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Japan's Economy: Monthly Review

Why Are Wages Stagnant in Japan?

Strengthening the third arrow of Abenomics (growth strategy) is the true path toward revitalizing Japan's economy

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Main Points

- **Economic outlook revised:** In light of the first preliminary Jul-Sep GDP release (Cabinet Office), we have revised our economic growth outlook. We now forecast real GDP growth of +2.6% y/y for FY13 (previous forecast: +3.0%) and +1.0% for FY14 (+1.2%). We have revised our economic outlook downward mainly in view of the economic growth rate for Jul-Sep 2013 coming in lower than anticipated.

- **Main scenario for Japan's economy:** After hitting bottom in November 2012, Japan's economy has entered a recovery phase. We believe it will continue to expand steadily supported by (1) increases in exports based on the backs of the US economic recovery, (2) ongoing depreciation of the yen and the rise in stock prices supported by the BOJ's monetary easing, and (3) economic stimulus measures to offset the effects of the consumption tax hike. Risks that will need to be kept in mind regarding the Japanese economy are: (1) turbulence in emerging economies, (2) China's shadow banking problem, (3) a reigniting of the European sovereign debt crisis, and (4) a surge in crude oil prices stemming from geopolitical risk.

- **Why are wages stagnant in Japan?:** The need to increase wages has become a leading political issue in Japan. In this report, we provide a multifaceted examination of the reasons why wages have stagnated in Japan and present our outlook going forward. First, an international comparison of real wages demonstrates that wages are stagnating in Japan not because labor's share is low, but because there are issues involving labor productivity and corporate competitiveness. Thus the key is to increase labor productivity and improve corporate competitiveness by strengthening the third arrow of Abenomics (growth strategy) in order to raise real wages in Japan. Second, a simulation of the future direction of wages reveals that wages are likely to gradually trend upward as the economy undergoes a cyclical recovery. It is also highly likely that regular payments will continue to grow at the macro level given an improvement in the supply-demand balance for labor. However, the increase in per-employee wages will be limited if it is based solely on a cyclical economic recovery. For wages

to exceed their former peak, it will be crucial for the government to (1) strengthen the third arrow of Abenomics (structural reform of non-manufacturing and medical and nursing care sectors) and to (2) address the problems associated with non-regular employment. Companies will also need to accelerate the pace of wage increases as much as possible to avoid the "fallacy of composition".

Summary

Economic outlook revised

In light of the first preliminary Jul-Sep GDP release (Cabinet Office), we have revised our economic growth outlook. We now forecast real GDP growth of +2.6% y/y for FY13 (previous forecast: +3.0%) and +1.0% for FY14 (+1.2%). We have revised our economic outlook downward mainly in view of due to the economic growth rate for Jul-Sep 2013 coming in lower than anticipated.

Jul-Sep 2013 real GDP increased an annualized 1.9% q/q in the first preliminary estimate

The first preliminary estimate of Jul-Sep 2013 real GDP (Cabinet Office) posted an advance of 0.5% q/q, annualized at +1.9%, the fourth quarterly positive growth in a row and overshooting the market consensus (+0.4%; annualized at +1.7%). The major factor behind the overshoot was a larger-than-expected positive contribution of inventories (+0.4 percentage points). Other demand components were almost on par with expectations in general. Domestic demand saw the fourth positive contribution to q/q GDP growth in a row (+0.9 points), while foreign demand saw the first negative contribution in three quarters (–0.5 points) due to a slide in exports. In other words, a slide in foreign demand held down GDP growth.

Main scenario: Japan's economy to continue growing

After hitting bottom in November 2012, Japan's economy has entered a recovery phase. We believe it will continue to expand steadily supported by (1) increases in exports based on the backs of the US economic recovery, (2) ongoing depreciation of the yen and the rise in stock prices supported by the BOJ's monetary easing, and (3) economic stimulus measures to offset the effects of the consumption tax hike.

In terms of GDP demand components, personal consumption has been the driving force behind the economic recovery. Although the Jul-Sep quarter saw a slowdown in the growing pace, it is very likely to be temporary and is expected to continue growing as the income environment improves. It is also highly likely that personal consumption will gain momentum toward end-FY13 and boost the economic growth rate as demand escalates in advance of the consumption tax hike scheduled in April 2014. Although exports turned downward in Jul-Sep 2013, we believe they will return to a growth path in view of the improvement in competitiveness ensuing from yen's depreciation to date and the expansion of foreign economies, mainly the US. Corporate earnings are also likely to improve further reflecting higher exports and firm domestic demand and we anticipate that capex will continue to grow.

Four risk factors: Examination of the world economic cycle

Risks that will need to be kept in mind regarding the Japanese economy are: (1) turbulence in emerging economies, (2) China's shadow banking problem, (3) a reigniting of the European sovereign debt crisis, and (4) a surge in crude oil prices stemming from geopolitical risk. Of these four risks, it is worth underscoring that the first is closely related to the second and third.

Examining the world economic cycle, advanced economies led by the US drove emerging economies in the past. However, a decoupling has currently taken place—advanced economies are performing

well but emerging economies are stagnating. We believe that this decoupling is occurring for three reasons: (1) the dwindling in the amount of loans from European financial institutions to emerging economies in light of the European debt crisis, (2) the sluggishness of the Chinese economy, and (3) concerns that money will be taken out of emerging economies based on worries that the Fed will implement exit measures from a quantitative easing. In the final analysis, we anticipate that the collapse of emerging economies will be avoided as the US economy continues to expand. Nevertheless, the state and the future direction of the Chinese economy will continue to require close monitoring.

BOJ monetary policy

The BOJ is likely to purchase additional risk assets (ETFs and other assets) in Apr-Jun 2014 and beyond in part to mitigate the adverse impact of a higher consumption tax rate.

1. Why Are Wages Stagnant in Japan?

Increasing wages a leading political issue

The need to increase wages has become a leading political issue in Japan. In this report, we provide a multifaceted examination of the reasons why wages have stagnated in Japan and present our outlook going forward.

First, an international comparison of real wages discloses that wages are stagnating in Japan not because of labor's share being low but because of issues related to labor productivity and the competitiveness of companies. Thus, a key issue will be increasing labor productivity and improving the competitiveness of companies by strengthening the third arrow or priority area of Abenomics (growth strategies) with the view to raising real wages in Japan.

