

# Economic and Strategy Viewpoint

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### Will trade wars end the cycle?

- The trade wars between the US and China have escalated with another round of tariffs from both sides. We expect the dispute to be prolonged with all trade between the two nations being subject to tariffs by the end of next year.
- The impact on global activity is negative, but the dispute would have to escalate beyond China and the US to end the cycle. Nonetheless, when combined with the impact of tighter monetary policy and a fading in fiscal stimulus the effect of the clash on trade and investment will contribute to a slowdown in 2019 and potential end to the US expansion in 2020.

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### Italy: Bond vigilantes at the gates

- Italy's huge public debt mountain has been a concern for investors for some time, but the threat of a fiscal splurge by the new populist coalition government has caused investors to take fright, pushing yields up sharply. The coalition has just unveiled its 2019 budget, and while there is some loosening, it is far more constrained than previously feared. We expect investors to flock back to Italy in the near term.
- In the long term, we are still concerned over the sustainability of Italy's public finances. Poor demographics, a lack of investment and weak productivity growth are likely to cause the economy to stagnate for decades to come. Debt will probably become an issue, and with Italy stuck in a monetary union, Italy lacks the ability to devalue its currency or to manipulate its bonds yields. The bond vigilantes may not be knocking at the door, but they are certainly at the gates.

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### Japan: Hidden slack unlikely to halt BoJ stimulus withdrawal

- Recent wage data provides some evidence of building wage pressures consistent with the very low unemployment rate.
- Female participation is a significant source of hidden slack in the economy, acting to dampen wage growth. This is a long term factor that should help to keep a lid on wages, although cyclical wage increases could occur in the shorter run.
- Becoming more relaxed about the 2% inflation target and concerned about the side-effects of ultra loose monetary policy, the BoJ will likely gradually withdraw stimulus despite limited progress on inflation.

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### Views at a glance

- A short summary of our main macro views and where we see the risks to the world economy.

### Chart: Equity markets suggest that the US is winning the trade war

Index (100= 1/1/2019)



Source: Thomson Reuters Datastream, Schroders Economics Group, G0030, 24 September 2018.

# Will trade wars derail the US expansion?

## US-China trade war steps up

Financial markets continue to focus on trade wars following the US decision to impose tariffs on another \$200 billion of imports from China from 24 September. This brings the total to nearly \$250 billion, around half of total imports from China. In response, China has put tariffs on an additional \$60 billion of imports from the US such that duties will now apply to \$110 billion of products. This covers nearly 90% of all China's imports from the US. Unless progress is made in trade talks, the latest tariffs will rise from 10% to 25% on 1 January 2019. The US has threatened to follow up with a third round of tariffs on the remaining \$267 billion of imports from China.

Clearly, any subsequent weakening in trade growth will have a greater impact on China than the US. The \$250 billion equates to around 11% of China's exports or 2% of GDP. Should the US impose a third round this would hit 3.5% of China's GDP. The equivalent calculation for the US suggests that only 1% of GDP would be affected if China put tariffs on all its imports from the US. Markets have done the same calculation, judging from the significant outperformance of the S&P500 against the China A-share index (see front page chart). As Donald Trump said: 'trade wars are good and easy to win' and the markets appear to be backing him.

However, as we have argued before, China has options beyond tariffs. For example, many US companies have chosen to trade with China through their locally based subsidiaries. Companies such as GM sell more cars in China than in the US whilst Apple sells twice as many iPhones, for example. As Korean companies in China have found, the authorities can make life very difficult through zealous enforcement of regulations should they fall foul of the government. More generally, US companies may find they are at a disadvantage when bidding for contracts and China is also currently considering a restriction on sales of exports such as rare earths which would affect US supply chains.

## Heading for a prolonged dispute

In our view, the situation between the US and China has the makings of a prolonged dispute. The red lines on each side are too ideological and entrenched to allow much room for manoeuvre. China sees its trade policies as an essential part of the growth strategy that will allow the economy to hurdle the middle-income trap, in line with its 'Made in China 2025' policy. Meanwhile, President Trump came to power promising to put 'America first' and he has assembled a team that believes China is a root cause of the decline in parts of the US economy from which he draws his base support. From this perspective, there will be no deal where both sides get around the table and agree a way forward. Tariffs are the new reality.

Clearly, it is not just China's economy which is affected, but the whole supply chain which includes many emerging Asian economies such as Korea, Taiwan and Malaysia. Hence the impact on emerging equity markets which have struggled year to date.

There will be winners though as importers in the US and China switch to alternative suppliers. For example, Brazil is likely to see increased demand from China for its soybeans following the imposition of tariffs on US imports. We could also see China switching toward suppliers in Japan and Europe for goods such as chemicals and manufacturing products.

Meanwhile, US companies will face a difficult decision on whether to pay the tariffs and try to pass them on in final prices, or to absorb them into their margins. The former leads to higher inflation whilst the latter will hit corporate profits. Neither outcome would be particularly good for growth as higher inflation will hit consumers, whilst weaker profits will dampen capital investment. For the Trump administration, the hope is that those companies will bring production back home. However, this is

**Ideological red lines mean neither side is likely to give way**

**Trade war would need to escalate beyond the US and China to derail the cycle**

**Earnings have driven US equities**

**Turn in the USD may offset the trade wars for emerging market equities**

likely to involve considerable cost, especially given the shortage of labour in the US. In the meantime, the uncertainty created by the trade wars may well dampen capital expenditure (capex) and certainly foreign direct investment (FDI) flows between the two countries.

So trade wars would hit global growth and affect emerging markets, particularly Asia, more than the US. On their own though they are not enough to derail the US expansion. In our view the trade wars would need to become worldwide to have a significant effect on global growth. For example, the Bank of England reports that a US tariff of 10% on all its trading partners could take 2.5% off US output and 1% off global output over three years through trade channels alone<sup>1</sup>. Tighter financial conditions or greater uncertainty would make this worse.

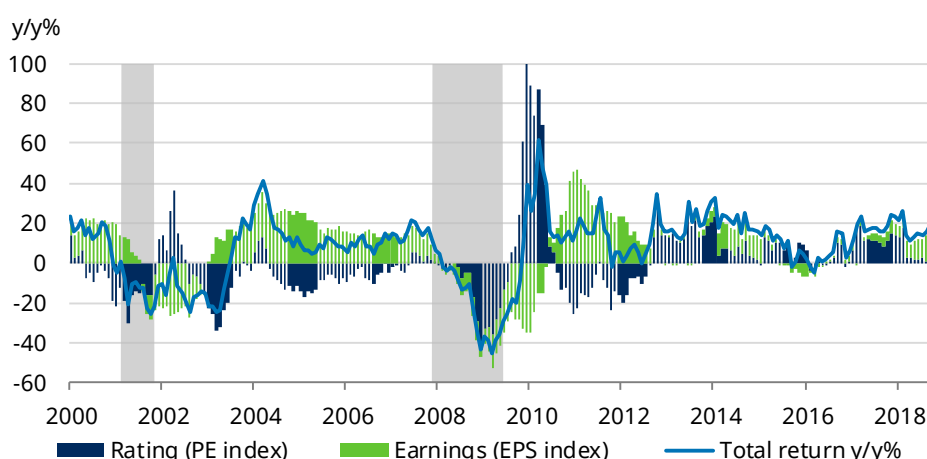
Alternatively, a scenario where other countries join the US in putting tariffs on China could result in significantly weaker global growth as a greater volume of trade is affected and could bring destabilising consequences such as a significant devaluation of the renminbi (RMB). This forms the basis of our 'China vs. rest of the world' scenario where global growth is some 0.6% weaker by the end of 2019 than in the baseline<sup>2</sup>.

