Current Status of Personal Consumption and Capital Investment

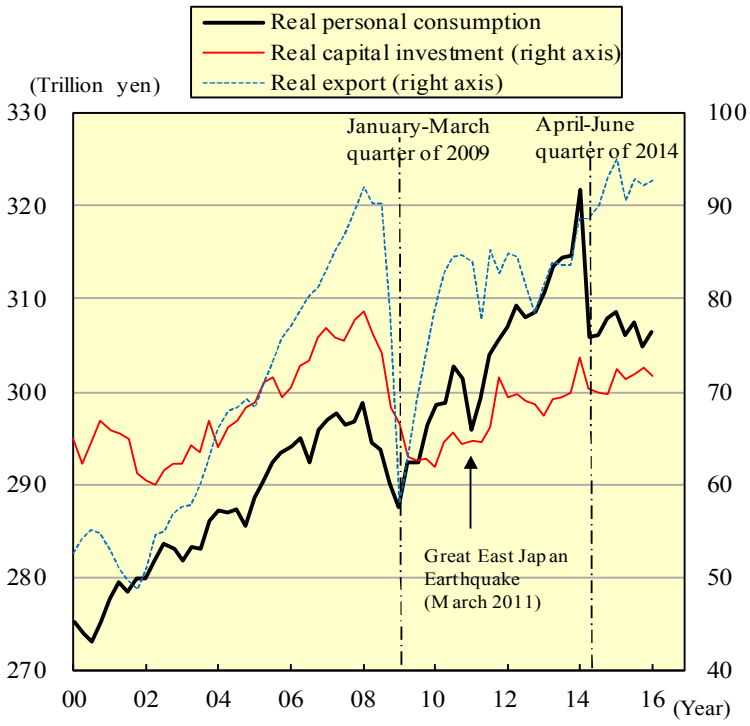
Recently, the Japanese economy has stayed somewhat anemic. Personal consumption is particularly sluggish. Taking a closer look, we can see that consumption of durable consumer goods such as electrical products and automobiles is significantly weak. That is because of the effects of the reaction to the last-minute upsurge in demand before the last consumption tax rate hike and the premature exhaustion of demand due to several rounds of the "eco-point" program to promote purchase of environment-friendly home electric appliances and tax reduction for automobiles. A rise in import prices due to the yen's weakening is also a major factor.

As the Bank of Japan aims to realize inflation as its top priority goal, export-dependent companies and market players are voicing hopes for further weakening of the yen. However, consumers have to curb their consumption because of rising prices due to the yen's weakening, a situation that has become a drag on the economy.

Sluggish Personal Consumption

According to GDP statistics recently announced by the Cabinet Office, inflation-adjusted real GDP in the January-March quarter grew 0.5% compared with the previous quarter, marking the first growth in two quarters. However, compared with the same period of last year, it grew only 0.1%. Figure 1 shows the trend in real personal consumption, real capital investment and real exports (these three demand components account for around 80% of GDP).

Figure 1 Trends in major components of real GDP



Note: The base year for the real figures is 2005.
Source: Cabinet Office

Although the collapse of Lehman Brothers in the United States in September 2008 caused all demand items to decline sharply, personal consumption continued to recover after hitting bottom in the January-March

quarter of 2009. However, since it fell steeply again following the consumption tax hike (from 5% to 8%) in April 2014, personal consumption has stayed sluggish. Between the April-June quarter of 2014 and the January-March quarter of 2016, capital investment and exports increased 2.0% and 4.5%, respectively, while private consumption grew only 0.1%.

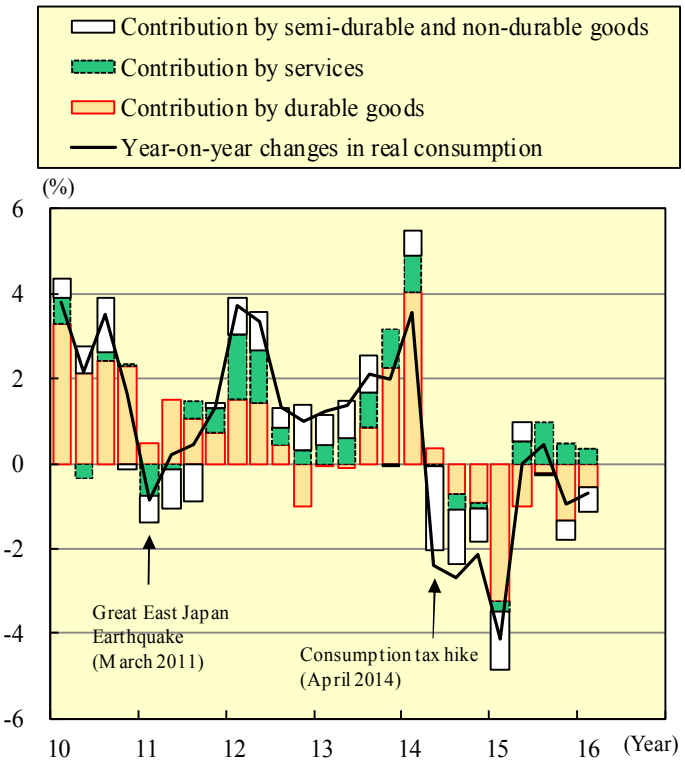
Figure 2 shows a breakdown of private consumption. Consumption of durable goods has been the weakest, and consumption of semi-durable and non-durable goods is also slack. Durable goods include home electric appliances, automobiles and furniture, and semi-durable goods include clothing and footwear. Non-durable goods include foods, beverages, detergents and cosmetics. This figure indicates the following points.