Second, a simulation of the future direction of wages reveals that wages are likely to gradually trend upward as the economy undergoes a cyclical recovery. It is also highly likely that regular payments will continue to grow at the macro level given an improvement in the supply-demand balance for labor. However, the increase in per-employee wages will be limited if it is based solely on a cyclical economic recovery. For wages to exceed their former peak, it will be crucial for the government to (1) strengthen the third arrow of Abenomics (structural reform of non-manufacturing and medical and nursing care sectors) and to (2) address the problems associated with non-regular employment. Companies will also need to accelerate the pace of wage increases as much as possible to avoid the "fallacy of composition".

1.1 International comparison of real wages: Key will be strengthening the third arrow of Abenomics (growth strategy)

Main reasons for the sluggish growth of real hourly wages are the lack of labor productivity growth and corporate competitiveness

First, we examine the reasons for the sluggish growth of wages in Japan by comparing wages internationally. Chart 1 portrays the changes in real hourly wages of major nations according to (1) labor productivity (2) "GDP deflator/CPI", and (3) labor's share.

By comparing the growths of real wages between 2000 and 2009 for Japan, the US, and Germany, we find that only in Japan has real wages fallen. Compared to the US and Germany, factors for the sluggish growth of real wages in Japan are the lack of labor productivity growth and the sizable decline in "GDP deflator/CPI". By comparison, downward pressure (degree of contribution) on real wages stemming from labor's share is largely the same for all three nations. Thus, it is difficult to say that the decline in labor's share is the main reason for the sluggish growth of real wages in Japan.

Labor productivity can be broken down into real GDP and total labor hours. While there is no significant difference in total labor hours between the three nations, a decisive factor for Japan has been the sluggish growth of real GDP. An examination of the components of real GDP reveals that the contributions of fixed capital formation and total factor productivity are relatively small for Japan compared to other nations.

A factor analysis of "GDP deflator/CPI" indicates that the terms of trade and the domestic demand deflator are making negative contributions. Even in periods when import prices were rising, Japanese companies did not pass through the cost increase to the price of export goods in order to maintain competitiveness. As a result, the terms of trade worsened and became a downward pressure on the GDP deflator.

Breakdown of Real Hourly Wages **Chart 1**

Annual growth (CY00-09 avg; %)	Japan	US	Germany
Real hourly wages	-0.5	1.3	0.2
Labor productivity	0.7	2.0	1.2
GDP deflator / CPI	-1.0	-0.3	-0.7
Labor's share	-0.3	-0.4	-0.3

Real hourly wages, labor productivity, and labor's share defined as follows:
Real hourly wages = nominal employee compensation / (no. of employees x hours worked) / CPI.
Labor productivity = real GDP / (no. of employees x hours worked).
Labor's share = nominal employee compensation / nominal GDP.

Thus, real hourly wages are expressed as:
Real hourly wages = labor productivity x GDP deflator / CPI x labor's share.

Then, % change (△ln) is expressed as:
△ln (real hourly wages) = △ln (labor productivity) + △ln (GDP deflator / CPI) + △ln (labor's share)
△ln (labor's share) = △ln (real GDP) - △ln (no. of employees) - △ln (hours worked)
△ln (labor' share) = △ln (nominal employee compensation) - △ln (nominal GDP)

Annual growth (CY00-09 avg)	Japan	US	Germany
Labor productivity (%)	0.7	2.0	1.2
Real GDP (%)	0.5	1.8	0.9
Contribution of hours worked (% pt)	-0.4	-0.2	-0.3
Contribution of labour composition change (% pt)	0.3	0.3	0.1
Contribution of capital services	0.5	1.1	0.8
Contribution of ICT capital services (% pt)	0.3	-	0.3
Contribution of non-ICT capital services (% pt)	0.3	-	0.5
Contribution of TFP (% pt)	0.1	0.3	0.3
Total hours worked (%) Plus-minus reversed	0.2	0.2	0.3
No. of employees (%) Plus-minus reversed	-0.3	-0.1	-0.3
Hours worked (%) Plus-minus reversed	0.5	0.3	0.7

Annual change (CY00-09 avg)	Japan	US	Germany
GDP deflator / CPI (%)	-1.0	-0.3	-0.7
GDP deflator (%)	-1.2	2.2	0.9
Contribution of terms of trade (% pt)	-0.3	-0.0	0.0
Contribution of domestic demand deflator (% pt)	-0.8	2.3	1.0
Contribution of import deflator (% pt)	-0.0	-0.1	0.0
Contribution of other items (% pt)	-0.0	-0.0	-0.0
CPI (%) Plus-minus reversed	0.3	-2.5	-1.6

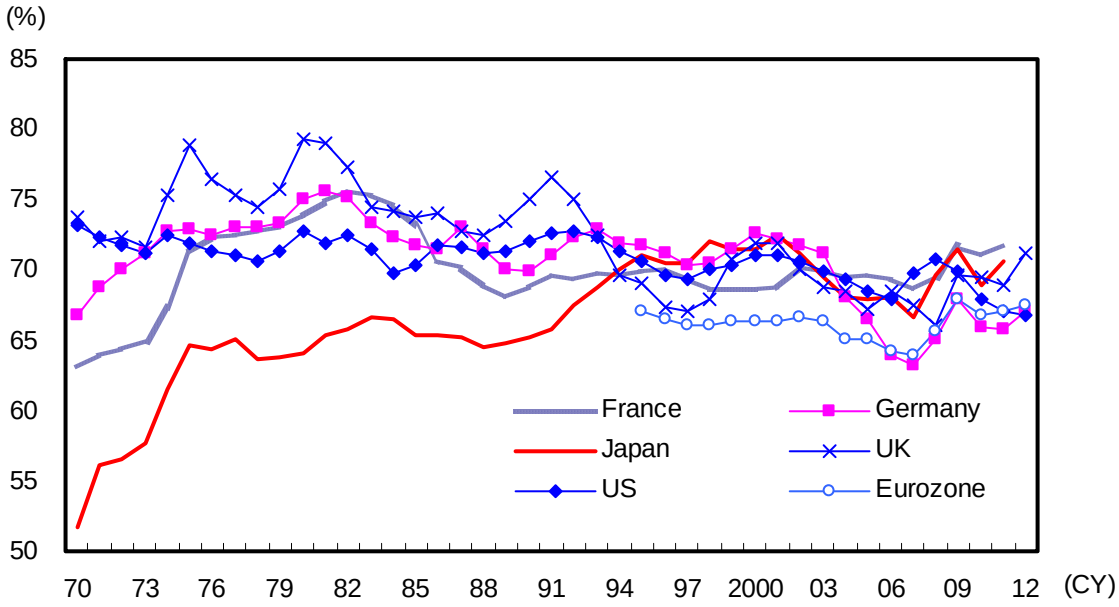
Annual change (CY00-09 avg)	Japan	US	Germany
Labor's share (%)	-0.3	-0.4	-0.3
Nominal employee compensation (%)	-1.0	3.6	1.4
Nominal GDP (%) Plus-minus reversed	0.7	-4.0	-1.7

Source: Cabinet Office, US Bureau of Economic Analysis, Bundesbank, EU KLEMS; compiled by DIR.
Note: TFP=total factor productivity.

