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Will Spring Labor Offensive bring wage hikes, thus leading to growth in consumption?

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Summary

- This year's Spring Labor Offensive is attracting attention as a possible means of triggering accelerated movement toward a virtuous circle based on domestic demand. The average rate of wage increase falls well below the government's target of 3%, and considering the fact that Japanese corporations are reporting historic highs in their earnings, there is a strong impression that this is simply not enough. As was pointed out in our January 2018 Monthly Outlook[1], in order to realize a truly meaningful wage hike, policy centering on labor market reform is required, including instigating means of improving productivity and breaking away from policies that promote mercantilism.

- Of course, from the viewpoint of the short-term economic cycle the rate of increase in wages in this period's Spring Labor Offensive represents an increase in comparison to last year. However, the negative effect on real income brought on by growth in "actual expenditure prices" far exceeds the extent of this year's wage hikes. It is essential that the growth rate in prices regain composure in order for consumption to recover and continue expanding. Moreover, though this has not yet materialized, in the long-term there are certain risks which we must be aware of, including the flattening of the wage curve, controls on non-scheduled cash earnings (overtime hours) as a result of the new ruling which limits overtime, and further increases in insurance premium burden. These factors also require close monitoring in the future.

- In light of the 2nd preliminary Oct-Dec 2017 GDP release we have revised our economic growth outlook. We now forecast real GDP growth of +1.8% in comparison with the previous year for FY17 (+1.7% in the previous forecast), +1.2% in comparison with the previous year for FY18 (+1.3% in the previous forecast), and +0.8% in comparison with the previous year for FY19 (+0.8% in the previous forecast). Japan's economy has continued accelerated growth due to the following factors: (1) favorable overseas demand, (2) inventory investment, and (3) replacement demand for durables. However, the effects of these three factors will gradually fade away in the future, while the consumption tax increase planned for October 2019 is expected to have a negative impact on income. Hence we expect Japan's economy to continue to slow down through FY2019.

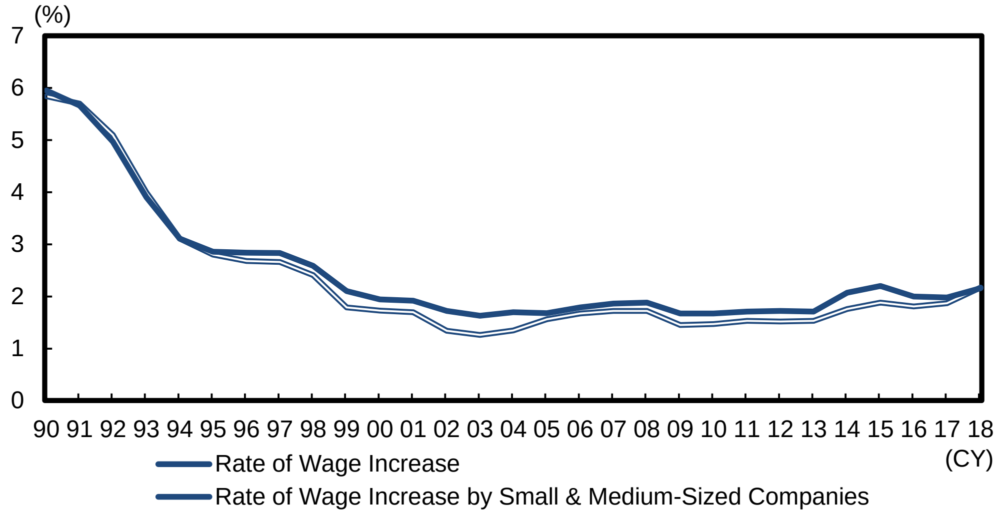
[1] Shunsuke Kobayashi, *Japan's Economy: Monthly Outlook (Jan 2018), No wage increase without restructuring / "Race to the bottom" hinders virtuous circle based on domestic growth* (Daiwa Institute of Research report, January 29, 2018)

1. Will Spring Labor Offensive Bring Wage Hikes, Thus Leading to Growth in Consumption?

This year's Spring Labor Offensive is attracting attention as a possible means of triggering accelerated movement toward a virtuous circle based on domestic demand. The average rate of wage increase during the 2018 Spring Labor Offensive (increase in base wage + annual pay raise) is 2.16% according to the Japanese Trade Union Confederation's initial tally of wage hike settlements (Chart 4). The rate of increase falls well below the government's target of 3%, and considering the fact that Japanese corporations are reporting historic highs in their earnings, there is a strong impression that this is simply not enough. As was pointed out in our January 2018 Monthly Outlook, in order to realize a truly meaningful wage hike, policy centering on labor market reform is required, including instigating means of improving productivity and breaking away from policies that promote mercantilism.

