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Japan's Normalization: Why Wages in Japan Can Rise

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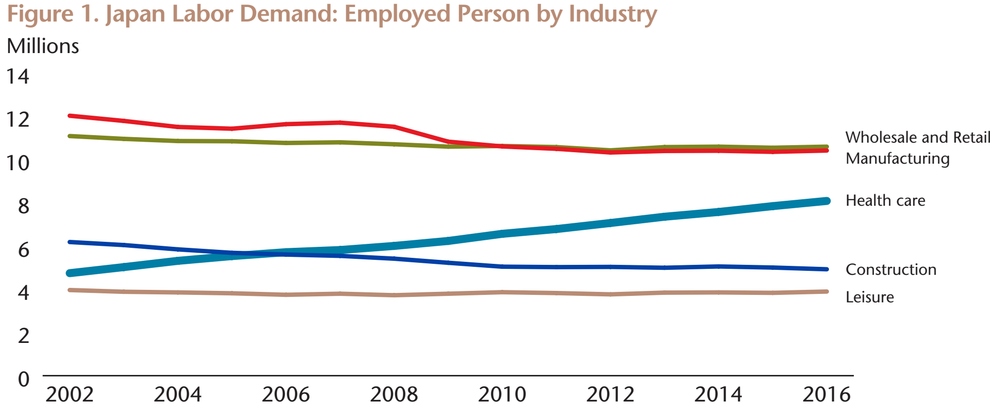
A look at the structural changes in Japan's labor market

Japan's greying population has been a popular reason for some investors to avoid the country. The perception is that an aging and declining population could lead to reduced aggregate demand, and the view is reinforced by an apparent lack of wage growth despite the efforts of the Abe administration. Pundits point to Japan's rigid labor market, including "lifetime employment," as a hindrance to meaningful wage increases and a major challenge to Japan's economic reforms. However, let's take a look at the light at the end of the tunnel. Can higher demand for labor and shrinking supply finally result in more meaningful wage growth in Japan like it does in other economies? Are attitudes toward lifetime employment changing? Let's look at the dynamics at play and consider what all this may mean for your investments

Demand: Non-agricultural employment reached an all-time high in 2016

First, let's consider the demand side of the equation. Japan's total employment reached its peak at 65.6 million in 1997. Since then, outsourcing of manufacturing jobs overseas, combined with increased adoption of automation, has resulted in a 28% reduction in employment in sectors like manufacturing and construction. Additionally, Japan's population peaked in 2008 and has been slowly declining since. Still, total employment has remained resilient at 64.4 million at the end of 2016. This was thanks to a shift in employment to service sectors such as health care, which have seen a surge in employment over the years. In fact, if you focus just on non-agricultural industries, employment has recently surpassed the all-time high recorded in 1997. Service sector jobs, such as those for health care and leisure, cannot be outsourced like manufacturing and those are exactly the areas where demand for labor will grow in an aging country. In addition, the structural shift toward e-commerce and the increased adoption of information technology by corporates has led to acute shortages in occupations like truck drivers and IT engineers. Demand for labor can still grow in an aging and declining population.

Figure 1. Japan Labor Demand: Employed Person by Industry



Source: Ministry of Internal Affairs and Communication

Supply: Jobs-to-Applicants Ratio at a 25 Year High

Next, we'll take a look at the supply side. The Bank of Japan's Tankan Employment Conditions survey points to the tightest labor market conditions since the early 1990s primarily due to a supply shortage. The jobs-to-applicant ratio reached 1.43x in December 2016, its highest level since July 1991. Some critics believe the higher jobs-to-applicant ratio is simply a function of Japan's declining population. However, a closer look at the data suggests otherwise. Since the beginning of the Abe administration in late 2012, the total labor population (total number of workers with jobs or actively seeking jobs) has actually increased, driven by higher female labor participation and higher employment for people 65 years old and higher. Meanwhile, as mentioned above, non-agricultural employment reached a record high in 2016, implying that many job seekers have actually found work. This has resulted in a smaller pool of job seekers even though the number of job offers has continued to increase. This has been the driver of the jobs-to-applicant ratio. What will happen to supply going forward? The government projects that even under its most bullish scenario, labor population would be flat at best by 2020. Labor participation by women and the elderly are both already above their respective averages for Organisation for Economic Co-operation and Development (OECD) countries. Given the relative stability of demand in health care and other service sectors, we believe Japan's labor market will remain tight for the foreseeable future.

Wage Growth: Muted Base Wage Growth is Primarily due to Rising Non-Regular Labor

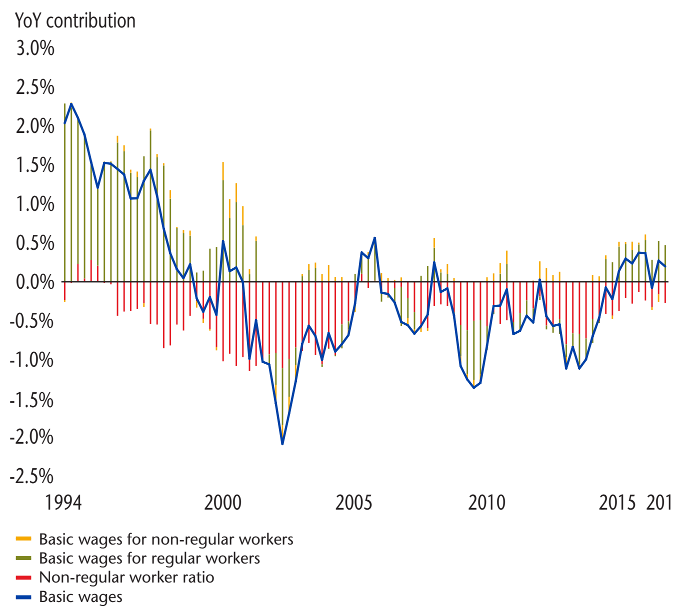
If demand is strong and supply is short, then why are wages in Japan not growing? Since the beginning of the Abe administration, wage growth in Japan has looked muted at best. However, the reality is quite different. As we outlined in a previous commentary in our 2015 weekly "Japan: Scrutinizing Wage Data," the apparent lack of wage growth is almost solely due to the increase in the non-regular worker ratio while base wages for both regular and non-regular workers have actually increased. Non-regular workers include workers that work on a part-time or contractual basis and enjoy less job protections than full-time regular workers.

