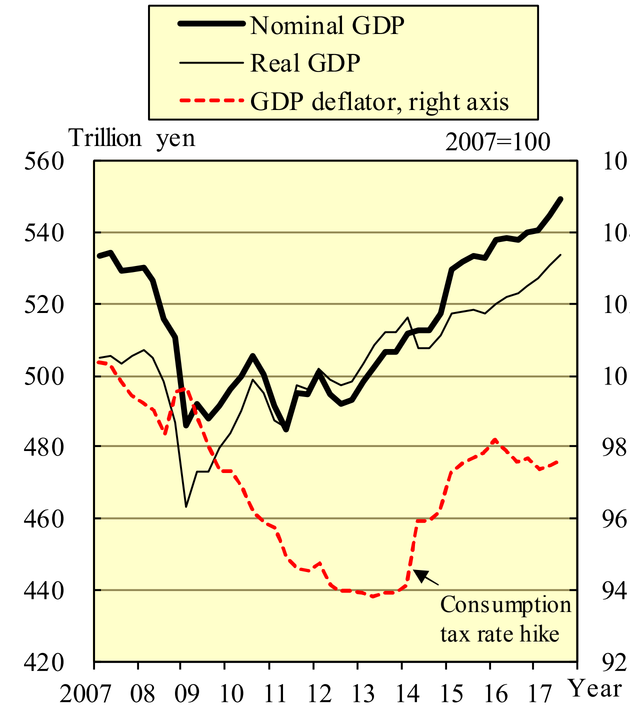
The Current Status of the Japanese Economy and Challenges

Although the Japanese economy is growing moderately, households are not as willing to spend money on consumption as might be expected from their income increase, and as a result, the amount of cash and deposits held by them is expanding. The amount of cash and deposits held by companies is also growing as capital investment has not increased much in the absence of strong growth in consumption and exports even though corporate earnings are at a record high level. However, the business environment is changing dramatically because of turbulent trends such as the rising share of e-commerce in retail and wholesale trade (online sales). The key to companies' long-term survival is capital investment. Now is the time for companies to make effective use of internal reserves that they have built up through wrenching efforts and transform themselves into an organization capable of achieving successful results in "blue-ocean markets," where competition has yet to intensify.

Continued Moderate Growth of the Japanese Economy

The Japanese economy entered a long period of recovery after hitting bottom in the midst of the global economic crisis triggered by the collapse of Lehman Brothers, and it has recently been growing moderately. In terms of real GDP, the Japanese economy grew at an annualized rate of 2.5% in the July-September quarter of 2017 on a year-to-year basis as shown in Figure 1, recording positive growth for the seventh consecutive quarter, as it was supported by the global

Figure 1 Nominal and real GDP and prices



Source: Cabinet Office

economic recovery. The Japanese economy is expected to continue growing at an annualized rate of 1-2%.

Meanwhile, although domestic prices started to rise because of the consumption tax rate hike (3 percentage points) in April 2014 and steep reduction of payments to other countries due to a crude oil price decline in the latter half of the year, they have recently been weak. The Bank of Japan (BOJ) has been implementing powerful monetary easing (unconventional monetary easing) for several years in order to raise the inflation rate to around 2%. However, as will be mentioned later, companies are expected to keep prices of goods and services as low as possible, so the 2% inflation target is unlikely to be achieved.

On the other hand, nominal GDP, which represents the product of real GDP multiplied by domestic prices, has been rising as a trend, recording an annualized growth rate of 3.2% in the July-September quarter of 2017 on a quarter-to-quarter basis and 2.2% on a year-to-year basis. This was the first positive growth in nominal GDP on a year-to-year basis in four and a half years. Nominal GDP is expected to continue growing at a rate similar to the real GDP growth rate.