From the viewpoint of the short-term economic cycle one could also say that the rate of increase in wages was insufficient, but on the other hand, it does represent an 0.18%pt acceleration in comparison to last year's 1.98% (of this 0.30% was increase in base wage). Assuming other conditions remain unchanged, one could interpret this as bringing some hope that earnings and consumption will be raised to at least some extent. The other conditions mentioned here are roughly speaking (1) status of worker wages other than labor union members, (2) items not covered in wage hike negotiations such as status of non-scheduled cash earnings (overtime pay), (3) pace of growth in the working population, (4) status of insurance premiums which are paid somewhere between the face value of income and disposable income, and (5) price trends which affect the growth rate of real disposable income.

Change in Status of Wage Hikes **Chart 1**



Source: Japanese Trade Union Confederation; compiled by DIR.
Notes: 1) Average wage method.
2) Data prior to 2017 uses results of final sum as of end June each year. Data from 2018 is the Japanese Trade Union Confederation's initial tally of wage hike settlements

In this report we predict the future of the income and consumption environment based on what is happening with the five conditions listed above. We conclude that negative factors abound in the near future from a rise in prices (number (5) above), and that the rate of increase in wages this year is not enough to offset that effect. Currently, in order for consumption to recover and continue expanding, it is essential that the growth rate in prices regain composure. Moreover, though this has not yet materialized, in the long-term there are certain risks which we must be aware of. These are (1) flattening of the wage curve, (2) reduction of non-scheduled cash earnings due to new overtime regulations, and (4) further increases in the burden of insurance premiums.

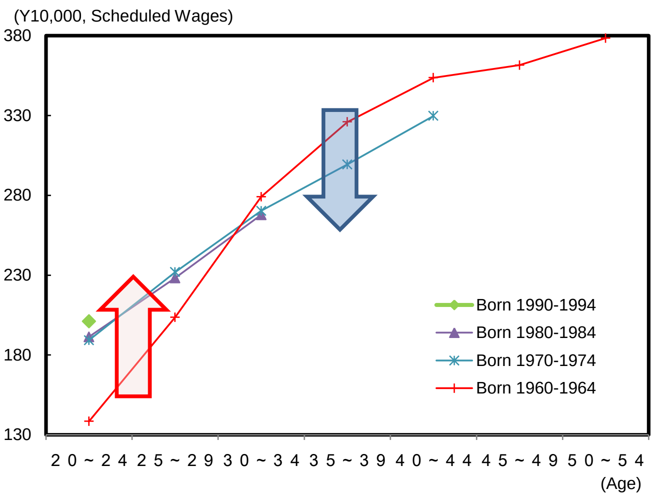
Wage curve flattening and cuts in overtime pay

First we consider (1) status of worker wages other than labor union members. There are two categories of workers to whom the Spring Labor Offensive does not apply – the majority of non-regular employees and management. As for non-regular employees, there are not many reasons to worry about a possible slowdown in the growth rate of wages. Realistically speaking, the wages of non-regular workers have continued to grow. Moreover, the effective opening–to–application ratio for non-regular (part-time) workers has continued to be in a tight situation. At the same time, the wage level, though it is growing, is still considerably below that of regular workers. Risk of a slowdown in the growth of wages in the future is considered to be lower than it is for regular workers.

On the other hand, there is a problem when it comes to management. Raising the wages of non-regular workers and labor union members is a factor in cost increases for corporations. In the past, Japanese corporations have inhibited the increase in costs associated with wage hikes by flattening the wage curve (Chart 2 & 3). We cannot ignore the possibility of this phenomenon occurring again in the future. Moreover, we must also remain aware of the tendency of many corporations to deal only with what is right in front of their eyes at the moment, and the influence this tendency has on the next situation mentioned: (2) items not covered in wage hike negotiations such as status of non-scheduled cash earnings (overtime pay). Along with the prospect of workstyle reform, the adoption of a new ruling which puts a cap on overtime hours (Regulation with Penalties on the Limitation of Number of Overtime Hours Worked) brings the risk of pushing down employee compensation overall by cutting back on non-scheduled cash earnings.

