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Japan’s Economy: Monthly Outlook (June 2019)

No recovery for domestic demand without growth in overseas demand

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Summary

- One of the pillars of Japan’s economic growth has been overseas demand, but it would be difficult to expect a recovery in this area for some time to come. This issue has been covered in our past reports. The shrinking of overseas demand’s contribution to growth is nothing new. It was already recording negative contribution rates to Japan’s economy back in FY2018. With overseas demand having turned in a negative direction, the overall growth rate managed to remain just below Japan’s potential growth rate only by virtue of relatively favorable domestic demand providing support.

- However, in FY2019 we can no longer depend on an economic scenario that assumes domestic demand will prop up the Japanese economy when overseas demand is ailing. In short, growth in domestic demand during FY2018 was actually the result of favorable corporate business results in FY2017. In a sense you could call this “savings from the previous fiscal year.” In FY2017, both domestic and overseas demand was favorable, and corporate business results recorded a historic high. Earnings from that year were used as a resource for the making of improvements in employment, basic salaries, and bonuses. This provided support for improvements in household consumption. At the same time, demand for labor increased as did factory operating rates, and this encouraged an expansion in corporate capital expenditure in FY2018.

- However, turning now to the present state of affairs, the only conclusion we can draw from the above is that it will be difficult to expect growth in domestic demand in FY2019. The slowdown in overseas demand and corporate business results in FY2018 has begun to take the edge off of momentum in household consumption and capital expenditure in FY2019. Looking at the factors making up employee compensation, the growth rate in the number of employees is expected to slow down, while the number of work hours per employee is expected to decline. A definite slowdown in the rate of growth for bonuses is also seen. Declining hopes for employment and income in the future will throw cold water on consumer confidence, bringing a strong possibility that propensity to consume will be inhibited. Then the planned increase in consumption tax in October will pour salt on the wound.

- Household consumption is not the only component with dire prospects. The decline in factory operating rates as a result of unfavorable domestic and overseas demand, as well as inventory accumulation also casts a shadow over the expansion scenario for capital expenditure. Ignoring for a moment the question of time lag, it is ultimately difficult to expect a recovery in domestic demand in Japan as it stands now without a resurgence of growth in overseas demand. Our outlook for the future of Japan’s economy therefore remains unchanged, with the slowdown expected to continue for some time.

Assumption that domestic demand will prop up Japan's economy when overseas demand is ailing won't stand up to counter-arguments

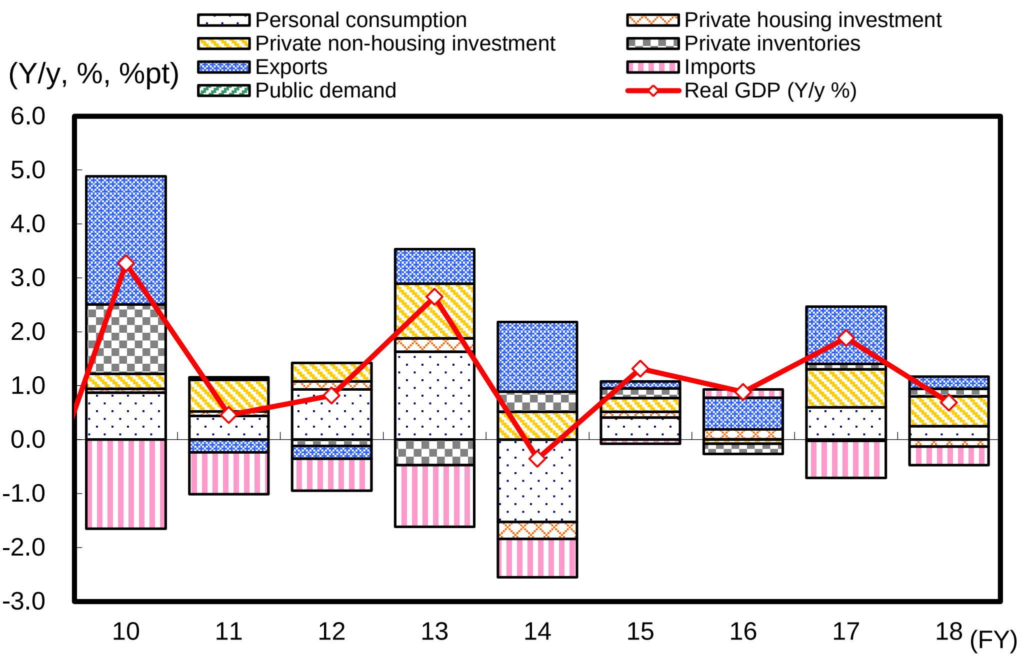
Overseas demand was once one of the pillars of Japan's economic growth, but it has become difficult to expect its recovery. This fact was indicated in our previous monthly outlook[1]. The shrinking of overseas demand's contribution to growth is nothing new. It was already recording negative contribution rates to Japan's economy back in FY2018 (contribution was down by -0.1%pt y/y). With overseas demand having turned in a negative direction, the overall growth rate (+0.7% y/y) managed to remain just below Japan's potential growth rate only by virtue of relatively favorable domestic demand providing support (Chart 1).

