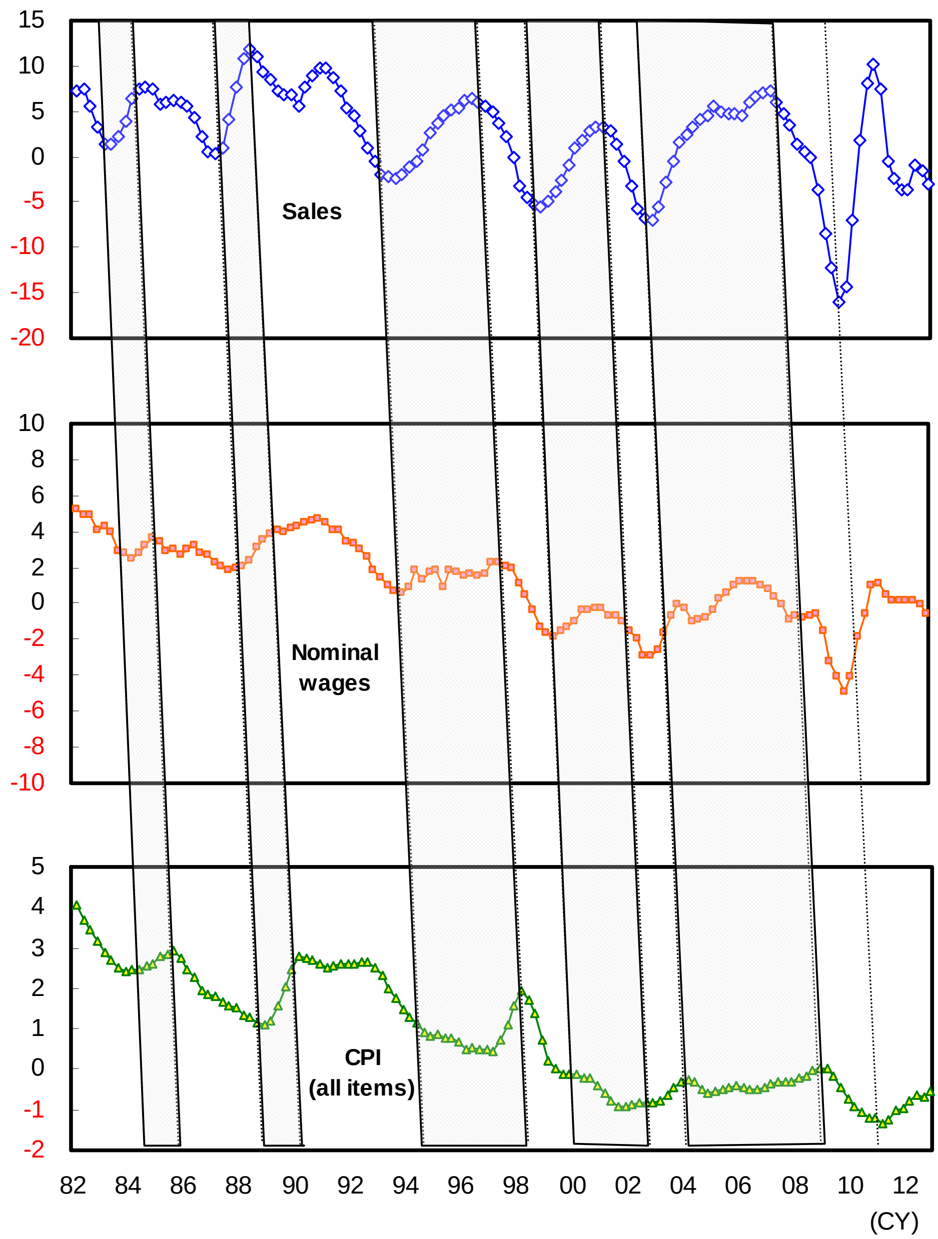
Issue 3: Increasing employee income

Cycle seen where increase in sales is followed by higher wages and higher prices

The third issue that Japanese are concerned about with respect to Abenomics is that, while inflation progresses, employee income might not grow.

However, as shown in Chart 4, an examination of the historical record discloses the existence in Japan of a cycle where an increase in sales is followed by higher wages and higher prices. In other words, about six to 12 months after sales increase, wages rise, followed by CPI after another six months. In its basic philosophy, Abenomics views the expansion of sales through monetary easing by the BOJ and through the pro-business policies of the government as the best approach for overcoming deflation. Bearing the above cycle in mind, it is safe to say that Abenomics has chosen precisely the right target to aim for.

