Economic Report: Autumn 2017

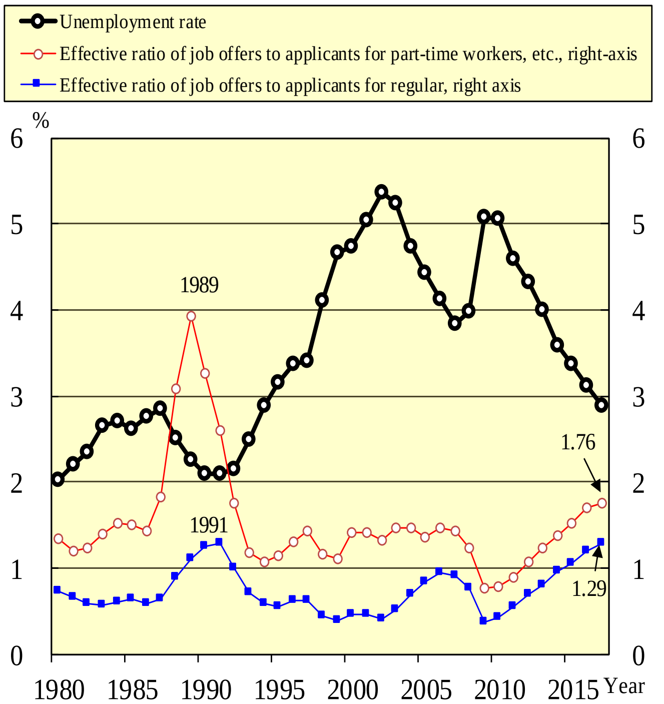
Why is the Wage Growth Slow?

In the April-July quarter, real GDP grew at an annualized rate of 2.5% on a quarter-to-quarter basis for the sixth consecutive growth, while on the employment front, the labor supply-demand balance is almost as tight as it was during the bubble economy era in the second half of the 1980s. However, the wage growth has remained weak, and companies generally continue to be cautious about the future business outlook. This paper examines why the wage growth is slow and business sentiment is generally cautious, and how the Japanese economy can be revitalized.

Despite the Tight Labor Market Condition, Wage Growth is Slow

The effective ratio of job offers to applicants, an indicator of the degree of the tightness of the labor market condition, has been rising year after year since hitting bottom in 2009 and the unemployment rate has remained low. Consequently, the labor supply-demand balance is almost as tight as it was during the bubble economy era in the second half of the 1980s. Looking at the effective ratio of job offers to applicants for workers as divided into part-time and regular workers, we can see that the ratio for part-time workers in January-June 2017 came to 1.76, which means that there were 1.76 job offers per applicant (**Figure 1**). This level is close to a figure recorded in 1987 (1.83) in the early part of the bubble economy era. The effective ratio of job offers to applicants for regular workers stood at 1.29, lower than the ratio for part-time workers but slightly higher than the previous peak reached in 1991 (1.28). The greatest cause of the tightening of the labor supply-demand balance is a decline in the number of youth workers due to the low birth rate. In particular, the supply-demand

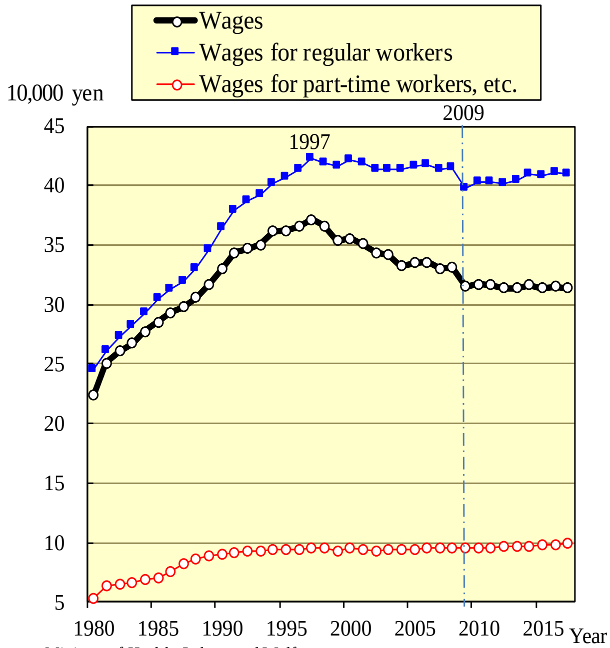
Figure 1 The unemployment rate and effective ratio of job offers to applicants for part-time and regular workers



Source: Ministry of Health, Labour and Welfare balance is acutely tight in such sectors as healthcare/welfare services, transportation, living-related services, information and communications, and accommodation.

