Japan in the World

Beyond two big surprises: Japanese economy in the age of uncertainty

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Beyond two big surprises:
Japanese economy in the age of uncertainty

The world economy faced two big surprises

Expectations for accelerating growth and inflation under Trumponomics

Protectionism – we should still be on alert

The background of protectionism and anti-globalism

The risk of the instability in the emerging economies and financial system

Japanese economy – gradual acceleration to continue

Exports and industrial production started recovering

Structurally enhanced profitability of Japanese companies

Slow wage growth in a tighter labor market

Achievement of inflation target still far away

Rising expectations for an expansionary fiscal policy

The growth strategy of the Abe administration focuses on the potential of global infrastructure demand

Revival of growth expectations needed to regain higher growth potential

See Appendix A-1 for analyst certification, important disclosures and the status of non-US analysts.
The world economy faced two big surprises in 2016.

One was the so-called Brexit in the UK referendum on 23 June, and the other was the election of Mr Donald Trump in the US presidential election on 8 November.

While these two surprises caused a surge in financial market volatilities and sharp appreciation of the JPY, those effects were temporary and ended quickly. The JPY depreciated and Japanese equites rose very sharply after the US presidential election, with the volatility of the markets receding.
Expectations are high for large-scale tax reductions and infrastructure spending during the Trump presidency. The market is coming to expect accelerated US growth and inflation supported by a more expansionary fiscal policy from the Trump administration, and this is resulting in higher market interest rates in the US and USD appreciation.

OPEC agreed on 30 November 2016 to a production adjustment. Inflation expectations in the world economy rebounded with higher commodities prices reflecting expanded fiscal demand in the Chinese economy and likely additional demand from increased infrastructure spending during the Trump presidency.

As the BOJ maintains a 0% target for 10-year JGBs under a yield curve control policy, a widening longer bond yield gap between the US and Japan is causing the JPY depreciate sharply against the USD.
While financial markets price in the positive aspects of Mr Trump’s economic policies, we should not forget that his protectionist stance was one of the reasons he won the election. Protectionism was also behind Brexit, the other big surprise in 2016.

Protectionist stances may remain persistent, or even strengthen, in the several political events scheduled in Europe like the general election in the Netherlands (March), the French presidential election (April and May), and the general election in Germany (Autumn).

Protectionism should cause further deceleration in world trade and can be a big negative for export-dependent economies like Japan. An accompanying shrinkage in capital flow could lead to elevated pressure for JPY appreciation.
The background for protectionism and anti-globalism is slowing potential growth and growth expectations in many developed countries, in our opinion. A common factor behind this trend will be demographics, including the aging of populations.

Slower growth deprives lower-income cohorts of a sense of improving life standards. Inflows of immigrants can raise concerns and dissatisfaction with the loss of job opportunities for lower-income earners. We think these factors might have led to Brexit and the election of Donald Trump as US president.

In 2017, the developed economies, including the US under the Trump administration, must address these issues more intensively, in our view.
On the other hand, against the background of favorable economic policies from the Trump administration, rising US interest rates and USD lower the value of many emerging currencies. Depreciation of emerging currencies raises concerns over accelerating capital flight as well as aggravating excessive foreign-currency-denominated debt issues.

At the moment, the debt and financial issues surrounding emerging economies have not materialized likely because fiscal stimulus measures taken in China caused the Chinese economy to recover, with the unwinding of excessive production and capacities expected, and international commodities prices, including those for metals, are improving.

Still, we should keep an eye on the development of emerging economies and financial systems in 2017.
Despite many uncertainties, we expect the Japanese economy to continue to recover gradually in 2017. We see the following as major drivers of a gradual acceleration of the overall economy: 1) starting the implementation of public works spending included in the 2nd supplementary budget of FY2016 and the economic stimulus package that the Japanese government announced in August 2016, and 2) strengthening cyclical momentum driven by exports, domestic manufacturing production, and business investments.
Signs that the Japanese economy has regained its growth momentum have already been seen with exports starting a gradual recovery.