Labor's share is not particularly low in Japan

As noted above, an international comparison reveals that labor's share is not particularly low in Japan. Chart 2 portrays the long-term trend of labor's share (employee compensation against national income) for Japan and other nations. The chart reveals that labor's share has increased notably around 1970 in Japan and that its current level is not necessarily low in international comparison. Because of the downward rigidity of wages, labor's share generally declines during economic expansions and increases during recessions. After 1990, labor's share in Japan surged temporarily during the economic downturn following the collapse of the Japanese asset bubble and after the Lehman crisis, but declined in subsequent periods of economic expansion. In all, labor's share is not on a downward trend. The sluggish growth of employee income is not a problem of distribution, but of a lack of growth.

Labor's Share by Nation/Area **Chart 2**



Source: OECD; compiled by DIR.

1.2 Will wages increase in Japan going forward?

1.2.1 Simulation of wage trend

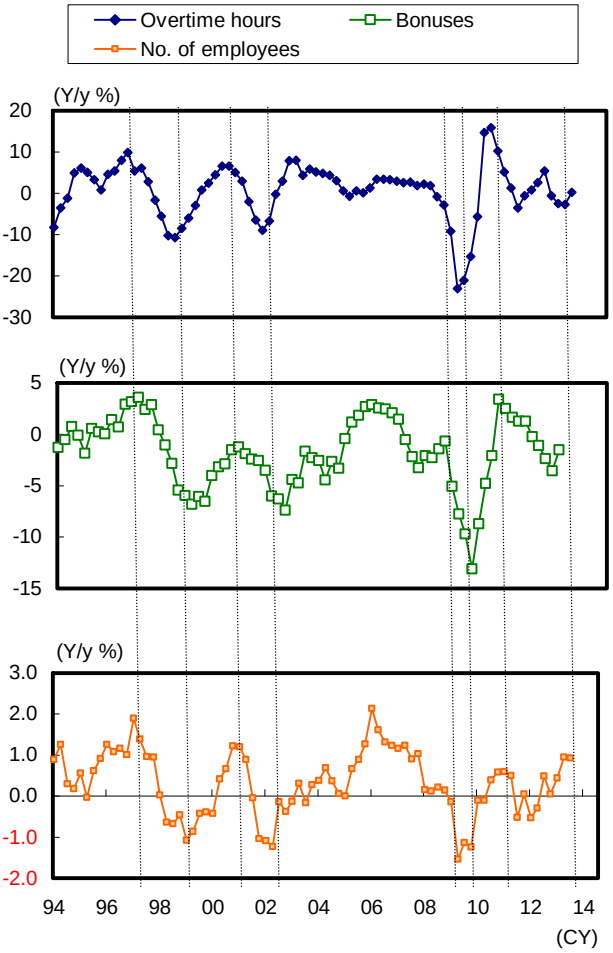
Employment and income environments improve in the following order: (1) overtime pay (2) bonuses (3) number of employees

Chart 3 shows the order in which employment and income environments improve. An examination of past economic recoveries reveals the following pattern:

First, overtime pay increases as overtime hours increase. Next, an increase in sales contributes to an improvement in corporate earnings and contributes to higher bonuses. Finally, as the supply-demand balance for labor tightens, the number of employees increases. Meanwhile, as illustrated by the trend of number of employees by industry in Chart 4, the number of employees in manufacturing sector increases first, followed by that in non-manufacturing sector with a slight lag.

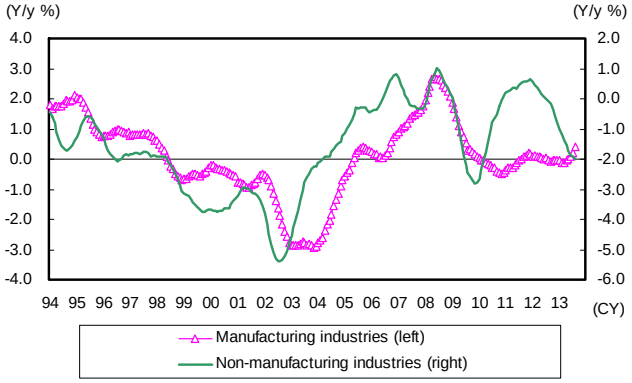
Overtime hours have been on a rise in 2013 and the increase in overtime pay is supporting the income environment. In addition, bonuses are increasing according to a *Keidanren* survey released on 13 November 2013, underscored by the prospect that winter bonuses of large corporations will grow by 5.8% y/y. The number of employees has already turned upward and the pace of increase is expected to increase going forward. Hence, the cyclical improvement of the employment and income environments will become a factor supporting Japan's economy and the lives of ordinary people.

Channel from Employment to Income **Chart 3**



Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications (MIC); compiled by DIR.
Notes: 1) Overtime hours=five-quarter central moving average.
2) No. of employees based on *Labour Force Survey* (MIC).

No. of Employees **Chart 4**



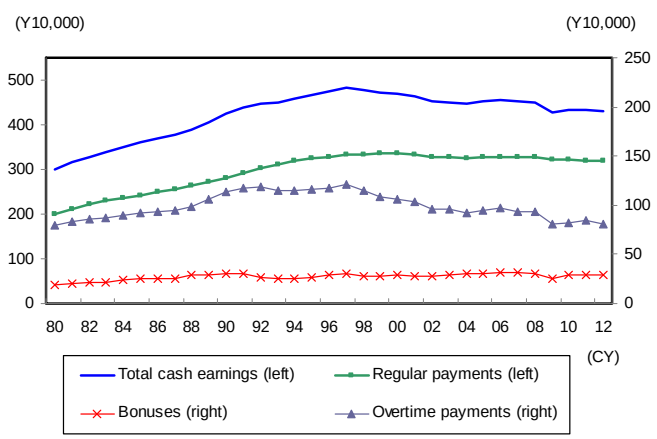
Source: Ministry of Health, Labour and Welfare; compiled by DIR.

