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ANALYSIS

Japan Outlook: Brave Face Fronting Oncoming Challenges

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Introduction

Japan's economy rebounded in the June quarter thanks to domestic demand. That is not surprising given that the labour market has tightened sharply in recent months, while wage growth has picked up consistently, if not sharply. The recent quarterly gain is the ninth in the past 10 quarters, following an unexpected decline in the March quarter. Although domestic demand was on solid footing in the June quarter, net exports detracted from GDP. The reason is twofold. Import costs have risen sharply on the back of higher commodity prices, particularly fuel prices, as Japan remains a large net oil importer. Second, exports are contracting. While the sharp export growth from last year was unlikely to be repeated, the recent slowdown in exports, even when the yen remains favourable, could be a source of downside risk heading into 2019.

Japan Outlook: Brave Face Fronting Oncoming Challenges

BY STEVEN G. COCHRANE AND FARAZ SYED

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GDP growth was expected to moderate in the September quarter, and will likely remain tepid in December following the slowdown in exports. However, steady job growth will support consumption (see Chart 1); on net, the economy added 890,000 jobs in the first nine months of 2018.

In an economy that is aging, with its human capital declining, potential GDP growth will remain low. Therefore, a contraction every so often can be expected, especially after 2017, when the economy expanded above potential. A more comprehensive barometer for Japan's economy is GDP per capita or GDP per worker, which have consistently outpaced GDP growth (see Chart 2). Yet despite the contraction in the first quarter, the Moody's Analytics outlook for Japan suggests GDP will grow near its potential pace, which hovers from 0.5% to 1%.

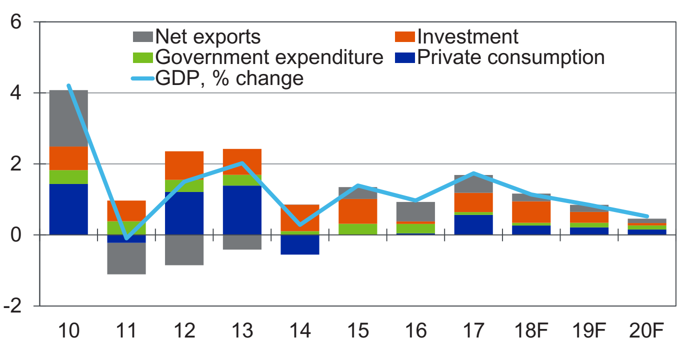
Services and manufacturing shine

Japan's manufacturing, which accounts for 21% of gross value added, tends to be a star performer when GDP growth is rising. However, the burgeoning growth in 2017 was shared among various sectors of the economy. Encouragingly, services outperformed, as evidenced by the increase in employment over the last 20 months. For example, scientific research and the medical industry added to nonagricultural job growth during this period (see Chart 3).

This is partly because of easing of Japanese immigration laws, which allow trainees and workers to enter the country if they have