Wage Curve by Birth Year and Age Group

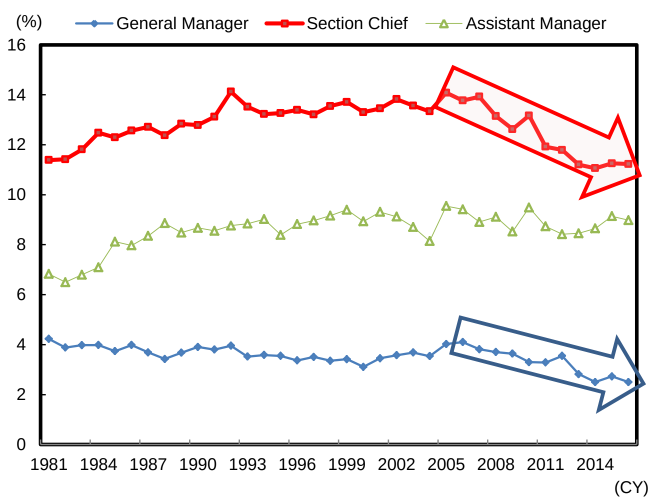
Chart 2



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

Proportion of Workers in Their 40s in Managerial Positions

Chart 3



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

The limitation on number of overtime hours worked beyond which there would be penalties makes an exception for certain types of businesses, but in principle, the limit is 45 hours per month or 360 hours per year. Depending on the labor-management agreement, overtime hours can be extended to as much as 720 hours per year. The new law is expected to go into effect in April 2019 at the earliest. According to the DIR risk scenario[2], if overtime hours which are cut back by the new regulation are not redistributed to other workers and new workers, non-scheduled cash earnings (overtime pay) would decline by Y8.5 trillion annually (Chart 7). This is the equivalent of 3% of employee compensation. Moreover, in order to compensate for overtime hours which have been cut back by redistributing the hours to new workers, 2.4 million fulltime workers would be required, but there is

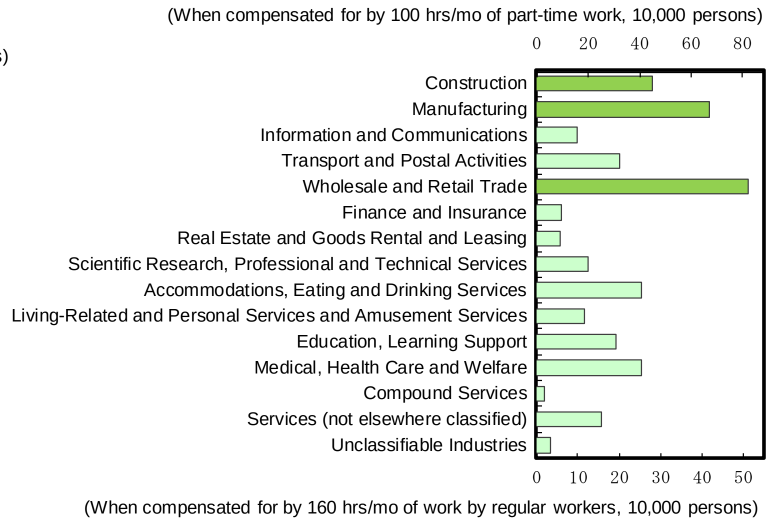
[2] Japan's Economic Outlook No. 194 (Summary): Domestic demand becomes driving force. In this report we examine the following: (1) Turning Point in US & Japan Economies, (2) Wage Trends, and (3) Regional Economies (August 24, 2017)

little margin for growth in the labor force participation rate. It is difficult to expect major growth in the number of employees in Japan.

Estimated Effects of Limitation on Overtime **Chart 4**

Total Overtime of More than 60-Hrs per Month

		(10,000 hrs)
Construction	+	4,508
Manufacturing	+	6,709
Information and Communications	+	1,562
Transport and Postal Activities	+	4,501
Wholesale and Retail Trade	+	8,227
Finance and Insurance	+	981
Real Estate and Goods Rental and Leasing	+	898
Scientific Research, Professional and Technical Services	+	2,014
Accommodations, Eating and Drinking Service	+	4,050
Living-Related and Personal Services and Amusement Services	+	1,857
Education, Learning Support	+	3,068
Medical, Health Care and Welfare	+	4,065
Compound Services	+	302
Services (not elsewhere classified)	+	2,517
Unclassifiable Industries	+	547
Management	−	1,817
Drivers (60-80 hrs overtime)	−	1,260
		42,727
Labour Force Survey Excess Count (x0.9)		38,454



Regulated Overtime Hours Converted to Labor Force

Regular Workers, 160 hrs/month	2.4 mil persons
Part-Time Workers, 100 hrs/month	3.85 mil persons

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 labor force surveys, 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 labor force survey and the monthly labor survey.

