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Will Private Consumption Maintain Its Firmness?

— Seven reasons why consumption has remained firm compared to declining income—

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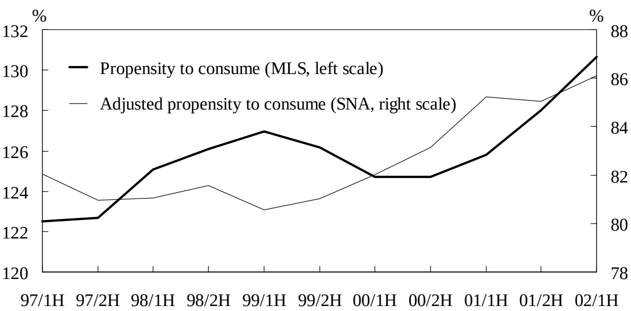
Firmer-than-expected private consumption

Structural adjustments in the labor market continue. These include reduction of bonuses, no regular increase in basic salary, and the switch from regular workers to part-time workers. The decline in household income, therefore, has still not come to a halt.

Macroeconomic statistics, such as GDP consumption, and economic indicators, such as automobile sales and department store sales, all showed that the underlying trend of consumption has been weak. However, another perspective on consumption is that it has been rather firm, taking account of the decline in income. In fact, the share of consumption among household income, that is, propensity to consume has been on an uptrend (Chart 1; bold line).

Hereafter, seven factors will be put forward as hypotheses for the firmness in private consumption despite the decline in income. Based on these factors, the outlook for private consumption is also examined.

Chart 1: Propensity to consume in macroeconomic measures



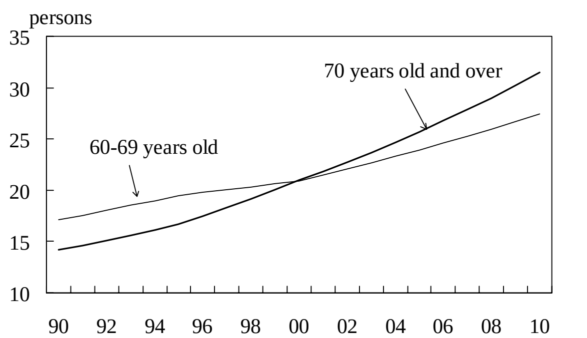
Note: Propensity to consume = private final consumption expenditure / compensation of employees; Compensation of employees = total cash earnings (*Monthly Labour Survey, MLS in the chart*) x number of regular employees (*Labour Force Survey*); Adjusted propensity to consume = (final consumption expenditure of households – imputed rents of owner-occupied houses) / (disposable income of households + fluctuation in pension funds and pension reserves – operating surplus of owner occupied houses)

Sources: Cabinet Office, "National Accounts"; Ministry of Health, Labour and Welfare, "Monthly Labour Survey"; Ministry of Public Management, Home Affairs, Posts and Telecommunications, "Labour Force Survey."

(1) Aging of population

Aging of the population can be considered a long-term and structural factor. In general, elderly households have low income, and the ratio of retired households among them is high. Hence, the ratio of basic consumption, such as food and housing expenses, is large. In view of the life-cycle, elderly households are in the phase of liquidating their assets for consumption. According to the *Family Income and Expenditure Survey* of the Ministry of Public Management, Home Affairs, Posts and Telecommunications, the propensity to consume of worker households was 73 percent, while that of elderly retired households was 126 percent. This indicates that elderly retired households are liquidating their assets for consumption. Hence, the acceleration of aging in the population in recent years has induced the uptrend in the propensity to consume in the macroeconomy (Charts 2 and 3).

Chart 2: Increase in the number of elderly people (Normalize the 20-59 year olds in each year as 100 persons)



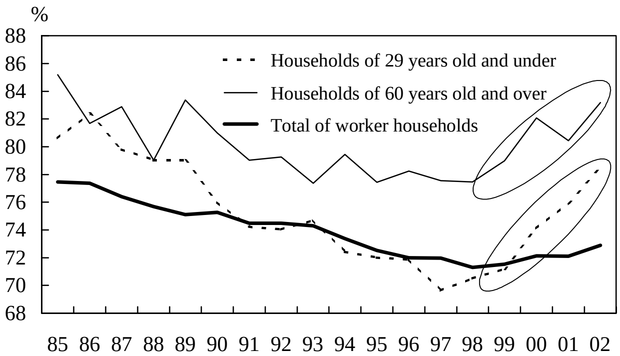
Sources; Ministry of Public Management, Home Affairs, Posts and Telecommunications, "Population Census Report"; National Institute of Population and Social Security Research, "Population Projection for Japan."