Can this schematic showing domestic demand propping up growth when overseas demand is unfavorable be extended linearly? In other words, can we expect the same phenomenon to occur in FY2019? The answer to that question is that this assumption is overly simplistic. In short, growth in domestic demand during FY2018 was actually the result of favorable corporate business results in FY2017. In a sense you could call this "savings from the previous fiscal year."

In FY2017, both domestic and overseas demand was favorable, and corporate business results recorded a historic high. Earnings from that year were used as a resource for the making of improvements in employment, basic salaries, and bonuses. This provided support for improvements in household consumption. At the same time, demand for labor increased as did factory operating rates, and this stimulated an expansion in corporate capital expenditure in FY2018[2].

However, turning now to the present state of affairs, the conclusion we draw from the above is that it will be difficult to expect growth in domestic demand in FY2019. The slowdown in overseas demand and corporate business results in FY2018 has begun to take the edge off of momentum in household consumption and capital expenditure in FY2019. In this report, we carry out a detailed examination of the current condition of Japan's economy.

Real GDP and Changes in Contribution Rate by Demand Component (%pt) **Chart 1**



Source: Cabinet Office; compiled by DIR.

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[1] For details see the DIR Report dated 30 May 2019, *Japan's Economy: Monthly Outlook (May 2019): Resumption of US-China "cold war" could cause Japanese exports to suffer a maximum decline of around 1.3 tril yen*, by Shunsuke Kobayashi & Yota Hirono.

[2] Though it may sound redundant, we could also restate this to say that it was overseas demand and a recovery in corporate business results in FY2016 (especially the 2nd half) that was behind the expansion in domestic demand in FY2017.

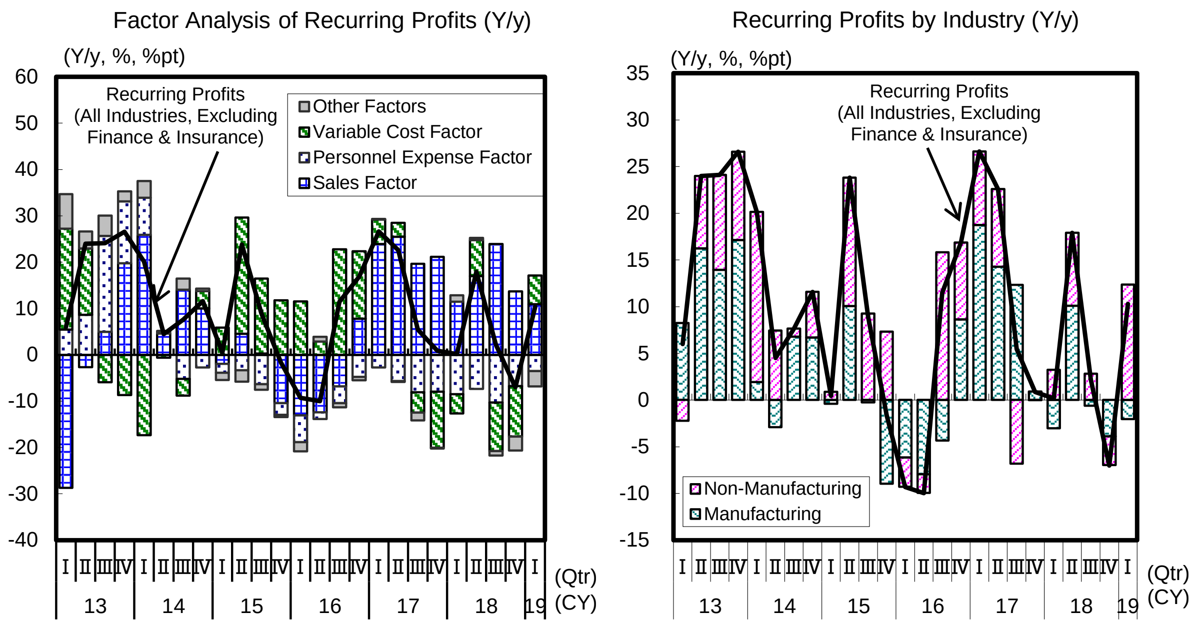
Increase in personnel expenses in FY2018 as a result of favorable business results in FY2017 becomes a burden in FY2019

First of all, let us consider corporate business results which took on such a central role in the previous arguments. As shown in Chart 2, sales recovered during the second half of FY2016 centering on the manufacturing industry[3]. Meanwhile, corporate earnings continued to grow in FY2017 due to a decline in the variable cost ratio made possible by lower input prices, representative amongst these being resource prices.