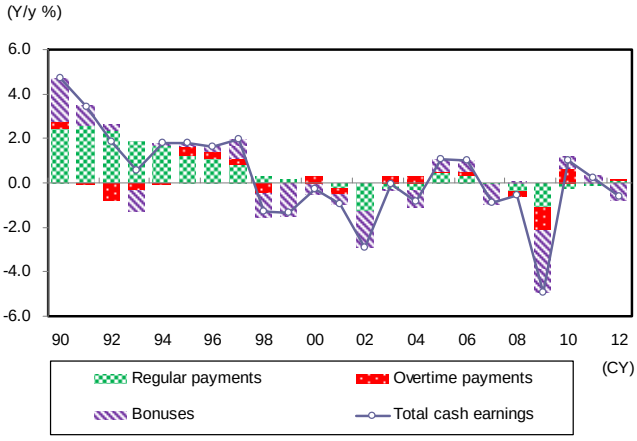
The main reason for the faltering income in Japan is the decline of bonuses

Based on the pattern shown above, we now examine the future direction of wages. While overtime payments and bonuses are currently improving, is it reasonable to think that per capita total cash earnings will actually improve in earnest? When considering the future income environment, it is helpful to examine the factors behind the decrease in income that encumbered Japan in past years.

Chart 5 shows the trend of total cash earnings in Japan. When examined by component, three features stand out: (1) regular payments have gradually fallen since 1997, (2) declines in bonuses have placed significant downward pressure on total cash earnings, and (3) overtime payments fluctuate along with business cycles. Total cash earnings have declined by about Y550,000 from their peak in 1997 of Y4.84 million, to Y4.3 million in 2012. About 80% of this decline can be explained by the decline in bonuses and about 20% from the decrease in regular payments.

Breakdown of Total Cash Earnings — Chart 5





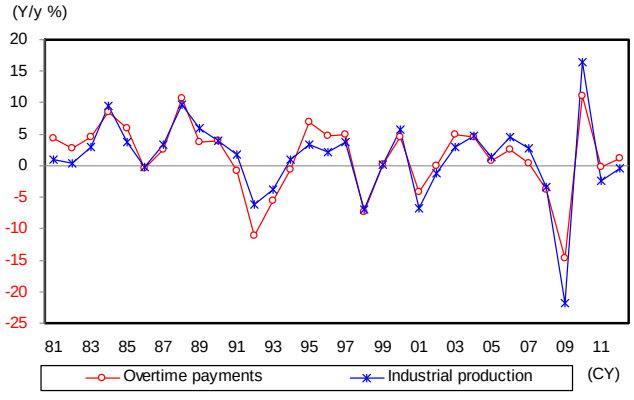
Source: Ministry of Health, Labour and Welfare; compiled by DIR.

Cyclical fluctuations a major aspect of overtime payments and bonuses

We now examine in detail overtime payments and bonuses. Chart 6 illustrates trend of overtime payments and industrial production. We can see in the chart that overtime payments closely track the fluctuations in production. Chart 7 portrays the trends of bonuses and recurring profit (recurring profit portrayed one-year previous), which affirms that bonuses move after corporate performance begin to improve with a slight lag.

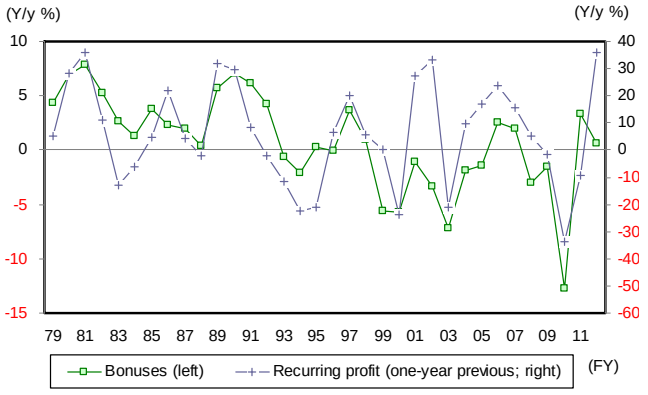
As noted above, the trends of overtime payments and bonuses are heavily influenced by business cycles. When the economy enters a recovery phase, production increases and corporate earnings improve. As a result, overtime payments rise around the same time as production, and bonuses increase with a slight lag.

Overtime Payments and Industrial Production — Chart 6



Source: Ministry of Health, Labour and Welfare, Ministry of Economy, Trade and Industry; compiled by DIR.

Bonuses and Corporate Earnings — Chart 7



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

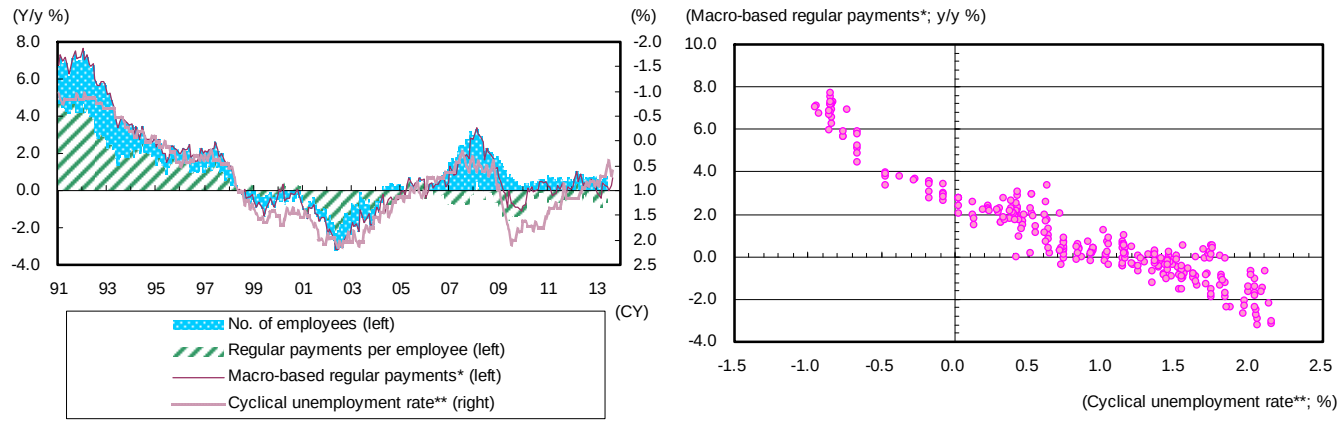
Macro-based regular payments likely to increase as the supply-demand balance for labor tightens

Next, we turn our attention to regular payments. While overtime payments and bonuses are closely linked to business cycles, regular payments show a close relationship to the supply-demand balance for labor. Chart 8 portrays the relationship between regular payments and the unemployment rate. We can see in the chart that macro-based regular payments (regular payments multiplied by the number of

employees) tend to rise in periods when the unemployment rate falls (the supply-demand balance for labor tightens) and decline in periods when the unemployment rate increases.

