www.pwc.com

Global Economy Watch

April 2019

Is demography still destiny? Japan's surprisingly expanding workforce

Mike Jakeman, PwC, Senior Economist

Get in touch:

Mike Jakeman
Senior Economist, PwC UK

M: +44 (0)7483 361717
E: mike.jakeman@pwc.com

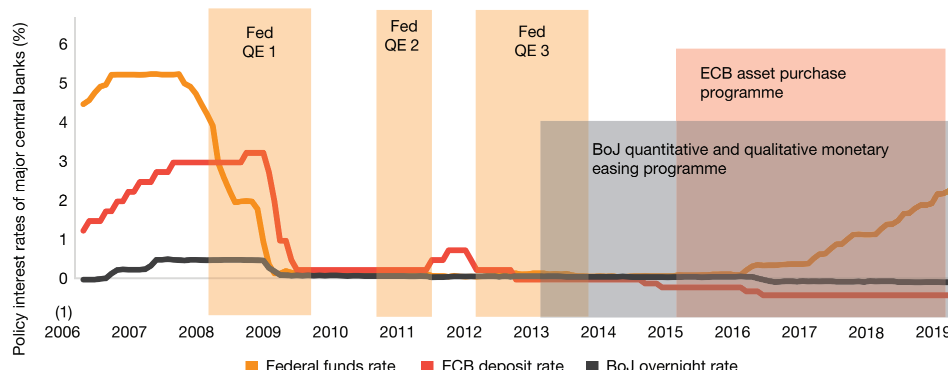
Dear readers,

In our previous edition of Global Economy Watch, which included our predictions for the world economy in 2019, we suggested that around 40 countries would see their labour forces shrink this year, owing to a combination of low birth rates and ageing populations. Interestingly, the country most closely associated with unfavourable demographics–Japan–was not among them. At present, the Japanese labour market is pulling off a neat trick. Although both the whole population and the working-age population are declining every year, the number of Japanese in the workforce is growing, and expanding at a rate that outperforms many other younger and more vibrant advanced economies. We explain how this is happening and assess whether it is sustainable in our feature article.

We also consider what the weakening global economy means for the central banks of the three largest advanced economies. Barring a major, immediate adjustment to monetary policy, the Federal Reserve's shrinking of its balance sheet, combined with the end of quantitative easing by the European Central Bank, means that these central banks will begin to drain liquidity from the global economy for the first time since the global financial crisis by the middle of this year. The combination of de facto monetary policy tightening at the same time as global growth continues to slow could generate some volatility in financial markets during 2019. We note that the Fed is still determining the level of assets it wishes to hold and expect it to end the process with a significantly larger balance sheet than it held before the financial crisis.

Finally, we continue to watch the effects of the trade conflict between the US and China. Not for the first time, hopes have been raised at the time of writing that a deal is imminent that would prevent another escalating round of tariffs. That would be propitious. The effects of the trade war have not been especially clear in the data so far, with some initial stockpiling inflating volumes. However, this temporary boost has now passed and the tariffs could begin to impede trade growth in early 2019. Unless that is, the world's two largest economies can agree that trade barriers are not in their interest.

Fig 1: A decade of unorthodox monetary policy will take years to normalise



Source: Refinitiv

Visit our blog for periodic updates at:
pwc.blogs.com/economics_in_business

Is demography still destiny? Japan's surprisingly expanding workforce

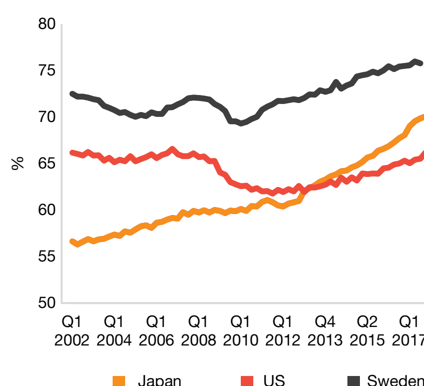
Japan has some of the world's most challenging demographics. Since the country's population peaked at 128 million in 2010, it has shrunk by 1.3 million people. Data for 2018 suggested that natural decline alone–the number of deaths minus the number of births, ignoring migration–reached 448,000, suggesting this decline is accelerating. The government has warned that the population could fall as low as 88 million by 2065. Furthermore, the population is old: 28% is over 65, compared with 18% in the UK and 15% in the US. This trend, too, will accelerate in the coming years.