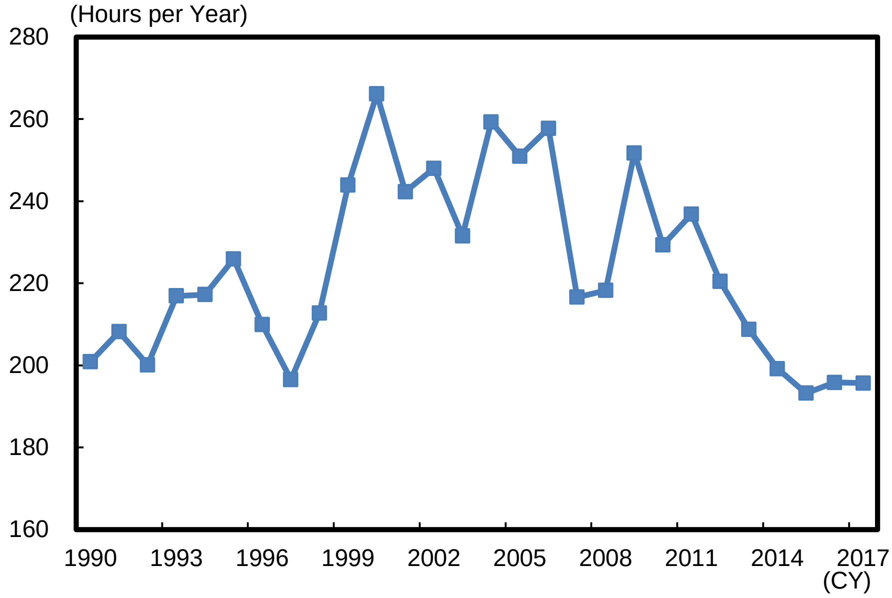
We can confirm the most recent situation for non-scheduled cash earnings by looking at the Monthly Labor Survey. According to these statistics, non-scheduled cash earnings were in a declining trend between 2015 and 2016, but have been gradually recovering since the latter part of 2017. As quantitative growth continues, the quantity of work is also secured, and there is low probability that the problem of cutting back on non-scheduled cash earnings (overtime) will progress. Hence, it appears that there is a causal relationship between the slowing of economic growth and the suppression of non-scheduled cash earnings rather than the other way around (i.e. suppression of non-scheduled cash earnings causing a hindrance to economic growth). In this sense, there is little chance that the problem of cutting back on non-scheduled cash earnings will appear in the short-term. On the other hand, in 2019 when the Regulation with Penalties on the Limitation of Number of Overtime Hours Worked is expected to go into effect, there are also plans of another increase in the consumption tax. Here we urge caution regarding the risk of the effects from these two factors spiraling out of control.

Based on the responses of workers on a labor force survey regarding working hours, we see that unpaid overtime (found by subtracting the responses of corporations regarding working hours on the Monthly Labor Survey) is not necessarily on the increase (Chart 5). With corporate earnings in favorable condition, rather than cost-cutting, a corporation could force employees to put in overtime without pay. However, it appears that there are few corporations willing to take the legal risk that would involve.

Negative effects of slowing growth in employment still a long way off

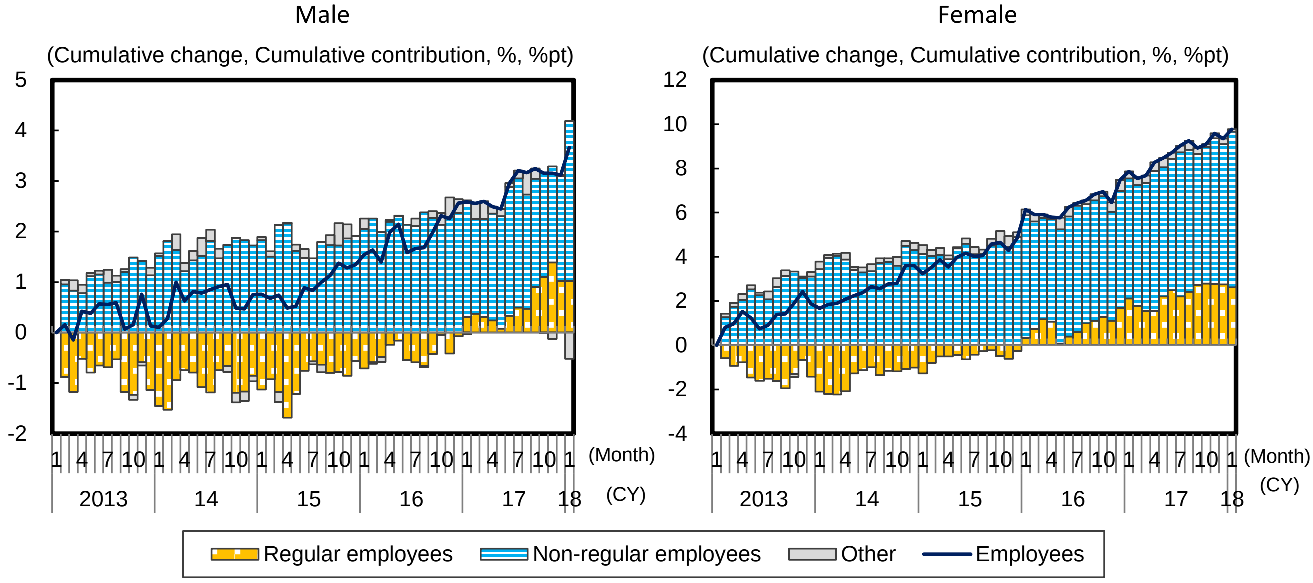
Now that we have performed a general overview of the situations of the various wage categories, we need to look at another factor which effects employee compensation on the macro level. This is (3) pace of growth in the working population. There have been rumors about an impending slowdown in growth of the working population ever since the early 2010s for reasons such as the peaking out and then inevitable decline of the working age population, and the continuing decline in the unemployment rate, but it appears that those fears have been groundless. This is because of growth in the labor force participation rates of women and senior citizens, as well as the return of the male non-labor force population to the labor market. There is also the factor of the decline in frictional unemployment. However, it goes without saying that these factors cannot remain operative indefinitely. Sooner or later the pace of growth in working population will have to peak out. However, even when the supply of working population has reached its limit, corporations can secure working hours by changing the status of non-regular employees to that of regular employees. This tendency has actually become more common recently (Chart 9). It goes without saying that this has a high probability of being a plus for worker income as well. Hence the slowdown in the pace of growth in working population can be absorbed somewhat by securing working hours associated with the change of employment status to regular employee, while at the same time, there seems to be little chance of this factor having any kind of negative effect on income and consumption.