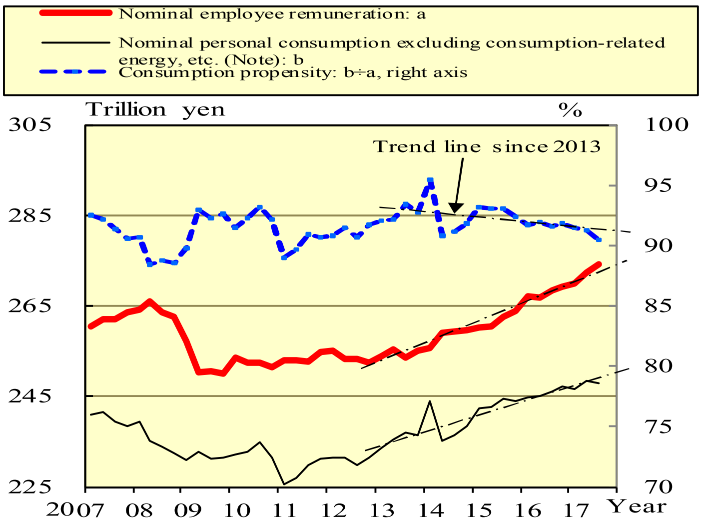
Individuals Generally Cautious about Consumption

As described above, although the Japanese economy is growing, there are some difficult problems in the household and corporate sectors.

In the household sector, consumers are generally cautious about consumption, resulting in an increase in the amount of cash and deposits.

As shown in Figure 2, nominal employee remuneration (nominal employee income) continued to

Figure 2 Nominal employee remuneration, nominal consumption, and consumption propensity



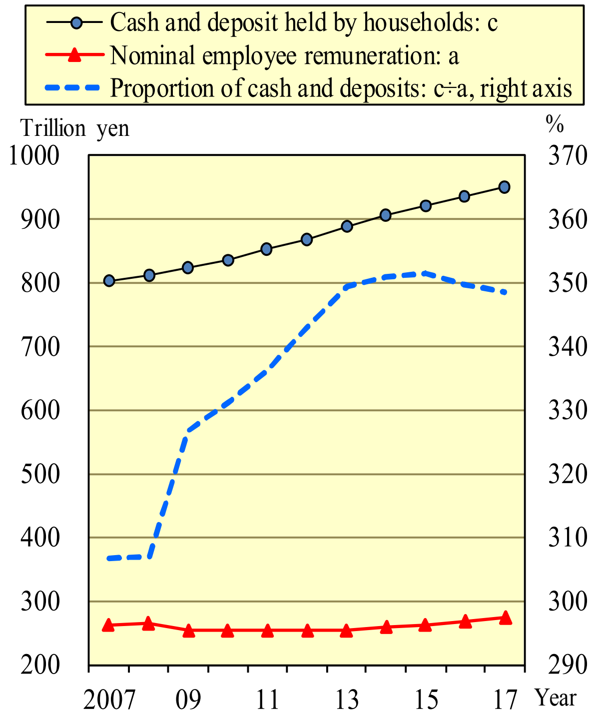
Note: Generally speaking, consumption propensity is calculated by dividing nominal personal consumption by nominal employee remuneration. However, in order to identify households' stance on consumption, it is better to exclude consumption-related energy and imputed rent from nominal personal consumption. Consumption-related energy should be excluded because it is difficult to reduce expenditure on most energy items regardless of price changes. Imputed rent should be excluded because it is a hypothetical figure and does not involve actual payment.

Source: Cabinet Office

rise slightly until around 2014 but has recently been growing at an annual rate of around 2%. The growth, which reflects a rise in the production level, is expected to continue at a similar rate. However, the growth in nominal personal consumption (excluding consumption-related energy) has been somewhat more moderate, at slightly less than 1% over the past one year. As a result, the trend line of the consumption propensity, which represents nominal personal consumption divided by nominal employee remuneration, has continued to decline since 2013, when the Abenomics policy started to be implemented in earnest, dropping around 1% over the past one year. This means that households have continued to increase savings, rather than expanding expenditure.

As shown in Figure 3, the outstanding balance of cash and deposits held by households has increased 18% over the past 10 years. In terms of the absolute amount, the increase was 147 trillion yen, which is equivalent to as much as 54% of the nominal employee remuneration in 2017. This behavior in the household sector is similar to companies' move to increase their cash and deposits significantly, which will be mentioned later (the proportion of cash and deposits declined in 2016 and 2017 because households shifted funds to financial products such as stocks and investment trusts in view of a stock price rise).