An ageing and shrinking population has important implications for the economy. Fewer workers mean that productivity has to rise every year just to prevent the economy from shrinking. Meanwhile, a higher proportion of pensioners in society means more people using public services, such as healthcare and transport, without contributing to government revenue through taxation. In this respect, Japan is a test case for other economies facing demographic challenges.

But in Japan something curious is happening. In 2018, the number of people aged 15 and over fell by 0.1%, but the number of people working rose by 1.7%. This growth was not enabled by a reduction in high unemployment; joblessness has been low and falling for years. Instead, an already strong labour market found a way to strengthen further. Figure 2 shows that in 2012 Japan had an employment rate that was about average among advanced economies. But by 2018, its participation rate had risen to among the highest in the world. Growth in employment also picked up.

Figure 3 gives an indication of where some of this growth has come from. Japan's female employment rate has historically been quite low, relative to its peers. Various reasons have been suggested as explanations, including a culture of long office hours, entrenched gender roles and a lack of flexibility in the labour market.

Fig 3: Japan's prime-age female participation rate has soared in recent years



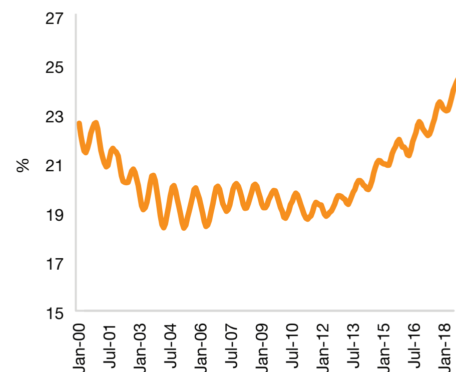
Source: Federal Reserve Bank of St Louis

But these characteristics of the job market are changing. As recently as 2002, there was a ten-percentage-point gap between the female employment rates in the US and Japan. But as the US rate plateaued, the Japanese rate rose, and it is now comfortably ahead of the US rate.

Another famous characteristic of the Japanese labour market–the 'm'-shaped distribution of women in work by age–is also shifting. A higher proportion of women are now returning to work sooner after having children. The shallower decline in participation among women in their 30s means the graph increasingly looks less like an 'm' and more like an 'n'.

Government policy has something to do with this. It has increased the number of nursery places and will make provision for all 3-5 year olds free by 2021. (Care for younger children will be provided for those on lower incomes.) A law passed in 2015 demands that larger firms set targets for hiring and promoting women. (There are no penalties for non-compliance.) Other legislation caps overtime at 100 hours a month, a move designed to both prevent over-work and generate new roles where demand clearly exists.

Fig 4: The proportion of older Japanese working beyond 65 is also rising



Source: Ministry of Internal Affairs and Communication, Labour Force Survey

Figure 4 shows another area of underutilised labour supply: older workers. (This group are not captured in the data shown on Figure 2.) During Japan's period of rapid economic development the proportion of over 65s in work fell steadily, eventually reaching a low of around 18% in the early 2000s. But as life expectancy has continued to grow, retiring at 60 has become less appealing.