Sales, Wages, and Prices (y/y %) **Chart 4**



Source: Ministry of Finance, Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.
Notes: 1) Y/y comparison of four-quarter moving average.
2) Shaded bars denote periods when sales were on uptrend. Bars tilted in order to show roughly 6-month lag from sales graph to nominal wages graph and from there to CPI graph, respectively.

Policies sought that will support transfer of income from corporate to household sector

Nevertheless, with the progress of globalization since the 2000s there is some concern that sales have lost some of their leading character relative to wages. In other words, as global competition intensifies, there is a tendency among companies to accelerate the increase or decrease in employee wages. There is no doubting the need in policy terms to strengthen a transmission mechanism that will enable higher sales to propagate appropriately to wage increases.

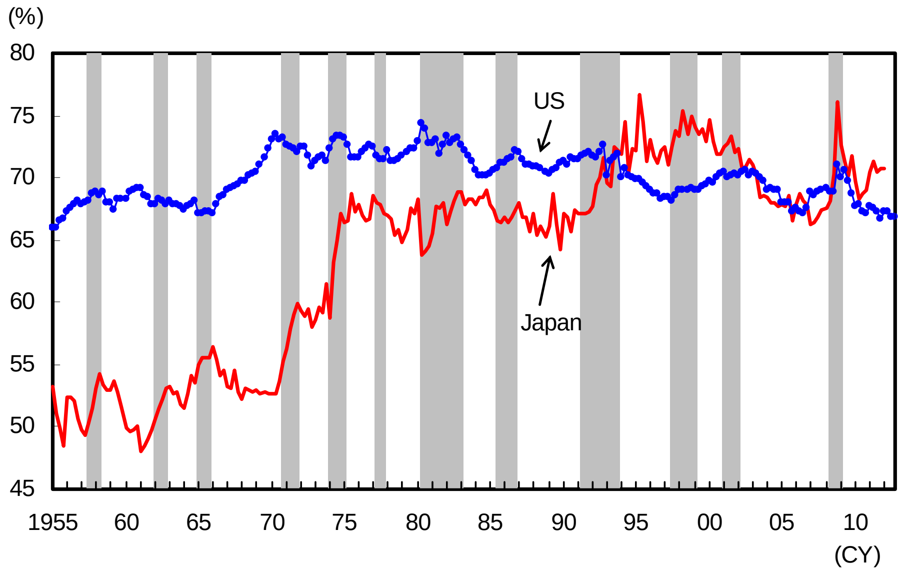
The Abe administration is planning to provide tax breaks to companies that increase the allocation of income to workers. While this policy can be commended to a certain degree, what is needed to strengthen the transfer of income from the corporate to household sector is a broader approach where higher wages are achieved by sharing the pain among government, business, and labor.

Due to an excessive preoccupation with averting unemployment during recessions, wage cuts became prevalent in Japan, and deflation has persisted. What is needed in the future is to have workers accept a greater degree of labor flexibility and to have companies actively increase wages in exchange. To encourage such developments, the government should support vocational training and workers' efforts to get jobs, provide tax breaks like that mentioned above, and support the restructuring of companies even more than before.

Labor's share not trending downward in Japan

The view loudly proclaimed by some economists that labor's share is trending downward in Japan is a misinterpretation of the facts. Chart 5 portrays the long-term trend of labor's share in Japan and the US. The chart reveals that labor's share is trending upward in Japan in the medium to long term and that its current level exceeds that of the US. Because of the downward rigidity of wages, labor's share generally declines during economic expansion and advances during recession. In the years since 1990, labor's share in Japan surged temporarily when the economy worsened sharply following the collapse of an asset bubble and after the Lehman crisis but declined in subsequent economic expansion periods. It is not the case that it is on a downward trend. In other words, the sluggishness of employee income is not a problem related to the allocation of national income but is mainly the outcome of an economic pie that has not expanded.

