Asset Management One

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Japan's Nominal GDP Nearing the 600 trillion Yen Milestone

15 September 2023

- Since the collapse of the bubble economy in the early1990s, Japan's nominal GDP has remained largely flat, mainly due to the fall in the GDP deflator, which reflects changes in the overall price level of goods and services, and deflation.
- Both real GDP, representing the volume of economic activity, and the GDP deflator, which measures price changes, have expanded. The long-anticipated achievement of the government's target of a nominal GDP of 600 trillion yen, set in 2015, is finally within reach.
- We conducted an analysis of how nominal GDP growth would affect businesses and households, considering factors such as the recent increase in the GDP deflator, households' expectations of price inflation, and income prospects.

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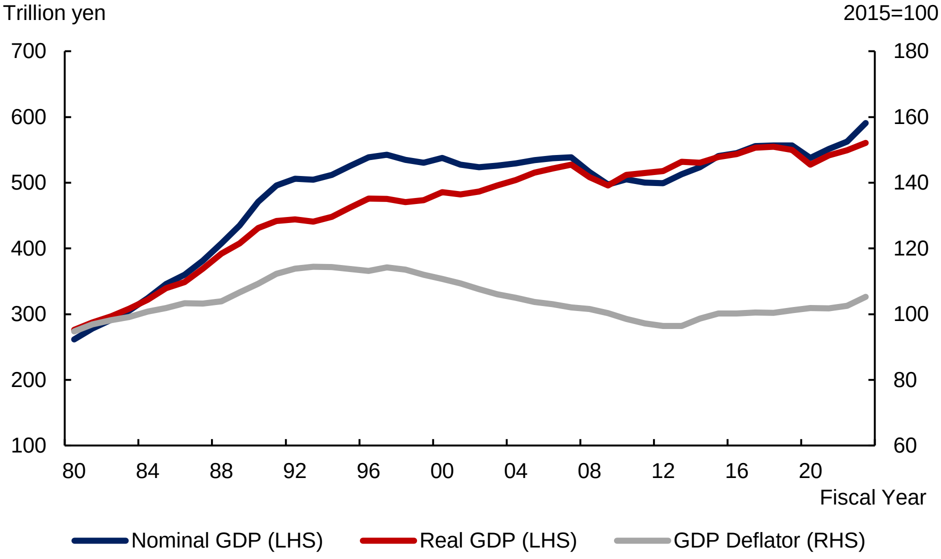
“Japan's Nominal GDP Approaches 600 Trillion Yen”

Japan's nominal GDP for the April-June quarter of 2023 reached a historic high, standing at JPY 590.7 trillion (seasonally adjusted, annualized). These figures, the first preliminary data released on 15th August, are the highest on record, based on data retrospectively adjusted for fiscal years before 1993 by the Cabinet Office. In July, the Cabinet Office unveiled its mid-year economic outlook, projecting a nominal GDP of JPY 601.3 trillion for the fiscal year 2024 as a reference point. This milestone represents the realization of a key economic goal set by the Abe administration in 2015 as part of its "New Three Arrows" policy package, specifically the "New First Arrow," which aimed to boost nominal GDP to its highest level in the post-war era, at JPY 600 trillion. Now, that goal is finally within reach.

A closer look at the long-term trends in GDP since 1980 (see Figure 1) reveals that both nominal and real GDP experienced rapid growth leading up to the bubble economy of the early 1990s. However, following the bubble's collapse, nominal growth nearly came to a halt, even though real growth continued at a moderate pace. This divergence between real and nominal values can be attributed primarily to the decline in the GDP deflator and the persistent deflationary conditions.