The first point is that although real consumption continued to grow at high rates ranging from 2% to 4% until the consumption tax hike in April 2014, it declined thereafter and stayed in the minus column in most of the subsequent period.

Second, consumption of durable goods has been particularly steep, becoming the biggest drag on overall consumption.

Third, although consumption of semi-durable and non-durable goods turned to positive growth in the April-June quarter of 2015, it started to decline thereafter.

Figure 2 Breakdown of real personal consumption (year-on-year, contribution)



Source: Cabinet Office

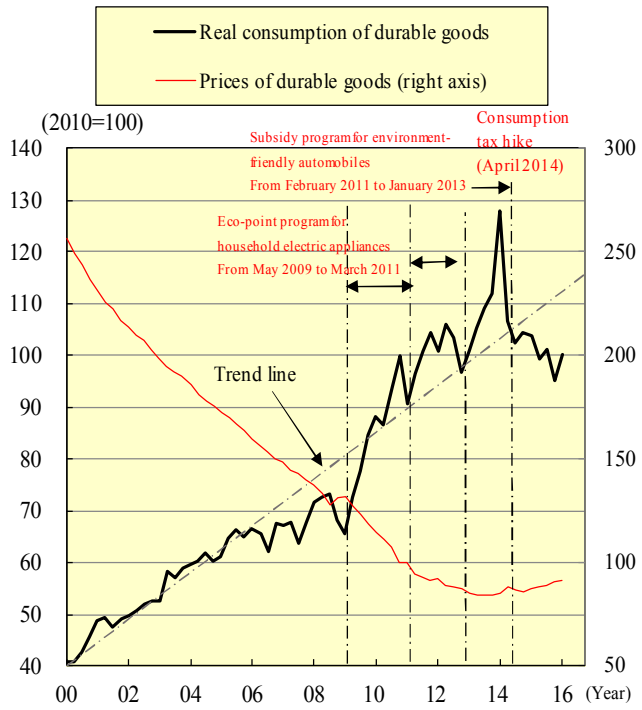
Fourth, consumption of services was recording negative growth for one year after the consumption tax hike, but it has thereafter been in the positive column. The firmness of consumption of services is attributable to an increase in demand for medical care and welfare services due to the aging of society, growth in demand for door-to-door parcel delivery due to growing Internet sales and the expansion in sales at securities companies caused by stock price rises.

Why Is Consumption of Durable Goods Sluggish?

The greatest cause of the sluggishness of the consumption of durable goods is the reaction to the last-minute upsurge in demand before the consumption tax hike. However, there are other causes as well. Figure 3 shows the trends in inflation-adjusted real consumption and prices. This figure is an indication of the following facts.

First, even though real consumption of durable goods has been recently sluggish, it has significantly increased over the long term, specifically since 2000, amid steep price declines. As a result of a steep drop in prices of electrical goods and IT-related products, consumers were able to purchase a relatively large volume of durable goods by allocating a certain proportion of their income. Over the 13 years between 2000 and the July September quarter of 2013, when prices hit bottom, prices declined by two-thirds. As a result, in 2013 consumers could purchase durable goods in a volume 2.7 times larger than in 2000 with the same amount of payments.

Figure 3 Real consumption of durable goods and prices



Note: Consumption of durable goods excludes "consumption-related import."
The value of "consumption-related import" was calculated by multiplying the value of import by the proportion of the consumption of durable goods in GDP.
Source: Cabinet Office

However, prices have rebounded since hitting bottom in the July-September quarter of 2013. Whereas prices rose 8.6% between the July-September quarter of 2013 and the January-March quarter of 2016, real consumption fell 8.3%. The price rise resulted mainly from an increase in import prices due to the yen's weakening. It is obvious that there has been an inverse correlation between prices and consumption (consumption increases when prices decline and vice versa).

