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Japan's Economy: Monthly Review

Has a Proper Environment Come Together for Raising the Consumption Tax?

Compared to 1997, domestic demand firm; some uncertainty remains in China and other foreign economies

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Summary

- **Economic outlook revised:** In light of the first preliminary Apr-Jun GDP release (Cabinet Office), we have revised our economic growth outlook. We now forecast real GDP growth of +3.0% y/y for FY13 (previous forecast: +3.1%) and +1.2% for FY14 (+0.7%). We have assumed the formation of the FY13 supplementary budget of around Y3 trillion (new spending basis) and have accordingly revised our FY14 outlook upward.

- **Has a proper environment come together for raising the consumption tax?:** In this report, we provide a multifaceted examination of the pros and cons of raising the consumption tax. At the present moment, we believe that a proper environment has come together for raising the consumption tax as scheduled. Compared to 1997 when the consumption tax was last raised, domestic demand is expected to trend firmly. There will be a need, however, to carefully assess the risk of a downswing in China and other foreign economies.

1. Economic outlook revised

In light of the first preliminary Apr-Jun GDP release (Cabinet Office), we have revised our economic growth outlook. We now forecast real GDP growth of +3.0% y/y for FY13 (previous forecast: +3.1%) and +1.2% for FY14 (+0.7%). We have assumed the formation of the FY13 supplementary budget of around Y3 trillion (new spending basis) and have accordingly revised our FY14 outlook upward.

Apr-Jun 2013 real GDP increased an annualized 2.6% q/q in the first preliminary estimate

In the first preliminary estimate for Apr-Jun 2013 (Cabinet Office), real GDP increased 0.6% q/q, annualized at 2.6%, the third quarterly positive growth in a row, although short of the market consensus (+0.9%; annualized at +3.6%). GDP growth fell below the market consensus mainly due to capex decreasing rather than turning positive as widely anticipated and from the negative contribution made by the sharp decline in inventory investment. Even so, domestic demand contributed positively to q/q GDP growth for the third consecutive quarter (+0.5 percentage points), and foreign demand made the second positive contribution in a row (+0.2 points). Overall, growth is continuing that is well-balanced between domestic and foreign demand. Also, given that the decline in inventory investment placed a substantial downward pressure on the GDP growth, the Apr-Jun result was not as bad as at first glance.

The GDP deflator rose 0.1% q/q, the first increase in five quarters, possibly signaling a bottoming out. On a y/y basis, it declined 0.3%, the 15th consecutive quarterly decline. Deflators for housing investment, capex, and public works spending increased from the previous quarter as companies passed through higher import prices from yen's depreciation and higher building material prices due to firm demand for construction investment. Nominal GDP increased 0.7% q/q, annualized at 2.9%, the third quarterly increase in a row.

Main scenario: Japan's economy to continue growing

After a hitting bottom in November 2012, Japan's economy has entered a recovery phase. We believe it will continue to expand steadily. Economic policies of the Abe administration (so-called "Abenomics") represent an appropriate set of policies with the potential of jump-starting the revival of the Japanese economy and monetary policy measures in particular are yielding marked results. We anticipate that the economy will continue to expand, supported by (1) the expansion of the US economy, (2) the persistent reconstruction demand related to the 2011 Great East Japan Earthquake and the formation of a large-scale supplementary budget, and (3) the ongoing depreciation of the yen and the ascent in stock prices accompanying the BOJ's bold monetary easing.

In terms of demand components, exports are expected to continue increasing. While the risk of a downswing in the Chinese economy will have to be kept in mind, exports will benefit from the expansion of overseas economies centering on the US and from the positive effects of yen's depreciation since end-2012 which has materialized with a lag. The improvement in corporate profits from the growth in exports is expected to increase personal consumption through higher household income. While capex remains sluggish, it is likely to improve reflecting the improvement in corporate profits and business confidence. Other factors will also come into play such as the reacceleration of public works spending from the implementation of the FY12 supplementary budget, and a surge in personal consumption and housing investment is highly likely in 2H FY13 in advance of the consumption tax hike scheduled for April 2014. Thus, we believe that the economy will gradually pick up speed in FY13.

