

# Japan GDP a clear signal for BOJ, while savings rate surges

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Japan's gross domestic product (GDP) dropped at an annualized rate of .6% in the first quarter, January through March. After eight consecutive quarters with positive growth, some cyclical payback was inevitable. However, the report sends a loud and clear message for policy makers in general, the Bank of Japan (BOJ) in particular: there is no room for complacency. All components of private demand contracted simultaneously; only exports reported solid growth; and now Japan's absolute level of GDP generated dropped back down to where it was last spring. In short: Japan's monetary policy has more work to do. This week's report strengthens our conviction that the BOJ will fully decouple from the US rates cycle—Japan's zero-rate anchor for both short and long rates will stay for at least another 15 to 18 months, in spite of rising US policy rates and bond yields.

## Highlights from the new facts presented in the report

Housing is the weakest spot, with the contraction now running for three consecutive quarters. The root cause is a classic "boom-bust cycle" that was triggered when the BOJ introduced its current zero-bond yield policy: from the first quarter of 2016 to the second quarter of 2017, residential investment surged by almost 10%, fuelled by the new super-low mortgage rates (which resulted from the BOJ capping 10-year bond yields at zero). Now that the rate elasticity has been exhausted, housing has dropped back 5.1% since its peak in the second quarter of 2017.

We look at housing as the all-important leading indicator for Japanese domestic demand in general, household sector risk appetite in particular. With the down cycle confirmed, when will the next up cycle start? We think it's about to start soon, because there is growing evidence that our thesis of "Japan's new middle class" is actually coming through: rising incomes, growing full-time job creation, and a pickup in household formation as marriage rates rise. These forces should combine to pull backup residential investment over the next couple of quarters.

The good news: the GDP report confirms a smart and steady acceleration in income growth: workers compensation rose .9% (quarter on quarter, not annualised, nominal) for the fourth consecutive quarter of growth. From a year ago, workers' compensation was up 3.2% in nominal terms, 2.0% in real terms. This is basically twice the year-over-year growth rate reported one year ago (1.4% nominal, 1.1% real, as reported for the first quarter of 2017). Workers' compensation is the best measure of the actual purchasing power of employees because, unlike the monthly wage and income data, it combines the number of people working and the average wage earned.

All said, the clear and steadfast rise in workers' compensation confirms that a virtuous cycle is now underway and that the purchasing power of the Japanese people is now rising. If, as we suspect, this

cycle continues, the residential investment and housing cycle should begin to stabilize soon—now that the BOJ-induced “boom-bust cycle” has corrected.

Consumers are building a war chest—the savings rate is up again, up 1% of GDP in the past 12 months. Despite the accelerating positive growth in workers’ incomes, consumption did not grow this quarter. In fact, from a year ago, workers compensation was up ¥8.5 trillion, but consumer spending was up only ¥2.8 trillion. So, workers’ households savings rose ¥5.7 trillion in the past 12 months, which is equivalent to 1% of GDP. Make no mistake—it is this rise in employees’ savings rate that is Japan’s biggest “structural problem.” It feeds both the structural external surplus and the fiscal deficit; also, it indicates a fundamental lack of confidence in the future, as well as a fear of future tax hikes or cutbacks in public services. The fact that Mr. and Mrs. Watanabe are building precautionary balances suggests, so far, that they do not believe in the success of Abenomics. To counter this fundamental mistrust is a Herculean task, but a good starting point would be more credible reform of social security and welfare programs, as well as more aggressive privatization and deregulation agendas, in our view.

All said, the message from the GDP report is straightforward—no room for complacency for policy makers; and with Japan’s Parliament session coming to an end early next month, BOJ Governor Haruhiko Kuroda and his new policy board will be in charge to ensure this one negative quarter was just a pause for breath rather than the start of a genuine downturn. Most importantly, the BOJ will want to do everything it can to prevent a rise in the yen. Japan cannot afford to put the positive export growth dynamic at risk while domestic demand is trying to recover from the first-quarter fall.

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