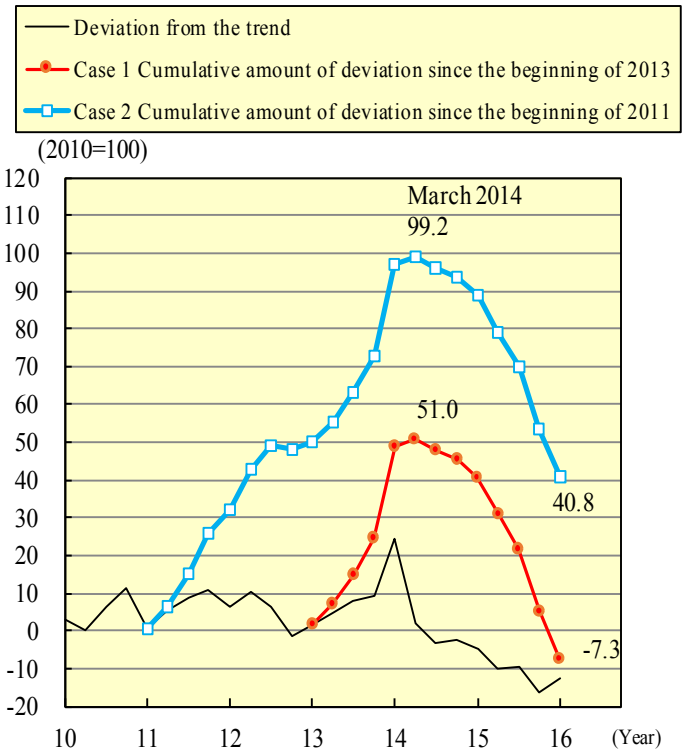
Second, we cannot ignore the effects of the reaction to the upsurge in demand before the consumption tax hike as well as the reaction to the inflated consumption due to demand-boosting measures, such as the eco-point program for environment-friendly home electric appliances and tax reduction for environment-friendly automobiles.

Real consumption of durable goods increased steeply between May 2009 and March 2011. The eco-point program for environment-friendly home electric appliances was intended to support the fight against global warming, invigorate the economy and promote the diffusion of terrestrial digital TVs. Under the program, consumers received benefits when they purchased home electric appliances meeting the prescribed criteria. As a result of this program, consumption of durable goods, which had until then been sluggish, increased significantly. A similar increase in purchases also arose as a result of the subsidy program for environment-friendly automobiles. This program was intended to contribute to the preservation of the environment by encouraging sales of new automobiles with superior environmental performance and to invigorate the domestic automobile market. Under the program, consumers received subsidy when they purchased automobiles meeting the prescribed criteria. As shown in Figure 3, the level of real consumption was higher than the trend line during the periods of the implementation of the eco-point program for environment-friendly home electric appliances and the subsidy program for environment-friendly automobiles. Moreover, the level of real consumption was substantially higher than the trend line between the beginning of 2013, when the talk about the consumption tax hike started to circulate, and the January-March quarter of 2014. Since the consumption tax hike in April 2014, the level of real consumption has been far lower than the trend line.

Figure 4 shows the results of the estimation of the cumulative deviation of real consumption from the trend line indicated in Figure 3 in two cases.

Case 1 takes into consideration only the effects of the upsurge in demand before the consumption tax hike. In this case, the deviation from the trend line since the January-March quarter of 2013. As a result, although the cumulative deviation, represented by an indicator whose base is 100 in 2010, rose to 51.0

Figure 4 Effects on subsequent consumption of demand-stimulating measures, including the eco-point program for home electric appliances and last-minute demand upsurge before the consumption tax hike



Source: Cabinet Office

in the April-June quarter of 2014, it continued to decline thereafter due to a fall in real consumption, falling to minus 7.3 in the January-March quarter of 2016. This means that the effects of the upsurge in demand before the consumption tax hike have disappeared.

However, in Case 2, which assumes the effects of the upsurge in demand due to the implementation of past demand-boosting measures, such as the eco-point program for environment-friendly home electric appliances and the subsidy program for environment-friendly automobiles, the conclusion reached provides a pessimistic outlook. The cumulative deviation from the trend line since the January-March quarter of 2011, represented by an indicator whose base is 100 in 2010, rose to 99.2. Even though the indicator subsequently declined, it remained at a relatively high level of 40.8 in the January-March quarter of 2016. Presumably, most air conditioners and TVs purchased in 2011 still have some time before reaching the end of their durability periods. Consequently, demand for durable goods is unlikely to start recovering for a while (around half a year).