Figure 3 Proportion of cash and deposits held by households



Source: Cabinet Office, Bank of Japan

Companies' Behavior behind Revenue Decline Coupled with Profit Growth

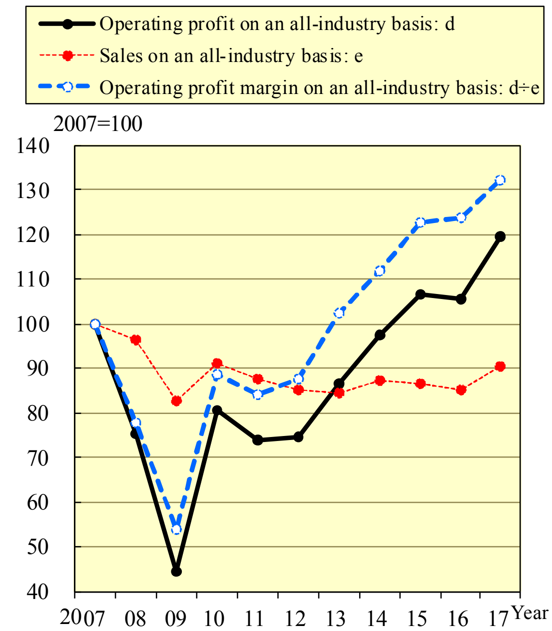
Next, we will look at the corporate sector. According to the Financial Statements Statistics of Corporations by Industry, published by the Ministry of Finance, annualized operating profits in the January-September period of 2017 on an all-industry basis (hereinafter referred to as the "2017 data") rewrote a record high for the first time in two years. Even so, the profit growth was not a result of sales growth, as had been the case in the high growth period. As shown in Figure 4, the profit growth resulted from a rise in profit per unit of sales (operating profit margin as calculated by dividing sales by operating profit) amid sluggish sales. In the severe business environment, corporate earnings hit a record high as companies increased their profitability by continuing to reduce various expenditures and costs, including raw materials cost, rather than by expanding sales.

Operating profits have continued to grow since hitting bottom in 2009, accompanied by a rise in the operating profit margin. However, sales have remained flat over the past 10 years. In seven of the past 10 years, sales recorded a year-to-year decline. Sales in 2017 were 90.5% of the level in 2007. Even as sales dropped nearly 10% compared with a decade ago, the operating profit margin rose around 30% and the operating profit amount grew around 20%. As sales did not grow, companies increased profits by raising the operating profit margin. This was the first time that a situation like this occurred in the Japanese economy in the postwar period.

How have companies raised their operating profit margin? Operating profit represents sales minus personnel cost and all other costs, including operating expenditure and raw materials cost (hereinafter referred to as "other costs").

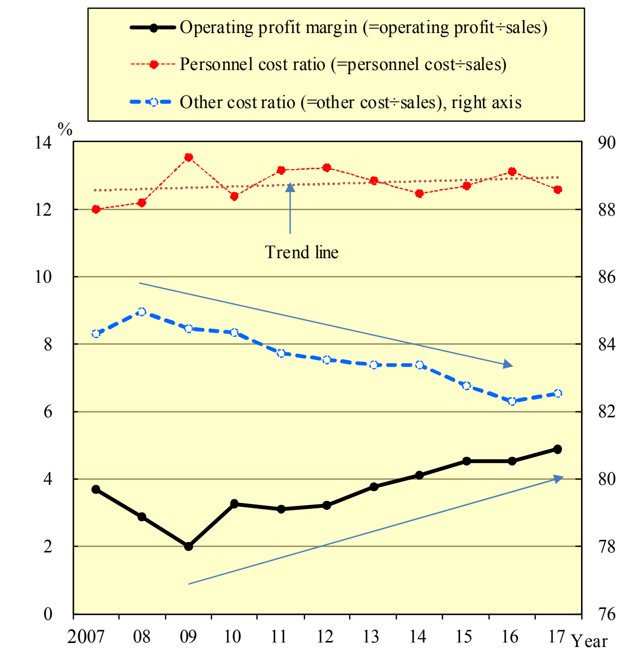
Figure 5 shows indicators calculated by dividing these items by sales: the operating profit margin, the personnel cost ratio and the other cost ratio (right axis).