However, even in the absence of such an escalation we should not dismiss the threat from trade wars as they create another headwind for the world economy, which alongside tighter monetary policy from the Federal Reserve (Fed) and a fading in fiscal stimulus will weigh on growth in 2019 and 2020. Our forecast sees US growth slowing to a 2% pace by the second half of next year with the cycle likely to end in 2020.

### Developed versus emerging – market implications

At this stage the US equity market seems unmoved by these concerns and is focused more on the strength of earnings growth. Looking at the breakdown, we can see that earnings per share growth has been the principal driver of returns this year (see chart 1). Share buybacks and tax cuts will have helped drive this outcome alongside the strength of economic activity. The de-rating of the market which many feared in the face of Fed tightening has not materialised. Valuations have actually been a small positive for returns, which may well reflect the relatively subdued rise in US bond yields.

**Chart 1: US equity market drivers**



Source: Thomson Reuters Datastream, Schroders Economics Group, G0031, 24 September 2018.

<sup>1</sup> From 'Protectionism to Prosperity' given by Mark Carney at the Northern Powerhouse Business Summit – Great Exhibition of the North, 5<sup>th</sup> July 2018, see [www.bankofengland.co.uk/speeches](http://www.bankofengland.co.uk/speeches).

<sup>2</sup> See the September Economics & Strategy Viewpoint for more details here.

However, this does highlight the vulnerability of the US equity market. Should growth slow as we expect next year then this would remove the key driver of returns. Whilst this does not bode well for risk assets, slower growth in the US is likely to be accompanied by a weakening in the US dollar (USD). Currency markets tend to move ahead of the interest rate cycle and so will anticipate the peak in US rates in 2019. This would provide some relief to the emerging markets whose relative performance is closely tied to the USD (chart 2). Relative emerging market performance will then depend on the balance between a longer trade war between the US and China and the easier liquidity that a weaker USD would bring.

**Chart 2: Emerging versus developed equity market performance and USD**



Source: Thomson Reuters Datastream, Schroders Economics Group, G0032, 24 September 2018.

# Italy: Bond vigilantes at the gates

**“We have to see how the government does its fiscal numbers. If they don't add up by the end of September, things could indeed get somewhat rough for Italy. This grave uncertainty about the fiscal plans is a significant rollback for Italy because it does mean that down the road, an Italian debt crisis — which would look pretty unlikely a year ago — is now a possibility.”**

Holger Schmieding, chief economist at Berenberg, London,  
22 August 2018.

**Italy's highly indebted government remains a big concern for investors in Europe**

When it comes to Europe's public finances, Italy has always been the 'elephant in the room'. With debt at around 132% of GDP, Italy is highly vulnerable to macroeconomic shocks and/or a loss in confidence by investors. Though not the most highly indebted in Europe – Greece still holds that title – Italy is simply too big to bail out.

Despite its fragilities, past governments have managed keep a tight rein on Italy's finances through both the global financial crisis and the sovereign debt crisis. Possibly too tight, as populists are now in charge, and they have threatened to let loose and not only cut taxes and increase public spending, but also to unwind some of the structural reforms implemented in recent years.

A fight with Brussels is inevitable, but it is not Brussels that Italy needs to fear. Bond vigilantes are circling, and they will ultimately decide whether Italy (and the Eurozone) will face another debt crisis.

## **Investors demand a premium to buy Italian debt**

**The 2019 budget target has disappointed investors, but is not as bad as previously feared**

The 2019 budget target was unveiled on 27 September 2019, with the government defying the advice of Giovanni Tria, Italy's Minister of Economy and Finance. Tria had recommended a deficit of 1.6% of GDP, which would have largely satisfied the European Commission, however, the target has been set at 2.4% of GDP, with additional funds being prepared for pre-election promises.

Italy is now on a collision course with the European Commission, which will assess all member states' budget plans from 15 October. It is very likely that the Commission will instruct Italy to lower its target, although it has little power to force Italy to comply. The Italian government will point to France, which plans to overshoot its previous 2019 target. The European Commission will probably manage to persuade the Italian government to lower its target slightly, but France's behaviour is not helping matters.

The initial reaction in markets to the news has been negative. The Italian FTSE MIB equity index fell by around 4% the following morning, with Italian banks suffering the most, as they are large holders of Italian government debt.

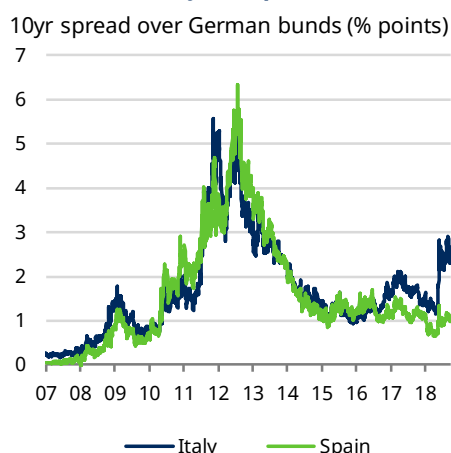
**The recent threat of a fiscal splurge has led higher yields...**

The yield spread between the 10-year Italian government bond (BTP) and German 10-year bond rose by around 35 basis points (chart 3). However, the spread remains well below the peak seen over the summer, when uncertainty over the 2019 budget and rumours over the possible sacking of the more moderate finance minister helped push the spread to highs not seen since 2012.

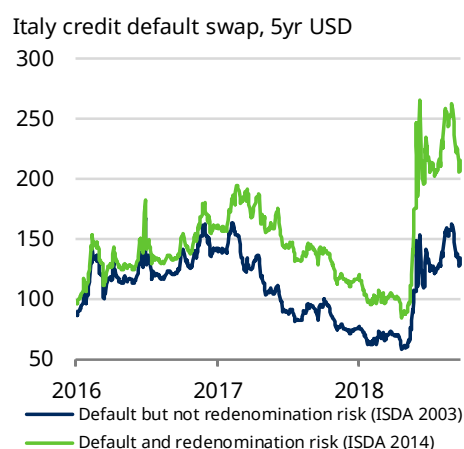
This period of fear followed the formation of Italy's populist coalition government. The coalition members, the League and Five Star Movement parties, joined forces by agreeing a fiscal programme that, if fully implemented, would likely expand Italy's budget deficit by around 5% of GDP (to around 6.6%) over a two to three-year period. Policies that have been promised include scrapping a planned hike in VAT, the introduction of a flat income tax, a tax amnesty, a minimum citizens' income and an unwind of pension reforms.