However, the wage level has not risen much relative to the tightness of the labor supply-demand balance (**Figure 2**). The wage level for part-time workers in June 2017 rose 4.8% compared with the level in 2009, which translates into an annual average growth rate of 0.6%. Over the same period, wages for regular workers rose 2.9%, which translates into an annual average growth rate of 0.4%. However, combined wages for regular and part-time workers declined 0.4%, which means that the wages dropped at an annual average rate of 0.1%. The most significant reason why the combined wages declined despite the growth recorded individually for regular and part-time workers is a decline in the proportion of regular workers although the fact that the growth rate for either category of workers is not large is also a factor.

Figure 2 Wages for regular and part-time workers

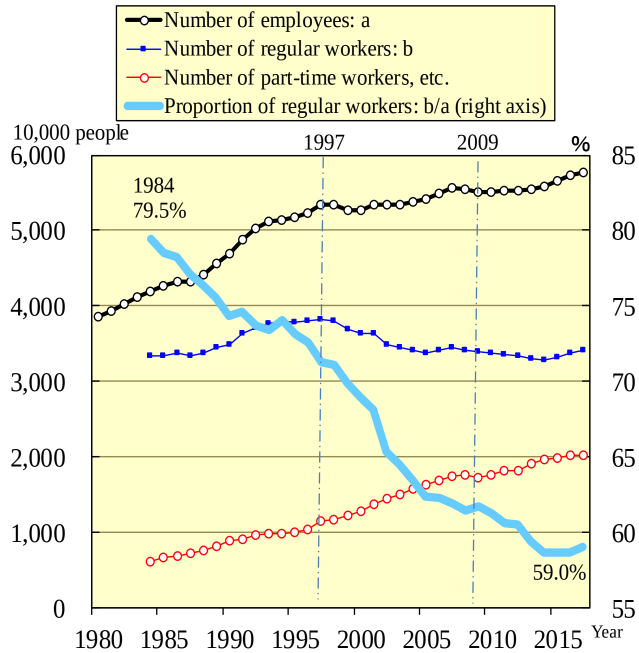


Source: Ministry of Health, Labour and Welfare

While the number of part-time workers increased 16.8% over the eight years from 2009 to 2017, the number of regular workers rose only 0.2%. As a result, the proportion of regular workers declined 2.7 percentage points from 61.7% to 59.0%. In short, although companies raised the wage level for part-time and regular workers and increased the numbers of both categories of workers, overall wages dropped because the proportion of part-time workers, whose wage level is lower, increased significantly.

This trend has been observed not only in recent years. The number of part-time workers has continued to increase almost every year for more than 30 years (**Figure 3**). On the

Figure 3 Number of employees by type (regular and part-time workers)



Source: Ministry of Internal Affairs and Communications other hand, the number of regular workers fell amid the tough business environment that followed the collapse of the economic bubble, and it has remained almost flat since 2009. As a result, the proportion of regular workers in the entire workforce has continued to decline almost consistently since 1984, when data gathering started. Although the proportion of regular workers has stopped dropping recently, it rose only 0.4 percentage points in January-June of 2017 compared with the same period of the previous year. Considering that companies are struggling to secure enough labor because of the tight labor-supply demand balance, it would be no wonder if they are more active in employing regular workers, but in fact, that is not the case.