Currently, the unemployment rate continues to decline and the increase in the number of employees is boosting macro-based regular payments. Since the unemployment rate is expected to fall further, the likelihood is high that macro-based regular payments will continue to rise.

Macro-based Regular Payments* and Unemployment Rate **Chart 8**



Source: Ministry of Internal Affairs and Communications; Ministry of Health, Labour and Welfare; compiled by DIR.
*Regular payments x no. of employees.
**Unemployment rate - structural unemployment; the latter estimated by DIR.

Will per-employee regular payments increase?

While regular payments are expected to continue increasing at the macro level, what is the outlook for regular payments on a per-employee basis? To determine the future direction of per-employee regular payments, it is useful to examine the past trend of regular payments by industry.

Non-manufacturing sector is the main culprit for the sluggish growth of regular payments

Chart 9 illustrates the trend of regular payments in the manufacturing and non-manufacturing sectors. Comparing the two graphs on the left side, we can see that while regular payments have gradually increased in the manufacturing sector, they have continued to fall in the non-manufacturing sector. In other words, non-manufacturing sector is the main culprit for the sluggish growth of regular payments in Japan.

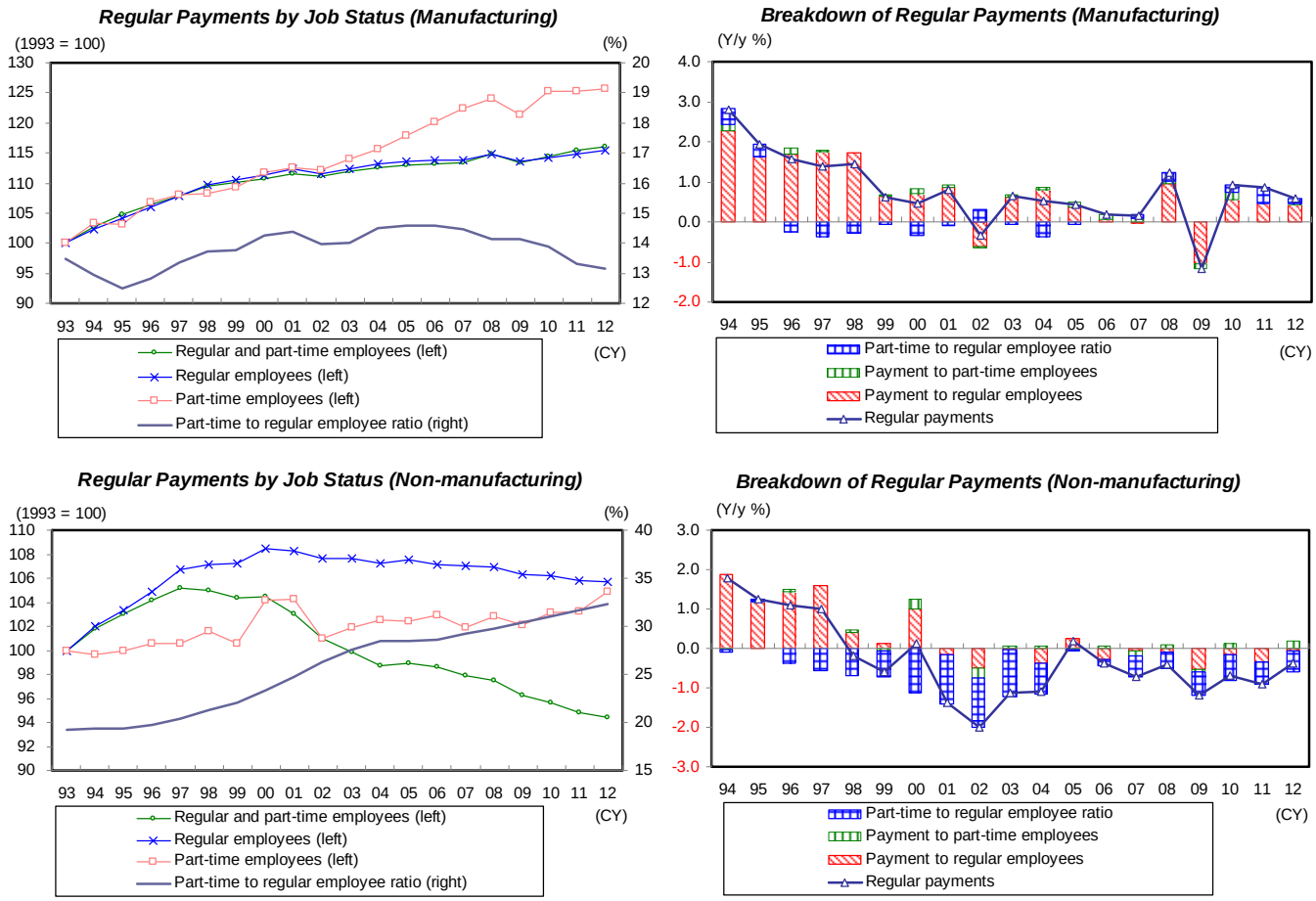
Decline in regular payments in non-manufacturing sector results from the decrease in income for regular workers and the increase in the part-time worker ratio

To further examine factors behind the decline in regular payments in the non-manufacturing sector, the lower right graph in Chart 9 breaks it down into (1) regular payments paid to regular workers, (2) regular payments paid to part-time workers, and (3) the part-time worker ratio. Regular payments have trended downward since 1998 in the non-manufacturing sector, and the chart confirms that this decline comes largely from an increase in the part-time worker ratio.

There is also a large difference between regular payments paid to regular workers in manufacturing sector versus those in the non-manufacturing sector. With the exception of 2002 and 2009, payments have not fallen in the manufacturing sector. In contrast, setting aside 2005, payments have fallen in the non-manufacturing sector since 2001. The decline in regular payments in the non-manufacturing sector

is the consequence of an increase in the part-time worker ratio and a decrease in the earnings of regular workers.