Figure 1: Nominal GDP, Real GDP and GDP Deflator



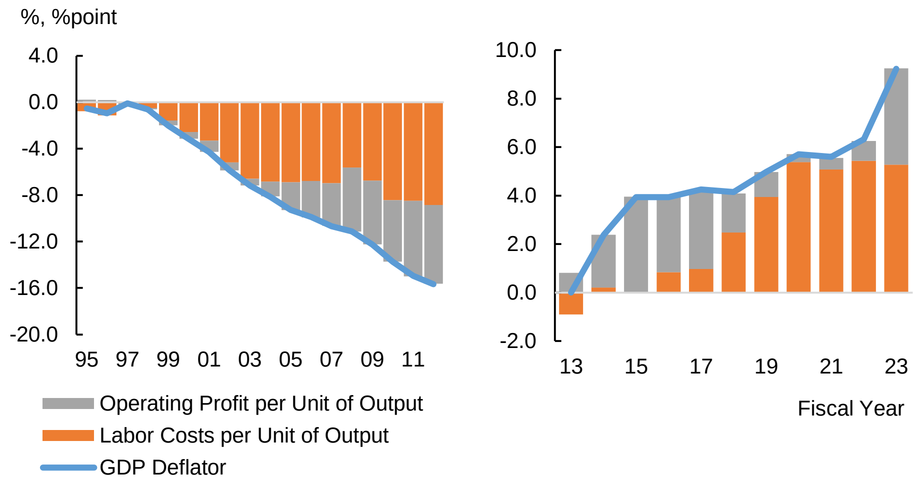
Source: Cabinet Office
Note: 1. Annual data from FY1980 to FY2023
2. FY2023 is from April to June
3. GDP series data retrospectively adjusted based on FY2015 is used from FY1980 to FY1993

In discussions surrounding economic growth, it's customary to evaluate it based on real values, which represent the volume of economic transactions, excluding the influence of price fluctuations. As a result, nominal values are rarely the focal point of these discussions. The decision by the Abe government at the time to set a nominal GDP target was driven by the intent to explicitly demonstrate that, in addition to real growth, overcoming deflation would also lead to an expansion in nominal values, which account for price changes.

GDP represents the total value added produced within a country. The GDP deflator, in essence, reflects the nominal value added per unit of output. When we delve into the distributional aspect, we can deconstruct the GDP deflator into two components: labor costs per unit of output and operating profit (which also encompasses factors related to the depreciation of fixed capital) (see Figure 2).

"Breaking Down the GDP Deflator from a Distributional Perspective"

Figure 2: Factor Breakdown of GDP Deflator



Source: Cabinet Office

Note: 1. Annual data from FY1995 to FY2023

2. FY2023 is from April to June

3. Cumulative Factor is calculated based on the following relationship.
Left Figure is compared to FY1994 from FY1995 to FY2012 and
Right Figure is compared to FY2012 from FY2013 to FY2023

4. GDP deflator
= nominal GDP / real GDP
= (nominal employee salary + nominal operating profit) / real GDP
= labor costs per unit of output + operating profit per unit of output

5. Nominal Profit includes the depreciation of fixed capital

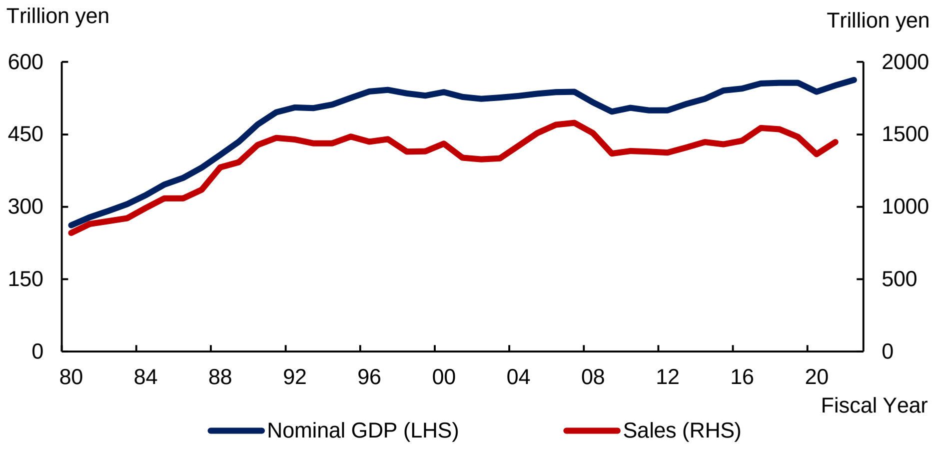
Examining the cumulative contributions to the decline in the GDP deflator from fiscal year 1995 to fiscal year 2012, we find that the drop in the late 1990s was predominantly driven by a reduction in labor costs — specifically, a decline in workers' incomes. Starting from the mid-2000s, there was a noticeable increase in the negative impact on the GDP deflator, including during the 2008 financial crisis when Lehman Brothers collapsed. This suggests that corporate profits came under significant pressure during that period.