Long-term Trend of Japan and US Labor's Share **Chart 5**

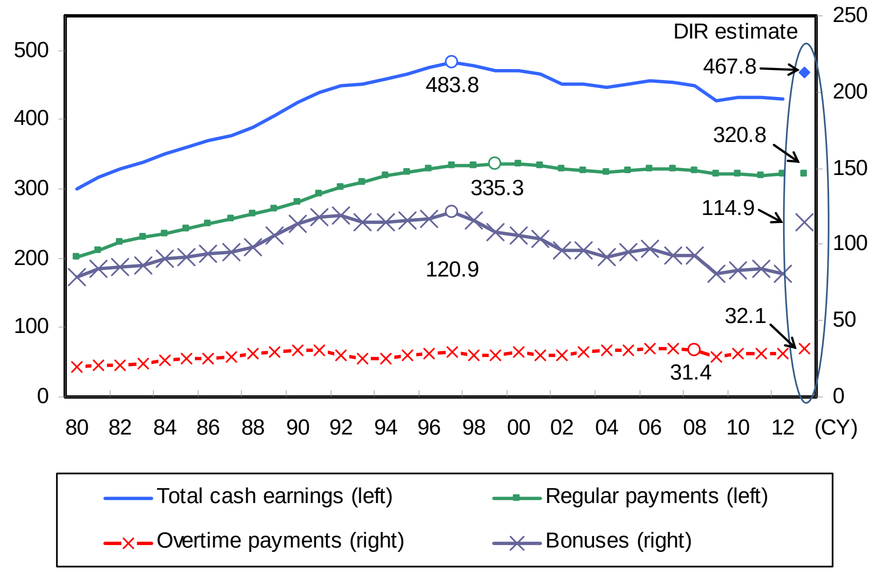


Source: US Bureau of Economic Analysis, Cabinet Office; compiled by DIR.
Notes: 1) Shaded areas denote economic downturns in Japan.
2) Due to discontinuity, Japan's labor's share adjusted based on 1990 SNA for 1955-79, 2000 SNA for 1980-93, 2005 SNA from 1994, and seasonally adjusted by DIR for 1955-79.

While wages expected to grow in cyclical terms, structural reforms necessary for stable growth

Chart 6 provides a simulation of per capita wage trend incorporating the cyclical economic recovery initiated by Abenomics. With the depreciation of the yen, production and corporate earnings have improved, and bonuses and overtime payments are expected to rise in cyclical terms. Regular payments, however, are continuing to decline, in large part owing to such structural factors as the stagnant labor productivity of the non-manufacturing sector and regulations restricting nursing care and social welfare businesses. Hence, hurdles to be overcome before we can see an increase in regular payments remain high. If an increase in regular payments cannot be counted on, there are limits to how high bonuses and overtime payments can rise, and, on this basis, total cash earnings are estimated to top out at Y4,678,000 annually, which is Y160,000 less than their all-time high. To conclude, to achieve a sustained increase in wages, it will be insufficient to depend solely on the cyclical recovery of the economy. What will prove indispensable are the promotion of structural reforms and deregulation and an increase in regular wages.

Estimation of Total Cash Earnings Per Employee, Assuming Regular Wage Not Increasing
(Y10,000; annually) **Chart 6**



Source: Ministry of Health, Labour and Welfare; compiled by DIR.
Note: Circles denote highest ever payments.

Outlook for Japanese Economy, Interest Rates **Chart 7**

	2012	2013				2014	FY11	FY12	FY13	FY14
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
Indicator	Actual		DIR estimates				Actual		DIR estimates	
Real GDP										
Q/q %, annualized	1.2	4.1	3.0	4.1	4.4	5.9				
Y/y %	0.4	0.4	1.2	3.1	3.9	4.2	0.2	1.2	3.1	0.7
Current account balance SAAR (Y tril)	4.3	2.9	4.6	5.4	6.0	6.9	7.6	4.3	5.7	12.5
Unemployment rate (%)	4.2	4.2	4.1	4.1	4.0	4.0	4.5	4.3	4.1	3.9
CPI (excl. fresh foods; 2010 prices; y/y %)	-0.1	-0.3	-0.1	0.3	0.5	0.6	-0.0	-0.2	0.3	2.9
Unsecured overnight call rate (period end; %)	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
10-year JGB yield (period average; %)	0.76	0.66	0.90	0.90	1.00	1.00	1.05	0.76	0.95	1.05

Source: Compiled by DIR.
Note: Estimates taken from DIR's *Japan's Economic Outlook No. 177 Update*.