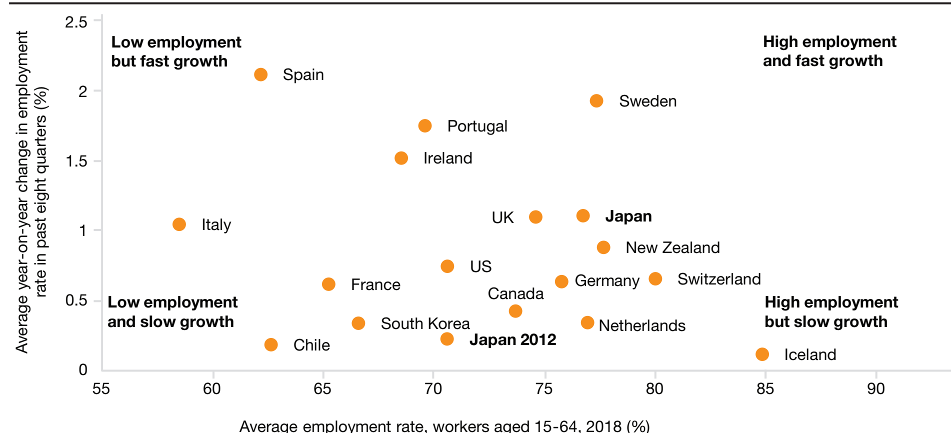
The government is also nudging would-be pensioners in the direction of remaining in work. It wishes to push up the retirement age for state workers from 60 to 65 and boost the public pension for those that opt to defer drawing from it.

Already, Japan is leading the world by retaining so many older workers; its rate of around 25% is higher than that in the US (18%) and the UK (10%).

Efforts to increase female and older workers' employment is partly because of cultural preference for these measures over higher immigration. Nonetheless, in late 2018 parliament approved the creation of two new visa categories, one that is time limited and another that offers the opportunity of eventual residency rights. It has branded these a stop-gap solution until it can get yet more Japanese in the workforce.

How long can these trends continue? If the decline in the unemployment rate continued at the (very steady) average rate of the past eight years since the population peaked, the economy would hit zero unemployment in 2027. It is possible that this date could be deferred if the labour force continued to grow, but the eventual impediment to this will be the shrinking population. Figure 2 suggests that Japan has a little further to go to emulate the employment rates of some European countries, but here too, there will be a limit. Eventually, the remarkable performance of its labour market will require more births and more immigrants to be sustained.

Fig 2: Since 2012 the Japanese employment rate has risen and growth in employment has accelerated



Source: OECD iLibrary

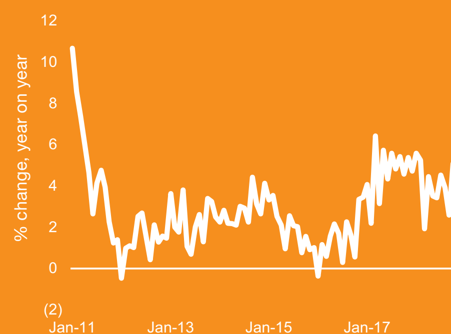
Economic update: The trade war is beginning to bite

For much of 2018 the US-China trade dispute seemed to be more phony war than actual conflict. Despite exchanging tariffs on goods worth hundreds of billions of dollars, China's exports to the US continued to grow and hit an all-time high in September 2018. However, some of this strong performance is likely to represent stockpiling, with firms and consumers opting to bring forward purchases as a hedge against tariffs being applied to more goods and at higher rates. Warnings from leading businesses about soft trading conditions in China suggest that this phase has ended. Indeed, the latest data suggests that this phase has ended.

Chinese exports to the US fell by 3.5% year on year in December, while imports plunged at a much faster rate.

Such is the size of the US and Chinese economies that weaker trade between them will become visible in global data. Figures from the CPB World Trade Monitor show that a bumper period of growth in merchandise trade is coming to an end. Trade volume growth was the weakest in November for more than two years. With global economic growth slowing in China and the G7, global trade growth is unlikely to bounce back strongly in 2019.

