Daily Note

JAPAN – NOT SO FAST

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- **Growth stabilises in Q2, underlying momentum remains soft**
- **Wages gathering pace but households, like corporates, are opting to save more**
- **Abenomics maturing, rebalancing still hinges on export strength**

As expected, Japan's economy returned to growth in Q2 after a disappointing start to the year. Real GDP expanded by 0.5% on the quarter, buoyed by a welcome rebound in domestic demand – private consumption rose 0.7%. Still, underlying momentum remains weak, with household spending staying on the back foot despite a marked pick-up in wages. What is going on?

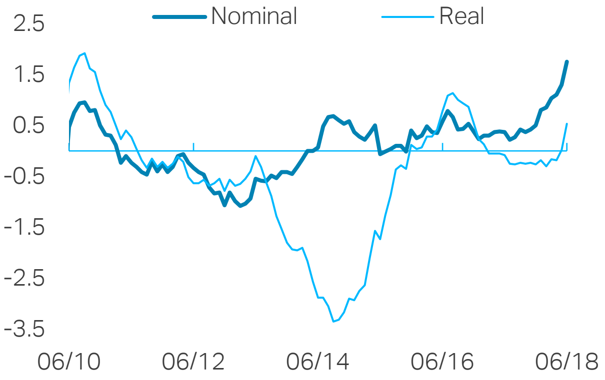
Employees' real compensation grew 3.7% YoY in Q2, consistent with the upswing in average monthly cash earnings. A 7% YoY increase in bonus payments propelled wage growth to 3.6% in June, or 2.8% in real terms. Such rates are unlikely to persist over the coming months, yet the direction of travel is clear. The share of bonuses in total pay has risen since the onset of Abenomics but remains low compared to history. Importantly, base salary growth for regular workers (i.e. those with indefinite-term contracts) is improving, albeit at a slower pace.

Faster wage gains are a necessary, but far from sufficient, condition for a sustainable pick-up in private consumption. Households must also be prepared to spend the extra income. However, Japanese workers' propensity to consume has tumbled in recent years (see chart below), with the decline accelerating in 2018. There is a confluence of forces at play.

This is partly about demographics. The combination of an ageing society and longer life expectancy translates into higher precautionary saving by the younger generation in anticipation of worsening dependency ratios. The rising participation of women and older people in the labour force since 2013 has also led to a growing share of double-income households, which tend to save more. Further, according to a recent BIS study, those – typically middle-aged – households with relatively high debt save much more in response to income increases.

Lift-off?

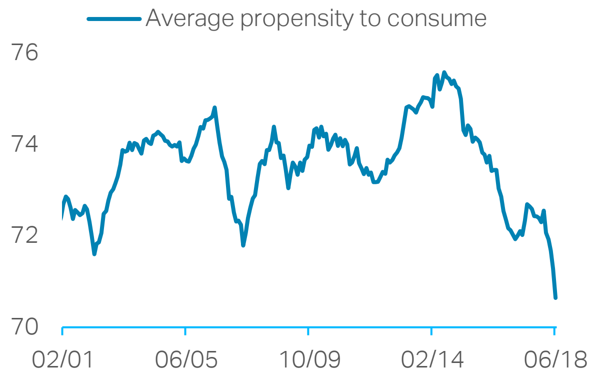
Average cash earnings ,YoY % (6m MA)



Source: Bloomberg, TS Lombard

Saving more

Workers' households, per cent (12m MA)



Source: CEIC, TS Lombard

But there are also more 'cyclical' fundamental reasons. With inflation showing signs of life since mid-2016, surveys have started to reflect steadily rising expectations for price increases – not least as the cost of oil has surged by 60% in yen terms in little over a year. Japanese consumers also see corporates across the board ramping up labour-saving investment (software, robots, etc), stoking concerns about future unemployment, even though the labour market is currently very tight. After all, in level terms, monthly cash earnings have yet to return to their late-1990s peak. Meanwhile, a VAT increase looms next autumn.