...and more demand for protection against a bond default, and an exit from the euro

**Chart 3: Bonds yield spreads**



**Chart 4: Redenomination risk is high**



Source: Thomson Reuters Datastream, Schroders Economics Group. 28 September 2018.

In addition, it is worth noting that through the summer, the equivalent spread for Spanish bonds did not follow the Italian spread higher. This suggests that investors are distinguishing between the political risk in Italy and its fragile public finances, and Spain, which also has its political issues, but its faster growth rate and lower level of debt makes it less risky.

Investors were not only concerned over the debt sustainability of Italy, but also the risk of it leaving the monetary union. Chart 4 shows the Italian five-year credit default swap (CDS) rates. These represent the annual cost of insuring against a restructuring or default by the Italian government for a five-year period. However, in 2014, a new contract standard was introduced (ISDA 2014) which included protection against redenomination risk. Therefore, comparing the previous contracts which still trade today (ISDA 2003) with the newer contracts, we can identify periods when investors are prepared to pay a premium to protect against Italy leaving the euro. The spike in the difference spread between these two CDS contracts occurred just after the election result was announced, and has remained elevated ever since.

### **Yields are up, but interest payments are still falling**

The rise in BTP yields has of course triggered concerns over the sustainability of Italy's public finances. Italy is often cited as the reason why the European Central Bank (ECB) cannot possibly raise interest rates. The argument goes that higher bond yields will quickly make Italian debt unsustainable.

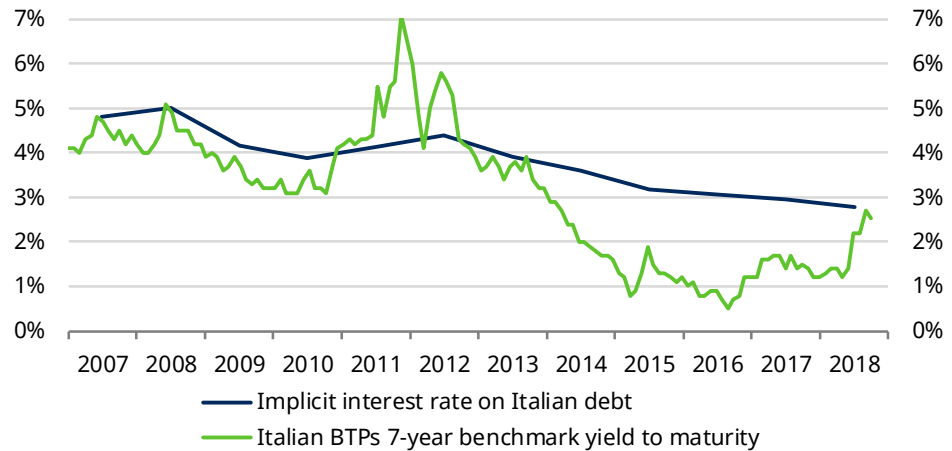
In reality, it takes time for changes in yields to have an impact on the interest expenditure by a government. This is because governments issue a range of bonds with varying maturities. The longer the average maturity of a nation's debt, the longer it takes for a rise or fall in yields to have an impact.

In Italy's case, the average maturity of its debts is just under seven years, although the distribution is skewed heavily to shorter-dated maturities (median maturity by value of just under five years). This suggests that rather than using the 10-year bond as the key reference, the seven-year bond would be more useful in looking at the impact on public finances. Chart 5 does this, comparing the seven-year BTP yield to maturity with the average interest rate paid on the existing stock of debt. We can think of the seven-year BTP yield as the marginal interest rate paid on new borrowing. Therefore, when this (the green line) is below the implied interest rate (blue line), then the average interest rate paid is falling. This has been the case since the end of 2013, with most of the impact of those years still yet to feed through (as bonds issued in 2011–2012 will be refinanced at much lower yields).

While yields have risen, it takes a long-time for the impact to register in the public finances

**Italy maintained strict fiscal discipline through the financial crisis, but interest payments are the main cause of its budget deficit**

**Chart 5: Average interest payments vs. current yields**



Source: Thomson Reuters Datastream, Schroders Economics Group. 28 September 2018.

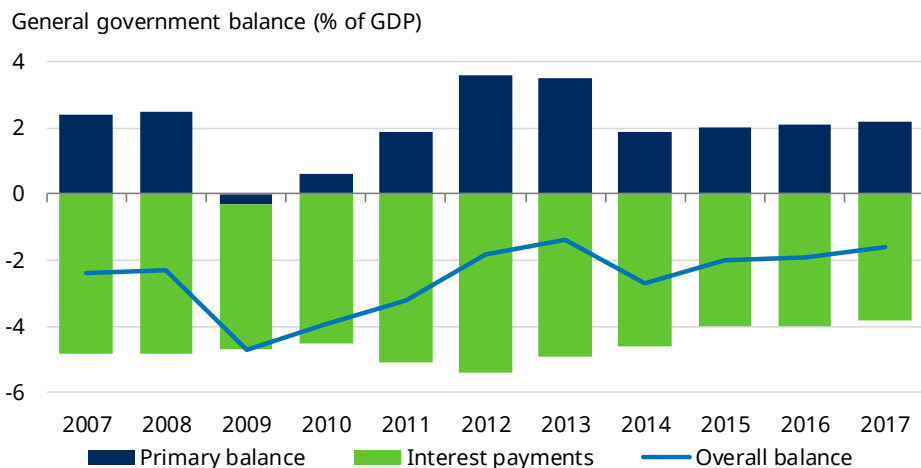
Moreover, the recent rise in the seven-year yield has barely reached the current average interest rate, and so has had a negative impact on Italy's budget. Were yields to rise further, then there would be an increase in interest paid at the margin, however, probably not in a meaningful way unless we saw a 200–300 basis points increase in a short space of time. Even then, it would take several years to show up.

A slow rise in yields, caused by, say, higher ECB interest rates, is therefore less of a concern than a sharp rise caused by a buyer's strike. If investors' confidence is shaken and panic sets in, then refinancing maturing bonds and interest payments due becomes an issue and could even cause a sovereign default.

### Budget risk is overdone for now

As mentioned earlier, past Italian governments have always been careful not to let spending get out of hand. Since 2007, the government's primary balance (budget deficit excluding interest payments) only went into deficit in 2009 (0.3% of GDP), before bouncing back to surplus the following year (chart 6). To put this into perspective, in 2009, the US ran a primary deficit of 9% of GDP, while many other countries also ran large deficits including the UK (8.3%), Spain (9.3%) and France (4.6%). Italy's management of its finances during the era of both the global financial crisis and the sovereign debt crisis is a remarkable achievement.

**Chart 6: Breakdown of Italy's budget deficit**



Source: Thomson Reuters Datastream, Schroders Economics Group. 28 September 2018.