Fig 5: After a strong period between 2016 and 2018, global merchandise trade growth is slowing



Source: CPB Netherlands Bureau

Central banks are facing difficult decisions

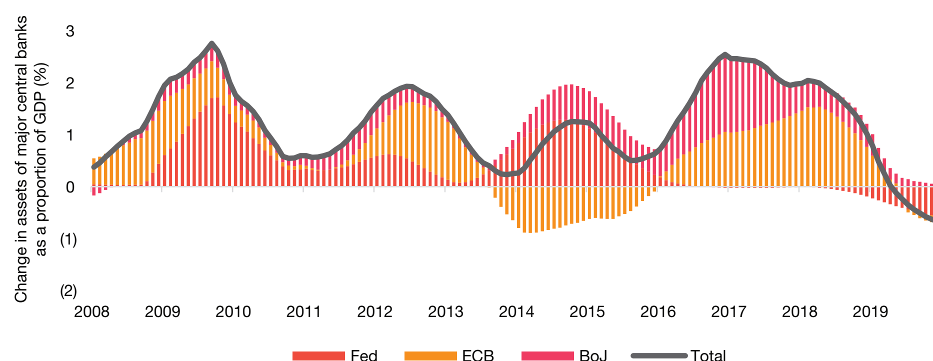
Central banks in the world's three largest advanced economies all responded to the global financial crisis of 2008-09 in the same way: by cutting interest rates and stimulating borrowing through quantitative easing ('QE'). These programmes added assets worth trillions of dollars to the balance sheets of the Federal Reserve ('Fed'), the European Central Bank ('ECB') and the Bank of Japan ('BoJ').

A decade on from the worst of the crisis, the central banks are seeking to 'normalise' monetary policy, or return interest rates to close to their pre-crisis averages. The Fed has made the most progress. It ended its third QE programme in 2014, raised its policy interest rate for the first time in 2015 and began to allow some of the assets bought under QE to expire in 2017. The ECB, by contrast, only ended its QE programme in 2018 and is still contemplating whether to stop repurchases of assets, while the BoJ continues to buy government bonds and private-sector assets each month.

The end of the ECB's bond-buying, combined with an increase in the rate at which the Fed is allowing bonds and securities to expire, means that an important threshold may be crossed in the first half of 2019. For the first time since the crisis, these three central banks together could be withdrawing funds from the global economy (see Figure 6). At the peak of the stimulus, in 2009 and again in late 2016, the value of the liquidity they were pumping into the global economy was growing at a rate equivalent to 2.5% of global GDP.

Such an injection at a time of rock bottom interest rates pushed up prices for a variety of assets as flush investors searched for a good return. This phenomenon is best observed in the housing markets of cosmopolitan cities, such as London, Sydney and New York, but it also extended to equities, art and bonds.

Fig 6: After a decade of stimulating the global economy, central banks will soon take liquidity from it



Source: Refinitiv

Note: US dollar terms, global GDP measured in market exchange rates

However, the combination of the Fed raising interest rates and reducing its balance-sheet has coincided with slower global economic growth and greater financial market volatility.

This shakier environment complicates central banks' future planning. Where the Fed faced a benign outlook when it began to raise interest rates in 2015, the path looks trickier for the ECB. Economic growth in the Euro zone has slowed significantly. The Fed said in January that global economic conditions necessitated that US interest rates remain at current levels. In China the government has again been distracted from its long-term goal of improving the economy's debt profile by the short-term need to ensure acceptable levels of economic growth.

It is possible that the ECB and the BoJ could change course. Neither has committed to tightening monetary policy. The BoJ has reduced the value of its monthly bond purchases, but has not set a lower target. The ECB is at the beginning of a wait-and-see phase of unknown duration.

It is not clear to what level the Fed wants to reduce its holdings. Prior to the crisis, it held assets of around $900bn, a slightly larger amount than the value of cash in the economy. (Cash is a liability for a central bank.) With the value of US dollars in circulation now at $1.5trn, it would take until early 2023 for the balance sheet to return to this level, assuming the maximum $50bn of assets were allowed to roll off each month.

But the Fed is likely to change course before then. It sees its balance sheet as a technical matter that enables it to control interest rates, rather than a policy issue. But if the economy slowed, it would struggle to persuade financial markets that it should continue to shed assets at the same time as cutting interest rates. Consequently, the Fed's balance sheet is likely to remain larger than it was pre-crisis, with its reduction halted by a shift in interest rate policy to support the economy when it next slows.

