OBSERVATION

TD Economics

March 30, 2015

JAPAN'S LONG SLOG IN STOKING WAGE AND PRICE GROWTH

Highlights

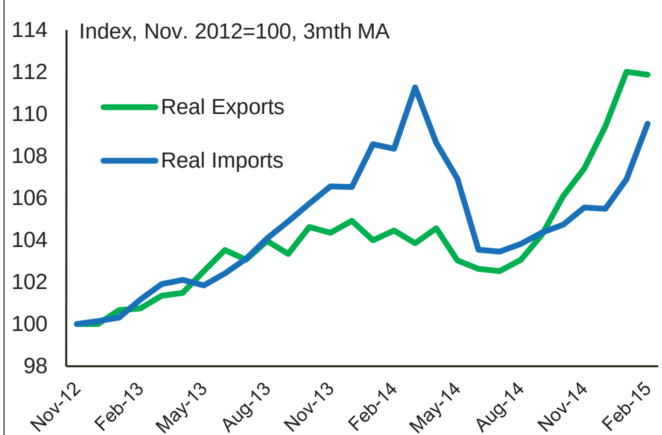
- Headline inflation decelerated to 2.0% Y/Y in February, which, excluding the impact of the tax hike in April 2014, leaves price growth at 0.0% Y/Y. While the near-term outlook for inflation is dim, the medium-term picture is more positive.
- Recent data suggests that the labor market is the tightest it has been since the 1990's. More importantly, tightness in the labor market and other pressures have led to increases in basic pay, with likely further increases ahead. Over time, this will lead to higher inflation.
- Domestic demand following the consumption tax hike has been remarkably subdued. Part of this is explained by severely negative real wage growth, as price growth exceeded gains in wages. However, with the impact of the consumption tax hike on inflation dropping out in April-May, real wage growth is set to turn modestly positive. Along with a more positive external sector, this sets the stage for more broad-based growth in the quarters ahead.
- While inflation is likely to rise in the medium term, it is set to fall short of the Bank of Japan's goal of 2% in FY 2015. It remains unclear whether there is enough appetite for an expansion in stimulus at the Bank of Japan; however, at the very least, it is likely to announce an extension of their current quantitative easing program. This points to further yen weakness relative to the USD in the medium-term.

As part of Abenomics, Japan's goal was to raise the pace of economic growth and to drive inflation up to 2% Y/Y. With the economy contracting last year on an annual basis and with headline inflation falling to 0% once the impact of the consumption tax is stripped out , it would be easy to think the policies have been a failure so far. The recent data presents a slightly better underlying picture.

Exports had to do much of the heavy lifting in 2014, as domestic demand weighed

An encouraging sign for economic growth is the pickup in exports over the past several quarters (Chart 1). Indeed, following the 20% devaluation in the yen relative to the U.S. dollar in 2012-13, exports were particularly slow in responding. What's more, real imports outpaced real exports over this period, with the result that net exports weighed on the economy. This is not typically expected following a massive devaluation, and was partly due to continued offshoring of production by Japanese firms. Since mid-2014, exports have resumed a higher growth profile relative to imports, as the competitive advantage from the Yen takes firmer hold.

CHART 1. REAL EXPORTS ARE NOW OUTPACING REAL IMPORTS, UNLIKE IN THE EARLY STAGES OF ABENOMICS



Source: Bank of Japan.

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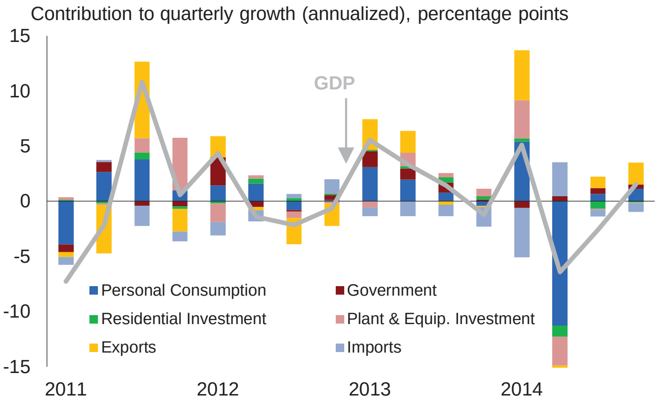
CHART 2. DOMESTIC DEMAND, INVESTMENT IN PARTICULAR, HAS BEEN TEPID.



Source: Japan Cabinet Office, TD Economics. Note: tally does not add up total GDP because inventories omitted.

Over the past several months, imports have also started to accelerate, potentially putting at risk the sustainability of Japan's recent net export gains. However, the recent monthly pattern of data is partially distorted by the Lunar New Year in China.With demand firming in key U.S. and European markets, and China likely to undertake further stimulatory measures, the external sector should at the very least no longer subtract from growth as it did in the early stages of Abenomics.