(2) Appetite for consumption among youth

By generation, income of the 20-29 age group showed the largest decline, reflecting severe job opportunities and the increase in part-time workers among this generation.

Nevertheless, their appetite for consumption is strong, as can be seen in mobile phone bills and automobile purchases. Consequently, their consumption propensity is rising, and is noticeably similar to that of the elderly (Chart 3). For many youth, whether single or married, their parents seem to be supporting them. This facilitates the rise in the propensity to consume in this generation, even though they face a severe employment situation.

Chart 3: Propensity to consume by age group *(Family Income and Expenditure Survey*)



Sources: Ministry of Public Management, Home Affairs, Posts and Telecommunications, "Family Income and Expenditure Survey," "Annual Report on the Family and Income Expenditure Survey."

(3) Increase in pension benefits and severance pay

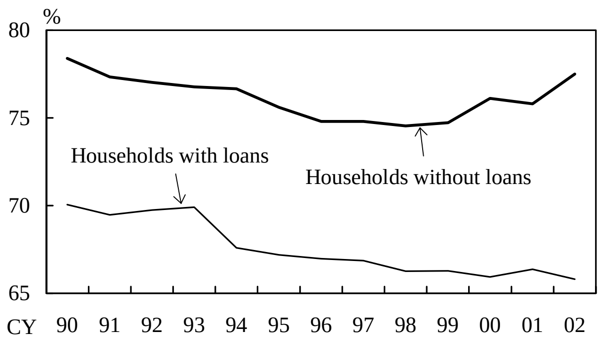
When looking at the developments in income from a macroeconomic perspective, *Monthly Labor Survey*, hereafter *MLS*, is frequently used for its early availability (wages multiplied by number of employees). However, the progress in aging and further restructuring in payroll have raised the total amount of pension benefits and severance pay. Thus, disposable income, including these benefits, has not decreased as much as *MLS* data.

With respect to the trend in the nominal disposable income on the SNA account, i.e., GDP statistics, net pension benefits—the received amount minus reserved amount generation-wide—have contributed to supporting overall income since fiscal 1998. Moreover, the increase in severance pay received during the first half of fiscal 2002 has pushed income up further. Taking these factors into account, the adjusted propensity to consume from the second half of fiscal 2001 shows that the rise was not as large as the propensity to consume on the *MLS* basis (Chart 1; thin line—see chart footnote for the adjusted propensity to consume).

(4) Shift from housing purchases

Households without mortgage loans have a 10 percent higher consumption propensity than those with loans. Even more, the former has shown an upward tendency (Chart 4). Outstanding housing loans have been on an uptrend to date, but with the low demand for new residential housing and the decline in the costs of house acquisition reflecting the falling land prices, the growth of outstanding loans among domestic banks and the Housing Loan Corporation (governmental financial institution) turned negative in 2002. The ratio of households with loan repayments, which had been on the rise since around 1998, has peaked, and started to decline in 2002. This indicates that consumers have possibly shifted their spending from housing investment to private consumption among overall household expenditure during these 1-2 years.

Chart 4: Propensity to consume (those with or without housing loans)



Sources: Ministry of Public Management, Home Affairs, Posts and Telecommunications, "Family Income and Expenditure Survey," "Annual Report on the Family and Income Expenditure Survey."

(5) Inertia in consumption

Private consumption has an inclination to move smoother than income. This can be explained in the following two ways. First, households do not decide their living expenditure based only on their present income. Projections on i) future income and ii) patterns of asset accumulation and liquidation are also broadly taken into consideration (this is the so-called permanent income hypothesis, or life-cycle hypothesis). Therefore, when one considers the income fluctuation to be temporary, consumption does not fluctuate as much as present income.

Second, in general, consumption habits are hard to change; that is, consumption inherently has inertia. For instance, education expenses, housing loans and rents, and food expenses cannot be cut back immediately according to income decline. It also takes some time for consumers to change their consumption habits even for optional living expenditures such as the purchase of luxury goods.

Consumption propensity in recent years has risen when income, mainly in bonuses, declined, and consumers have been maintaining their living expenditure by liquidating their savings. According to the *Public Opinion Survey on Household Financial Assets and Liabilities* conducted by The Central Council for Financial Services Information, an affiliate of the Bank of Japan, there was an increase in the ratio of households responding "withdrew savings due to a decrease in regular income" as the reason for the decrease in financial assets. In particular, this tendency was conspicuous during 1998-1999 and 2001-2002 when household income plunged. This reflects such behavior of households that they are compelled to withdraw savings to keep their living standard.