Corporate earnings remained at a high level in FY2018 and beyond, but the pace of growth began to slow, becoming nearly flat. This was due to a variety of developments, including improvements in the variable cost ratio coming to a stop, and the slowdown in the pace of sales growth. Notable amongst the various factors was growth in personnel expenses which brought downward pressure on profits. This phenomenon is partly a structural one standing at the root of the labor shortage problem, and is determined by Japan’s demographics. But the pace of growth in personnel expenses between FY2017 and the first half of FY2018 shows a clear line of demarcation with similar situations in the past. That is, business results were given excessive outlooks in FY2018 and beyond due to the favorable corporate earnings of FY2017, and the pace of improvements in employment, basic salaries, and bonuses expanded between FY2017 and FY2018 (with a slight delay in comparison to business performance).

However, the slowdown in the global economy was due largely to the downward revision of outlooks for corporate business performance in FY2018 and beyond. The increase in personnel expenses had become a drag on profits and with the reversal in corporate profits during FY2017-2018, the incentive to cut personnel costs has been increasing.

Changes in Recurring Profits (Corporations of All Sizes) **Chart 2**



Source: Ministry of Finance; compiled by DIR.

[3] The following report provides more detail on the improvement in corporate business results centering on overseas demand at the time. DIR Report dated 20 October 2017, *Japan’s Economy: Monthly Outlook (Oct 2017): Pointers to guide through this political season; Light and shadow of the “cherry-picking” economy*, by Shunsuke Kobayashi.

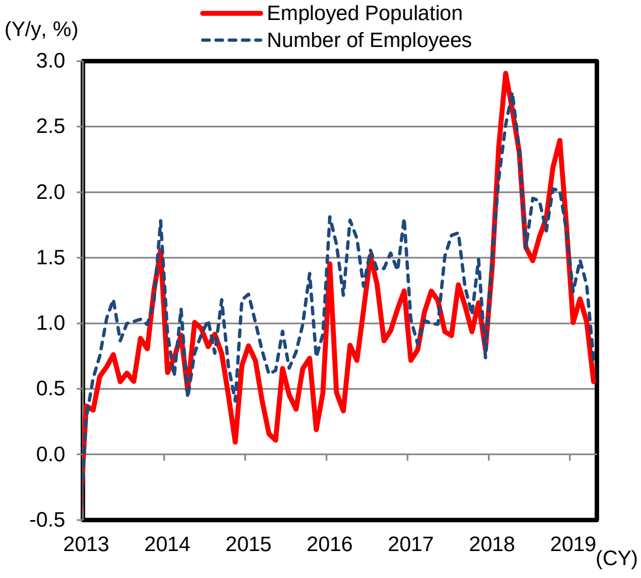
Pace of improvement in employment slows down, while hours worked per employee decline. Improvement in bonus pay also comes to a halt.

Employee compensation can be broken down into the following factors: (1) number of employees x (2) number of hours worked per employee x (3) hourly wage + (4) total bonus pay. The current situation of these factors can be described as (1) slowdown in growth rate, (2) decline, (3) no clear signs detected of acceleration or slowdown in growth rate (the wage increase rate determined during the annual spring wage negotiations is also expected to remain the same as last year). Meanwhile, (4) is difficult to determine due to the sparseness of data at this time, but considering the fact that bonus pay usually reflects corporate earnings for the fiscal year in question, it is probably reasonable to assume that there will be a clear slowdown in the pace of growth.

Taking a look at actual figures we find the following: as is indicated in Chart 3, the growth rate in number of employees was especially high in 2018, and has since then slowed down until we get to the present point. Meanwhile, Chart 5 shows that the trend in changing employee status to that of regular employee has come to halt centering on male employees, while improvement in the quality of employment has also stopped.