Returning central banks' accounts to more familiar territory will be a long process that poses risk to global economic growth and will prove more challenging to policymakers than initially expected. It is also likely to be interrupted, or delayed, if there is another global economic shock.

Global economic projections commentary: March 2019

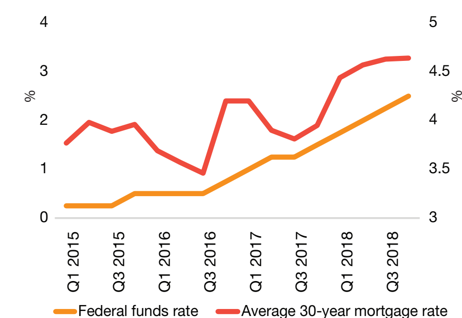
The Americas

Confirmation from the Federal Reserve of a slower pace of interest rate increases and an end to the longest government shutdown in history have calmed fears about the US economy in 2019. We have maintained our projection of real GDP growth of 2.4% this year, after an estimated expansion of 2.9% in 2018.

In Canada another year of growth of around 2% is expected in 2019 as domestic consumption is likely to remain constrained by several factors. Mortgage rates will continue to rise, while labour force and wage growth will remain moderate as the economy heads towards full capacity.

As Brazil continues to recover from recession, long-awaited pensions reforms in February are likely to be the first of several pro-growth measures that boost the economy. This, along with a continued improvement in business confidence, deregulation plans to increase investment and continuing accommodative monetary policy, is expected to result in growth of 2.4% this year.

US: Banks have passed on to mortgage borrowers only some of the increase in the Fed's base rate since 2015



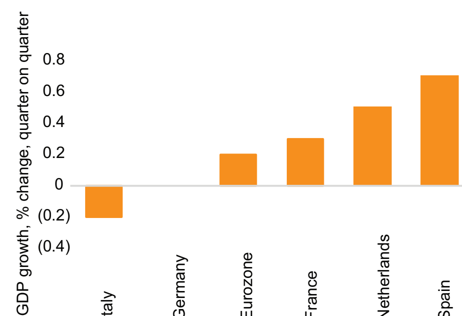
Source: Refinitiv

Europe

The Eurozone economy continued to cruise along at a rate of about 0.2% quarter-on-quarter in Q4 2018. The national breakdown of the latest data showed us that this figure was dragged down by Germany—where output was flat—and Italy, which contracted for a second consecutive quarter—pushing it into its fifth recession in the 21 century. Put together, these two economies make up almost half of Eurozone output.

More impressive was that the slack from Germany and Italy was picked up by the strong performance of Spain, the Netherlands, France and some of the periphery economies. Will this continue? Early evidence suggests that the slowdown in Germany, the largest economy, was temporary and focused on a few large manufacturing sectors. However, the bigger issue on the mind of businesses in the Eurozone is how to contain the spill-over effects in the event of a disorderly Brexit.

Eurozone: A strong performance from Spain, in particular, in late 2018 helped to offset weakness in Italy and Germany



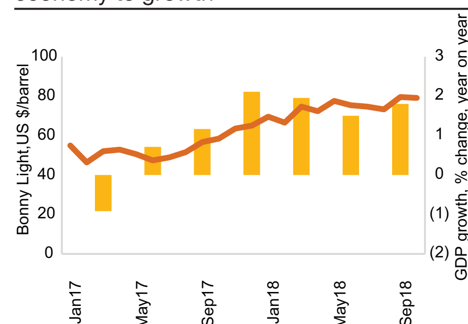
Source: Eurostat

Eastern Europe, Middle East and Africa

Nigeria's economy grew at its fastest pace since 2015 in the fourth quarter of 2018, at 2.4% year on year. This continued the recovery from the 2016-17 recession. However, maintaining this pace of growth is set be contingent on two factors. First, the price of oil: higher oil prices were instrumental in pulling the economy out of the recession, and the oil sector still constitutes around 9% of overall GDP. Second, a smooth outcome to the delayed presidential and legislative elections held in February.