Consumption-stimulus measures such as the eco-point program for environment-friendly home electric appliances and the subsidy program for environment-friendly automobiles have only temporary effects. They are "harmful economy-stimulus measures" in that they cause long-term economic instability by exhausting demand prematurely.

Why Is Consumption of Semi-Durable and Non-Durable Goods Sluggish?

Consumption of semi-durable and non-durable goods still remains because of a frontloading of demand in the run-up to the consumption tax hike in April 2014 as shown in Figure 5. As clothing, footwear, foods, beverages, detergents and cosmetics may be purchased early for stocking up in many cases, last-minute demand for such goods grew before the consumption tax hike in the January-March quarter of 2013 albeit not so steeply as in the case of durable goods.

However, demand for semi-durable and non-durable goods hit bottom in the April-June quarter of 2014 and bounced back to a level 3.1% higher than the bottom in the January-March quarter of 2015. But it later resumed declining and still remains weak. This indicates that although the effects of the last-minute upsurge in demand disappeared within around one year, some other factor dampened consumption.

The dampening factor is a rise in prices. Not only did the import cost rise due to the yen's weakening that started at the end of 2014, but companies also raised sales prices after recognizing an increase in consumers' purchasing power due to a fall in crude oil

prices, resulting in a sales volume decline. Companies raised prices in ways that avoid making consumers feel an increased burden. For example, some companies implemented effective price hikes by reducing products' volume per package, while others emphasized products' benefits by characterizing them as "available in limited areas" or as "premium products." In some cases, companies persuaded consumers to accept price hikes through resourceful design or advertising ideas.

A comparison of year-on-year changes in real consumption of semi-durable and non-durable goods and changes in prices shows an inverse correlation in most of the covered period, as depicted in Figure 6. When prices rise, real consumption drops, and when prices decline, real consumption grows.

The government and the Bank of Japan aim to raise the inflation rate as a policy goal. However, they should understand that they cannot achieve this goal because as inflation reduces real consumption.

Figure 5 Real consumption of semi-durable and non-durable goods and prices (level)

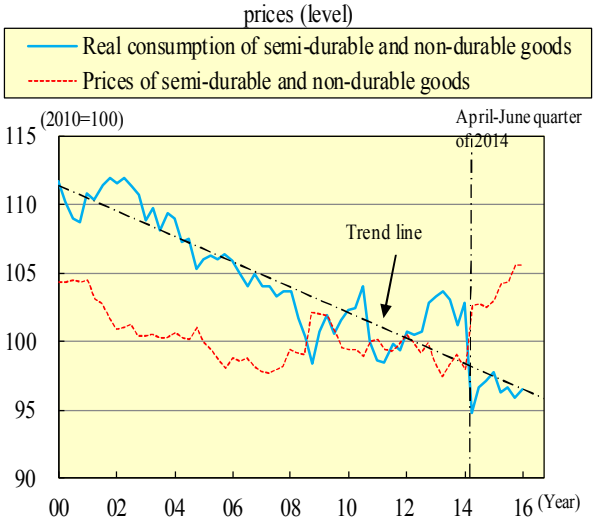
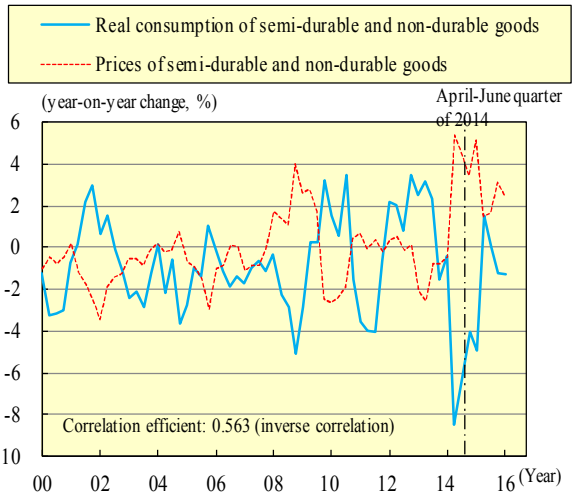


Figure 6 Real consumption of semi-durable and non-durable goods and prices (rate of change)



Note: Consumption of semi-durable and non-durable goods excludes "consumption-related import." The value of "consumption-related import" was calculated by multiplying the value of import by the proportion of semi-durable and non-durable goods in GDP.

Source: Cabinet Office

Is There a Capital Investment Shortage?