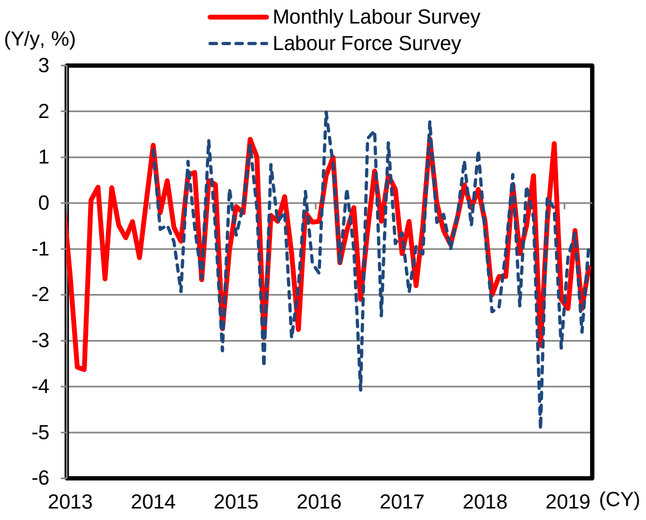
Looking now at number of hours worked per employee, Chart 4 indicates that decline has continued since the latter half of 2018 due to the new overtime regulations with penalties. Moreover, the pace of the decline has increased.

Change in Number of Employees **Chart 3**



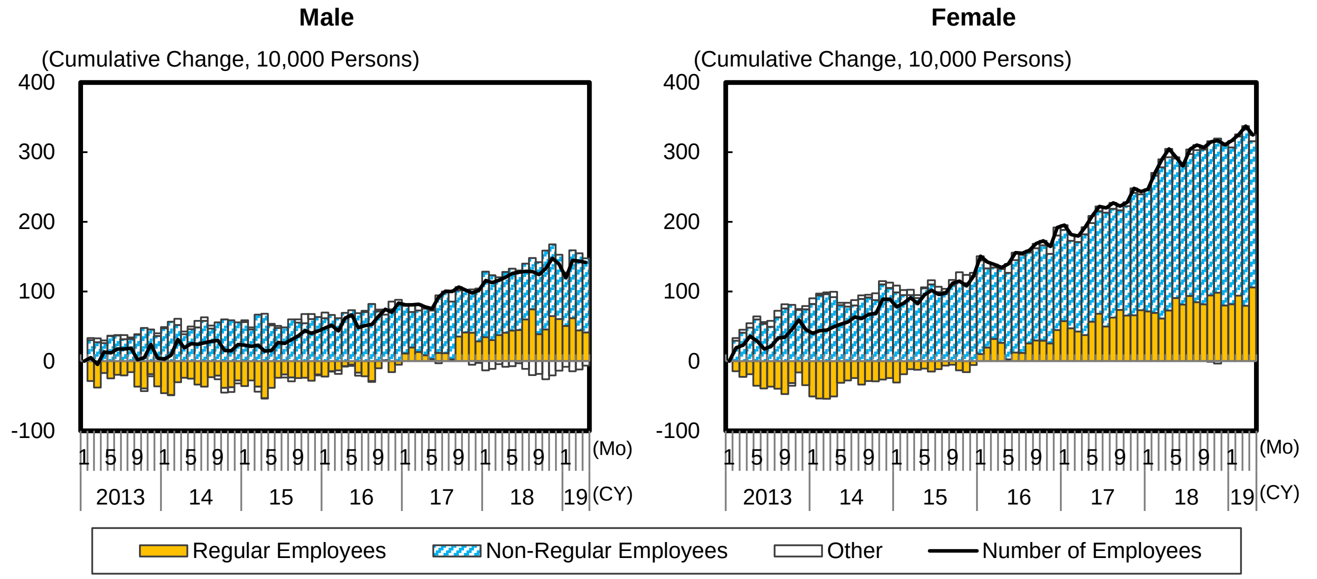
Source: Ministry of Internal Affairs and Communications; compiled by DIR.

Change in Hours Worked per Employee **Chart 4**



Source: Ministry of Internal Affairs and Communications, Ministry of Health, Labour and Welfare; compiled by DIR.
Note: Monthly Labour Survey uses common data set.

