

Interview with Dr. Kyohei Morita, Chief Economist, Managing Director of the Economic Research Department of Global Markets Research, Japan Nomura Securities Co., Ltd., Financial & Economic Research Center

Japan's Economic Outlook: Coping with the Labor Shortage Will Create a New Economy

By Japan SPOTLIGHT

Japan SPOTLIGHT interviewed a distinguished economist, Dr. Kyohei Morita, to discuss whether the Japanese economy, which has escaped from deflation but is still plagued by a weak yen and an increase in the cost of living, has really recovered from the “lost 30 years”.

(Interviewed on July 23, 2024)

Diagnosis of the Current State of the Japanese Economy

JS: There appear to be two opinions about the Japanese economy: one is that it has escaped from deflation, has achieved a virtuous cycle of wages and prices, and is on a stable growth path, while the other is pessimistic, saying that as a result of the decline in national strength, the yen is structurally weak and will never become stronger. First of all, in your judgment, do you think the current Japanese economy is steadily escaping from deflation and is achieving a virtuous cycle of wages and prices?

Morita: I think it is possible to evaluate that the economy is steadily getting out of deflation. On the other hand, I still have some doubts about whether the virtuous cycle of wages and prices has fully taken root. To begin with, how should we view this virtuous cycle? If a virtuous circle is defined as a state in which both wages and prices rise as a whole, then Japan is probably still in the middle of the road.

In particular, what makes today's Japanese economy insufficient to grow is weak demand and consumption from households, making the route for transmitting the power from wages to prices unstable. Therefore, wages and prices should be integrated under a two-way mechanism in which power can be transmitted from wages to prices and also from prices to wages. If this can be defined as a virtuous cycle of wages and prices, then I think that it has not yet been fully established.

JS: If so, are you saying that the current price increases are the result of raw material prices, such as oil prices, and food prices, which are rising due to the war in Ukraine and other factors, and not inflation resulting from steadily rising wages?



Dr. Kyohei Morita

Morita: We believe that we are moving in that direction, but we have not yet fully reached that stage. When we consider prices in Japan, we focus on three major factors.

The first is the factor you mentioned – the global rise in oil and food prices, which will push up inflation in Japan. The second thing we are focusing on is the price-setting behavior or wage-setting behavior on the corporate side. This too is changing gradually. Monetary policy probably has little to do with it, but the structural shortage of labor is the backdrop for the change in behavior on the corporate side. The third factor is whether behavioral changes by households have occurred.

In other words, the question is whether we have reached the stage of structurally increasing consumption, and I think we have not yet reached that point. In this sense, I do not think we can say that price increases in a positive sense have taken root.

JS: Are real wages said to have risen?

Morita: Real wage increases are not yet positive in a sustainable fashion when viewed on a year-on-year basis. In addition, the pace of improvement in consumer sentiment itself is also somewhat slow.

JS: While inflation in the United States and Europe is coming to an end, I believe that Japan is in a situation where inflationary fears are hard to dispel in the midst of the ongoing depreciation of the yen. How do you view this?

Morita: While the weak yen has mainly pushed up goods prices, which has damaged some of the purchasing power of households, there are some economic actors, perhaps mainly Japanese exporters, who have benefited from the weak yen. This means that the issue of exchange rates will bring about income distribution challenges in the economy, not that a weaker yen is absolutely bad or a stronger yen is

absolutely bad. At all times, whether the yen weakens or appreciates, we believe that it will bring about some distortion in the distribution of income within the Japanese economy. I do not believe that the Bank of Japan (BOJ) has the ability to correct this distortion, and I do not believe the BOJ should immediately conduct monetary policy with an eye on exchange rates. In this sense, I believe the problem of a weak yen is one that requires fiscal ingenuity in terms of how to distribute domestically the increased costs and benefits associated with a weak yen.

JS: How long the yen will remain weak is a very big issue for asset management. Given the current situation, is it safe to assume that the yen will gradually appreciate as US interest rates fall and the Japan-US interest rate differential shrinks?