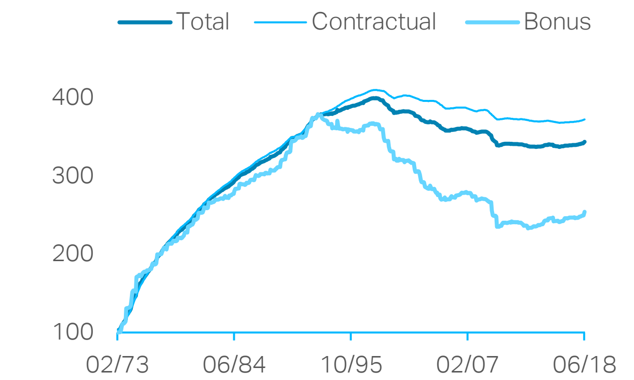
It could also be that households' cautious stance is a response to simmering macro risks. Global growth is cooling, with trade wars casting a shadow over export volumes. Ironically, the path to rebalancing away from export-reliant growth depends on a benign external environment. Corporates are unlikely to offer larger wage hikes if they lack the confidence that profits will continue to be supported by solid foreign demand. Similarly, consumers will be reluctant to spend if they view higher pay as only temporary, preferring instead to save the windfall.

Prolonged monetary policy divergence – as the BoJ lags the Fed and the ECB – also risks fanning yen weakness that saps purchasing power. What is more, as we wrote last week, with monetary firepower all but exhausted, fiscal stimulus could be left to pull the economy along, with the risk of ultimately taking Japan closer to the financial rocks.

After five years of Abenomics, wage growth is finally showing signs of life. But these are still early days. For now, Japanese households are acting like corporates, saving more of their rising earnings and thus keeping a lid on both growth and inflation.

Uphill road

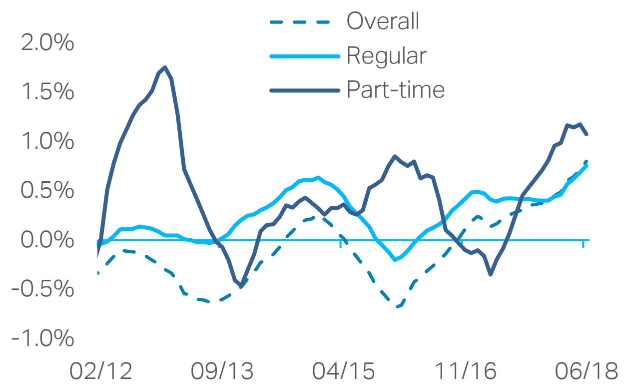
Nominal wages (100 = Dec 1972)



Source: CEIC, TS Lombard

On the mend

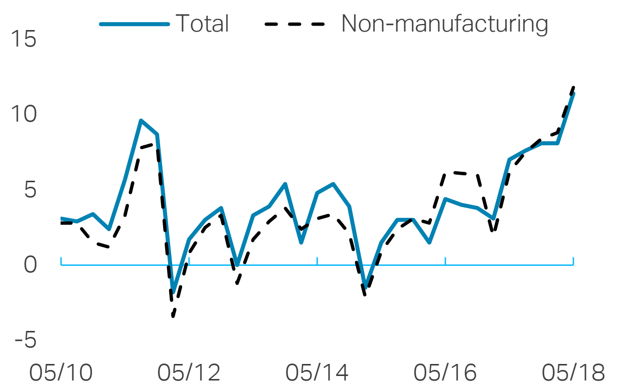
Contractual pay, YoY (12m MA)



Source: CEIC, TS Lombard

Labour-saving boom

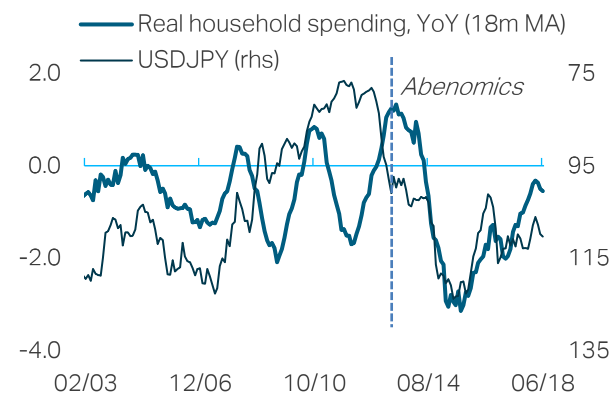
Software investment plans (index)



Source: Tankan, Datastream, TS Lombard

Yen sensitivity

Per cent



Source: Datastream, TS Lombard