The legislative election in South Africa in May could also prove influential on that country's economic performance, if the incumbent African National Congress, now under the leadership of Cyril Ramaphosa, is re-elected and demonstrates that it is committed to structural reform. The third quarter of 2018 saw the economy escape recession, after contracting in the first half of the year. We project a stronger performance in 2019, with the economy expanding by 1.6%.

Nigeria: Prices for local crude have risen by 35% since late 2017, helping to return the economy to growth



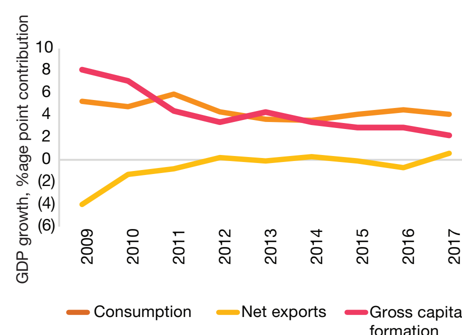
Sources: Reuters, Nigeria National Petroleum Corporation

Asia

China's long-term economic slowdown is set to continue in 2019-20. The effects of the trade conflict with US will result in the government introducing stimulus measures to support the economy, which is likely to delay work on deleveraging and debt restructuring. We expect growth of 6.3% in 2019, slowing further, to 6.2%, in 2020. However, China will continue to add huge amounts of output to the global economy.

India is likely to remain the fastest-growing large economy in the world over the next two years. Its low GDP per head and huge catch-up potential means growth in excess of 7% a year should be attainable. Japan may be among a group of Asian countries that suffers from a trade conflict-related weakening of external demand. However, consumption growth should be strong in the middle of 2019 ahead of an increase in the consumption tax in October. We expect growth of 1% this year, a similar pace to that of 2018.

China: In recent years consumption has overtaken investment as the largest contributor to economic growth



Source: Refinitiv

Projections: March 2019

	Share of 2017 world GDP		Real GDP growth				Inflation			
	PPP	MER	2018e	2019p	2020	2021-2025p	2018e	2019p	2020p	2021-2025p
Global (Market Exchange Rate ('MER'))		100.0%	3.3	3.0	2.9	2.8	3.0	2.5	2.5	2.6
Global (Purchasing Power Parity ('PPP') rates)	100.0%		3.8	3.6	3.5	3.4	3.5	3.1	3.0	3.0
G7	30.6%	46.0%	2.1	1.8	1.6	1.5	2.1	1.8	1.8	1.9
8E7	37.6%	26.6%	5.4	5.2	5.3	5.1	3.6	3.8	3.8	3.8
United States	15.3%	24.3%	2.9	2.4	1.9	1.8	2.4	1.9	1.8	1.9
China	18.2%	15.0%	6.6	6.3	6.2	5.9	2.2	2.4	2.7	2.9
Japan	4.3%	6.1%	0.8	1.0	0.3	0.6	1.1	1.7	1.7	1.2
United Kingdom	2.3%	3.3%	1.4	1.1	1.6	1.8	2.5	1.8	2.0	2.0
Eurozone	10.2%	13.9%	1.7	1.3	1.6	1.5	1.6	1.4	1.8	2.0
France	2.2%	3.2%	1.5	1.3	1.5	1.8	1.9	1.2	1.7	1.9
Germany	3.3%	4.6%	1.5	1.0	1.6	1.4	1.9	1.7	2.0	2.3
Greece	0.2%	0.3%	2.1	2.0	2.2	1.5	0.6	0.6	1.5	1.8
Ireland	0.3%	0.4%	6.4	3.5	3.7	3.0	0.5	1.1	1.5	1.9
Italy	1.8%	2.4%	0.8	0.5	0.9	0.8	1.1	1.0	1.5	1.7
Netherlands	0.7%	1.0%	2.5	1.9	2.3	1.9	1.7	2.4	1.8	2.0
Spain	1.4%	1.6%	2.5	2.3	1.8	2.0	1.7	1.5	1.9	1.9
Poland	0.9%	0.7%	5.0	3.8	3.0	3.0	1.8	2.2	2.5	2.5
Russia	3.2%	1.9%	1.7	1.5	1.8	1.5	4.0	4.5	4.8	4.7
Turkey	1.7%	1.1%	3.0	(0.3)	2.6	2.4	16.3	19.3	14.2	13.0
Australia	1.0%	1.7%	3.2	2.8	2.7	2.8	2.5	2.5	2.5	2.5
India	7.4%	3.3%	7.4	7.6	7.7	7.7	4.8	5.0	4.6	4.1
Indonesia	2.6%	1.3%	5.3	5.2	5.1	5.2	4.0	3.7	4.3	4.1
South Korea	1.6%	1.9%	2.8	2.8	2.8	2.8	1.6	1.9	2.0	2.0
Brazil	2.6%	2.6%	1.3	2.4	2.1	2.1	3.7	4.0	3.9	4.0
Canada	1.4%	2.1%	2.1	2.0	1.8	1.7	2.3	2.1	2.0	1.9
Mexico	1.9%	1.4%	2.1	2.3	2.7	2.7	4.7	4.0	3.5	3.0
South Africa	0.6%	0.4%	0.8	1.6	1.7	1.8	5.3	4.8	5.4	5.5
Nigeria	0.9%	0.5%	2.0	2.5	2.5	2.5	16.3	11.9	13.0	14.0
Saudi Arabia	1.4%	0.9%	2.7	1.9	1.9	2.1	3.5	3.1	3.0	3.0