Morita: The US will start cutting interest rates in September this year, and we believe there will be three rate cuts by the end of this year and four next year. In the process, the interest rate differential between Japan and the US will close, and as a result it will work in the direction of a decline in the dollar-yen, i.e., a weakening of the dollar against the yen. Of course, there are aspects that cannot be explained by the interest rate differential alone, and there remains the issue of the need to separately dispel structural issues in the Japanese economy. However, we believe that there is a great possibility that the dollar will weaken against the yen, at least in conjunction with the difference in the direction of monetary policy between the US and Japan. I believe the dollar could be as high as 140 yen per dollar by the end of next year.

JS: As you mentioned earlier, personal consumption is not growing very fast. Are there any possible structural reasons for that?

Morita: I think there will be some structural factors, as well as cyclical aspects. First, with regard to the cyclical aspects, further progress in wage increases is likely based on the assumption that the economic recovery will continue. Next year, the rate of increase in wages in *shunto*, or spring wage negotiations, will be positive, although not to the same extent as this year's level. In addition, real wages will gradually turn to a year-on-year increase, probably in the first half of next year. I believe that we can expect a concomitant improvement in personal consumption toward the beginning of next year.

On the other hand, given the fact that some people are concerned about the future sustainability of various social security programs and the employment environment, structural downward pressure on consumption will not be wiped out even with future wage increases and other factors.

JS: It has been said that Japanese companies are only hoarding money without making new capital investments, and that this type of corporate behavior is causing deflation. What are your thoughts on capital investment?

Morita: With regard to capital investment, I believe we are heading

toward a somewhat structural increase phase based on four major factors. The first is to respond to digitalization; the second is labor saving to tackle a labor shortage; the third is capital investment in response to environmental issues; and the fourth is to build up the supply chain in one's own country, as global supply chains are in the process of being reorganized.

Thus, the environment is becoming structurally easier for capital investment to increase. However, even when capital investment is planned, there remains the problem of not being able to achieve it as planned and budgeted due to a lack of manpower or as a result of rising raw material costs.

JS: Geopolitical risks are currently very high. Considering the US presidential election and other factors, they could increase in the future. If that is the case, what will happen to the growth of external demand? Can we expect much?

Morita: The outcome of the US presidential election is still uncertain, but if Donald Trump is re-elected he will most likely use tariffs as a tool in a trade war. So there are some concerns that trade may decline somewhat, and Japan could be heading into a phase where stable export growth is not necessarily possible. But this is precisely why it is necessary to do everything to create a supply chain in Japan that is intertwined with the restructuring of global supply chains and link it organically to them. Even if external demand is sluggish, I believe that the need for domestic capital investment itself will increase, as long as we face geopolitical risks.

JS: It may be difficult to increase outward FDI as geopolitical risks increase, but can the structure of earnings from the so-called investment balance surplus continue?

Morita: Outward FDI is important, but inward FDI will also be an extremely important issue for the Japanese economy. Even in an environment of geopolitical tensions, domestic capital investment by Japanese firms and inward FDI by foreign firms into Japan will become all the more important in ensuring a more stable production chain. Perhaps then, the income account surplus will shrink in the future. Japan will likely be in a position to pay more dividends and interest to other countries than before.

Outlooks for the Short, Medium & Long Terms

JS: What would you envision the Japanese economy to look like in the immediate future, 2024-2025, based on what you have just said? Many seem to believe that Japan's economic growth rate will be considerably above the predicted 0.5% and remain at around 1% or 1.5%.

Morita: If the time horizon is this year or next year, we believe there is a high possibility that an economic recovery exceeding the potential growth rate will be realized after the April-June period of this year.

Personal consumption has been quite sluggish so far, but considering future wage hikes and slower inflation, I think there is a high possibility that an economic recovery exceeding the potential growth rate will be realized in the April-June period this year and beyond.

JS: In the medium to long term, since the population is expected to continue to decline, is it inevitable that the Japanese economy will shrink, basically due to the continued depreciation of the yen, coupled with a lower growth rate corresponding to the population decline?