Chart 1: Consumption Remains the Key

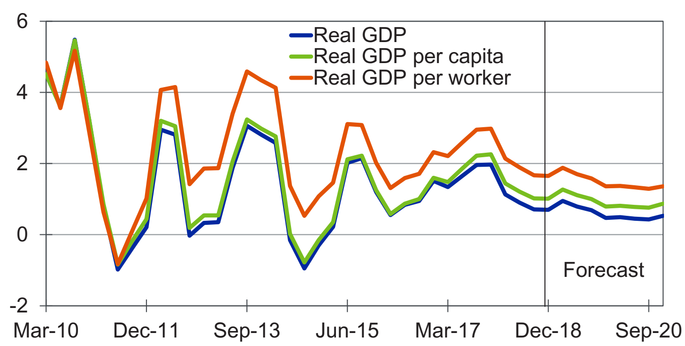
Ppts contribution to real GDP growth



Sources: Japan Cabinet Office, Moody's Analytics

Chart 2: Sanguine Prospects

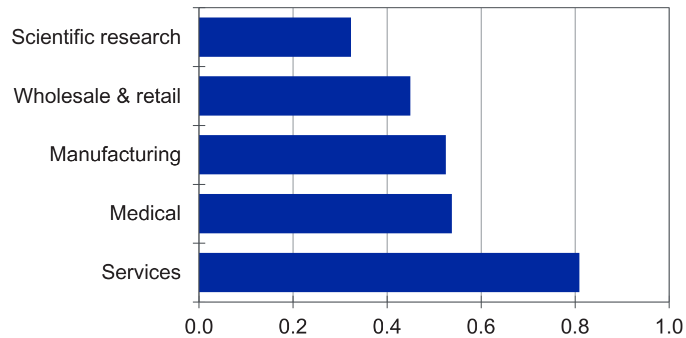
% change yr ago



Sources: Japan Cabinet Office, Moody's Analytics

Chart 3: Top 5 Industries for Employment

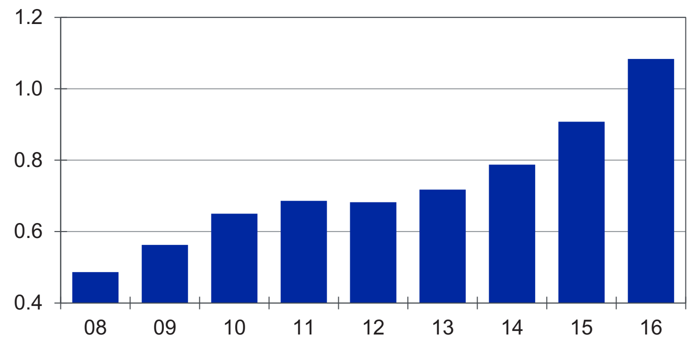
Ppts contribution to total employment from Jan 2017 to Sep 2018



Sources: Japan Statistics Bureau, Moody's Analytics

Chart 4: Foreign Workers Rise Sharply

Foreign workers in Japan, mil



Sources: Ministry of Health, Labour and Welfare; Moody's Analytics

the designated skill set. Over the last five years, Japan's foreign-born labour force has almost doubled. Though it is too early to wax lyrical about Japan opening its immigration, it does suggest that the government is aware of its ageing population and is willing to obtain an overseas skill set (see Chart 4). The government has recently drafted a bill to allow foreign workers into industries with skills shortages. This includes blue-collar workers for construction, but the list is also expected to include workers in the medical and nursing industries.

The desire for foreign labour will likely persist as long as Japan's labour market remains tight. Japan's unemployment rate has fallen to 2.3% and the jobs-to-application ratio has risen to 1.63 in September—163 jobs available for every 100 jobs seekers. Thus, with an easing of foreign labour laws, Moody's Analytics expects employment to increase throughout 2018 and 2019.

Ripe for wage hikes?

With the labour market tightening, Japanese wages have their best opportunity of the past three decades to rise. Fundamentally, there is little reason why wages should not increase. After a poor 2016, corporate Japan staged a comeback in 2017, with manufacturing and nonmanufacturing profits rising thanks to export growth. Overall, total profits increased more than 20% in 2017. Profits are unlikely to keep the pace from 2017, although they have continued to rise in 2018, and Japanese manufacturers remain flush with cash (see Chart 5).

The spring wage negotiations, known as the shunto, kicked off in early 2018. Large manufacturers agreed to increase wages for the fifth year in a row, although the increase fell short of the government's 3% goal. But overall, wages in Japan have increased in 2018.

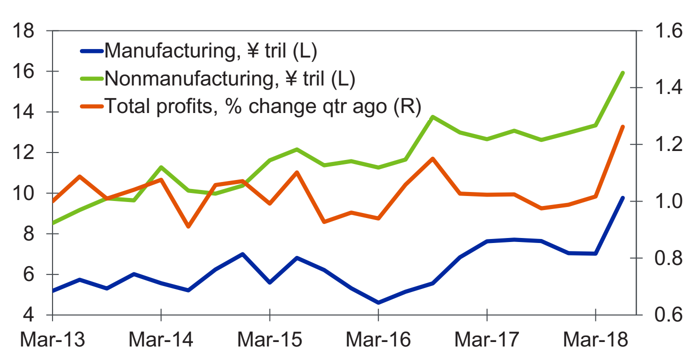
The positive momentum in wage growth, along with a pickup in oil prices, lifted core inflation to 1% in September. The current level of wage growth will prevent Japan from falling back into deflation, but it is unlikely to boost inflation above the central bank's original 2% target (see Chart 6).