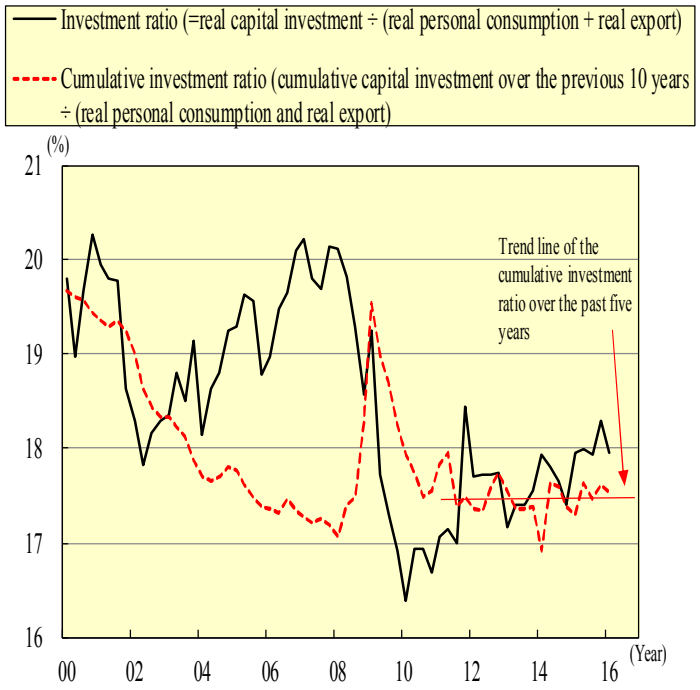
There is the view that a weakness of capital investment is another factor behind the anemic recovery of the Japanese economy. This view reflects the fact that corporate earnings are at the highest level ever. In short, implicit in the view is criticism of companies for not making active capital investments despite enjoying high levels of earnings.

However, such criticism is somewhat misguided. When deciding whether or not to

increase capital investment, companies pay the greatest attention to whether demand will increase and profits can be generated. That depends on whether demand components targeted by capital investment, such as personal consumption and exports, will increase.

Figure 7 shows the results of the calculation of the "investment ratio," which is obtained by dividing real capital investment (numerator) by the sum of real consumption and real exports (denominator). A rise in the investment ratio means higher growth in real capital investment than in the sum of real consumption and exports, which indicates that capital investment is becoming more active. Meanwhile, a fall in the investment ratio indicates that capital investment is becoming less active.

Figure 7 Ratio of capital expenditure to the sum of consumption and export (investment ratio)



Source: Cabinet Office

Figure 7 shows that although the investment ratio has been on an uptrend, the absolute level is still low, around half the peak level that was reached in 2007. Therefore, the abovementioned criticism is accurate in its recognition of a lack of active capital investment.

However, equipment and facilities now used to meet the current demand related to consumption and export include not only those introduced in the current year but also those introduced a few years ago. While computer-related equipment and software programs are replaced in a relatively short period of time, manufacturing machinery is used for five to 10 years in many cases. Factory buildings are often used for 20 to 30 years.

Therefore, we calculated the "cumulative investment ratio," which is obtained by dividing the cumulative amount of real private-sector capital investment over a certain period — over the previous 10 years in this case — by the sum of real personal consumption and real exports over the same period.

As a result, we found that the cumulative investment ratio has remained almost flat for the past several years. The ratio temporarily rose in 2009 because real personal

consumption and real export, which are the components of the numerator of the calculation, plunged as a result of the Lehman Shock. Except at that time, the cumulative investment ratio has stayed relatively stable. In the period leading to around the time of the Lehman Shock, the cumulative investment ratio was declining in the process of the resolution of the excess capacity built up in the bubble era. From the results, we can conclude that the capital investment now being made by companies is commensurate with the current demand. In other words, capital investment is not weak.

Even so, it is not that companies do not need to increase capital investment. One critical challenge for companies is whether they can provide products and services that meet customers' various needs, rather than expanding production capacity. We hope that companies will positively consider making capital investment for that purpose.

There are markets outside Japan. It is now possible to contact people around the world via the Internet. There should be ample room for companies to accurately identify foreign customers' potential needs and develop products and services carefully tailored to such needs. That is not the once-popular mass production approach but the high mix, low volume approach to the provision of products and services, which is suited to the diversified global economy. It is not too much to say that whether or not the Japanese economy can be reinvigorated hinges on a successful shift to this approach.

Haruhiko Murayama
General Manager, Tokyo Economic Research Division
Kyoto Research Institute, Inc.

FINANCIAL FORUM 2016. Summer No. 113