Factors Behind Sluggish Regular Payments **Chart 9**



Source: Ministry of Health, Labour and Welfare; compiled by DIR.
Note: Establishments with five or more regular employees.

Reasons why the part-time ratio has risen and the earnings of regular workers have fallen in the non-manufacturing sector

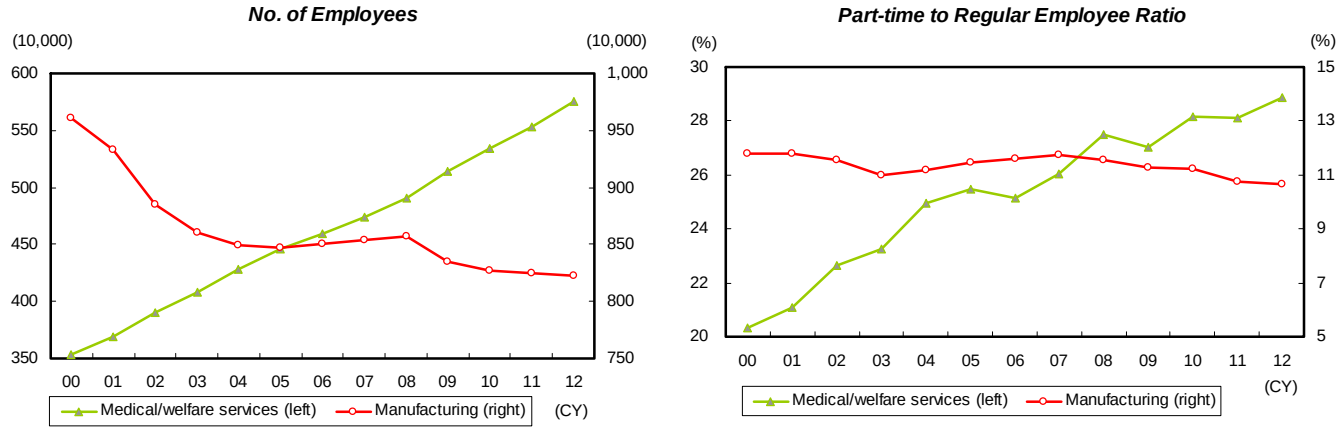
What explains the increase in the part-time ratio and the decline in the earnings of regular workers in the non-manufacturing sector? The deciding factor is the increase in the number of employees in the healthcare and social welfare services industries.

A rise in the part-time worker ratio and a decline in earnings of regular workers have concurrently taken place in the healthcare and social welfare services industries

When we look closely at the employment structure of these industries, we find that the part-time worker ratio has gone up and regular payments paid to regular workers have continued to decline. These only take place in the service sector, mostly in healthcare and social welfare services.

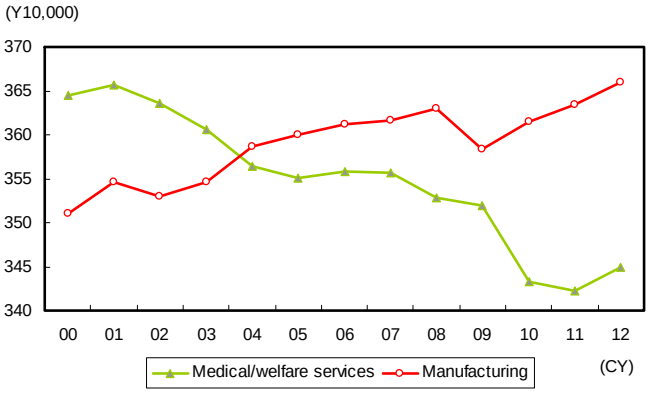
The increase in the part-time worker ratio in the healthcare and social welfare services industries, where the number of employees is rapidly growing, contributes to an increase in the part-time worker ratio for the non-manufacturing sector as a whole. Similarly, if the regular payments paid to regular workers decline in industries where the number of employees is rising, the regular payments paid to regular workers will decline for the entire non-manufacturing sector.

No. of Employees and Part-time Ratio: Manufacturing vs. Medical/welfare Services — Chart 10



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

Regular Payments (Regular employees): Manufacturing vs. Medical/welfare Services — Chart 11

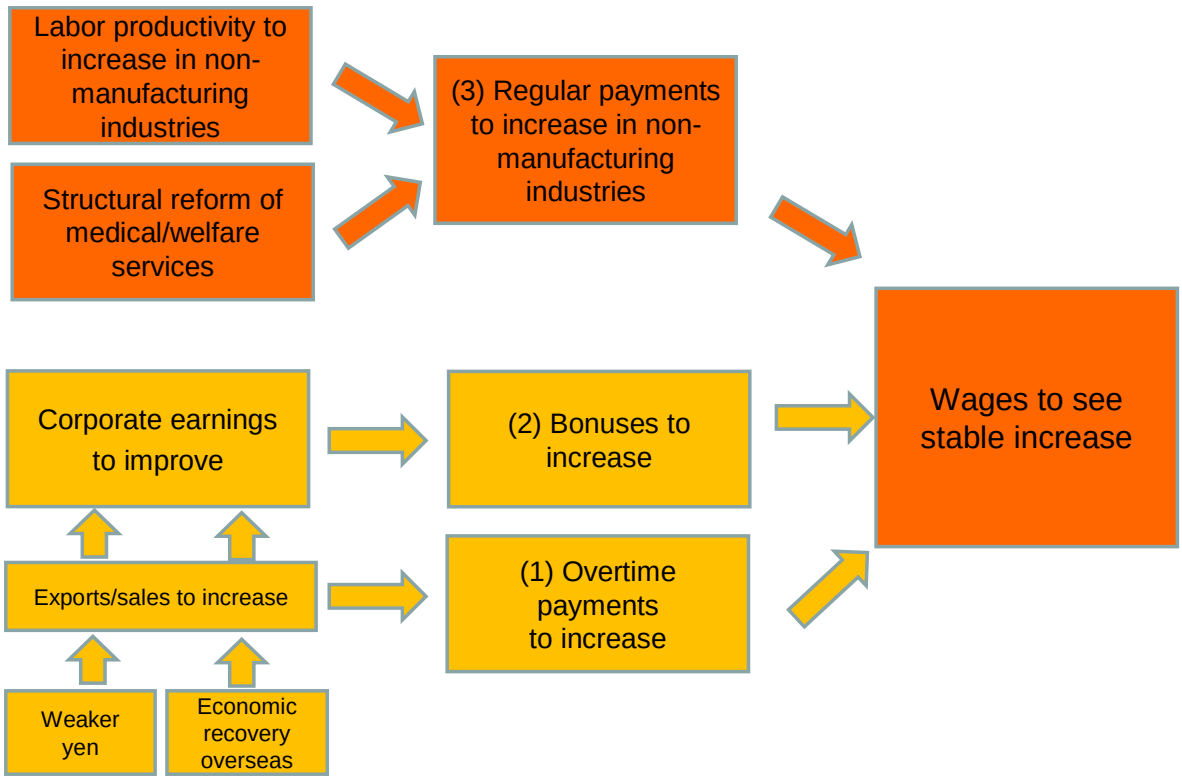


Source: Ministry of Health, Labour and Welfare; compiled by DIR.