For inflation to reach the elusive 2% mark, wages will likely have to rise at 3% on a consistent basis. There is little indication that this will occur over the coming year. Auto manufacturers such as Toyota remain the barometer for wage increases, and they fell short of delivering union demands. Companies remain wary of increasing worker wages because they are unconvinced that the growth momentum will last.

BoJ paves way for tighter policy

The Bank of Japan's July monetary policy meeting paved a way towards tighter policy. The central bank tweaked a variety of measures. First, the BoJ formally introduced 'forward guidance' to keep interest rates

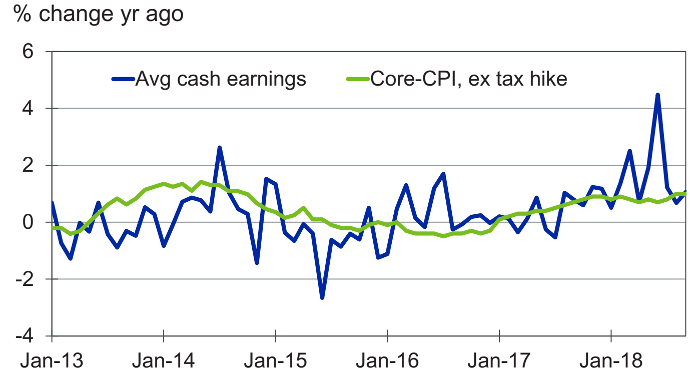
Chart 5: Rising Corporate Profits



Sources: Ministry of Finance, Moody's Analytics

Chart 6: Wages Lead Inflation Higher

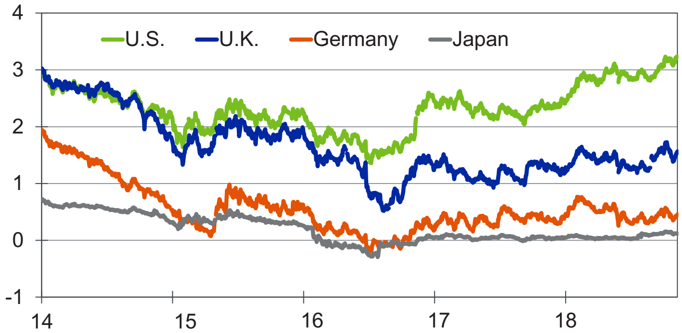
% change yr ago



Sources: Japan Cabinet Office, Moody's Analytics

Chart 7: Global Bond Yields on the March

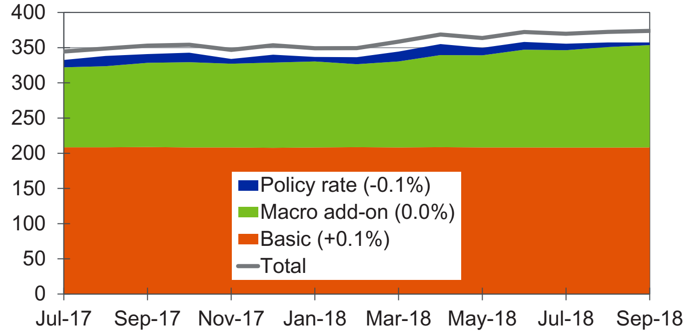
10-yr yields on selected sovereign bonds, %



Sources: Bank of Japan, Moody's Analytics

Chart 8: Policy Rate Balance Is Lowered

Current account balances at the BoJ, ¥ tril



Sources: Bank of Japan, Moody's Analytics

low. Second, it is committed to implementing greater flexibility by allowing the 10-year Japanese government bond yield to move 'upwards' and 'downwards'. And the most significant change, which supports the Moody's Analytics view of tighter policy, is that the BoJ will lower the 'policy rate balance', or excess reserves, to which the negative 0.1% interest rate is applied.