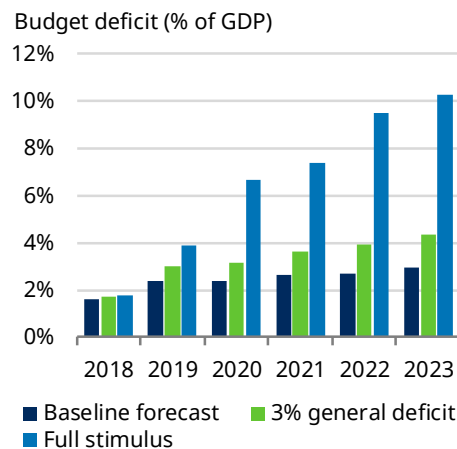


As Italy has run a primary surplus in 10 out of the past 11 years, clearly the problem is the interest on its existing stock of debt, which when taken into account, means the government is running an overall budget deficit.

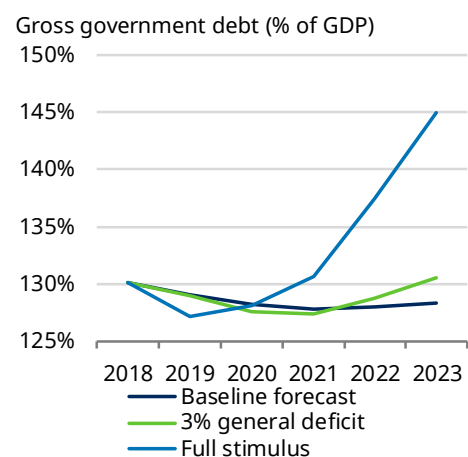
Looking ahead, the small expansion of policy (0.8% of GDP) announced in the 2019 budget is by no means a disaster, as with growth and inflation taken into account, Italy should see debt fall as a share of GDP next year. The European Commission will protest over the fiscal slippage in the coming months, but markets are likely to be relieved that the government has only partially followed through with its manifesto promises. Full implementation of those promises could have led to a far higher rise in bond yields, and a quick deterioration in public finances. Charts 7 and 8 show our simulations of the general deficit and gross debt levels given three scenarios: the baseline scenario, which is based on what was announced in the budget; a 3% of GDP deficit; and lastly, the full stimulus package, worth around 5% of GDP, spread over a couple of years. The full stimulus package would have caused the deficit and debt numbers to balloon within a few years.

**A big fiscal splurge would have quickly caused government debt to spiral out of control**

**Chart 7: Simulated deficits projections**



**Chart 8: Simulated debt projections**



Source: Thomson Reuters Datastream, Schroders Economics Group. 28 September 2018.

### Short-term risk is abating, but long-term risk remains

In the near term, we expect most investors to warm back up to Italy. Despite all the bluster, the government only plans to loosen fiscal policy slightly, and within the tolerance of markets. Moreover, the yield on offer in Italy will be difficult to ignore, especially when European investors have few places remaining to generate a decent income. We expect the spread between Italian and German bonds to narrow in the coming months, and for the news flow to become more neutral.

A sense of calm is likely to return; however, the elephant is still in the room. Italy's government has not suddenly become a coalition of liberal fiscal conservatives. The political pantomime will probably repeat itself this time next year when setting the 2020 budget. Meanwhile, Italy will remain vulnerable to any hit to growth, be it cyclical or a shock.

In the long term, Italy will struggle to keep public borrowing under control. Our trend growth projections show an improvement in real growth compared to the past decade, but not a recovery to the period prior to the global financial crisis. Chart 9 provides a breakdown of the contributions to trend growth including the contribution from capital (total investment), the labour contribution (total hours worked), and finally total factor productivity (TFP), which can be thought of as the extra output produced by combining labour and capital together.

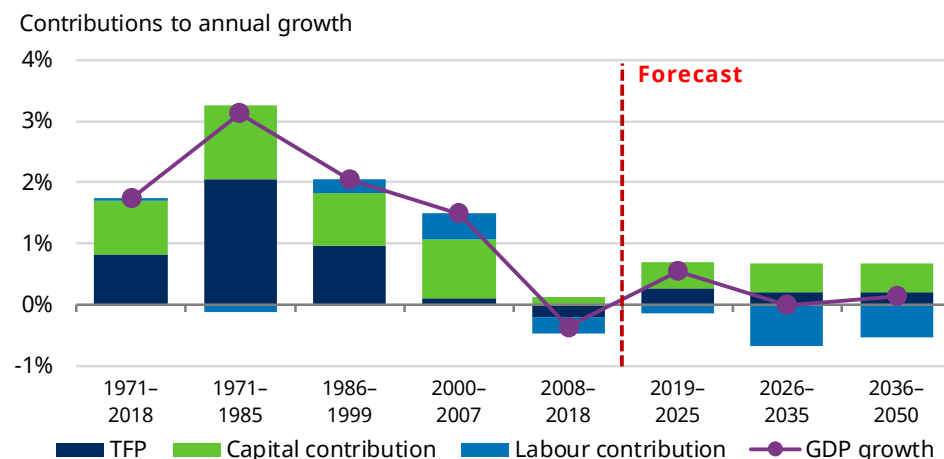
**In the near term, we expect fears over Italy's finances to abate, as the higher yields on offer are hard to beat for European investors**

**In the long term, poor trend growth will make it difficult for Italy to keep public finances sustainable**

Our forecast shows growth in capital not recovering to pre-crisis levels, but this is common in most countries given the impact of the financial crisis. The labour contribution is however very poor, with most of the impact being driven by an ageing population. Italy still has low labour participation rates, which we forecast to rise, but the benefit of these improvements will not be enough to make up for the falls forecast in the working age population. Indeed, Italy's total population is already shrinking. Its new government's restrictive policy on migration is unlikely to help matters.

Lastly, productivity growth is forecast to recover to growth rates that are better than those estimated for 2000–2007 and 2008–2018. The improvement is driven by expectations of further reforms, especially in reducing bureaucracy in business administration, along with legal reforms that should reduce costs. However, despite the higher TFP growth rate, it is still not enough to make up for the drag from labour supply.

**Chart 9: Italy's trend growth to worsen due to demographics**



Source: Thomson Datastream, Schroders Economics Group. 28 September 2018.

In aggregate, the forecast for Italy's growth beyond the next six years is dire. To keep public finances sustainable, Italy will have to make up for the fall-off in real growth by either running higher inflation, lowering interest costs, or running a larger primary surplus. The first two options are almost impossible without control of its own monetary policy, while the third is politically a non-starter.

The bond vigilantes may not be knocking at the door, but they are certainly at the gates.

# Hidden slack unlikely to halt BoJ stimulus withdrawal

“What will serve as both a factor for and outcome of growth will be to mobilise the power of women.”

PM Shinzo Abe, General Assembly of the UN, September 2013.