Toward a steady wage increase

As we have discussed above, overtime payments and bonuses are expected to increase cyclically along with the expansion of the economy, while macro-based regular payments are expected to increase gradually as the supply-demand balance for labor tightens. However, in order for per-employee regular payments to steadily increase, we must overcome structural issues that are placing a downward pressure on regular payments. Specifically, we should look further into measures (1) reducing the part-time worker ratio and (2) increasing labor productivity in the services sector, especially in the healthcare and social welfare services industries where the number of employees is growing.

Path to Stable Wage Growth **Chart 12**



Source: Compiled by DIR.

Unless regular payments increase, per-employee wages will not reach their former peak

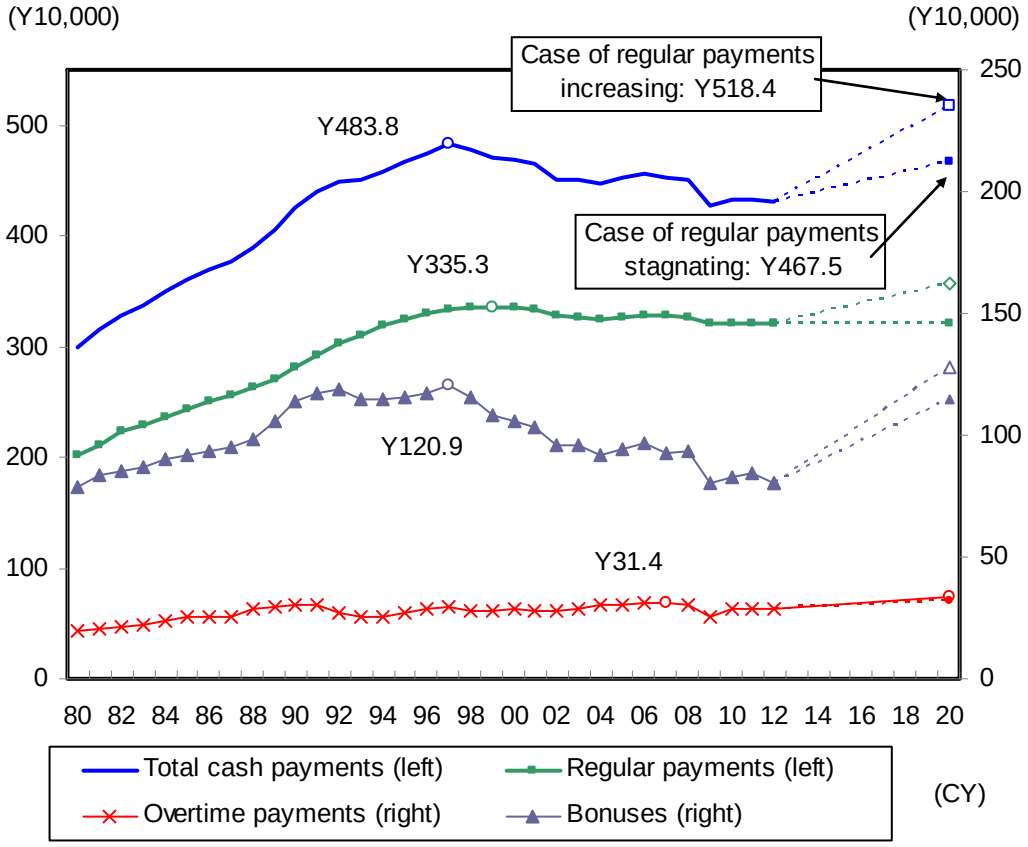
Even if overtime payments and bonuses increase cyclically, without structural reforms and deregulation, per-employee regular payments will not turn upward. In such a scenario, a sustained increase in wages will be difficult to achieve. The reasons are as follows:

First, the increase in overtime payments comes from an increase in overtime hours. Since companies cannot force employees to work excessive overtime hours, once overtime hours increase by a certain amount, companies begin to consider hiring more employees. Historical data shows that fewer companies feel that the number of employees they have is excessive once overtime hours are over 150 hours per year. Thus, should overtime hours reach such a level, companies will respond not only by extending working hours but by hiring more workers. Therefore it is unlikely that per-employee overtime pay will continue to rise.

Second, it is likely that the increase in bonuses will eventually reach a ceiling. When we examine a time series to ascertain the level bonuses reach relative to regular payments, even when the economy was growing firmly in the 1980s, total annual bonuses trended at a level corresponding to about 4.5 months of regular payments. Hence even if bonuses rebound, they are highly likely to hit a ceiling at around 4.5 months of regular payments.

Finally, Chart 13 presents the results of simulating per-employee wages for the case where regular payments increase and the case where they are flat. In the case where regular payments increase, per-employee wages will easily exceed their former peak. In contrast, per-employee wages will hit a ceiling at a level Y150,000 less than their former peak in the case where regular payments are flat. Thus, the increase in regular payments is indispensable for the stable growth of per-employee wages.

Simulation of Per Employee Wages **Chart 13**



Source: Ministry of Health, Labour and Welfare; compiled by DIR.
Notes: 1) Hollow circles in the past denote record highs.
2) Hollow marks at end-simulation period indicate cases where regular payments assumed to increase, while solid marks indicate those where regular payments assumed to decline.