Figure 4 Operating profit, sales and operating profit margin on an all-industry basis



Source: Ministry of Finance

Figure 5 Operating profit margin, personnel cost ratio and other cost ratio on an all-industry basis



Note: Other costs=sales cost + sales and administration cost – personnel cost

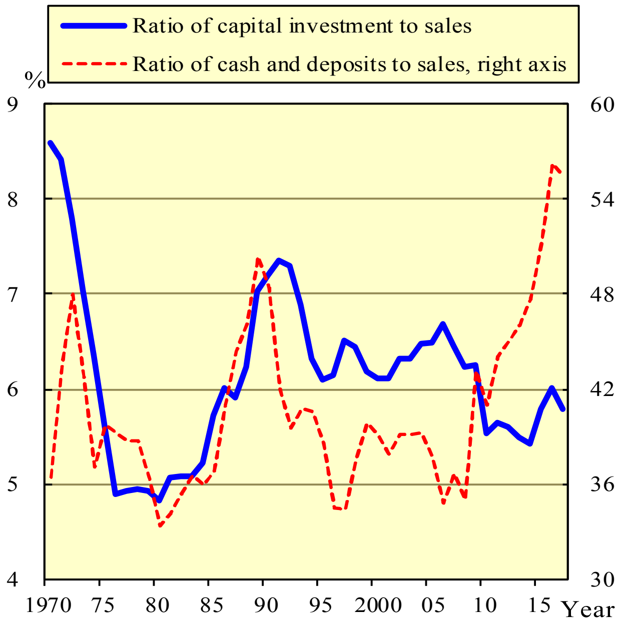
Source: Ministry of Finance

The figure indicates that the trend rise of the operating profit margin reflects the fact that the other cost ratio has almost consistently risen over the past 10 years even as the personnel cost ratio remained flat.

This means that companies have engaged in “reduction equilibrium management,” which refers to an approach of continuing to reduce the other cost ratio while keeping the personnel cost flat in order to raise the operating profit margin. Personnel cost accounts for around 12-13% of sales, while other costs account for slightly over 80%. Therefore, reducing other costs is more effective in raising profitability. As cutting the personnel cost ratio means either lowering wages or reducing the number of employees, most companies have wanted to avoid doing so by all means. As sales remained sluggish, companies had to reduce other costs. Reducing various costs all at once was difficult, so companies gradually lowered the costs. Consequently, operating profits have recently hit a record high.

In the past, when profits grew significantly, companies returned part of the increase to households in the form of a wage rise and actively made capital investment in anticipation of future sales growth. However, in the latter half of the 1980s, Japan fell into a serious state of excess employment and capacity amid economic saturation due to mature demand, and it took much time and effort to resolve this situation. The economic bubble that arose in the latter half of the 1980s was symbolized by stock and land price upsurges. However, the underlying factor was an excessive increase in wages and capacity. Learning from the lesson of the bubble economy era, companies have not merely remained cautious about raising wages even while they have earned record profits. They have also been generally cautious about capital investment. As a result, cash and deposits have piled up. As shown in Figure 6, the ratio of capital investment to sales remained relatively low at 5.8% in 2017. This is 70-80% of

Figure 6 Ratio of capital investment to sales and ratio of cash and deposits to sales



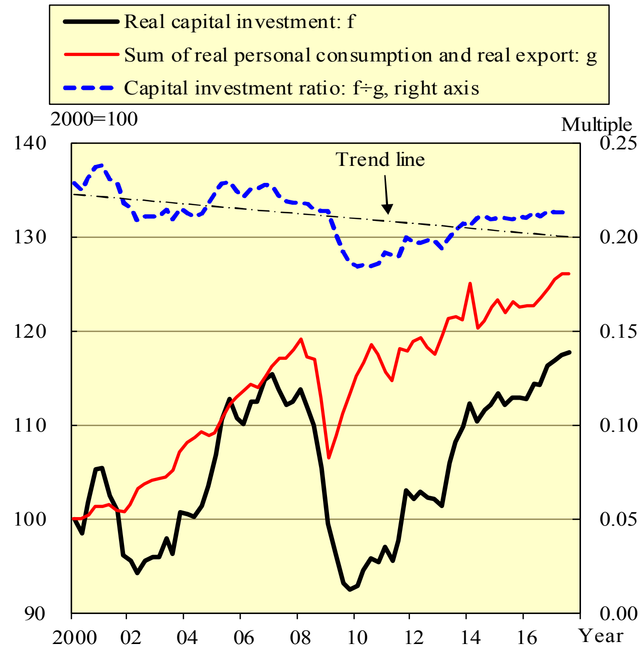
Note: Capital investment includes depreciation cost