Characteristics of the current recovery

When we compare the current recovery with past recoveries, the current recovery is distinguished by a robust household sector that is being supported by a recovery in consumer confidence from a rising stock market. While the improvement in the income environment, exports, and capex was somewhat slow in relative terms, these categories are actually not faring all that poorly compared to past recoveries in Japan and the US.

Two criticisms against Abenomics not well-founded

Two criticisms are currently being made against Abenomics: (1) it will have an adverse impact on the economy if long-term interest rates rise and (2) employee income will fail to increase as inflation progresses, and living standards will fall, we believe these criticisms have little basis. Going forward, the Abe administration will need to actively engage in measures such as (1) the maintenance of fiscal discipline by making fundamental reforms to the social insurance system and (2) strengthening comprehensive growth strategies through deregulation and the reduction of the effective corporate tax rate.

Four risk factors: Examination of the world economic cycle

Risks that will need to be kept in mind regarding the Japanese economy are: (1) turbulence in emerging economies, (2) China's shadow banking problem, (3) a reigniting of the European sovereign debt crisis, and (4) a surge in crude oil prices stemming from geopolitical risk. Of these four risks, it is worth underscoring that the first is closely related to the second and third.

Looking at the world economic cycle, advanced economies led by the US drove emerging economies in the past. However, a decoupling has currently taken place—advanced economies are performing well but emerging economies are stagnating. We believe that this decoupling is occurring for three reasons: (1) the dwindling in the amount of loans from European financial institutions to emerging economies in light of the European debt crisis, (2) the sluggishness of the Chinese economy, and (3) concerns that money will be taken out of emerging economies based on worries that the Federal Reserve Board will implement exit measures from a third round of quantitative easing (QE3). In the final analysis, we anticipate that the collapse of emerging economies will be avoided as the US economy continues to expand. Nevertheless, the state and the future direction of the Chinese economy will continue to require close monitoring.

BOJ monetary policy

With the recovery of Japan's economy, we believe that the timing for the BOJ to implement further accommodative measures will be FY14 or later. The BOJ is likely to purchase additional risk assets (ETFs and other assets) in Apr-Jun 2014 or later in part to mitigate the adverse impact of a higher consumption tax rate.

2. Has a Proper Environment Come Together for Raising the Consumption Tax?

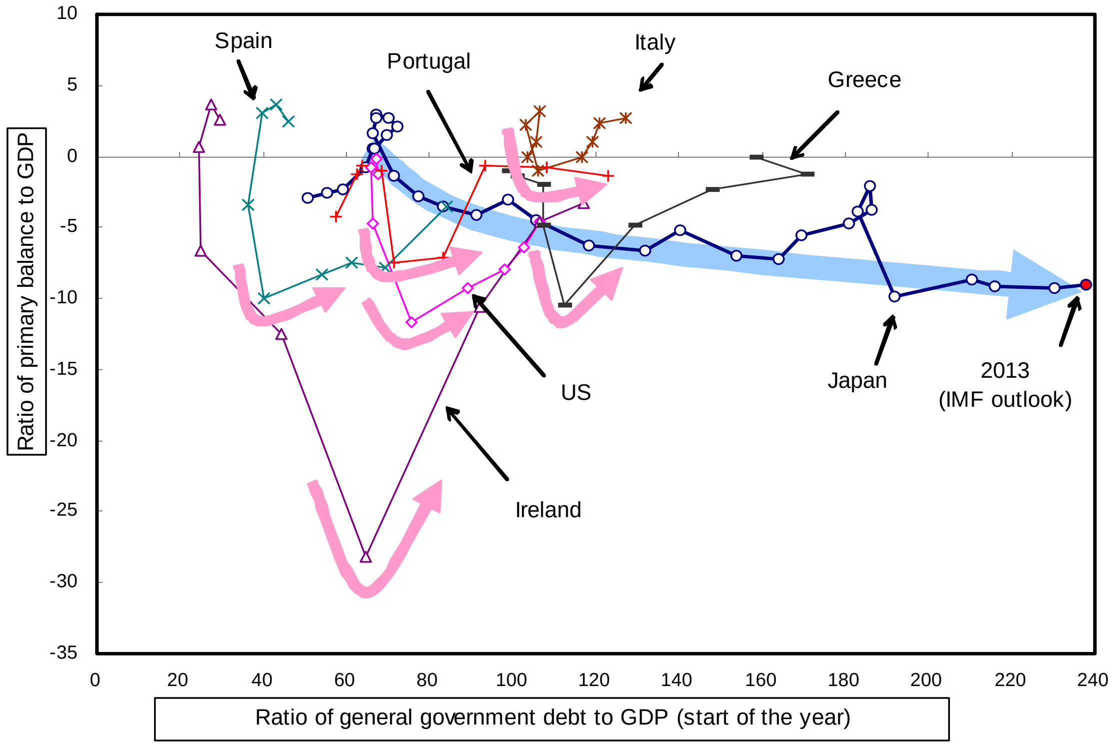
2.1 Necessity for increasing the consumption tax