However, since fiscal year 2013, coinciding with the inception of Abenomics, the descent of the deflator has been halted. Initially, there was a resurgence in corporate profits, but subsequently, labor costs began to rise. Even though we have data for only the April-June quarter in fiscal year 2023, it is apparent that companies are maintaining their profits by passing on increased costs, notably in response to soaring raw material prices.

We're considering the impact of nominal GDP growth on both businesses and households.

Nominal GDP is a combination of real values, which reflect the volume of economic transactions, and a deflator that represents prices. When we talk about corporate sales, which consist of both transaction volume and prices, they serve as a prime example of nominal values (see Figure 3). After the collapse of the bubble economy, there was a period of slow growth in real GDP and subdued growth in nominal GDP. For companies, this could be seen as a strategy of maintaining transaction volumes by keeping selling prices low. However, in the wake of the COVID-19 pandemic, companies have begun to adopt a proactive stance in passing on fair prices to counter rising raw material costs (refer to Figure 2). This shift is expected to lead to an expansion in sales and improved profit margins in sync with the rise in nominal GDP.

Figure 3: Corporate Sales and Nominal GDP

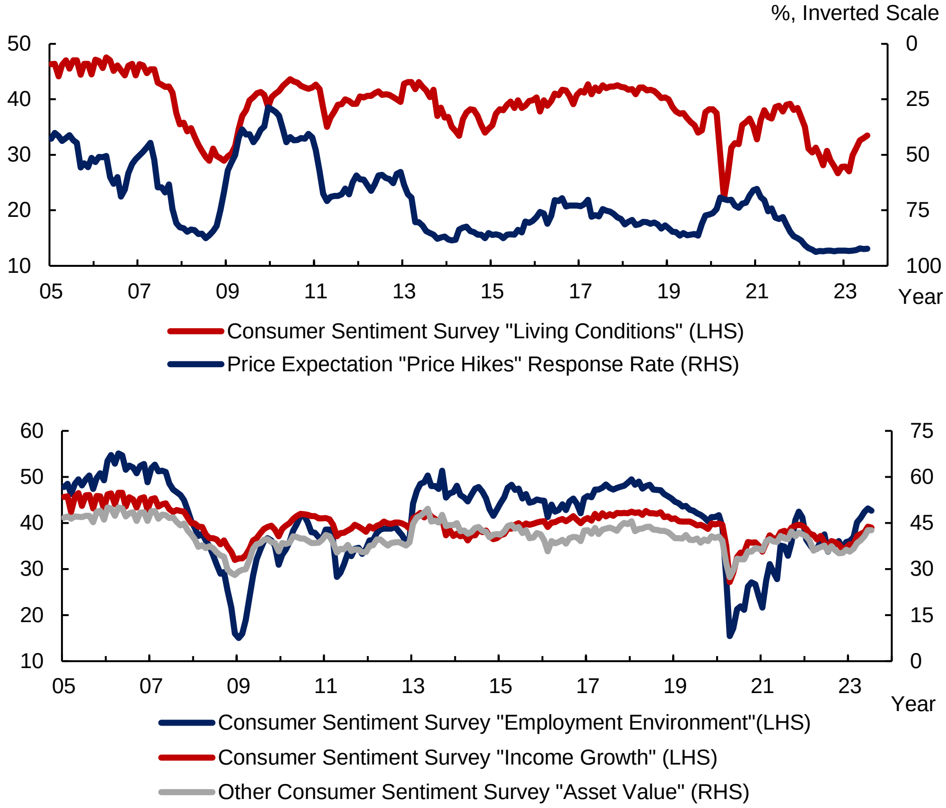


Source: Cabinet Office and Ministry of Finance, Japan
Note: 1. Annual data from FY1980 to FY2022
2. Sales are shown by FY2021

"The Complex Impact on Household Finances"

The impact on household finances is multifaceted. According to a consumer sentiment survey conducted by the Cabinet Office (see Figure 4), there has been a historical tendency for 'living conditions' to deteriorate as expectations of price increases rise. In the past, when evaluating 'purchasing power' (a person's ability to afford goods and services), the trajectory of prices tended to receive heightened attention when wage increases were not on the horizon.