Were it not for the contribution of net exports, the past year would have been far worse for economic activity. Domestic demand was particularly feeble in 2014, following the consumption tax hike in April. Consumers had front-loaded purchases into the first quarter to spare their wallets the impact of the tax hike. Private consumption plummeted 18.7% annualized in the second quarter. However, this was not followed by a rebound in subsequent quarters as the sticker shock diminished. Expenditure growth failed to exceed 2.0% Q/Q annualized in the third and fourth quarters.

Investment fared even worse. Consumption provided a positive contribution to growth in the second half of the year, but the same cannot be said for investment (Chart 2). Gross fixed capital formation continued to contract in the third and fourth quarters of last year. Evidently, the negative impact of the tax hike, both on household demand and confidence, weighed on firms planned capital expenditures.

This is all very dismal on the surface, but there was preliminary evidence that momentum turned as the year came to a close. Consumption and investment both improved in the fourth quarter relative to the third, even if growth was still on the weak side. Perhaps more importantly, core real capital goods shipments (ex-transportation), jumped up in January, pointing to a thawing in investment. However, more data will be required on all fronts to confirm that these trends are deepening.

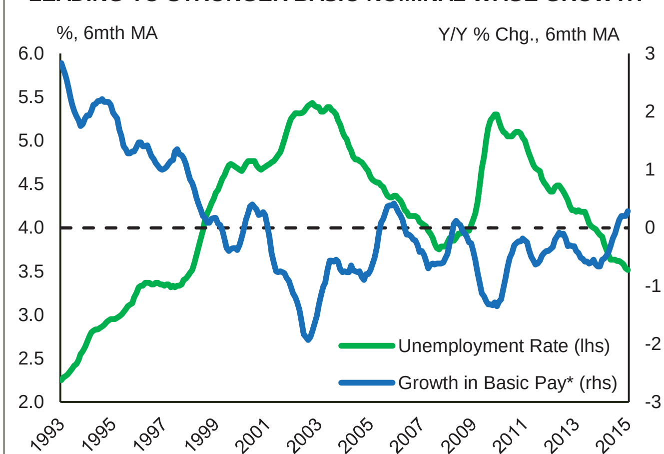
Recent wage developments have been positive

In contrast, a clearer positive signal is being sent on the wage front. Total monthly cash earnings grew 1.3% Y/Y in both December and January. More importantly, basic pay, as measured by scheduled cash earnings, which excludes bonuses and overtime, grew by 0.8% year-over-year in nominal terms in January. This was the largest gain since January 2000, and a positive sign that tightness in the labor market and political/popular pressure are finally underpinning greater wage growth (Chart 3). Indeed, the unemployment rate in February was 3.5%, a figure that (with the exception of December 2014) hadn't been reached since the 1990's. Moreover, the jobs to applicants ratio, at 1.15 in February, is the highest it has been since 1992.

Wage growth is likely to advance further this year. As part of annual spring wage negotiations, the Japanese Trade Union Confederation stated that preliminary results were pointing towards a rise in base pay of roughly 0.8% Y/Y for this fiscal year, roughly double what last year's preliminary results were pointing for FY2014. While this figure applies mainly to larger companies, it comes on top of additional overtime and bonus pay, and further affirms the upward trend in wages.

So far, the gains in wage growth have not been as supportive for economic growth as would typically be expected. This is because inflation continues to capture the lingering

CHART 3. TIGHT LABOR MARKET AND ABENOMICS LEADING TO STRONGER BASIC NOMINAL WAGE GROWTH



Source: Ministry of Health, Labour and Welfare (Japan). *Scheduled cash earnings.

influence of last year's VAT hike. Consumer prices ex-fresh food clocked in at 2% Y/Y in February, causing inflation-adjusted wage growth to be severely negative over the past year (Chart 4).

According to the Bank of Japan (BoJ), roughly 2.0 percentage points of inflation is due to the consumption tax hike. This impact will largely fall out of the data in April-May. In addition to declines in energy prices, inflation will fall to close to zero and could temporarily dip into negative territory.