Estimate of Unpaid Overtime (All Industries) **Chart 5**



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

Factor Analysis of Employees **Chart 6**



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

Factors which held down disposable income until now will disappear

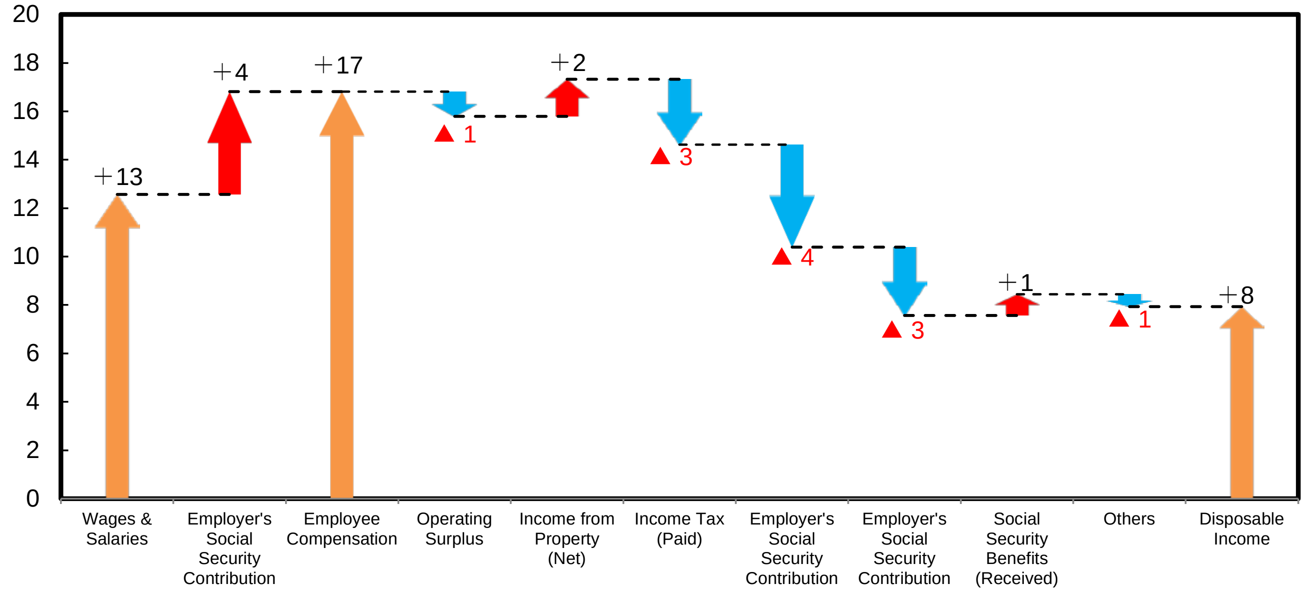
As of this point we have considered the question of face value of salaries. Next we look at (4) status of insurance premiums which are paid somewhere between the face value of income and disposable income. Looking back, we see that despite the fact that employee compensation grew by around Y9.5 trillion between FY2012 and FY2015, disposable income grew by only Y2.6 trillion. This was due to a combination of raising the highest tax bracket on Japan's income tax, and around Y4 trillion of growth in income tax collected as a result of the growth in income. In addition, social security contributions by employees grew by around Y3 trillion. Despite growth in the face value of salaries, net income (or take-home pay) did not increase, hence putting a damper on the expansion trend in consumption on the part of the working generation (Chart 7).