Factors behind the Slow Wage Growth

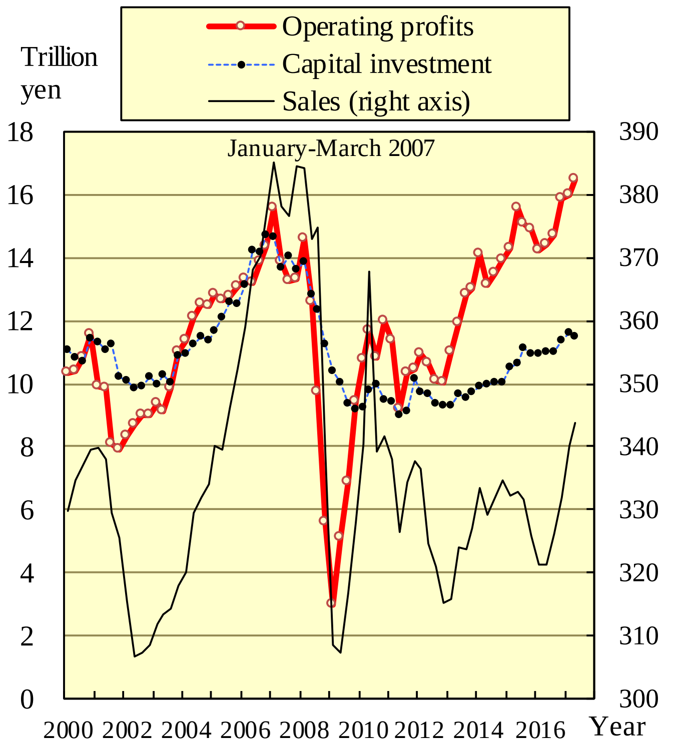
As was mentioned earlier, the Japanese economy has shown clear signs of recovery since the second half of last year, with real GDP recording positive growth for six consecutive quarters (one and a half years). The level of companies' operating profits in the April-June quarter was as much as 6.1% higher than the previous peak (the January-March quarter of 2007) **(Figure 4)**.

However, relative to the significant growth in operating profits, the increases in capital investment and sales are moderate. Compared with the peak levels, while the operating profit level was 6.1% higher, the sales level was 10.8% lower and the capital investment level was 21.8% lower.

The greatest reason why sales and capital investment have remained weak despite profits surpassing the past peak is that the Japanese economy has continued on the path of "diminishing equilibrium" as it is gradually "maturing."

The ratio of sales to the total sum of operating profits, personnel expenses and depreciation costs (total value added) has been declining for

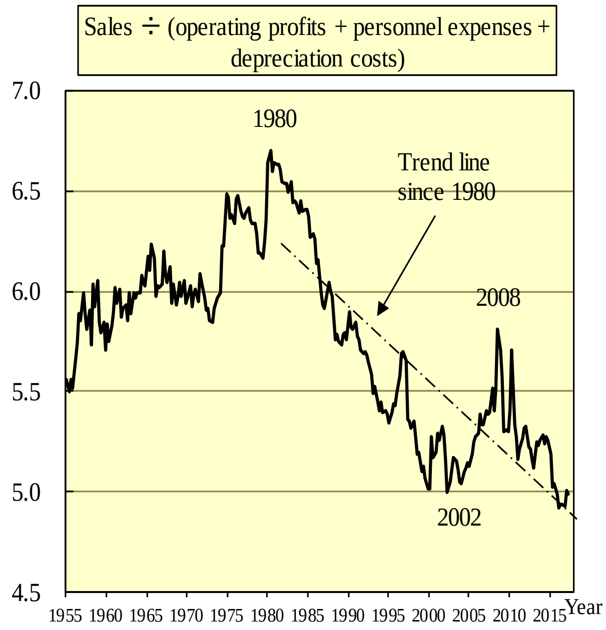
Figure 4 Companies' operating profits, sales and capital investment



Source: Ministry of Finance

most of the time since 1980 (**Figure 5**). This ratio continued on an uptrend from the period of Japan's high economic growth until 1980, but has continued to decline since hitting the peak (6.7) in the April-June quarter of 1980. In recent quarters, the ratio has declined to around 5.

Figure 5 Ratio of sales to value added



Source: Ministry of Finance

This ratio is an indicator of how much sales are necessary in order to create a unit of value added, so a rise in the ratio means a decline in the efficiency of an economy while a fall in the ratio means an improvement in the efficiency. The trend in this ratio may be understood to mean that whereas production of a final product required the work of six or seven companies in 1980, it has required the work of only five companies recently. Companies have continued to renew themselves and become leaner and leaner by reducing waste. The emergence of the term "sixth industry" is emblematic of this trend. In the agricultural and fishery industries, there are moves to go beyond the traditional primary industry activity of producing agricultural or fishery products and deliver the products directly to consumers, for example, by making effective use of IT as a survival effort. The agricultural and fishery industries' attempt to change into a sixth industry (6=1+2+3) by combining their existing activities with those of the secondary and tertiary industries can be seen as a natural phenomenon in light of the above trend.

The decline in this ratio is not in itself a problem. It is a consequence of individual companies' continuous self-renewal efforts made in pursuit of more and more profit-earning opportunities and it means that the economy is becoming leaner and more robust. However, it also means that the economy as a whole is on the path of "diminishing equilibrium." It cannot be denied that the pursuit of cheaper raw materials and lower personnel expenses has ultimately led to declining sales for the Japanese economy as a whole, thereby dampening households' consumption appetite and making business sentiment cautious.