Factor Analysis of Growth and Decline in Number of Employees — Chart 5

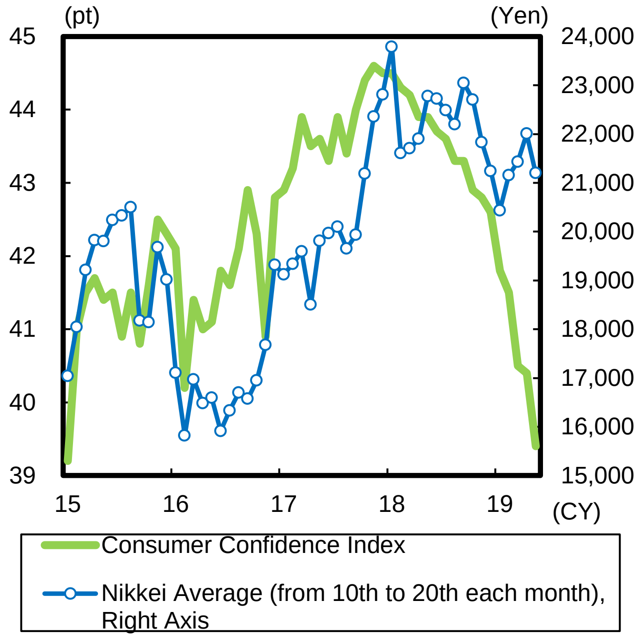


Source: Ministry of Internal Affairs and Communications; compiled by DIR.
Note: Seasonal adjustment performed by DIR.

Furthermore, as hopes fade for the future of employment and income, and anxieties increase, these negative developments throw cold water on consumer confidence (Chart 6). The deterioration of consumer confidence of course holds down the propensity to consume. Therefore, there is a very good chance that growth in consumption will be even more suppressed than employee income in FY2019.

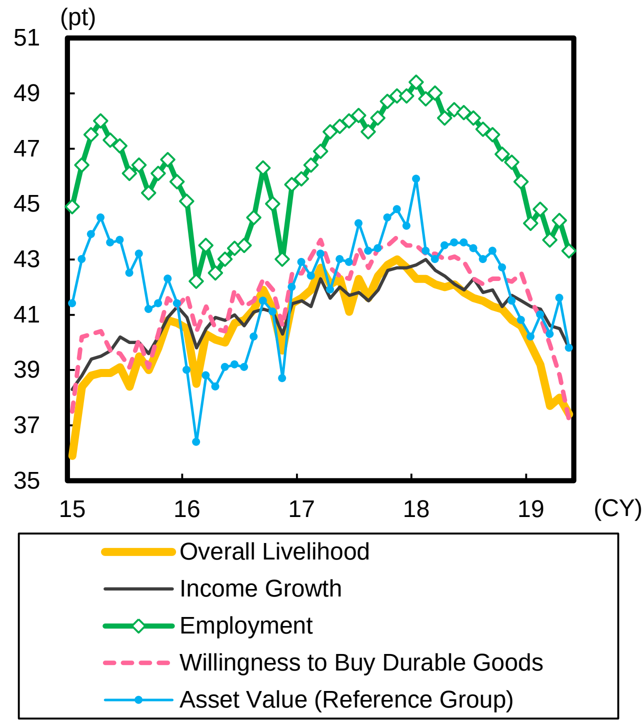
Then the planned increase in consumption tax in October will pour salt on the wound. The increase in the consumption tax rate is estimated to bring a total increase in tax burden of around 5.7 trillion yen considering both the central government and regional governments. Increase in burden related to financial resources from a review of the tobacco tax and income tax is expected to be around 0.6 trillion yen. But at the same time, a reduced tax rate will also be introduced, thereby reducing this by around 1.1 trillion yen, bringing the total in expected tax burden to around 5.2 trillion yen.

Consumer Confidence Index and Nikkei Average Chart 6



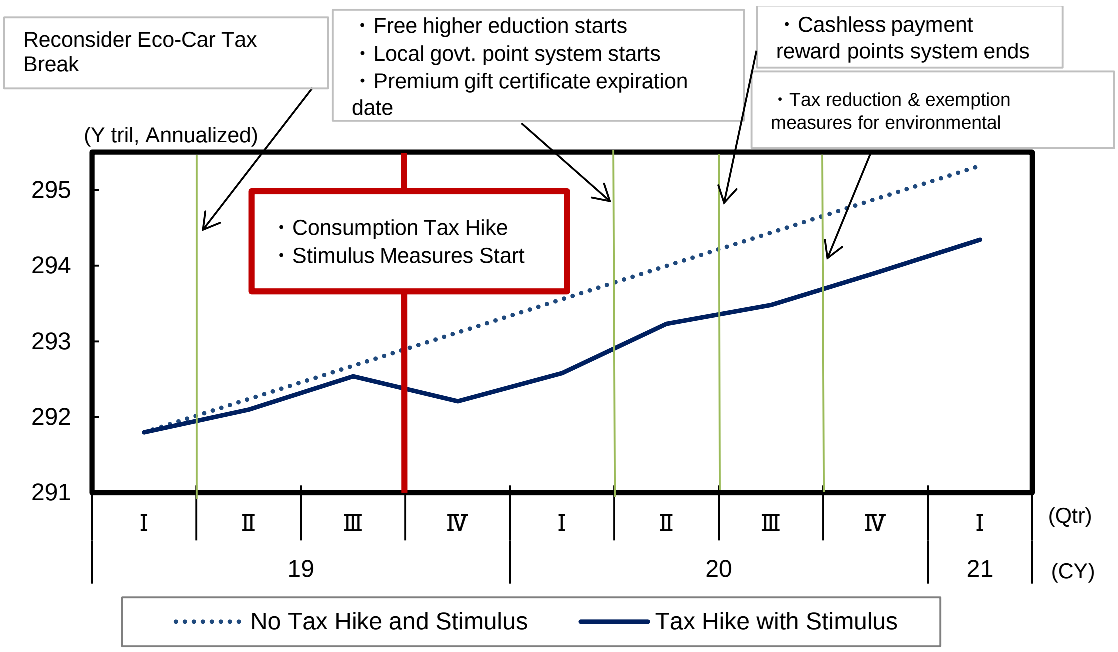
Source: Cabinet Office, Nikkei Inc.; compiled by DIR.
Note: The consumer confidence index covers households of two or more people, and is seasonally adjusted.