However, since FY2016, the effects of the increase in the tax rate have run their course. Meanwhile, the rate of annual growth in insurance premiums is also expected to move toward peaking out after the close of FY2017. Generally speaking, negative factors which held down growth in disposable income in comparison to growth in employee compensation have pretty much disappeared.

Of course, the root cause of Japan's problems, a declining birth rate and aging population accompanied by a growing social security burden, will most likely not change. Hence the same problems may recur in the future. However, in the short-term, there are few reasons for anxiety regarding the outlook for disposable income.

Factor Analysis of Changes in Wages, Salaries, Employee Compensation, and Disposable Income
Chart 7

(Rate of Change Between FY2012 and FY2016, Y tril)



Source: Produced by DIR based on data from the Cabinet Office.

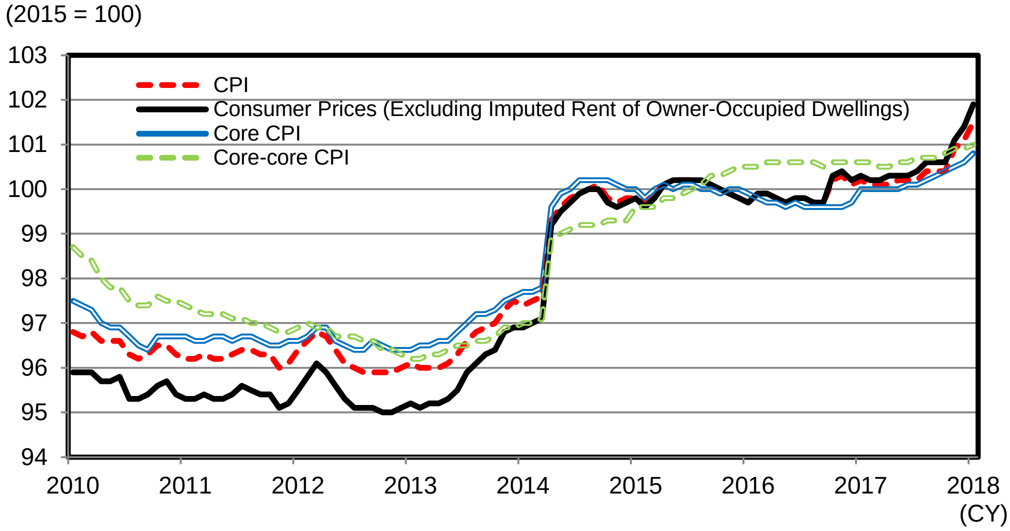
Damages to real income associated with sharp growth in "actual expenditure prices" becoming more serious

As was discussed earlier, factors such as the flattening of the wage curve and controls on non-scheduled cash earnings (overtime hours), as well as rising insurance premium burden could become a drag on income. However, in the short-term, it is thought that there is little to fear in regard to the nominal disposable income of employees. To put it simply, the fact that the rate of wage increase during the 2018 Spring Labor Offensive exceeds that of the previous year is something to be positive about.

The problem we see developing in the future is the one referred to in our fifth category: (5) price trends which affect the growth rate of real disposable income. An important factor to consider in predicting where consumption will go is the trend in how consumer prices (excluding imputed rent of owner-occupied dwellings) are handled in household expenditure. This index continually marked time between 2014 when the consumption tax was raised and 2016, and since 2017 has been on the rise. The growth rate of the index has grown rapidly since the end of 2017. This tendency has been generated by rising prices for energy and perishable foods. This phenomenon is beginning to look a lot like cost push inflation as service prices rise due to increasing personnel expenses and then the tendency gradually spreads to a wide range of other goods. This also brings progress in price pass-through (Chart 8).

The y/y growth rate in consumer prices (excluding imputed rent of owner-occupied dwellings) reached 1.7% as of January 2018. The rate of wage increase resulting from this year's Spring Labor Offensive is not enough to offset the negative effect on real income brought on by growth in "actual expenditure prices". As wage negotiations for the current period reach their conclusion, it is essential that the growth rate in prices regain composure in order for consumption to recover and continue expanding. Meanwhile, long-term concerns remain, including the flattening of the wage curve, controls on non-scheduled cash earnings (overtime hours) as a result of the new ruling which limits overtime, and further increases in insurance premium burden. These factors also require close monitoring in the future.