At the outset, forward guidance appears to be an accommodative measure to telegraph that rates will be kept at the zero bound.

However, forward guidance—after five years of quantitative and qualitative easing— stems from a desire to keep short-term expectations anchored when the BoJ begins to tighten policy further. Any hints of tighter BoJ policy has caused a sharp JGB selloff, and the BoJ is aware that an official taper announcement will exacerbate the rise in yields, as evidenced during the 2013 taper tantrum when investors pulled out of emerging markets on expectations of Federal Reserve asset-purchase tapering.

Thus, rather than seeing forward guidance as a more accommodative policy measure, Moody's Analytics believes the BoJ is paving the way for tighter policy. Forward guidance will be used to remind financial markets that short-term rates will be kept at the lower bound even as the BoJ begins to tighten its policy.

The BoJ's statement said there would be greater flexibility in allowing the 10-year JGB yield to move 'upwards' and 'downwards', away from its target of 0%. This was confirmed in BoJ Governor Haruhiko Kuroda's press conference, when he suggested this tolerance would let the yield go to plus or minus 0.2%.

However, with global yields rising, the policy is likely aimed to allow the 10-year to trade slightly higher (see Chart 7). The BoJ is aware that financial institutions suffer when the yield curve flattens because they raise funding through the short end of the curve, but investments are linked to the long end of the curve. A flattening of the curve lowers net interest margins.

The changes at the July meeting to allow the 10-year to trade more freely are also aimed at steepening, not flattening, the curve. For example, global yields have moved upwards, not downwards. And with the Federal Reserve expected to raise interest rates further, global yields are expected to rise. The Bank of England and the European Central Bank are also expected to tighten, not loosen, their policy stances over the coming year. This points to upward bias in global yields. Thus, more flexibility in the yield curve means allowing the 10-year JGB to rise. This points to the BoJ looking towards a tighter policy stance.

Lower balance for negative rates

The BoJ's most significant policy shift is lowering the excess reserve balance to which a negative interest rate is applied. The BoJ has three tiers to its current accounts. The first is where a positive interest rate of 0.1% is applied. Second is the macro add-on balance to which a 0% rate is applied. And finally, there is the policy rate balance, or the excess reserve balance, to which a -0.1% rate is applied.

The BoJ has lowered its policy rate balance, to which a negative rate is applied, from around ¥10 trillion to ¥5 trillion. This is the same as increasing the excess reserve balance rate from -0.1% to -0.05%. Although details of the exact number can change month to month based on arbitrage transactions, the move is a clear case of making interest rates 'less negative'. Financial sector profitability was likely the greatest catalyst in reducing the excess reserve balance (see Chart 8).

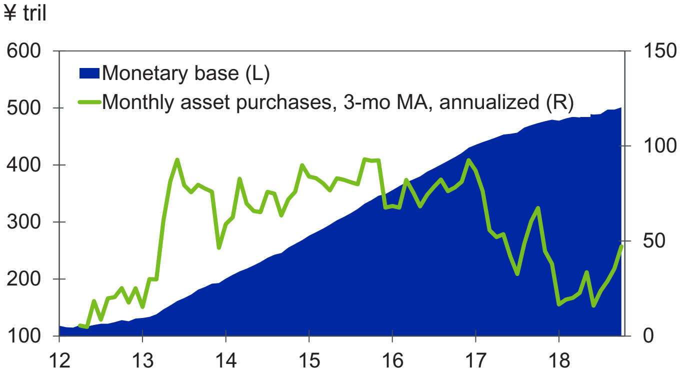
Overall, a lower excess reserve balance to which a negative interest rate is applied is emblematic of the BoJ paving the way for less stimulatory policy.

Implications: What is next?