Manufacturing production almost bottomed out in 3Q 2016 and manufacturers project production will increase further in the short run.

While there have been inventory adjustments in materials and electronic devices in Asia including China, production activities for those products have shown signs of recovery simultaneously in Japan.

Looking ahead, if the Trump administration in the US makes large-scale infrastructure investments, production of capital goods, which have a larger share of exports to US, should also increase significantly.
The momentum of Japanese companies’ business investments showed some soft patches in FY2016 due sharp JPY appreciation in 2016 H1 and the resulting undershoot of recurring profits.

In addition to the recovery in production activities, recent JPY depreciation should drive the business investment projection upward, particularly in the export-oriented manufacturing sector.

We think the structurally enhanced profitability of Japanese companies in recent years will also sustain relatively vigorous expenditure for properties and equipment.
On the other hand, we do not expect the regained growth momentum in the Japanese economy to lead to a significant acceleration of wages and household consumption.

With the continuing tightening of the labor market, wage growth for non-regular workers has accelerated significantly. However, wage growth for regular workers that usually is set as a ‘base-up’ in Shunto, a spring round of concentrated wage negotiations, remained stagnant.

Reflecting the past undershooting of corporate profits and inflation, requests for wage increases already made by major labor unions seem rather cautious despite strong political pressure for acceleration. We think that we cannot expect that much higher wage growth in the 2017 Shunto.

Source: Nomura, based on MHLW data
It is natural to expect less frequent additional easing actions under the new monetary policy framework introduced after the Comprehensive Assessment in September 2016. Rather, rising US bond yields and USD appreciation reflecting the expectations for Trumponomics have led to expectations for an earlier exit of the BOJ from the current monetary accommodation.

Despite the diminishing negative contributions from energy prices, underlying low inflation should still continue as a result of slow wage growth and stagnant consumption demand that reflects a lack of improvement in the income environment.

As such, we cannot completely rule out the possibility of further monetary policy easing by BOJ.
Rising expectations for an expansionary fiscal policy

Outline of the economic stimulus package (announced on 2 August 2016)

<table>
<thead>
<tr>
<th>Main measures/Implementation timeline</th>
<th>FY16</th>
<th>FY17</th>
<th>Later</th>
<th>Overall scale</th>
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</thead>
<tbody>
<tr>
<td>Fiscal spending measures</td>
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<td>Additional national and local government spending</td>
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<tr>
<td>Regional port-harbor infrastructure to attract inbound visitors to Japan</td>
<td>About ¥4.3trn</td>
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<td>¥7.5trn</td>
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<td>Establishment of agricultural produce export bases</td>
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<td>Natural disaster prevention and recovery measures</td>
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<td>Efforts to stimulate consumption through such means as lowering employee insurance premiums</td>
<td>About ¥1.7trn</td>
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<td>Eliminating the number of no-pension years by shortening the qualifying period for receiving pension benefits</td>
<td>About ¥1.5trn</td>
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<td>One-off cash handout for lower income households</td>
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<td>Fiscal Investment and Loan Program</td>
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<td>Maglev Chuo Shinkansen</td>
<td>¥3trn</td>
<td></td>
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<td>Shinkansen lines</td>
<td>¥0.8trn</td>
<td></td>
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<td>Creation of allowance-based scholarships, infrastructure support, etc</td>
<td>¥2.2trn</td>
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<td>(¥3.3trn+¥0.9trn in initial budget)</td>
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<td>¥6trn</td>
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<td>Lending by government-affiliated financial institutions, etc</td>
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<tr>
<td>Low-interest US dollar funding for companies</td>
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<td></td>
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<td>¥0.8trn</td>
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<td>US dollar lending to Japanese banks by the Japan Bank for International Cooperation</td>
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<td>Financial support for SMEs</td>
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<td>Spending by private-sector companies receiving state subsidies</td>
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<td>Infrastructure and other support for overseas development, etc</td>
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<td></td>
<td>¥4.8trn</td>
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<tr>
<td>Total</td>
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<td>¥28.1trn</td>
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Monetary easing by central banks in many developed economies might have reached its limits, and the BOJ implicitly admitted the limitation by changing its policy framework. Some think that the Japanese government may follow the direction of the expansionary US fiscal policy expected during Mr. Trump’s presidency.