Consumer Sentiment Index Chart 7



Source: Cabinet Office; compiled by DIR.
Notes: 1) Households of two or more people. Seasonally adjusted.
2) Asset value is not a component in the consumer confidence index.

Effects of Consumption Tax Hike and Related Countermeasures on Consumption (Illustration) Chart 8



Source: Cabinet Office, News Reports; compiled by DIR.
Notes: 1) The effect of local government points is assumed to be the same as premium gift certificates.
2) Tax Hike with Stimulus does not take into consideration last minute demand or reactionary decline.

Free preschool education and expanded social security are expected to bring an increase in benefits of around 3.2 trillion yen. The overall result is expected to bring an estimated fiscal austerity effect on a net basis of around 2.0 trillion yen. In addition, a variety of economic measures are to be implemented. There is expected to be an overall total of around 2.3 trillion yen, and is likely to be an amount larger than the amount of growth in tax revenue provided by six-months' worth of consumption tax increase (around 1.0 tril yen between October 2019 and March 2020).

However, when we look at the central factors in the consumption tax hike countermeasures, the majority is in public investment, mostly for the purpose of strengthening national resilience, such as disaster prevention and mitigation (1.35 tril yen). Hence the area that will gain most of the direct benefits is expected to be the construction sector rather than households.

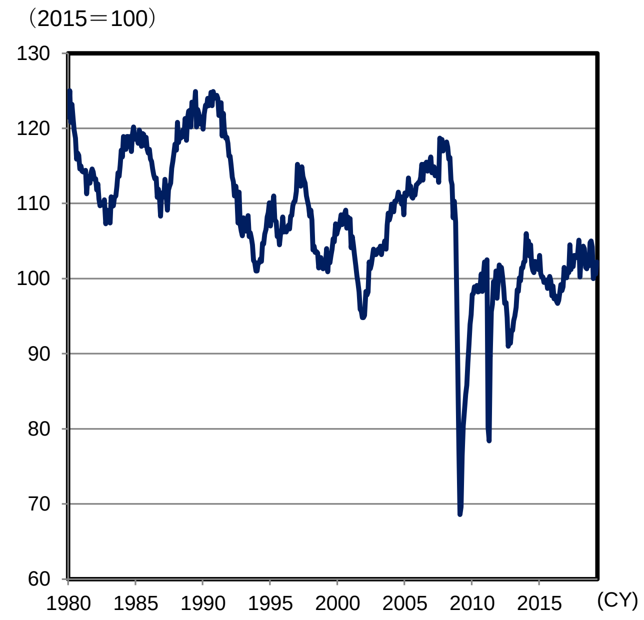
Considering the above, fiscal matters will likely be somewhat of a negative factor in relation to consumption in FY2019[4], while at the same time public investment will have a positive effect, and may push overall domestic demand up just a bit. Of course, by FY2020 the effects of the various consumption tax hike countermeasures will have disappeared.

Dark clouds hover over future of capex with demand for labor weak and factory operating rates in decline

The outlook is getting tough not only for household consumption. One of the pillars upholding capital expenditure has been the demand for labor saving methods to counteract the shortage of labor. There are also fears that the dark clouds referred to here could be made to loom even larger by the recent stagnation of demand for labor.