Driving the increase in non-regular workers has been rising female labor participation and retiring regular workers re-entering the workforce as non-regulars. Currently, non-regular workers account for 37.9% of Japan's workforce. It is well known that this ratio has been steadily increasing over the years. An April 2013 labor law amendment enabled workers who have reached the retirement age of 60 to continue working as a non-regular worker has pushed up this figure even more. In addition, Japan's female labor participation has also steadily increased, though many women are in non-regular positions. We believe the rise in Japan's non-regular workforce is at a crossroads now. Japan's baby boomer generation will soon start turning 75 years old, which is the healthy life expectancy of Japan. Female labor participation has moved up from 59.6% in 2000 to 66.7% in 2015 and is already higher than the OECD average. Further upside in terms of participation rate from these 2 groups, let alone the absolute number of workers may be limited going forward. Thus, we believe the non-regular work ratio is close to the peak and unlikely to expand further.

With that said, it is true that wage growth under the Abe administration has been disappointing. Hourly wage growth in the past four years averages out to roughly 1%, which is wholly inadequate. Japan's labor unions, which have traditionally favored job security over wage growth, have yet to adapt to this new environment. However, supply-and-demand realities are catching up as evidenced by the momentum behind full-time regular employment. 2015 was the first year in 21 years when the growth in regular employment exceeded the growth of non-regular employment and this trend continued in 2016. Since there is a meaningful wage gap between regular and non-regular workers, a simple shift toward regular employment can prompt faster and more meaningful wage growth.

In addition, labor market fluidity is slowly but surely increasing. In 1990, the percentage of workers who had switched jobs was approximately 3% for men and 4% for women. In 2016, those figures had nudged higher to 4.0% for men and 5.8% for women, primarily driven by the younger generation who has little expectation of lifetime employment. Data published by leading staffing companies shows that the number of workers seeking to switch jobs has increased substantially in recent years. As these workers progress in their careers, they are much more likely to seek jobs based on their merits, including pay.

Figure 2. Japan Base Wage Growth Breakdown



Source: Ministry of Health, Labor and Welfare

Workstyle Reforms: Measures May Help But Momentum is Already There

The Abe administration is currently focusing its efforts on so-called "workstyle reforms" aimed at changing Japan's work culture by placing limits on overtime hours and mandating equal pay for equal work. The goal is to prod companies, particularly in Japan's service sectors, to improve productivity so that such businesses can pay higher wages. We believe these measures may have an immediate effect on larger corporations where reputation risk is an important factor. Tighter enforcement of existing labor laws are forcing many large companies to adopt drastic measures such as shutting down office computers after a certain hour. The steeper challenge will be to enforce such rules at small and medium enterprises (SMEs) which account for 70% of Japan's employment. For SMEs, the realities of labor market supply and demand will likely have a larger impact on how they pay their workers than government reform measures. In fact, statistics show that wages are already growing faster at SMEs than larger companies though the absolute level of pay is still relatively lower.

Conclusion

We believe wage growth in Japan will accelerate over the medium term, primarily due to favorable supply demand conditions. Growing demand for labor from service sectors, a shortage of supply due to diminishing excess labor pool and transition to a more liquid labor market is likely to result in increased full time regular employment and hence higher wage levels. In a sense, we think Japan is becoming a normal economy where a tighter labor market translates into higher wages.

Low wages and the lack of wage growth are at the core of Japan's low birth rate and deflation. Low wages make it prohibitive for the younger generation to get married and have children. This in turn results in the outlook for a declining population and lack of inflation bonus making it unattractive for companies to make long-term investments in the domestic market. Sustained wage growth is needed to trigger a reversal in these trends.

What are the Implications for Investing in Japan?

We believe there will be winners and losers from this shift toward faster wage growth. Ultimately, all companies will have to improve productivity, which we think of as a function of pricing and efficiency. In terms of pricing, naturally, companies with pricing power are best positioned to pass through higher personnel costs. Those same companies may see opportunities to consolidate market share. We believe such natural consolidation is a healthy and welcome event for Japan Inc. It will be interesting to see what happens in Japan's service sector as it has been several decades since rising labor costs have been a reason for raising prices. There are many services that Japanese consumers have become accustomed to receiving for free or at a very low price but such practices will have to change. Meanwhile, when it comes to efficiency, labor intensive business models that are dependent on abundant supply of cheap non-regular labor will be challenged in the years to come. Those include businesses in areas such as retail, restaurants and healthcare services. Companies in these sectors must enhance their efficiency through the adoption of automation and IT. Rising IT investment is already leading to a shortage of IT engineers. That is not to say that all companies in such sectors are doomed. In fact, those that can adapt to the environment faster also have opportunity to consolidate market share. Another opportunity is in business process outsourcing (BPO). BPO demand is expected to grow steadily as companies increasingly outsource non-core functions such as call centers, billing, human resources and procurement, to specialist providers.

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