Even so, the decline in the ratio was somewhat inevitable given the economic environment in Japan and abroad. As the Japanese economy has already become mature, new business opportunities are becoming few and far between. Becoming lean by reducing as much waste as possible as a survival effort is a natural course of action for companies. Business managers have been cautious about raising wages probably because they know that well.

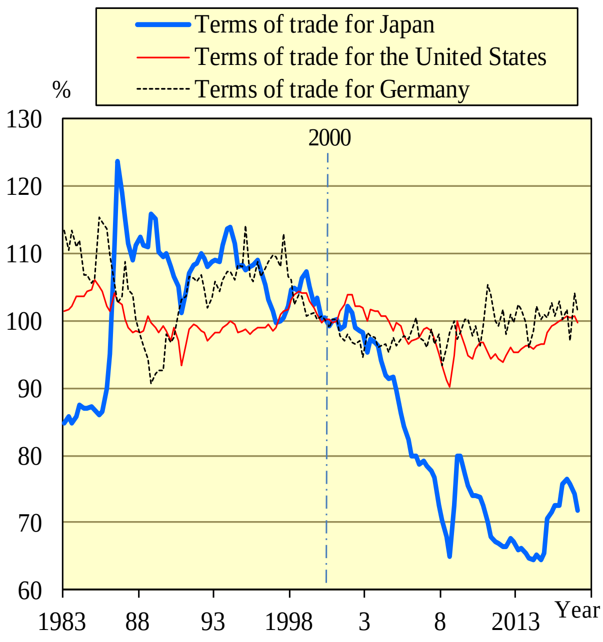
A Decline in International Competitiveness is Another Factor Behind Declining Sales

The prolonged stagnation of the Japanese economy owes mainly to the fact that many Japanese companies have pursued the path of diminishing equilibrium amid the maturing of the economy, but a decline in international competitiveness is also a factor.

Since the beginning of the 2000s, the Japanese economy has faced a tough environment in terms of both imports and exports. On the import front, the cost of making payments to other countries has risen due to a rise in crude oil prices. On the export front, as a result of intensifying competition with neighboring emerging countries, export prices of electric machinery, which had the largest share in Japanese exports, have been reduced by more than half. Consequently, it has become difficult to absorb the additional import cost by raising export prices. In economics, this situation is called a deterioration (decline) of the terms of trade. This means that income earned by the Japanese economy flows out of Japan to other countries. The deterioration of the terms of trade has shrunken demand and pushed down prices in Japan.

A comparison of the terms of trade, which are represented by the value obtained by dividing export prices by import prices, of Japan, the United States and Germany shows that the terms have deteriorated significantly for Japan alone (**Figure 6**). The terms of trade for the United States and Germany have remained flat in contrast to the significant deterioration for Japan due to reasons such as that: in the case of the United States, the share of electric machinery in exports is small and the country was able to export products with high value added, including aircraft and pharmaceuticals, at high prices; and in the case of Germany, many of the export destination countries

Figure 6 Terms of trade (=export prices ÷ import prices) for Japan, the United States and Germany



Source: Cabinet Office, U.S. Department of Commerce, and Bundesbank were located within the EU area, where Germany has an advantage.

Each of Japanese imports and exports accounts for around 15% of Japan’s GDP. If exports’ share in the economy is 15% and if export prices decline 30%, for example, nominal GDP is reduced by as much as 4.5% (=15% x minus 30%). If cumulative effects are also taken into consideration, the deterioration of the terms of trade has had the effect of reducing Japan’s GDP by an annualized rate of nearly 0.7%. As crude oil prices have recently remained relatively stable at a low level, the Japanese economy has been spared from being hurt by a further deterioration of the terms of trade, but it cannot be denied that Japan’s international competitiveness has already declined considerably.