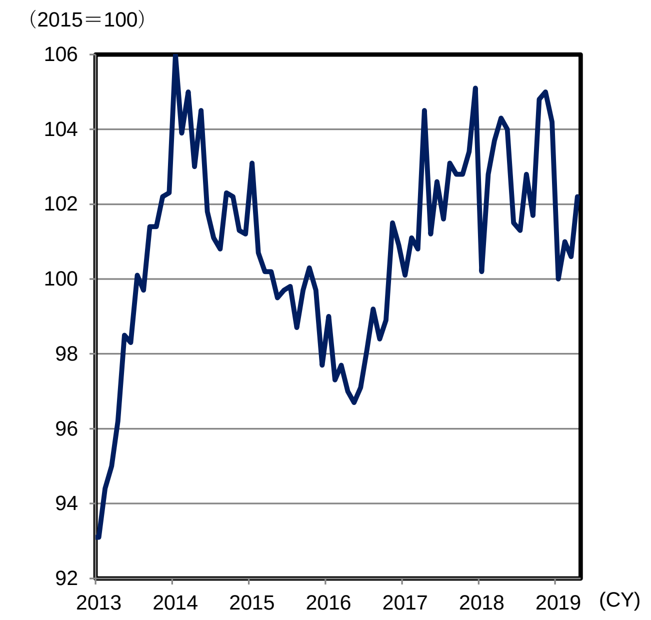
But an even weightier reality is that the other major pillar of capex, capacity increase, is becoming extremely difficult to sustain. The level of the factory operating rate in the manufacturing industry has suffered a major decline since the end of 2018 in comparison to 2017-2018, due to sluggish overseas demand (Chart 10).

Change in Manufacturing Industry Operating Rate (Over the Long-Term)
Chart 9



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

Change in Manufacturing Industry Operating Rate (Since 2013)
Chart 10



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

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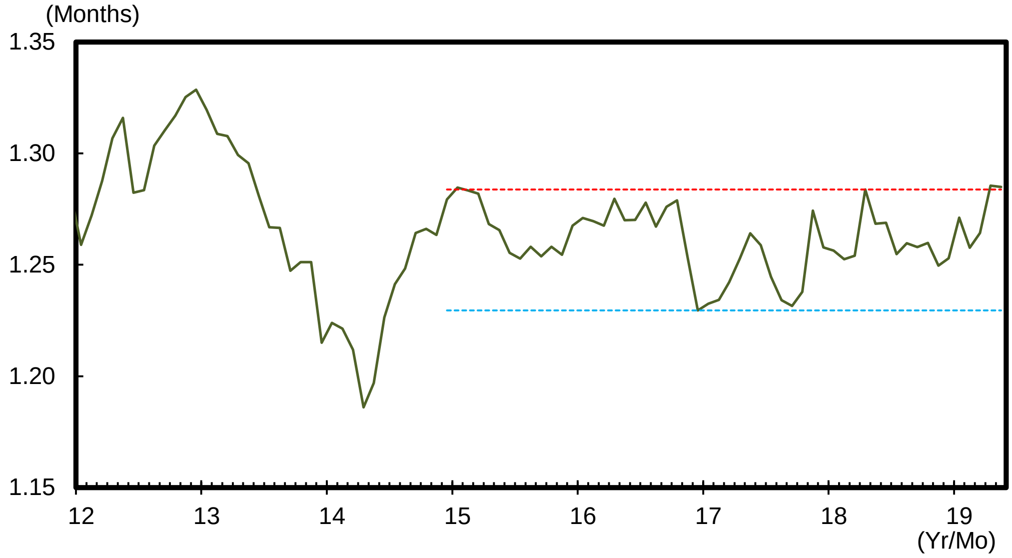
[4] There is little basis to the argument that propensity to consume improves when advances are made in fiscal reconstruction, thereby offsetting the problem of consumption is being held down by a sense of uncertainty about the future due to the consumption tax hike. For further detail on this subject, see the following DIR report dated 26 March 2019: *Japan's Economy: Monthly Outlook (March 2019): Doubts regarding five prevailing views on Japan's economy*, by Shunsuke Kobayashi & Yota Hirono.

As was mentioned previously, there is a good chance that the expansion of household consumption could come to a temporary stop. As is shown in Chart 11, there is a very strong possibility that the need to adjust inventories that have accumulated could also continue into the future. It is difficult to hope for a dramatic improvement in the operating rate under these conditions. The more realistic result is that there will be a direct connection with a decline in capital expenditure oriented toward capacity increase.

Considering the above, we can summarize the implications of this report as follows. Our conclusion is that, ignoring for a moment the question of time lag, it is ultimately difficult to expect a recovery in domestic demand in Japan as it stands now without a resurgence of growth in overseas demand. Our outlook for the future of Japan's economy therefore remains unchanged, with the slowdown expected to continue for some time.