Morita: It is true that an economy is more likely to grow if the population is growing. In that sense, it is true that a declining population raises the hurdle to economic growth by a certain degree. But this does not mean that it is necessary to conclude that Japan's rate of growth will steadily decline under a declining population. The reason is that although Japan's population is indeed declining, the country has financial assets that are the envy of other countries. If even a few percent of the financial assets held by households are recognized as a financial source of spending, the potential rate of increase in consumption will be significant.

In addition, hereafter, there would be increased private investment aimed at promotion of the digital economy and labor saving. As well as such investment increases, if Japan can realize a more organic management of households' financial assets, such as the recent Nippon Individual Savings Account (NISA) program (tax exemption for small amounts of investment by individuals), we would be able to overcome the challenge of a labor shortage in Japan, though it would certainly raise the hurdle to growth.

Labor Shortage to Bring About Structural Reform of the Economy

JS: For economic growth, the most important thing seems to be the growth of labor productivity anyway. Indeed, it seems there is a possibility that new productivity-enhancing innovations such as digitalization, AI, renewable energy and decarbonization technologies will be born in Japan. In this context, can we be a bit optimistic about labor productivity growth over the medium to long term? On the other hand, I am also concerned about whether we are really in a business environment that makes use of AI and IT. What are your thoughts on this?

Morita: I believe that one of the drivers of digitalization is a lack of manpower, or a declining population. The reason why software-related investment did not progress in Japan is because we could avoid labor shortages in some ways. For example, a labor shortage was averted in the form of higher labor participation rates by women or the elderly. However, I think it was the pandemic that woke up Japanese companies like an alarm clock to the realization that they really needed to respond to a labor shortage. The pandemic forced them to deal with the labor shortage because many people were not

able to come to work. Until then, Japanese companies may have had a value system that it is a kind of virtue to have people do everything, but I think the pandemic forcibly collapsed that system. It forced Japanese companies into an environment in which they could not always depend on people to carry out their corporate activities. As an extension of this situation, I believe we are now at the point where a real labor shortage is occurring in Japan, and this labor shortage, or the population decline that underlies it, is finally forcing Japanese companies to change their behavior. This includes digitalization of capital stock and a change in price-setting or wage-setting behavior.

JS: It is said that lifetime employment and the seniority-based salary and promotion system, which are the hallmarks of Japanese-style management, are now disappearing. Is this one of such changes?

Morita: Yes. I believe this is one of those significant changes. Especially among the younger generation, I don't think they are working under the strong assumption of lifetime employment and seniority. So I believe that the improvement of labor market mobility is progressing.

Perhaps the generation that is now entering the labor market have seen the working environment of their own parents' generation and realize that lifetime employment and an environment in which wages automatically increase as long as you continue to work for the same company no longer exist and that they cannot survive with such assumptions. As they become more and more the main players in the labor market, I believe the liquidity of the labor market will increase.

At the same time, I believe this will also entail a process in which their labor power, a kind of household asset, will turn into a risk asset. Until recently, the labor force possessed by the Japanese was an extremely safe asset. Under the name of seniority, returns were also increasing steadily. In this way, there used to be almost no need for asset management through risk diversification because they did not have risks that needed diversifying.

However, with today's young people, their labor force work more like risk assets. In some cases, they may lose their jobs, and in other cases, their wages may increase or decrease. The younger generation will have risks that should be diversified. As a tool to diversify, the need to invest in risk assets, including the NISA program, will increase. The purpose of investing in risk assets should not be limited to making profits. Such investments will provide them with an opportunity to diversify the risk inherent in their employment activities.

JS: It is said that a characteristic of Japanese corporate management is that it responds very gradually to marked changes in the external environment. Because it is gradual there is, for example, no sudden increase in unemployment. Corporate behavior will gradually change and mid-career hiring will increase, but there will not be a huge increase in unemployment. There is a positive view of the Japanese economy, and it suggests that this Japanese-style capitalism, in which the good aspects of capitalism are preserved while at the same

time responding to the needs of society and changing gradually, may become a model for the world economy in the 21st century.