Learning from Countries Creating High Value Added

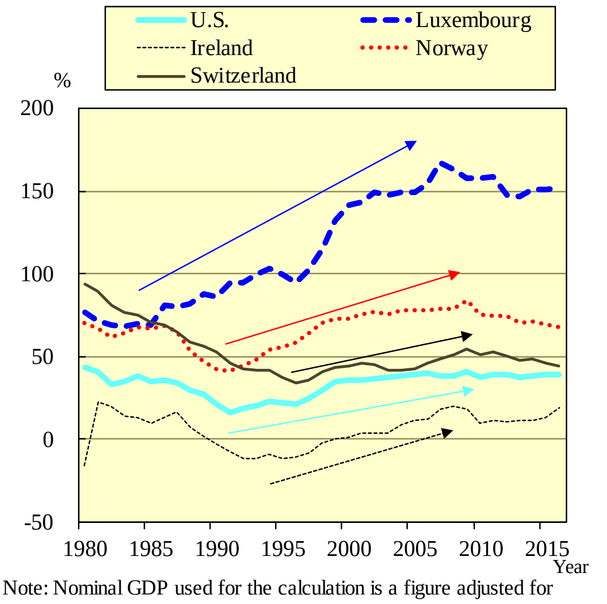
Above, I explained that the weak growth of wages in Japan is attributable to the fact companies and households have pursued the path of diminishing equilibrium in a mature economy and that a decline in Japan’s international competitiveness has put on an additional pressure.

In order to revitalize the Japanese economy, it is essential to remove the yoke of the diminishing equilibrium that has been ongoing in the mature economy and to improve international competitiveness. To do so, it is particularly important to increase per-capita value added (per-capita gross income or nominal GDP).

Looking at cases of countries which have succeeded in increasing per-capita value added will be an effective way of considering that point.

If we select five countries whose per-capita value added is particularly high among developed countries and look at how much higher (in percentage terms) their value added is than Japan’s, there is an interesting finding. Luxembourg’s per-capita value added in 2016 is as much as 152% higher than Japan’s. The excess rate compared with Japan is 68% for Norway, 44% for Switzerland and 39% for the United States. Japan’s per-capita value added and most of the other countries’ diverged considerably in the period from around 1990 to the first half of the 2000s (**Figure 7**).

Figure 7 Excess rate of per-capita nominal GDP compared with Japan



Note: Nominal GDP used for the calculation is a figure adjusted for purchasing power parity

Source: IMF

Therefore, for Japan to increase its per-capita value added, it will be useful to understand how those countries increased their per-capita value added in that period.

Luxembourg has been a center of goods distribution and personnel exchange because of its geographical location in the middle of Europe and its well-developed road and air links. In the 1980s through the first half of the 2000s, Luxembourg succeeded in increasing its per-capita value added significantly due to the following two known factors. One is the fact that many internet-related companies have located their headquarters in the country, encouraged by the low corporate tax rate. Amazon, for example, has its European headquarters in Luxembourg. Another factor is the vigorous support provided by the country’s government for e-commerce transactions through measures such as enacting e-commerce-related legislation in 2008 for the first time in the world.

In the case of Norway, revenue from the North Sea oil fields is a significant factor. Drilling for the North Sea oil fields started in the 1970s following a steep rise in prices of oil produced in the Middle East, bringing generous revenue to the countries surrounding the sea. Norway’s abundant oil and natural gas reserves have raised the Norwegian people’s living standards through exports, enabling the country to provide a high level of welfare services.

Switzerland’s per-capita value added started to increase around 1995. The greatest factor is said to be a change of course taken by the Swiss watch industry after being dealt a devastating blow by intense competitive pressure from Japanese rivals: the watch industry shifted to products with high value added, which are made of top-quality materials and which are manufactured with great care by artisans, and the products thus manufactured have won global recognition (Luxembourg, Norway, and Switzerland have maintained their ratio of the current account balance to GDP in the positive column every year, with their terms of trade rising by 14%, 8% and 10%, respectively, over the past 10 years).

Ireland, which was previously one of the poorest countries in Europe, has achieved remarkable growth since the second half of the 1990s. The decision to actively attract superior foreign IT companies by steeply lowering the corporate tax rate is considered to be the most successful factor. Microsoft and other IT companies have cultivated the European market with Ireland as their base.

The high per-capita value added of the United States is also attributable mostly to the prosperity and overseas expansion of its IT industry.

What is common to these successful cases is that the countries have increased their international competitiveness by seizing the trends of the shift to IT and globalization. When these countries were actively pursuing the shift to IT and globalization, Japan, unfortunately, was unable to take a bold step forward, as it was encumbered by the struggle to resolve the bad loan problem. However, it is not too late to start following the suit of the successful countries. Japan must increase its per-capita value added by whole-heartedly embracing the trends of the shift to IT and globalization while exercising its own strengths.

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