Months in Stock in the Manufacturing Industry **Chart 11**



Source: Ministry of Economy, Trade, and Industry; compiled by DIR.
Notes: 1) Months in stock = inventory value (monthly balance) / shipment value (monthly value, 12-month backward moving average)
2) Real inventory value and real shipment value were calculated by extending figures in METI industrial statistics (2015) using the Indices of Industrial Production.

Japan's Economic Outlook No.201 Update

	FY18	FY19 (Estimate)	FY20 (Estimate)	CY18	CY19 (Estimate)	CY20 (Estimate)
Main economic indicators						
Nominal GDP (y/y %)	0.5	1.6	1.2	0.7	1.5	1.4
Real GDP (chained [2011]; y/y %)	0.7	0.6	0.5	0.8	0.8	0.5
Domestic demand (contribution, % pt)	0.8	0.5	0.6	0.8	0.7	0.5
Foreign demand (contribution, % pt)	-0.1	0.1	-0.0	-0.0	0.1	0.0
GDP deflator (y/y %)	-0.2	0.9	0.7	-0.1	0.7	0.9
Index of All-industry Activity (y/y %)*	0.7	0.5	0.6	1.0	0.5	0.7
Index of Industrial Production (y/y %)	0.2	-0.2	1.1	1.1	-0.8	1.3
Index of Tertiary Industry Activity (y/y %)	1.1	0.8	0.5	1.2	0.9	0.5
Corporate Goods Price Index (y/y %)	2.2	1.7	2.0	2.6	1.0	2.8
Consumer Price Index (excl. fresh food; y/y %)	0.8	0.5	0.2	0.8	0.6	0.3
Unemployment rate (%)	2.4	2.4	2.4	2.4	2.4	2.4
Government bond yield (10 year; %)	0.04	-0.04	-0.04	0.07	-0.04	-0.04
Balance of payments						
Trade balance (Y tril)	1.8	5.1	5.2	1.2	4.8	5.3
Current balance ($100 mil)	1,792	2,135	2,143	1,741	2,087	2,154
Current balance (Y tril)	19.9	23.2	23.3	19.2	22.7	23.3
(% of nominal GDP)	3.6	4.1	4.1	3.5	4.1	4.1
Real GDP components						
(Chained [2011]; y/y %; figures in parentheses: contribution, % pt)						
Private final consumption	0.4 (0.2)	0.3 (0.1)	0.5 (0.3)	0.4 (0.2)	0.3 (0.2)	0.5 (0.3)
Private housing investment	-4.3 (-0.1)	2.1 (0.1)	-1.7 (-0.0)	-5.8 (-0.2)	2.5 (0.1)	-1.9 (-0.1)
Private fixed investment	3.5 (0.6)	1.2 (0.2)	0.8 (0.1)	3.9 (0.6)	1.7 (0.3)	0.8 (0.1)
Government final consumption	0.9 (0.2)	0.8 (0.2)	0.9 (0.2)	0.8 (0.2)	0.9 (0.2)	0.9 (0.2)
Public fixed investment	-3.9 (-0.2)	3.6 (0.2)	0.7 (0.0)	-3.3 (-0.2)	1.4 (0.1)	2.1 (0.1)
Exports of goods and services	1.3 (0.2)	-0.5 (-0.1)	1.0 (0.2)	3.3 (0.6)	-1.6 (-0.3)	1.3 (0.2)
Imports of goods and services	2.0 (-0.3)	-1.4 (0.2)	1.2 (-0.2)	3.4 (-0.6)	-2.1 (0.4)	1.1 (-0.2)
Major assumptions:						
1. World economy						
Economic growth of major trading partners	3.7	3.3	3.4	3.9	3.3	3.5
Crude oil price (WTI futures; $/bbl)	62.9	54.0	54.0	64.9	54.2	54.0
2. US economy						
US real GDP (chained [2012]; y/y %)	3.0	2.3	1.8	2.9	2.6	1.9
US Consumer Price Index (y/y %)	2.3	2.3	2.3	2.4	2.1	2.4
3. Japanese economy						
Nominal public fixed investment (y/y %)	-2.3	4.8	1.3	-1.6	2.7	3.0
Exchange rate (Y/$)	110.9	108.2	108.2	110.4	108.7	108.2
(Y/€)	128.3	122.6	122.6	130.0	123.3	122.6

Source: Compiled by DIR.
Note: Due to rounding, actual figures may differ from those released by the government.
* Excl. agriculture, forestry, and fisheries.
Estimate: DIR estimate.