Morita: I believe that different economic systems have their own advantages, strengths and weaknesses. I think it is always a relative issue. In this context, I think that in the phase of seeking new growth opportunities, we will need economic systems that are easy to metabolize. The slow pace of change in Japanese companies is partly a result of the lack of liquidity in the labor market, and I think the liquidity of the labor market strongly influences the speed of change in corporate behavior from a macro perspective. Given that the labor market is currently undergoing change in Japan, I think it would be better for companies to accept the necessary changes rather than focusing on stability.

Is Making Money from Overseas Investments Sustainable?

JS: I am wondering if the situation can continue where the country earns money from overseas investments and has a large income surplus, so that even if the trade balance is in deficit, the current account balance would not be in deficit.

Morita: With a stable surplus in the income balance, I believe the current account surplus itself will continue for a while. This is because the underlying basis of the income balance is the stock of income. Since the income balance is derived from the stock of direct investments accumulated overseas to date, I think that surpluses will continue to a certain extent. In the longer term, domestic capital investment and inward FDI will be more important in connection with the reorganization of the global supply chains mentioned earlier. If this happens, the income balance surplus will shrink, but if the income balance surplus shrinks in this way, I think Japan's underlying economic activities will change to be more sustainable. I believe that Japan's economic activities will be more sustainable by then, despite a possible narrowing of the current account surplus.

JS: I am concerned about an increase in the budget deficit in the future as interest rates in Japan rise and government bond expenses balloon in the coming years. In coping with the expanding fiscal deficit, I think we need to seriously consider raising the general consumption tax permanently and at the same time rationalizing expenditures. Considering that we have no choice but to increase spending on welfare and defense to cope with the aging society and rising geopolitical risks, I think we have to consider a fairly large-scale policy change, such as rationalizing all expenditures based on a philosophy of wise spending, while at the same time raising the general consumption tax. I think we should start this as soon as possible.

Morita: There are many factors involved, including economic,

political, and social aspects, but first of all, the fact is that Japan has only a fiscal account deficit or a government deficit, but not a current account deficit. So I think the path, through which the government deficit leads to a sharp rise in interest rates, is still narrow, since with a current account surplus, the risk of foreign owners of Japanese government bonds selling them will be limited.

However, this does not justify spending on one's own, and it is still necessary to change to "wise spending" and thereby gain the confidence of a wide range of generations that government spending is supporting them. In this light, I think it necessary to change to a wise spending policy. In terms of gaining such confidence, I think we are already at a point where we should start approaching the quality of the deficit rather than the quantity of the budget deficit at any time.

JS: Finally, I understand the importance of inward direct investment in Japan, but it is not increasing. How to increase it is quite difficult, but I think we have to take this seriously. There is the idea of using AI to compensate for the decline in population, but there is also the idea of compensating for it with foreign labor. I think it would be better to create an economy that incorporates foreign human resources as soon as possible.

Morita: I agree with you there. I believe that the need to create an environment in which more people from outside Japan can participate in the Japanese labor market is steadily increasing, not only in terms of inward FDI but also in terms of the labor force. This is partly because there is a labor shortage in Japan, and partly because there is no guarantee that foreign workers would come to Japan when other countries start to seriously adopt a policy of accepting foreign labor. Especially when the yen depreciates, the benefits of coming to Japan may diminish. So I totally agree with you that we should create an environment in which labor from other countries would be ready to join the labor force in Japan.

JS: I think we need to create Japanese universities that foreign students want to study at, and Japanese companies that make them feel that working in Japan will bring them good things. It would lead to creating more friends for Japan, which could also be a solution to rising geopolitical risks.

Morita: I think you are right. It is extremely important that more people from overseas participate in Japan's labor market. If we only look at that part, it will lead to solutions to our labor shortage, but will also be an opportunity to resolve friction between nations at the grassroots level.

JS: I understand. Thank you very much for your time.

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