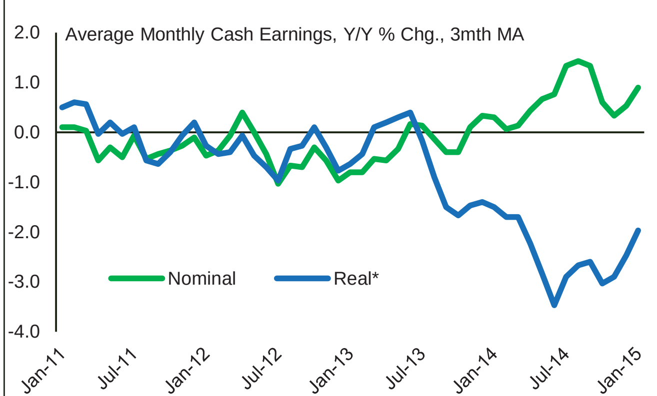
The benefit of low inflation and moderate wage growth will be to boost the real incomes of consumers. In turn, this is likely to lead to stronger consumption growth, which, in combination with a more positive external sector, could set the stage for more robust and broad-based economic growth in the quarters ahead.

This rise in economic growth will be helped along by lower oil prices. The fall in oil prices will provide massive savings to the Japanese economy – money which can be spent on other goods and services. Japan is the third largest net oil importer, surpassed only by the U.S. and China. However, because its economy is smaller, the cost of net oil imports was a massive 3.4% of GDP in 2013, far more than the U.S. at 1.4% or China at 2.5%.

Near-term outlook for inflation is dim, but more positive further out

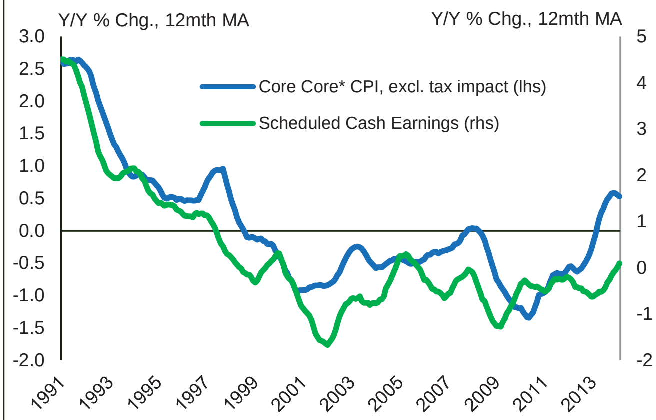
Stronger economic and wage growth is key for the outlook for inflation. While headline inflation will depend on the evolution in oil prices, a better indicator of underlying price trends is what is known in Japan as "core core" CPI – consumer prices ex-food, ex-energy. Excluding the effect of the tax hike, core core CPI grew 0.3% Y/Y in in February, which is low but remains positive. There is a strong relationship between basic wage growth and core core CPI (Chart 5). Stronger wage growth this year should lead to gains in core core prices. In combination with an anticipated rise in energy prices later this year, headline inflation is likely headed towards 1% Y/Y or higher in 2016, which is one more step in Japan's long hard slog to positive inflation.

CHART 4. REAL WAGE GROWTH HAS BEEN SEVERELY NEGATIVE BUT SHOULD SOON TURN MODESTLY POSITIVE, AS THE IMPACT OF THE VAT ON INFLATION DROPS OUT



Source: Ministry of Healthy, Labour and Welfare (Japan). *The Bank of Japan deflates nominal wage growth by CPI ex-imputed rent, which has been running higher than headline CPI growth.

CHART 5. STRONGER WAGE GROWTH IS POINTING TOWARDS FASTER CORE INFLATION LATER THIS YEAR



Source: Ministry of Internal Affairs and Communications. Ministry of Health, Labour and Welfare, TD Economics. *CPI ex-food, ex-energy.

Bank of Japan likely to at least extend current quantitative easing program

Nevertheless, this outcome would fall short of the Bank of Japan's goal of reaching 2% inflation in FY2015, and leaves the Bank of Japan in something of a quandary. Last October, it undertook an expansion in monetary stimulus and used the following as part of the argument: "… if the current downward pressure on prices remains, albeit in the short term, there is a risk that conversion of deflationary mindset, which has so far been progressing steadily, might be delayed ". This argument still rings true today, as energy prices have fallen even more since October. Market-based inflation expectations, as priced by inflation swaps and breakevens, have also declined further. It remains to be seen whether survey-based expectations are displaying a similar decline, and more will be known in April, when the Tankan survey and long-term forecasts from Consensus Economics are released.

Taken alone, this could argue for a further expansion in monetary stimulus. However, the last vote in favor of additional stimulus was tight at 5-4, and it is unclear whether there is enough appetite for the BoJ to do even more. Whether the Bank of Japan announces an expansion in stimulus remains up in the air, but at the very least, they are likely to announce an extension of their current quantititative easing program. All things considered, this would point towards further weakness in the Japanese Yen in the medium-term. This, in turn, would come full circle in providing further underpinning to export growth amidst a strengthening global economy, as well as temporarily raise inflation further, providing more time to anchor inflation expectations closer to 2%.

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