Policy was tightened, despite a failure in progress towards the inflation target

The recent change to monetary policy by the Bank of Japan (BoJ), allowing slightly higher government bond yields, marks the first step towards the withdrawal of liquidity from the central bank. Remarkably, policy was tightened despite an acknowledgement of a failure in progress towards the 2% inflation target. Meanwhile, recent eye-catching wage data suggests that Japan has run out of labour slack, perhaps providing some (much needed) ammunition for the BoJ to move away from ultra-loose monetary policy.

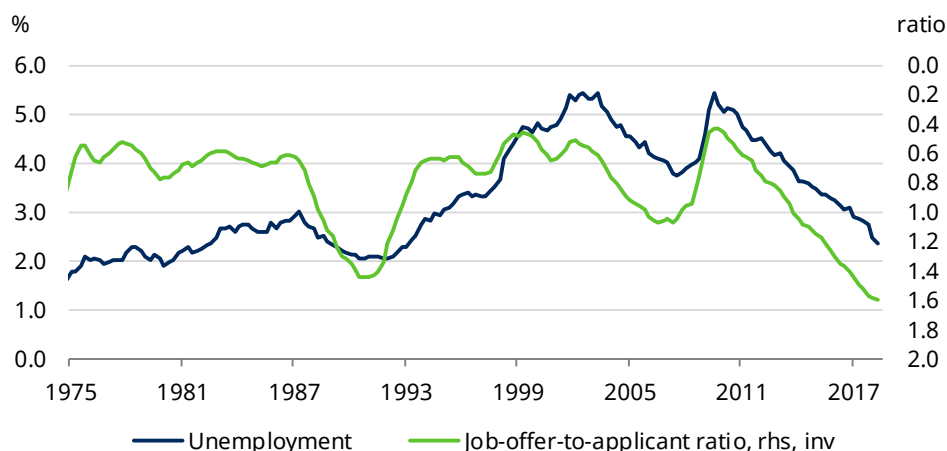
We explore this further and find that although conventional measures suggest an extremely tight labour market, females account for much of the hidden slack and female participation has much further to rise. Combined with deeply entrenched cultural factors, this should help keep a lid on wages in the long run. Recent wage data does point to cyclical pressures consistent with the low unemployment rate. Turning to the BoJ, concerned about the side-effects of ultra loose monetary policy, the central bank will likely gradually withdraw stimulus despite limited progress on inflation. The recent change to yield curve control and the government's more relaxed approach to the 2% inflation target suggests this is already underway.

## Unemployment at a 25-year low

Conventional measures of labour market slack suggest an extremely tight labour market in Japan (chart 10). Unemployment currently stands at 2.5% – a 25-year low. Another key gauge of labour market tightness, the number of jobs per applicant, has risen to 1.6, a multi-decade high. Consistent with the picture painted by these numbers, firms report severe labour shortages across all sizes and industries in the Tankan survey. In the longer term, a declining labour force that results from demographics will also add to labour shortages, presenting a challenge to the Japanese administration.

Conventional measures of labour market slack suggest an extremely tight labour market

Chart 10: Unemployment and jobs-to-applicant ratio at multi-decade lows



Source: Thomson Reuters Datastream, Schroders Economics Group, 20 September 2018.

**Measures of employment underutilisation, or 'hidden slack', give us a better picture**

As labour becomes a scarcer resource, this should put upward pressure on wages. Although there has been some strong wage data recently, there are still relatively few signs of a pick-up in wages – particularly in comparison to the degree of labour market tightness suggested by the headline unemployment rate.

### Hidden slack is higher for females and young workers

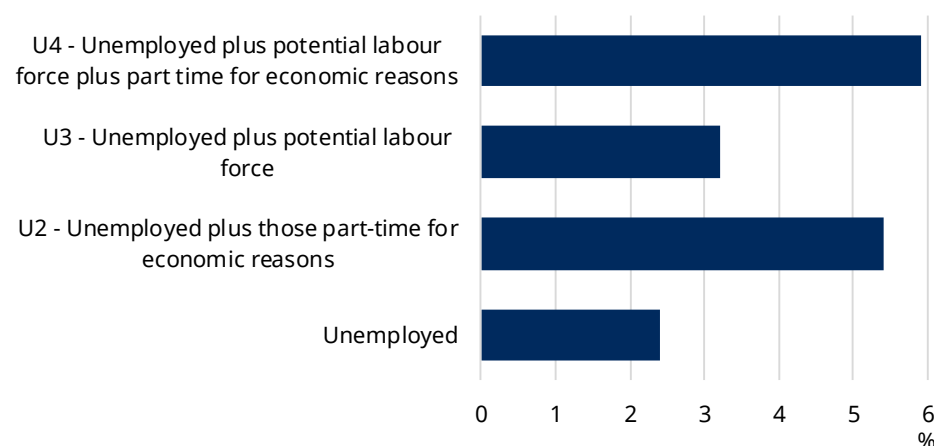
To get a better picture of the amount of labour market slack in the economy, we look at wider measures of employment underutilisation, or 'hidden' slack. This incorporates people who are not actually in the workforce, but are still attached to the labour force in some way and ultimately still wish to work.

In addition to unemployment, U2 includes those working part-time and wishing to work more hours. U3 also includes the 'potential labour force', defined as people who have recently looked for a job and ready to work as well as those who have not looked for a job recently but are ready to work. U4 is the widest measure of slack, combining those unemployed part-time but wishing to work more and the potential labour force.

Chart 11 shows the latest hidden slack measures. With U2 at 5.4% and U3 at 3.2%, the majority of the labour market slack that exists is additional capacity of workers already employed. By demographic, U2 is highest in young workers (15–24) at 9.5% and working age females, where the U2 rate ranges from 5.8% to 9.5% (higher for younger females). It is also young workers and females who drive up the 'potential labour force' rate included in U3.

Similar to the unemployment rate, we would say that the labour market has run out of slack when it reaches a level below which inflation rises (NAIRU). Unfortunately, due to lack of historical data we cannot tell whether these numbers are low or high. Although we cannot conclude from these figures alone whether Japan has run out of slack this gives us a more complete picture of where hidden slack is in the economy.

**Chart 11: Hidden slack in Japan, Q2 2018**



Source: Thomson Reuters Datastream, Japan Labour Force Survey, 28 September 2018.

Part time for economic reasons include those employed, work less than 35 hours, wishing and able to work more. Potential labour force includes unavailable jobseekers and available potential jobseekers.