Trends in Consumer Price Indices — Chart 8



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

2. Economic Outlook Sees Growth of +1.8% in FY2017, +1.2% in FY2018, and +0.8% in FY2019

In light of the 2nd preliminary Oct-Dec 2017 GDP release we have revised our economic growth outlook. We now forecast real GDP growth of +1.8% in comparison with the previous year for FY17 (+1.7% in the previous forecast), +1.2% in comparison with the previous year for FY18 (+1.3% in the previous forecast), and +0.8% in comparison with the previous year for FY19 (+0.8% in the previous forecast). Japan's economy has continued accelerated growth due to the following factors: (1) favorable overseas demand, (2) inventory investment, and (3) replacement demand for durables. However, the effects of these three factors will gradually fade away in the future, while the consumption tax increase planned for October 2019 is expected to have a negative impact on income. Hence we expect Japan's economy to continue to slow down through FY2019.

Growth led by domestic demand, but issues remain: (1) decline in housing investment, (2) weak consumption, and (3) capital investment deflator brings unease

Private sector final consumption expenditure achieving growth for the first time in two quarters by +0.5% q/q. Stock price highs and the growing global economy brought support to an improvement in consumer confidence, while in addition, continued expansion of consumption was helped along by growth in consumption of durable goods (+3.6%) due to replacement demand. We have seen the gradual dissipation of the negative effects of pre-consumption over demand and Eco-car related tax breaks, which helped to increase consumption since 2009 along with the Ecopoint program effecting household electronics, as well as last-minute demand prior to the increase in consumption tax. Since 2016, moderate replacement demand for durables appeared.

On the other hand, consumption of goods other than durables left something to be desired. While the consumer price index grows centering on the price of fresh foods and energy, real employee compensation fell by -0.4% and there are hints that on the other side of the recent demand for durables lies an increasing tendency to pinch pennies. As for trends in goods and services, semi-durables continue to expand at +2.5%, while non-durables suffered a decline of +0.1% and services grew +0.3%, leaving overall performance marking time.

2017 Oct-Dec GDP (2nd Preliminary Estimate) **Chart 9**

		2016	2017				
		Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	
						First	Second
Real GDP	Q/q %	0.3	0.5	0.6	0.6	0.1	0.4
Annualized	Q/q %	1.1	1.9	2.4	2.4	0.5	1.6
Personal consumption	Q/q %	0.0	0.3	0.9	-0.6	0.5	0.5
Private housing investment	Q/q %	0.8	1.2	0.9	-1.7	-2.7	-2.6
Private non-housing investment	Q/q %	1.5	0.2	1.2	1.0	0.7	1.0
Change in private inventories (contribution to real GDP growth)	Q/q % pts	-0.2	0.1	-0.1	0.4	-0.1	-0.0
Government consumption	Q/q %	-0.2	0.1	0.2	0.1	-0.1	-0.0
Public investment	Q/q %	-1.9	-0.2	4.8	-2.6	-0.5	-0.2
Exports of goods and services	Q/q %	2.7	2.0	0.0	2.1	2.4	2.4
Imports of goods and services	Q/q %	0.6	1.7	1.9	-1.2	2.9	2.9
Domestic demand (contribution to real GDP growth)	Q/q % pts	-0.1	0.4	0.9	0.1	0.1	0.4
Foreign demand (contribution to real GDP growth)	Q/q % pts	0.4	0.1	-0.3	0.5	-0.0	-0.0
Nominal GDP	Q/q %	0.2	-0.0	0.9	0.7	-0.0	0.3
Annualized	Q/q %	1.0	1.1	3.6	2.7	-0.1	1.1
GDP deflator	Q/q %	-0.0	-0.2	0.3	0.1	-0.1	-0.1
	Y/y %	-0.1	-0.8	-0.3	0.2	0.0	0.1

Source: Cabinet Office; compiled by DIR.
Notes: 1) Due to rounding, contributions do not necessarily conform to calculations based on figures shown.
2) Q/q figures seasonally adjusted.