Figure 4: Consumer Price Expectation and Sentiment



Source: Cabinet Office
Note: Monthly data from January 2005 to July 2023

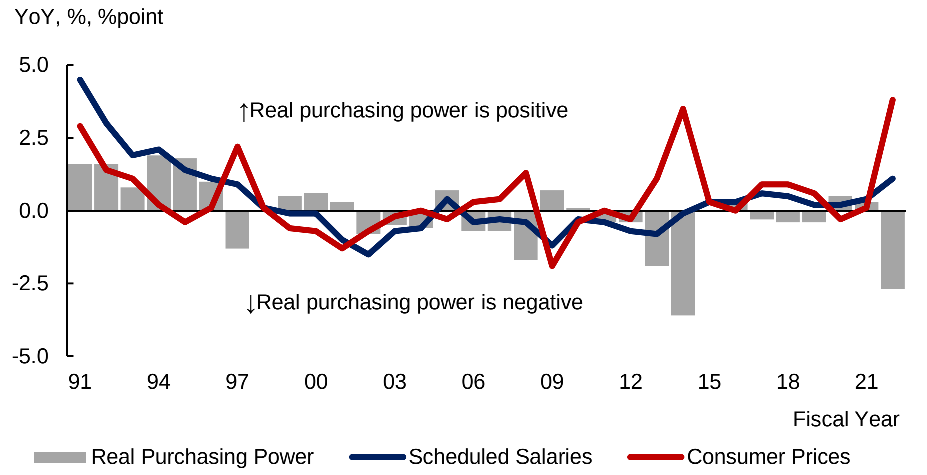
However, in recent times, despite more than 90% of respondents anticipating price hikes, the 'living situation' has been on an upward trajectory since hitting a low point in November of the previous year.

This improvement can be attributed in part to expectations of a return to normalcy following the disruptions caused by the Covid pandemic. Furthermore, when examining other aspects of the same survey, we observe that expectations regarding the 'employment environment' and 'income growth' have also shown signs of improvement. It appears that the anticipation of increased income and improvements in other facets of living conditions may have mitigated the deterioration in overall living conditions during the current period of rising prices.

This situation not only reflects the impact of price movements but also suggests a growing confidence in the economy's potential for a virtuous cycle, where both prices and wages experience an upward trend.

Let's assess 'purchasing power' by considering its relationship with real prices and salaries (see Figure 5). In fiscal year 2022, consumer prices (comprehensive, excluding imputed rent for owner-occupied homes) saw a substantial year-on-year increase of +3.8%. While scheduled salaries also experienced a year-on-year growth of +1.1%, the real purchasing power diminished during this period.

Figure 5: Real Purchasing Power



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications and Ministry of Health, Labor and Welfare

Note: 1. Annual data from FY1991 to FY2022
2. Consumer Prices are comprehensive, excluding imputed rent for owner-occupied homes
3. Real Purchasing Power = Scheduled Salaries (YoY) − Consumer Prices (YoY)

During this year's Spring Wage Negotiations, the wage increase rate reached approximately +3.6%, marking the highest level since 1993, according to the final tally by Rengo (the Japanese Trade Union Confederation). Notably, base increases that were reflected in scheduled salaries rose to about +2.1%. There are expectations for an improvement in real purchasing power, partly driven by an anticipated slowdown in consumer price growth in the latter half of the fiscal year. This slowdown is a result of decreasing import prices, which serve as a leading indicator for consumer prices.

Now, let's take a closer look at household financial assets. According to data from the Bank of Japan, as of the end of March 2023, the total financial assets of Japanese households will reach 2043 trillion yen. Among these assets, cash and deposits account for a significant portion, totaling 54.2%. Assuming deposit interest rates and other factors remain unchanged, the increase in prices will result in a real reduction in the value of cash and deposits.

In the aforementioned consumer sentiment survey, there is a notable increase in expectations regarding the future growth of 'asset value.' This includes assets such as land and shares that households currently own. It's important to note that the gap in purchasing power may expand, depending on the types of financial assets held by individuals and households.

"Achieving Balanced Growth for an Economic Upturn"

Sustained expansion in nominal GDP hinges on the simultaneous growth of both real GDP and the GDP deflator. In fiscal year 2023, we anticipate real GDP growth surpassing 2%, driven by increased consumption and capital investments. Combined with the uptick in the GDP deflator, there's now a strong likelihood that nominal GDP growth will exceed the 5.3% rate observed in fiscal year 1991.

This forecast heralds the beginning of a virtuous cycle in which economic activity thrives, transaction volumes expand, allowing for a more accurate price setting. Consequently, this cycle is expected to spur increased investment by businesses, leading to higher wages for employees, further amplifying transaction volumes.

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