Japan risks forfeiting the sustainability of government finances

The biggest concern that Japanese are concerned about with respect to Abenomics is the risk that the government failing to maintain fiscal discipline will invite the triple blow of falling JGB prices, falling stock prices, and a falling yen.

It hardly needs mentioning that government finances are facing a crisis in Japan. Chart 1 examines conditions for the sustainability of budget balances as formulated by Henning Bohn, professor of economics at the University of California.

Primary Balance and General Government Debt (% of GDP) **Chart 1**



Source: IMF; compiled by DIR.
Note: 1981-2013 for Japan and 2005-13 for others; IMF outlook for Japan and Portugal from 2011 and others from 2012.

Clearly, Japan's situation is far worse than that facing southern European nations. In the chart, the vertical axis shows the ratio of the primary balance to GDP and the horizontal axis the ratio of general government debt to GDP at the start of the year. In simple terms, a line graph rising to the right indicates that budget balances are sustainable, and a line graph falling to the right indicates that such balances are unsustainable. In other words, nations with line graphs rising to the right are those where the ratio of general government debt to GDP at the start of the year (budget balance on a stock basis; horizontal axis) is problematic, but, at the same time they are nations that are just about managing government finances in a way that promises improvement with respect to the ratio of the primary balance to GDP (budget balance on a flow basis; vertical axis). In contrast, nations with line graphs falling to the right are those where the ratio of general government debt to GDP is problematic, and, despite this situation, are also managing government finances in a reckless manner that will further worsen the ratio of the primary balance to GDP.

Southern European nations are positioned to the left of Japan in the chart, positioning clearly lower than Japan's place along the horizontal axis (ratio of general government debt to GDP at the start of the year). Also, the line graph for Japan is basically trending toward the lower right, which casts serious doubt on the sustainability of its budget balance. In contrast, European nations are generally trending to the upper right, and it is possible to say that their budget balances are sustainable, albeit only just.

The prospect of the European sovereign debt crisis spreading to Japan and giving way to a sharp decline in JGBs is not by any means remote. It will be important for the Japanese government to accept European sovereign risk as a valuable lesson and to work toward rebuilding government finances such as by raising the consumption tax.

Reducing social security costs will be key to achieving sound government finances in Japan

Increasing the consumption tax alone will be insufficient to achieve sound government finances in Japan and a substantial reduction in social security costs will be essential.

Chart 2 presents simulation results for the medium- to long-term fiscal balance. We developed seven scenarios comprising varying pairs of nominal and real GDP growth rates in Japan and then simulated the fiscal balance for different growth rates in social security costs under respective scenarios. The results are shown in terms of ratio of the primary balance to nominal GDP as of FY20. According to simulation results, even in Scenario 1 (optimistic one with nominal growth of 3.0% and real growth of 2.0%) for the medium- to long-term trend, social security costs will have to be reduced at an annual pace of 4% in the latter half of the 2010s if the primary balance is to turn positive in FY20. Considering social security costs have been on an uptrend in recent years, a very high hurdle stands in the way of achieving a balanced primary balance in FY20.