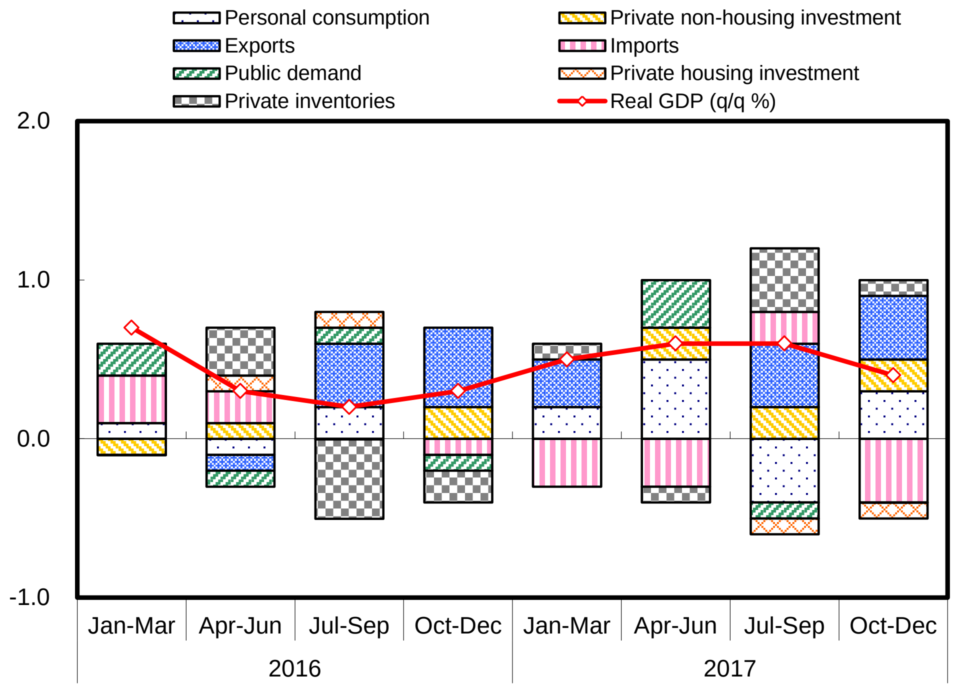
Housing investment declined for the second consecutive quarter at -2.6% q/q. The positive effects of strategies in dealing with inheritance tax are beginning to disappear, and rising prices may be putting a damper on demand. Meanwhile, housing inventory continues to accumulate.

Capital expenditure grew for the fifth consecutive quarter at +1.0% q/q. Capital expenditure continues to maintain an undercurrent of growth due to the expansion of production activities associated with recent growth in exports, and the growing seriousness of the shortage of manpower. In addition, ample funds allow corporations to promote a stable expansion of capital expenditure. However, caution should be exercised, as demand for capital expenditure nears the limits of supply as can be seen in the balance of machinery orders which continue to accumulate a an unprecedented rate. This indicates that the growth rate in quantitative capital expenditure (in real terms) will remain at a more moderate rate in comparison to the strength of demand for the time being. Hence manufacturers who benefit from capex spending are expected to move toward improved earnings due to rising prices and higher profitability. However, as of this point, a definite increase in the capital investment deflator has not been confirmed.

Private sector inventory brought a positive contribution to GDP growth for the second consecutive quarter at +0.1%pt. Material & supplies inventory contributed +0.0%pt, while work in progress inventory was also at +0.0%pt, and finished goods contributed +0.1%pt, with distribution inventory at -0.0%pt. Public investment suffered a decline for the second consecutive quarter at -0.2% q/q. The balance of orders is at a high level, and with the FY2016 supplementary budget carried out mostly during the Apr-Jun period, a moderate decline was experienced after that point.

Exports grew for the sixth consecutive quarter at +2.4% q/q. According to trade statistics for the Oct-Dec period, exports to the US declined due to a downturn for automobiles, while semiconductor manufacturing equipment and ICs were favorable, leading to growth in exports to the EU and Asia. On the other hand, imports grew by +2.9% for the first time in two quarters due to the recovery in domestic demand. As a result, contribution of overseas demand to GDP growth was -0.0%pt.

Contribution to Real GDP (% pt; seasonally adjusted basis) **Chart 10**



Source: Cabinet Office; compiled by DIR.

Economic Indicators and Interest Rates — Chart 11

Indicator	2017		2018				FY16	FY17	FY18	FY19
	Jul-Sep	Oct-Dec	Jan-Mar	Apl-Jun	Jul-Sep	Oct-Dec				
	Actual		DIR estimates				Actual	DIR estimates		
Real GDP										
Q/q %, annualized	2.4	1.6	1.1	1.0	1.0	1.1				
Y/y %	1.9	2.0	1.8	1.5	1.2	1.0	1.2	1.8	1.2	0.8
Current account balance SAAR (Y tril)	22.9	23.2	23.7	23.8	23.7	23.7	20.4	22.7	24.1	25.2
Unemployment rate (%)	2.8	2.7	2.5	2.5	2.5	2.5	3.0	2.7	2.5	2.5
CPI (excl. fresh foods; 2015 prices; y/y %)	0.6	0.9	0.8	0.9	1.0	0.8	-0.2	0.7	0.9	1.3
10-year JGB yield (period average; %)	0.05	0.05	0.05	0.05	0.05	0.05	-0.05	0.05	0.05	0.05

Source: Compiled by DIR.
Note: Estimates taken from DIR's *Japan's Economic Outlook No. 196 Update (Summary)*