The BoJ's latest policy wrangling raises questions on when the central bank will actually begin tapering. Moody's Analytics believes official tapering announcements are unlikely in the first half of 2019 because the central bank has already slowed its pace of asset purchases; the increase in the monetary base has decelerated sharply. Rather than hitting the ¥80 trillion annualized monthly target, the BoJ is purchasing at a much slower rate, at times half the target amount. This has led financial markets to deem the BoJ's purchases as 'stealth tapering' (see Chart 9).

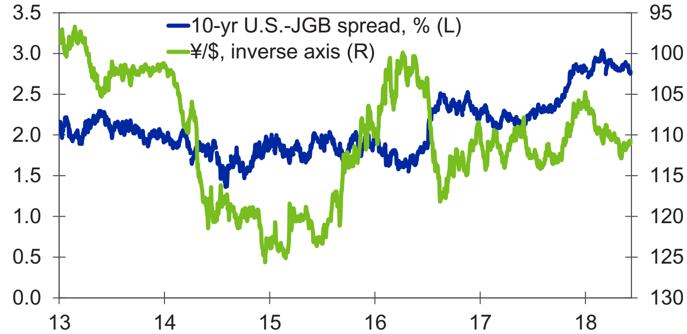
The need for 'stealth tapering' is worth exploring. The BoJ is running out of JGBs to

Chart 9: BoJ Varies Its Purchasing Pace



Sources: Bank of Japan, Moody's Analytics

Chart 10: Rising U.S. Yields Cap the Yen



Sources: Bank of Japan, Moody's Analytics

purchase, particularly maturities of 10 years and higher. Financial institutions, including Japan's large pension funds, hold JGBs as part of their asset allocation mix. Although under the Abenomics era—the economic policies of Prime Minister Shinzo Abe— these funds have looked to diversify towards international holdings, there is still a clear appetite for domestic JGBs.

Moreover, financial institutions require a minimum amount of JGBs to hold as part of their minimum capital requirements. With government debt in excess of 200% of GDP, a large increase in JGB supply through fiscal stimulus remains unlikely. Thus, there is a natural need to slow down asset purchases.

But officially announcing tapering is tricky when the BoJ has not hit its 2% inflation target. Moody's Analytics forecasts inflation is unlikely to hit 2% at a sustainable level over the medium term. This makes tapering especially worrisome, as the BoJ risks losing credibility by tightening policy before meeting its objectives.

Therefore, rather than a Fed-like official tapering announcement, the BoJ will continue to tweak policy measures to pave the way for tighter policy. Further changes to yield curve control, or its purchasing mix, remain a likely option over the coming year as the BoJ mulls ways to reduce its stimulus. Using 'forward guidance' will also be crucial to preventing yields from rising sharply because of incremental tighter policy.

The currency remains a crucial part of the BoJ's consideration, too. A high-octane U.S. economy has wet the sails of 10-year Treasuries, which has helped widen the interest rate differential between Treasuries and JGBs. Higher U.S. rates will likely keep downward pressure on the yen, especially when yield curve control will cap the 10-year JGB. On balance, higher U.S. rates will help offset the impact of any tighter BoJ policy on the yen (see Chart 10). Moody's Analytics forecasts the yen will remain in favourable range for Japanese exporters, which is around ¥110 to ¥115 per dollar.

Downside risks: Trade wars

Moody's Analytics has utilised its global macroeconomic model to quantify the impact of trade wars. The first scenario, which carries a 50% probability, is being played out. Tariffs have been imposed on $250 billion worth of Chinese imports to the U.S. Thus far, China has imposed tariffs on $50 billion of U.S. exports to China.