**Female participation still remains low, despite the striking recent increase**

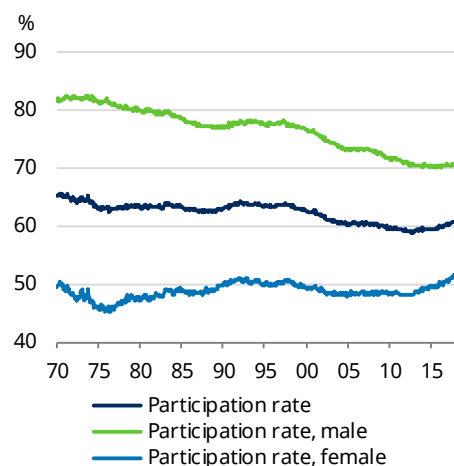
## Participation of females and old workers is still on Abe's agenda

### There is more scope for females to join the labour force

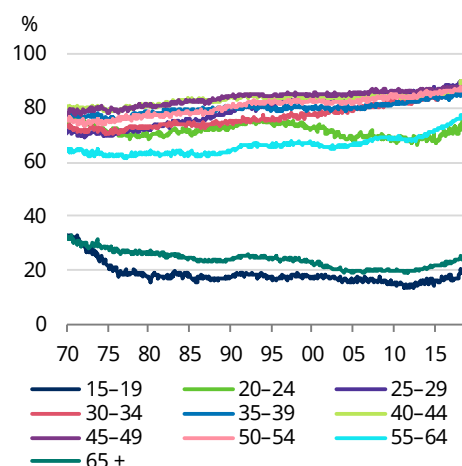
Participation in the labour force is relatively high in Japan, especially amongst the working age population (see chart 13), where participation is higher than the OECD average<sup>3</sup>. Chart 12 shows that despite the striking increase in female participation (15 years and above), particularly since the beginning of the Abe administration, this still remains fairly low for females. This is also the case when compared to other developed market economies<sup>4</sup>. If the female participation rate rose by 5% (to around US levels) and all these inactive females joined the labour force becoming unemployed, this would raise the unemployment rate to 6.8%. This shows that female participation presents a key source of slack in the economy. Furthermore, raising the participation rates of females (as well as older workers) is still very much on Prime Minister Abe's policy agenda, as highlighted in his recent party leadership election campaigning. Of course, significant changes in participation takes several years, so although this is a factor dampening wages growth in the long run, this does not rule out cyclical wage pressure in the short run.

Higher female participation has been a factor in the high part-time employment growth in recent years as many females enter the workforce into part-time employment rather than full-time. This is also broadly consistent with the higher U3 rates for females. Faster part-time employment growth has helped dampen overall wage growth as part-time workers are generally paid less full-time.

**Chart 12: Participation by sex**



**Chart 13: Participation by age**



Source: Thomson Reuters Datastream, Schroders Economics Group, 28 September 2018.

### Japan is embracing robotics over immigration

## Immigration remains politically unpopular

There are other potential sources of labour, such as more foreign workers; although this does not seem to be a promising source of labour. Japan still has a strict immigration policy with a tough path to permanent residency. This is clear in the data – there are only 1.28m foreign workers, less than 2% of labour force. Nonetheless, the 18% y/y growth in foreign workers between 2016 and 2017 suggests that the government has become more open to foreign workers. Specifically, the recent creation of a 'designated skills' residency status across five low-skilled sectors should allow up to 500,000 workers into Japan by 2025 (0.7% of the total current labour force). Yet workers will not be able to stay for more than five years or bring family.

<sup>3</sup>OECD data shows that Labour force participation rates of 15–64 in Japan was 77.5% versus and OECD average of 72.1.

<sup>4</sup>OECD data shows female inactivity rate (1 – Participation) for 15 years + is higher in Japan than Spain, UK, Sweden, US, Germany.

## Wages are less responsive to labour market slack than other economies

Immigration remains politically unpopular and Prime Minister Abe maintains the stance that he has 'no intention of adopting so-called immigration policy'.

Elsewhere, Japan is embracing the idea of using robotics as part of the solution to combat the shrinking and ageing population – particularly in the nursing sector with '2025 crisis' in mind. This is the year in which the oldest of the baby boomer generation becomes 75 years old. The Japanese government aims to have a robotics production market of 1.2 trillion JPY (0.4% GDP) alongside a boost in labour productivity to over 2% by 2020. This 'robot revolution' plays a key role in the government's strategy for realising 'Society 5.0'. This is the next industrial revolution, which includes the Internet of Things, big data, AI, robotics and the sharing economy.

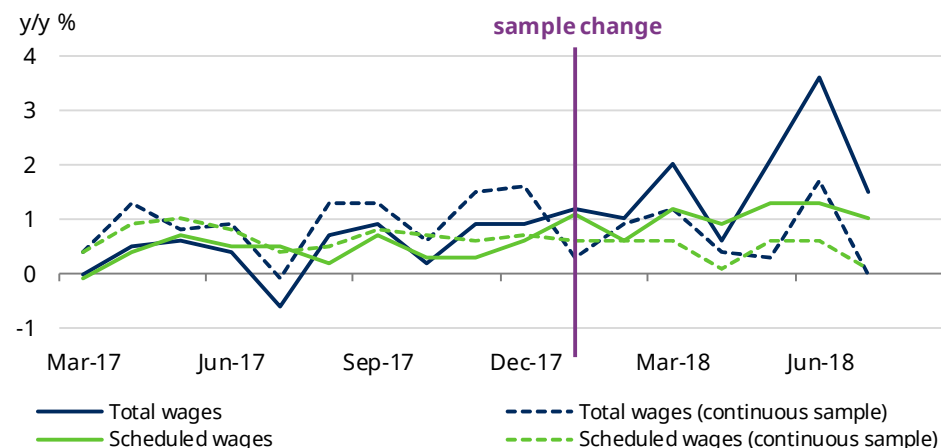
### Cultural factors keep slack unimportant for wage growth

Attributed to various cultural factors, wages are less responsive to labour market slack than other economies.

The 'Job-for-life' phenomenon, backed by seniority-based-pay, is associated with a strong commitment from employers to preserve jobs during economic downturns. The OECD<sup>5</sup> found that Japan's workforce is among with most 'resilient' in terms of limiting the rise in unemployment in economic downturns. Faced with a sharp drop in output firms do not shed workers, instead reducing productivity. The flexible wage system, where overtime and bonuses account for a significant proportion of total wages, allows nominal wages to fall and finally, unions prioritise stable employment rather than wage growth.

Turning to wages, the striking increase in wage growth in recent months (chart 14) has caught investors' attention and raised the question of whether wages are finally picking up in Japan. Wage growth is currently 1.5% y/y and the less volatile scheduled wages component, which excludes overtime and bonuses, stands at 1% y/y. The pick-up in wages coincided with a sample change at the beginning of year, when half the firms surveyed were changed. We continue to bear in mind that scheduled wage growth for the sample of firms that were surveyed continuously is still lacklustre. Nonetheless, this does provide some evidence of building wage pressures consistent with the fall in the unemployment rate.

**Chart 14: Recent pick-up in wage growth**



Source: Morgan Stanley Research, Ministry of Health, Labour and Welfare (MHLW), Schrodgers Economics Group, 28 September 2018.

<sup>5</sup>Labour Market Resilience: The role of structural and macroeconomic policies, OECD 30 August 2017.

## Recent data suggests building wage pressures

### BoJ to withdraw stimulus despite failure on inflation target

In conclusion, we find that although conventional measures suggest an extremely tight labour market, females account for much of the hidden slack and female participation has much further to rise. Combined with deeply entrenched cultural factors, this should help to keep a lid on wages in the long term. This does not rule out cyclical wage pressure in the shorter run and recent wage data provides some evidence to support this. Nonetheless, still concerned about the side-effects of ultra loose monetary policy, the BoJ will likely gradually withdraw stimulus despite any limited progress on inflation.