Source: Ministry of Finance

the peak levels in the 1970s (8.6%) and in 1991 (7.4%). On the other hand, the ratio of cash and deposits to sales was 55.4%, around 10% higher than the previous record high (50.3% in 1989).

The reason why companies are not very willing to make capital investment is that demand for consumption and export is not so strong as to justify active capital investment. Figure 7 shows a comparison between real capital investment and the sum of real personal consumption and real export, both of which are demand-side indicators of capital investment, in terms of an index figure calculated using the level in 2000 as the base figure of 100. Recently, capital investment has grown at a pace faster than the sum of consumption and export. However, the trend line of the ratio of real capital investment to the sum of real personal consumption and real export (capital investment ratio) declined moderately after 2000, and the recent rise has remained moderate. Capital investment has remained stagnant for a long period of time.

Figure 7 Reason for the weakness of growth in capital investment



Source: Cabinet Office

Need for Active Investment and Reform

As shown above, households' willingness to spend money on consumption does not grow as a wage increase cannot be expected. Companies' willingness to make capital investment does not grow, either, as consumption remains weak. As a result, cash and deposits have increased steeply in both the household and corporate sectors. Increasing fiscal spending will not fundamentally change this situation but only expand the fiscal deficit. Nor will powerful monetary easing increase capital spending significantly, but it will only aggravate the BOJ's balance sheet and weaken the financial system.

There are three fundamental factors behind these problems in the household and corporate sectors. The first factor is the maturity of the Japanese economy. The second is the weakening of Japan's competitiveness amid the broad trend of globalization and shift to IT. The third is Japan's inability to take fundamental measures to correct this situation.

Therefore, solutions must be ones that focus on these factors.

The first solution is creating new domestic demand through active capital investment. At the moment, not only the Japanese economy but also the global economy is undergoing a drastic change. For example, retail and wholesale trade is in the midst of the turbulent trend of the rising share of e-commerce (online sales). As a result of the improvement of the Internet search function, it has become possible to place online orders for products at the lowest available price for immediate delivery. At brick-and-mortar stores, consumers are often disappointed to find products out of stock, but in the case of e-commerce, it is possible to have products delivered from stores with stock or from warehouses, eliminating the risk of making a wasteful store visit. In the manufacturing industry, IoT, which connects various things via the Internet, big data and artificial intelligence (AI), are about to dramatically change the ways of production and sales. The wall between the manufacturing and nonmanufacturing industries is also becoming lower. Companies must make capital investments that open up the future (including investments in research and development and measures to strengthen infrastructure) through effective use of internal reserves that they have built up through strenuous efforts.

The second solution is increasing export competitiveness, creating products and services that cannot be provided by companies from other countries, and demonstrating the attractiveness of those products to the world. Exports' share of nominal GDP in Japan, at 16%, is much smaller than the shares in South Korea (68% in 2016) and Taiwan (50% in 2016). Export targets should be set higher than now.

The third solution is awakening (reawakening) and strengthening the animal spirit of companies. It is also necessary to invigorate consumers' (business managers') sentiment. To create new demand, it is necessary to create innovative products and services. For example, the United States' present prosperity owes much to new-age companies that have brought innovations, such as Apple, Google and Microsoft. In Japan, too, it is essential to quickly create infrastructure that enables emerging companies to develop and prosper. Large incumbent companies must also become innovative. If large companies find it difficult to become innovative, they may have to consider implementing bold internal reform measures such as splitting themselves up. It is also necessary to quickly change the mindset of depending overly on governmental support or monetary easing.

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

FINANCIAL FORUM 2018. Winter №119