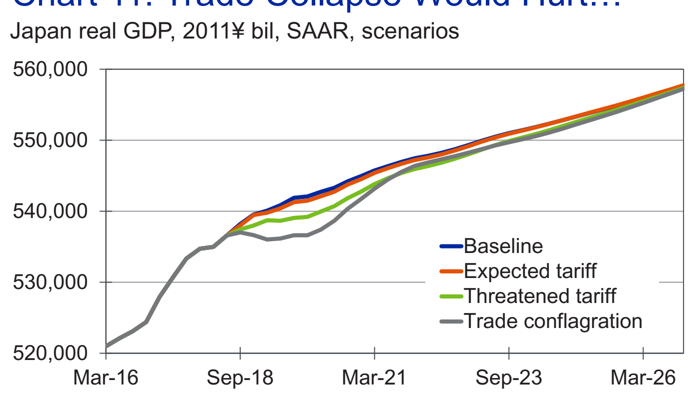
If tensions do not escalate further, these measures will have only a minor impact on the Japanese economy; GDP growth will be nearly 0.1 percentage point below baseline in 2019. The yen could increase on risk-off sentiment if trade jousting between the U.S. and China continues, which will lead to lower export receipts (see Chart 11).

The second scenario, the threatened trade scenario, has a 40% probability of occurring. This involves a 10% tariff on an additional $400 billion of Chinese imports and a 25% hike on $275 billion in vehicle imports. This would cause the yen to rise compared with the baseline; risk-off sentiment and lower demand from China, which is Japan's largest export partner, would hurt overall export receipts and regional trade.

Moreover, fears would increase that the U.S. administration could turn towards Japan on its crusade against trade deficits: The U.S.-Japan bilateral trade deficit sits at $69 billion. Under this scenario, Japan's GDP would grow 0.4 percentage point below baseline in 2019. The stock market would also fall as anxiety around trade intensified.

The final scenario is called trade conflagration, which has a 10% chance of occurring. This scenario involves a blanket 25% tariff on the bilateral trade between U.S. and

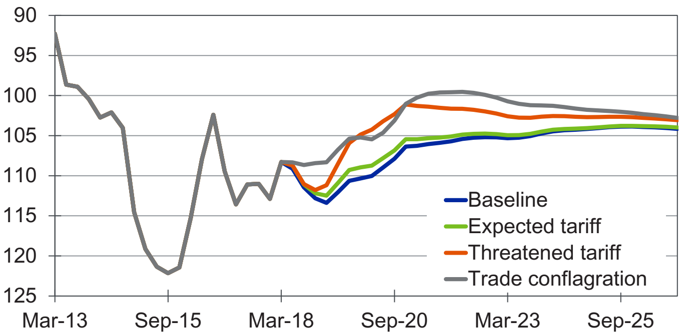
Chart 11: Trade Collapse Would Hurt…



Source: Moody's Analytics

Chart 12:…Because the Yen Would Rise

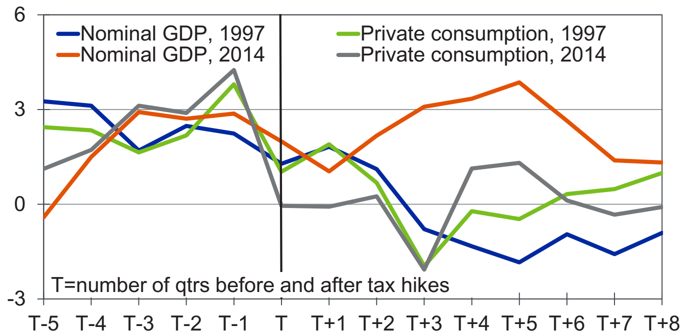
¥/$, inverse axis, scenarios



Source: Moody's Analytics

Chart 13: Tax Hikes Lead to Recession

% change yr ago



Sources: Economic and Social Research Institute, Moody's Analytics

China, which amounts to $650 billion. In this scenario, regional trade would drop dramatically, with Japanese shipments to Asia falling precipitously. A drop in sentiment and a risk-off appetite would cause the yen to rise by the end of 2019.

The yen's appreciation would add to a further decline in export values, while volumes would be hit hard by lower global demand. Japanese firms would become anxious about growth prospects, leading to an increase in layoffs as production and manufacturing dropped (see Chart 12). Overall, as the unemployment rate rose, GDP growth would slow by 0.7 percentage point compared with the baseline.