Sources: PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios. UK and Ireland numbers are contingent on a reasonably smooth Brexit.

Interest rate outlook of major economies

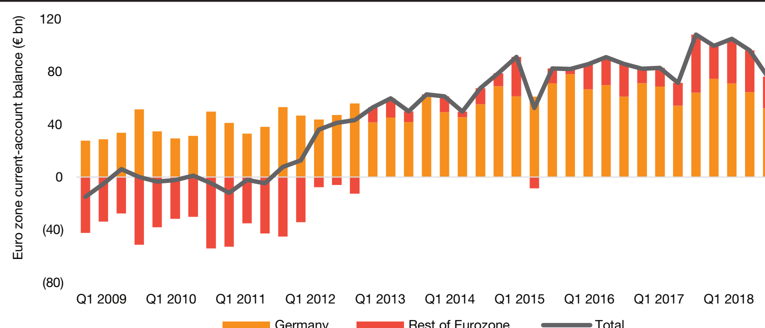
	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	2.25-2.5% (December 2018)	One or two rate rises in the second half of 2019	March 19-20
European Central Bank	0.00% (March 2016)	No rate rise in 2019	April 10
Bank of England	0.75% (August 2018)	A rate rise expected in second half of 2019 on the assumption of a reasonably smooth Brexit	March 21

Chart of the month

The chart on the right shows the transformation of the Euro zone economy's current-account balance from a series of narrow deficits to a long period of significant surpluses.

This reveals that much of the recent economic boom in Europe, when the regional economy grew at an above-trend rate, was driven by stronger demand for European exports from the US and from China. We expect this effect to continue to fade in 2019.

The Euro zone economy was boosted in recent years by growth in export demand from China and the US, but this support is now fading



© 2019 PwC. All rights reserved.

This information is only for general guidance on matters that may be of interest and is provided "as is". While PwC may have performed sensitivity analyses on prospective financial information (PFI) and underlying assumptions, this information and any tables aggregating PwC's comments or observations of vulnerabilities and sensitivities should not be relied upon for any decision making or for any other reason by a person or entity. As events and circumstances frequently do not occur as expected, there may be material differences between PFI and actual results. This information should not be used as a substitute for consultation with your professional advisors. Any use of this information is at the user's own risk.

PwC makes no representations or warranties, express, implied, statutory or otherwise with respect to this information or its content. PwC expressly disclaims any contractual or other duty, responsibility or liability to any person or entity in relation to the content including, without limitation, the PFI and any results from access to this information.

"PwC" refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network. Please see www.pwc.com/structure for further details.

190405-170941-MJ-OS