(6) Improvement in consumer confidence

In late fiscal 2001, anxiety about restructuring as well as angst regarding the terrorist attacks in the U.S. and the BSE problem considerably depressed consumer sentiment. In the first half of fiscal 2002, however, the worst phase in consumer sentiment had passed, due mainly to the recovery in production and to the increase in overtime hours worked and new job offers. In other words, the consumer sentiment that had been severely depressed eased to some degree, and this propped up consumption to some extent.

Since fall 2002, however, the improvement in the employment situation has been slowing, with the production recovery coming to a halt. Thus, close attention should be paid to consumer sentiment, which has started to weaken again.

(7) New products

Passenger car sales in 2002 were favorable mainly because manufacturers introduced and promoted aggressively some high-quality and low-priced small cars, which stimulated consumers' appetite. In addition, communications products such as ADSL and mobile phones with a built-in camera, and audiovisual appliances such as plasma display/LCD TVs and DVD recorders also attracted buyers. Even some "white goods" such as top-open drum washing machines and electrical appliances with negative ion effect and other new features enjoyed strong sales. Other successful strategies to spur consumer demand included *depachika* (food corner in the basement floors of department stores selling foods with a hint of luxury) and online shopping via the Internet.

Outlook for private consumption

In sum, consumption propensity increased throughout 2002 because: (1) the demographic factor has contributed to supporting consumption through the aging of population; (2) the inertia property of consumption has mitigated downward pressure from the decline in income; and (3) there were supports from easing of consumer sentiment that had been severely depressed, and firms' efforts to call forth potential demand.

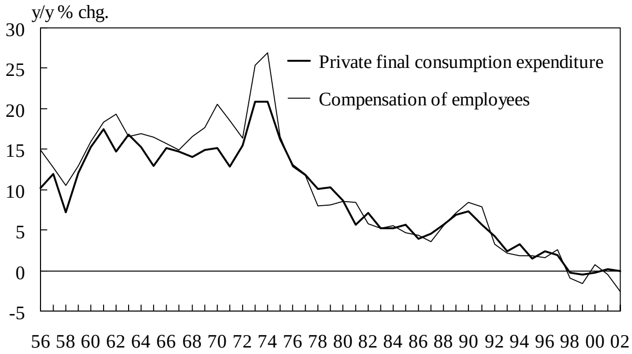
Based on these factors, we briefly look at the outlook for private consumption. The above structural factor (1) is expected to keep contributing to rising trend of the propensity to consume. However, the inertia effect of (2) will possibly dissipate in time: living expenditure will be gradually adjusted toward the appropriate level for current income unless the income situation turns significantly upward.

The emergence and dissipation of the inertia effect can be viewed as follows. Income and consumption have a stable relationship in the long-term (Chart 5). But once this relationship breaks temporarily for some reason such as the inertia effect, consumption is gradually adjusted to recover the original balance with income. This idea can be analyzed by an Error Correction Model (ECM). Applying this method by also taking the aging effect into account, it can be easily seen that consumption during 1998-1999 and in 2002 was stronger than the theoretical level in balance with income in the long term (Chart 6). Therefore, it is natural to conclude that in 2003, downward adjustment pressures will be exerted on consumption relative to income.

Future course of the factor (3) is unpredictable. At least, however, with the uncertainty about the outlook for the economy, developments in consumer sentiment warrant attention.

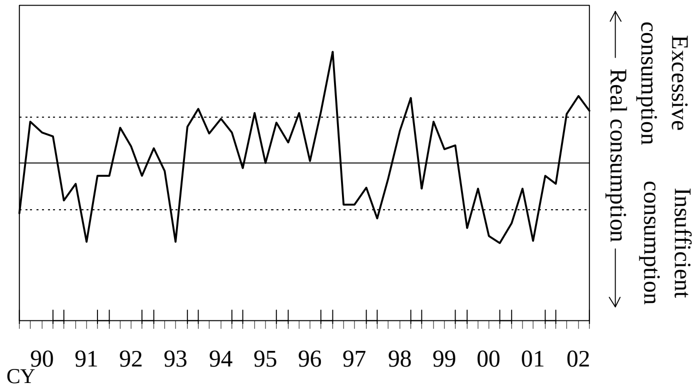
In sum, structural factors such as aging of the population will mitigate the concern of a plunge in private consumption. However, since private consumption to date may have been unsustainable, downside risk in the future should be kept in mind.

Chart 5: Long-term developments in income and consumption



Source: Cabinet Office, "National Accounts."

Chart 6: Strong consumption compared to income (divergence from the long-term balance)



Note: This table has plotted the error correction term (real private final consumption – long-run equilibrium level). The long-run equilibrium relationship is calculated among real compensation of employees, amount outstanding of real financial assets, and the ratio of the elderly (population of 60 years old and over / total population). The dotted line is the standard deviation 1 of the error correction term.

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