Overall, although Moody's Analytics expects growth to persist in Japan's baseline scenario, the threat of trade wars could cause growth to slow markedly. That said, continued accommodative policies by the BoJ, along with Japan's overseas investments, will somewhat cushion the ill effects.

Downside risks: Tax time

The Abe government is committed to persist with the sales tax hike scheduled for late 2019. However, private consumption, which accounts for around 60% of Japan's GDP, remains fragile at best. This is why the government's commitment to increasing the sales tax to 10% from 8% is surprising—consumption and GDP declined after the previous two sales tax increases, in 1997 and 2014 (see Chart 13).

Moreover, econometric modeling shows that the sales tax in 2014 shaved 0.7 percentage point off core inflation. Given the malaise caused by the previous tax hikes, Moody's Analytics expects the economy to take a hit when the sales tax is increased in 2019.

However, the degree of slowdown is unlikely to be as severe because ¥2 trillion out of the ¥5 trillion from the revenue will be diverted to fiscal stimulus. Although Japanese governments notoriously spend less on fiscal stimulus than originally planned, fiscal spending of some form will partially offset lower consumption. An increase in investment prior to Japan's Olympic Games in 2020 could also help.

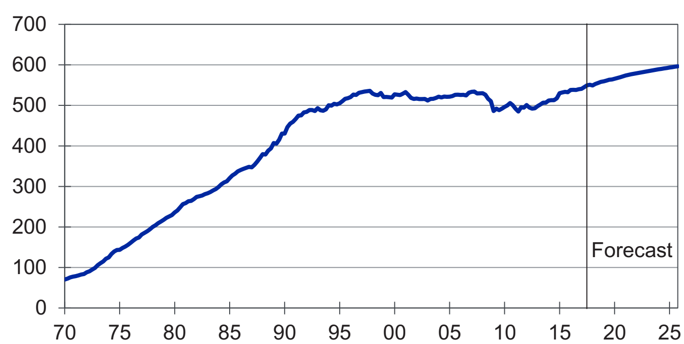
On balance, Moody's Analytics believes the tax hike will likely lead to a decline in consumption, and the economy could slip into a small recession. However, a fallout similar to the previous tax hikes is unlikely.

Overall, the Japanese economy remains resilient. Nominal GDP growth has accelerated since Abenomics was introduced in early 2013. Accommodative monetary policy has provided a tailwind to exporters over the past few years. And although inflation has not hit 2%, the rise in nominal GDP along with sustained employment growth has helped Japan escape the deflation mindset. Prospects of continued employment growth could see wage growth begin to materialise on a more consistent basis, which would prevent overall deflation (see Chart 14).

Moody's Analytics forecasts Japan's GDP to rise 0.9% in 2018, followed by 0.7% in 2019, though the sanguine outlook is clouded by the prospect of trade wars and the tax hike.

Chart 14: Escaping Deflation, for Now

Nominal GDP, ¥ tril



Sources: Japan Cabinet Office, Moody's Analytics

About the Authors

Steven G. Cochrane, PhD, is Chief APAC Economist with Moody's Analytics. He leads the Asia economic analysis and forecasting activities of the Moody's Analytics research team, as well as the continual expansion of the company's international, national and subnational forecast models. In addition, Steve directs consulting projects for clients to help them understand the effect of regional economic developments on their business under baseline forecasts and alternative scenarios. Steve's expertise lies in providing clear insights into an area's or region's strengths, weaknesses and comparative advantages, relative to macro or global economic trends. A highly regarded speaker, Dr. Cochrane has provided economic insights at hundreds of engagements over the past 20 years and has been featured on Wall Street Radio, the PBS News Hour, C-SPAN and CNBC. Through his research and presentations, Steve dissects how various components of the macro and regional economies shape patterns of growth. Steve holds a PhD from the University of Pennsylvania and is a Penn Institute for Urban Research Scholar. He also holds master's degree from the University of Colorado at Denver and a bachelor's degree from the University of California at Davis. Dr. Cochrane is based out of the Moody's Analytics Singapore office.

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