The recent change to yield curve control policy and the government's more relaxed approach<sup>6</sup> to the 2% inflation target suggests this is already underway.

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<sup>6</sup>See Reuters Article: 'Japan PM Abe says BoJ's easy policy shouldn't continue forever', 14 September 2018.

# Schroders Economics Group: Views at a glance

## Macro summary – October 2018

### Key points

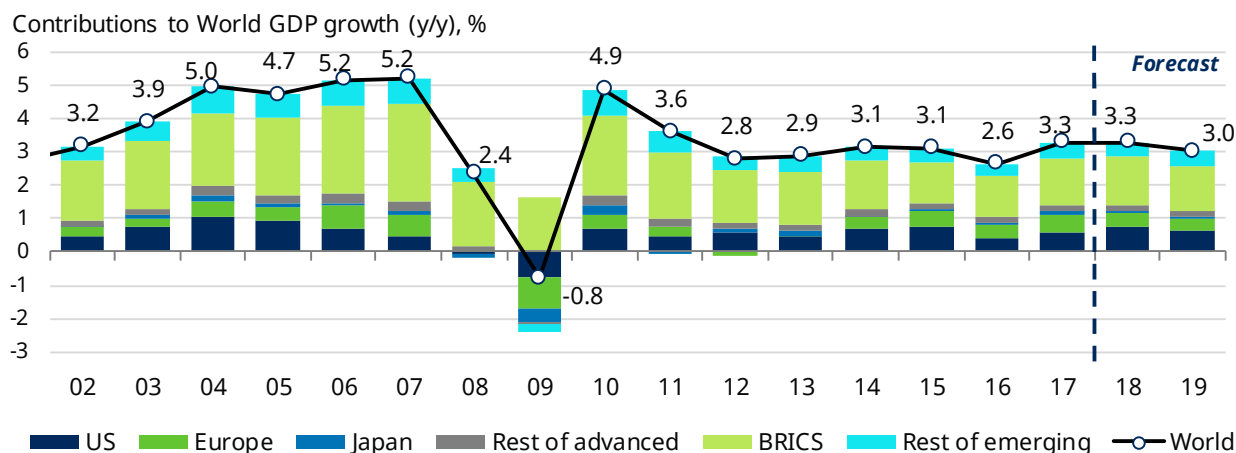
#### Baseline

- Global growth is expected to reach 3.3% in 2018 unchanged from 2017, before moderating to 3.0% in 2019. Inflation is forecast to rise from 2.3% in 2017 to 2.7% in 2018 and 2019. Core inflation in the US is expected to rise back above 2% in 2018 and the world economy moves firmly into the expansion phase of the economic cycle.
- US growth is forecast at 2.8% in 2018 and 2.4% next, incorporating President Trump's fiscal stimulus packages. The Fed has now started balance sheet reduction (quantitative tightening) and with core inflation rising, we expect another rate hike in December and two more in 2019, ending the forecast at 3%.
- Eurozone growth is forecast to moderate to 2.0% in 2018, but remains robust overall. Italian political risk is back and has reintroduced volatility. Growth should moderate in 2019 to 1.7%, but this remains above trend. Inflation is expected to remain under 2%, with higher energy price inflation in 2018 replaced by higher core inflation in 2019. The ECB is likely to end QE in December 2018, before raising interest rates in 2019. The refinancing rate is forecast to reach 0.50%, and the deposit rate to reach zero, having been negative.
- UK growth is likely to slow to 1.2% in 2018 as Brexit uncertainty weighs on confidence. Inflation is forecast to fall back slightly to 2.4%, as sterling depreciation effects are replaced with energy and domestically generated inflation. 2019 is very uncertain given Brexit, but we assume a transition period will be agreed that preserves the status quo of single market and customs union membership. The BoE is expected to remain on hold for the rest of 2018 and hike twice in 2019 post-Brexit (to 1.25%).
- Japanese growth is forecast to slow from 1.7% in 2017 to 1.0% in 2018 and 2019, as inflation almost doubles to 0.9% owing to higher oil prices. After tweaking yield curve control policy in the summer, the BoJ is not expected to move again over the forecast period.
- Emerging economies are forecast to see growth largely unchanged at 5% over 2018 before slowing to 4.8% in 2019. China's GDP growth is forecast to continue its secular decline, exacerbated by trade wars.

#### Risks

- Risks to the baseline forecast skewed towards a more stagflationary outcome. 'Trade war: China vs. RoW', 'Oil back to \$100' and 'Italian debt crisis' are the main causes. 'Mid-cycle slowdown' is the only deflationary scenario, while 'Global trade liberalisation' provides a productivity boost scenario. There are two reflationary scenarios: 'Trump's growth boom' and 'Global fiscal expansion'.

#### Chart: World GDP forecast



Source: Schroders Economics Group, 15 August 2017. Please note the forecast warning at the back of the document.



# Schroders Baseline Forecast

## Real GDP

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus
<b>World</b>	100	3.3	3.3	↓ (3.4)	3.3	3.0	↓ (3.2)	3.1
<b>Advanced*</b>	62.8	2.3	2.3	↓ (2.4)	2.3	2.0	↓ (2.2)	2.1
<b>US</b>	27.1	2.2	2.8	↓ (2.9)	2.9	2.4	↓ (2.6)	2.6
<b>Eurozone</b>	17.4	2.5	2.0	↓ (2.4)	2.1	1.7	↓ (2.1)	1.8
<b>Germany</b>	5.1	2.4	1.9	↓ (2.3)	1.9	1.7	↓ (2.2)	1.7
<b>UK</b>	3.8	1.7	1.2	↓ (1.4)	1.3	1.3	↓ (1.6)	1.5
<b>Japan</b>	7.2	1.7	1.0	↓ (1.3)	1.1	1.0	↓ (1.1)	1.2
<b>Total Emerging**</b>	37.2	5.0	5.0	↓ (5.1)	4.9	4.8	↓ (5.0)	4.8
<b>BRICs</b>	24.2	5.7	5.9	(5.9)	5.8	5.6	↓ (5.8)	5.7
<b>China</b>	16.4	6.8	6.6	(6.6)	6.6	6.2	↓ (6.4)	6.4