1.2.2 Measures needed for wage growth

The government should strengthen the third arrow of Abenomics (structural reform of the non-manufacturing sector and the areas of medical and nursing care)

According to the above simulation, the future direction of wages indicates that they are likely to trend gradually upward as the economy undergoes a cyclical recovery. It is also highly likely that regular payments will continue to grow at the macro level, given the improvement in the supply-demand balance for labor. However, the increase in per-employee wages will be limited if it is based solely on the cyclical economic recovery. In order for per-employee wages to exceed their former peak, it will be indispensable for the government to (1) strengthen the third arrow of Abenomics (structural reform of the non-manufacturing sector and the areas of medical and nursing care) and to (2) address the problems associated with non-regular employment in order to increase per-employee regular payments.

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

To increase regular payments, it is important to aggressively engage in structural reforms and deregulation to improve labor productivity and corporate competitiveness. A major reason why deflation has persisted in Japan is the low labor productivity of the non-manufacturing sector. This is the consequence of a low capital-labor ratio, mainly on IT-related investments. The capital-labor ratio has been slow to increase for the non-manufacturing sector compared to the manufacturing sector and total factor productivity (a measure of technological progress) remains stagnant for the non-manufacturing sector.

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

The medical and nursing care area has been a major reason for the sluggish growth of per-employee regular payments. What is desirable are concrete measures to increase the labor productivity involving drastic deregulation such as allowing a wider range of entities to operate special nursing homes for the elderly, eliminating the ban on "mixed medical treatments" (combining medical procedures that are covered with public health insurance with those that are not), and allowing public companies to enter the healthcare sector.

Three points regarding employment policies

Three points deserve attention regarding employment policies:

First, what needs to be recognized is that employment is essentially a form of secondary demand. The guiding principle to follow is the idea that the best employment policy is to steadily expand Japan's economy.

Second, building on this guiding principle, what should be placed at the core of employment measures are active ones that center on job training (active employment measures) rather than those that relieve pain after the fact (passive employment measures). The crux of employment policies should be in increasing the "employability" of workers.

Third, an urgent issue that needs addressing is the elimination of unfair segregation between regular and non-regular workers. The quintessential principle is "the same pay for the same work." Should attempts be made to forcibly convert non-regular workers into regular workers, it would result in an outflow of jobs overseas and risk placing non-regular workers in a more difficult situation. In legislative terms, a temporary agency law should be passed and the legal status of non-regular workers should be clarified in the main body of such law.

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

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, wages rise about six to 12 months after sales increase, followed by a rise in CPI after another six months. Some concern, however, is raised by sales losing some of its leading characteristic since the 2000s with the advancement of globalization.

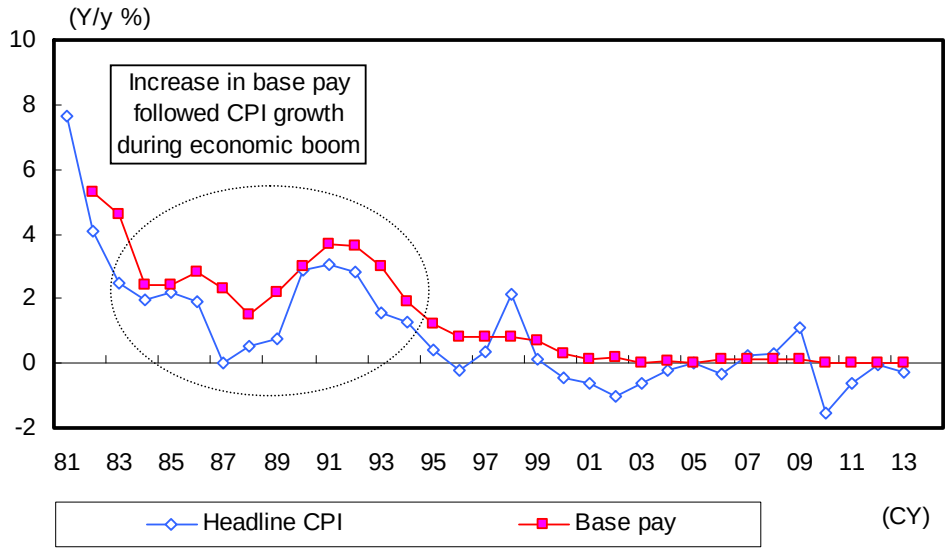
What is needed in policy terms going forward is a strengthening of the transmission mechanism that enables higher sales to lead to wage increases. The Abe administration is planning to give tax breaks to companies that increase the compensation of workers. While this policy can be commended to a certain degree, to strengthen the transfer of income from the corporate to household sector, a broader approach should be taken that could be possibly called a reversed "Akkoord van Wassenaar 1982" where higher wages are achieved by government, business, and labor sharing the burden.

Companies should accelerate the increase in base pay as much as possible

In addition to policy measures, companies should accelerate the pace of wage increase as much as possible to avoid the "fallacy of composition" coming into play. In particular, getting companies to increase base pay across-the board will be extremely important.

An examination of prior data when base pay was increased indicates that the size of the pay increase was determined with previous year's CPI growth rate in mind. Hence, from the perspective of regular payments, wages have tended to lag CPI. Given such tendencies, declines in the growth rate of the CPI have led to decreases in wages, a situation that gave way to a deflationary spiral in Japan. In contrast, in nations such as the US, wages and prices tend to change at nearly the same time, giving the strong impression that prices are determined by wages. There is a need to build a mechanism in Japan like developing a suitable labor environment so that companies can accelerate the pace of wage increase as much as possible.

Increase in CPI and Base Pay **Chart 14**



Source: Ministry of Internal Affairs and Communications, Keidanren (Japan Business Federation), Institute of Labour Administration; compiled by DIR.
Note: Increase in base pay through 1989 based on estimates by Institute of Labour Administration; that from 1990 based on survey by Keidanren.

Outlook for Japanese Economy, Interest Rates **Chart 15**

	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	0.6	4.3	3.8	1.9	3.4	4.2				
Y/y %	0.3	0.3	1.1	2.7	3.3	3.2	0.3	1.2	2.6	1.0
Current account balance SAAR (Y tril)	4.3	3.1	8.9	2.2	2.3	2.8	7.6	4.4	4.1	7.7
Unemployment rate (%)	4.2	4.2	4.0	4.0	4.0	3.9	4.5	4.3	4.0	3.8
CPI (excl. fresh foods; 2010 prices; y/y %)	-0.1	-0.3	0.0	0.7	0.8	0.9	-0.0	-0.2	0.6	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	0.77	0.73	0.75	0.80	1.05	0.76	0.76	0.90

Source: Compiled by DIR based on various statistics.
Note: Estimates taken from DIR's *Japan's Economic Outlook No. 179*.