We, however, do not expect further significant expansion of fiscal expenditure beyond the large-scale economic stimulus package in August 2016, as the Japanese economy should improve gradually and tax revenue overshoots look unlikely due to corporate profits falling short as a result of JPY appreciation up to now.

Source: Nomura, based on Cabinet Office data
The growth strategy of the Abe administration focuses on the potential of global infrastructure demand

The Abe administration is increasing its efforts in labor market reform under the banner of ‘Realizing Society where all citizens engaged’ and ‘Work-style reform’. Against the background of an aging and decreasing population in Japan, labor market reform that can lead to higher labor participation and higher labor productivity is definitely crucial.

However, among the various agendas for the growth strategies of the Abe administration, promotion of infrastructure exports is one of the most successful so far.

In particular, we see top sales by various ministers including Prime Minister Abe himself, which are partly intended to counter the Chinese presence in this area, as having been effective in promoting infrastructure exports.

The decomposition of global infrastructure demand

Note: Figures are forecasts for 2020.
Source: Nomura, based on METI data
We think more intensive and comprehensive efforts to promote growth policies are needed as it is not easy to accelerate the Japanese economy’s potential growth with the great disadvantages of an aging and decreasing population.

To realize higher potential growth, we should raise Japanese companies’ expectations for longer-term economic growth.

The political environment in some countries remains uncertain. By way of comparison, Japan’s situation is relatively stable, as evidenced by high approval ratings for the incumbent administration.

More private-sector campaigns should also be needed to accelerate growth strategies that benefit from Japan’s political stability.

In 2017, we should have a good chance to do that, as we got through the two big surprises in 2016 and we face a rather stable economic environment.

Source: Nomura, based on Cabinet Office data
Takashi Miwa is the Chief Japan Economist of Nomura Securities Co. Ltd. He provides in-depth analysis and forecasts of the Japanese economy, based on interregional analysis of the macro economy and financial market analysis across various asset classes. He has a particular strength in analysing the macro economy from legal and administrative perspectives. Since joining Nomura Research Institute in 1990, he has engaged in macroeconomic analysis and financial market forecasting for various regions. In 1994-96, he moved to the Fixed Income Department of Nomura Securities and analysed the macro economy from more market-oriented perspectives while engaging in forecasting monetary policy and interest rates. He also made feasibility studies and conducted investment strategy planning with a view to the start of European Monetary Union in 1999.

He received his master’s degree in Law from the University of Tokyo in 2001 and his bachelor's degree in Liberal Arts and Science from the University of Tokyo in 1990. While in the graduate school of law, he studied contract law, corporate law and bankruptcy law, and made an analysis of financial contracts and corporate behaviour from the perspectives of ‘Law and Economics’. This experience proved useful in analysing banking behaviour, administrative responses and price reactions of fixed income and other securities during Japan's financial turmoil through 2003 and the global financial crisis after the collapse of Lehman Brothers in 2008.

From 2001, he provided economic analysis and investment ideas for major regional financial institutions including regional banks in Japan and gained an extremely good reputation among the top management of those clients. He moved to Nomura Securities in 2004. After belonging to the Economic Research, Investment Research, and Investment Research and Investor Services departments, he took his current position in May 2016.

He has authored several textbooks on economics and finance for beginners that are popular among university students and young graduates starting careers in financial institutions.
Appendix A-1

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