## Inflation CPI

y/y%	Wt (%)	2017	2018	Prev.	Consensus	2019	Prev.	Consensus
<b>World</b>	100	2.3	2.7	(2.7)	2.8	2.7	↑ (2.4)	2.7
<b>Advanced*</b>	62.8	1.7	2.2	↑ (2.1)	2.0	2.1	↑ (1.9)	1.9
<b>US</b>	27.1	2.1	2.8	(2.8)	2.5	2.6	↑ (2.4)	2.3
<b>Eurozone</b>	17.4	1.5	1.8	↑ (1.6)	1.7	1.6	↑ (1.5)	1.6
<b>Germany</b>	5.1	1.7	1.9	↑ (1.8)	1.8	1.8	(1.8)	1.8
<b>UK</b>	3.8	2.7	2.4	↓ (2.6)	2.4	2.2	↑ (1.9)	2.1
<b>Japan</b>	7.2	0.5	0.9	↓ (1.2)	0.9	1.3	↓ (1.4)	1.1
<b>Total Emerging**</b>	37.2	3.2	3.7	↑ (3.6)	4.1	3.7	↑ (3.3)	4.0
<b>BRICs</b>	24.2	2.2	2.7	↓ (3.0)	2.8	3.2	↑ (2.9)	3.0
<b>China</b>	16.4	1.5	2.1	↓ (2.4)	2.1	2.4	↑ (2.0)	2.3

## Interest rates

% (Month of Dec)	Current	2017	2018	Prev.	Market	2019	Prev.	Market
<b>US</b>	2.00	1.50	2.50	(2.50)	2.68	3.00	(3.00)	3.17
<b>UK</b>	0.75	0.50	0.75	(0.75)	0.86	1.25	(1.25)	1.22
<b>Eurozone (Refi)</b>	0.00	0.00	0.00	(0.00)	-0.30	0.50	↓ (0.75)	-0.08
<b>Eurozone (Depo)</b>	-0.40	-0.40	-0.40	(-0.40)		0.00	↓ (0.25)	
<b>Japan</b>	-0.10	-0.10	-0.10	(-0.10)	0.08	-0.10	(-0.10)	0.13
<b>China</b>	4.35	4.35	4.35	(4.35)	-	4.00	(4.00)	-

## Other monetary policy

(Over year or by Dec)	Current	2017	2018	Prev.	Y/Y(%)	2019	Prev.	Y/Y(%)
<b>US QE (\$Tn)</b>	4.3	4.4	4.0	(4.0)	-9.1%	3.4	(3.4)	-15.0%
<b>EZ QE (€Tn)</b>	2.3	2.2	2.4	(2.4)	9.1%	2.4	(2.4)	0.0%
<b>UK QE (£Bn)</b>	435	445	445	(445)	0.0%	445	(445)	0.0%
<b>JP QE (¥Tn)</b>	537	521	549	↓ (551)	5.3%	563	↓ (567)	2.6%
<b>China RRR (%)</b>	16.00	17.00	15.00	15.00	-	14.00	14.00	-

## Key variables

FX (Month of Dec)	Current	2017	2018	Prev.	Y/Y(%)	2019	Prev.	Y/Y(%)
<b>USD/GBP</b>	1.32	1.35	1.30	↓ (1.35)	-3.9	1.35	(1.35)	3.8
<b>USD/EUR</b>	1.18	1.20	1.14	↓ (1.18)	-5.1	1.18	↓ (1.20)	3.5
<b>JPY/USD</b>	112.9	112.7	110	(110)	-2.4	108	(108)	-1.8
<b>GBP/EUR</b>	0.90	0.89	0.88	↑ (0.87)	-1.2	0.87	↓ (0.89)	-0.3
<b>RMB/USD</b>	6.88	6.51	6.90	↑ (6.35)	6.0	7.00	↑ (6.30)	1.4
<b>Commodities (over year)</b>								
<b>Brent Crude</b>	82.3	55.6	73.6	↑ (71.6)	32.3	73.2	↑ (59.7)	-0.4

Source: Schroders, Thomson Datastream, Consensus Economics, August 2018

Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.

Market data and Consensus data as at 25/09/2018

Previous forecast refers to May 2018

\* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, United Kingdom, United States.

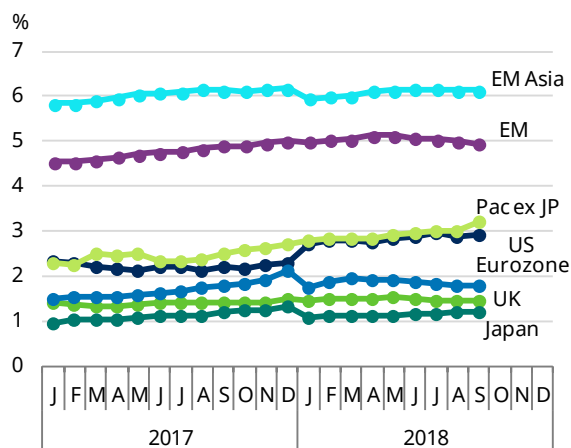
\*\* **Emerging markets:** Argentina, Brazil, Chile, Colombia, Mexico, Peru, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

## Updated forecast charts – Consensus Economics

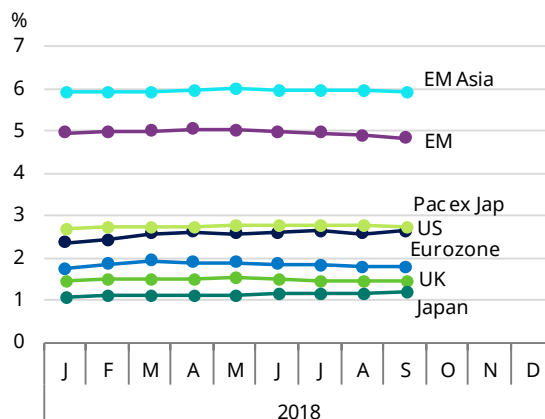
For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

**Chart A: GDP consensus forecasts**

**2018**

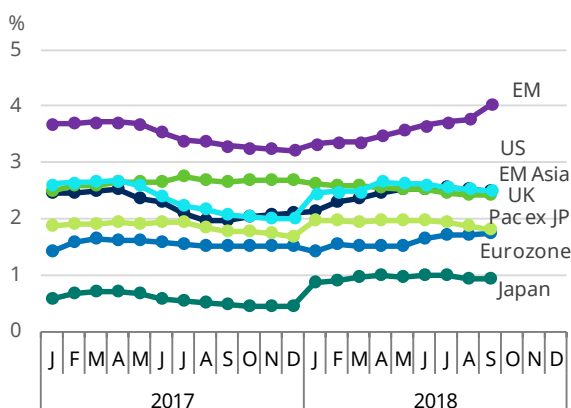


**2019**

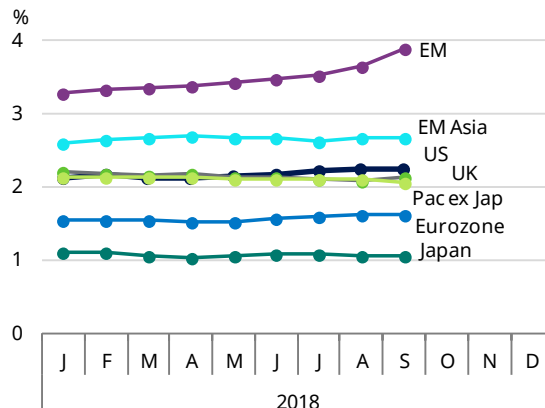


**Chart B: Inflation consensus forecasts**

**2018**



**2019**



Source: Consensus Economics (28 September 2018), Schroders Economics Group

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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