FY20 Primary Fiscal Balance (% of GDP) **Chart 2**

Scenario		1	2	3	4	5	6	7
Nominal GDP		+3.0%	+2.0%	+1.5%	+1.0%	+0.0%	-1.0%	-2.0%
Real GDP		+2.0%	+2.0%	+1.0%	+1.3%	+0.6%	-0.1%	-0.7%
Social security expenditure	+4%	-3.0	-3.4	-3.9	-4.1	-4.8	-5.6	-6.4
	+3%	-2.5	-3.0	-3.4	-3.6	-4.3	-5.0	-5.8
	+2%	-2.1	-2.5	-3.0	-3.1	-3.8	-4.5	-5.2
	+1%	-1.6	-2.1	-2.5	-2.7	-3.3	-4.0	-4.7
	+0%	-1.2	-1.6	-2.1	-2.2	-2.8	-3.5	-4.1
	-1%	-0.8	-1.2	-1.6	-1.8	-2.4	-3.0	-3.6
	-2%	-0.5	-0.8	-1.2	-1.4	-1.9	-2.5	-3.1
	-3%	-0.1	-0.4	-0.8	-1.0	-1.5	-2.1	-2.7
	-4%	0.3	-0.1	-0.5	-0.6	-1.1	-1.7	-2.2

Source: Compiled by DIR based on various materials.

Major assumptions

1) Consumption tax to rise by 3% pt in April 2014 and 2% pt in Oct 2015.
2) Figures in the table on central/local government basis; figures used for calculation are general government basis for employee compensation and central/local government basis for other.
3) Nominal and real GDP growth rates through FY15 estimated by DIR; thereafter as described in scenarios.
4) Elasticity of tax revenue vs. nominal GDP assumed to be 1.1.
5) Real revenues other than taxes extended based on nominal GDP growth rate.
6) Growth rate of social security expenditure through FY15 estimated by DIR based on “Estimation of Impact of FY13 Budget on Revenue and Expenditure in Following Years” (Ministry of Finance; in Japanese).
7) Public gross fixed capital formation through FY15 estimated by DIR and assumed to grow at the same rate as nominal GDP thereafter.
8) Interest payment = outstanding balance of public debt (previous FY) x effective interest rate (previous FY) + increased portion of public debt x long-term interest rate.
9) Other expenditure extended based on nominal GDP growth rate.

2.2 Conditions are met for raising the consumption tax

Here we provide a multifaceted examination of the pros and cons of raising the consumption tax by comparing the current situation with the last time the tax was raised in 1997.

The collapse of personal consumption in 1997 was triggered by Japan's financial crisis and the Asian currency crisis

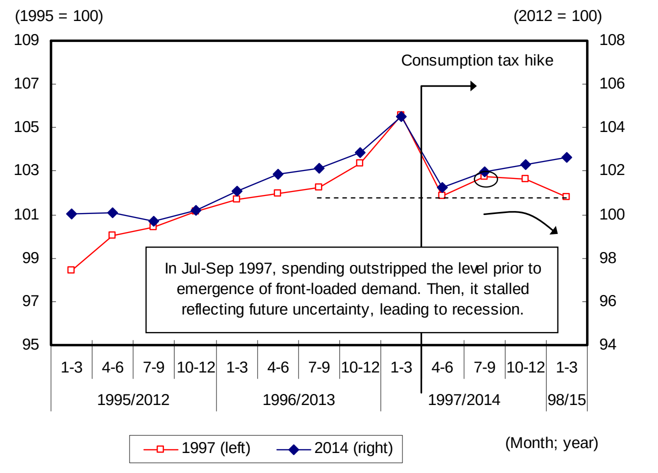
Chart 3 compares trends of personal consumption before and after consumption tax hikes (actual figures for the 1997 case; estimates for the 2014 case). Our conclusion is that personal consumption would not collapse as it did in 1997 if the consumption tax is raised in April 2014.

In the case of the consumption tax hike in April 1997, personal consumption retreated in Apr-Jun 1997 in reaction to the surge in demand in the previous quarter, but it then returned to its level before the surge in demand in Jul-Sep 1997. Thus, the collapse of personal consumption that began in Oct-Dec 1997 is best explained by factors other than the increase in the consumption tax.

Main reasons for the collapse of personal consumption in 1997 were (1) escalation of Japan's financial crisis following the bankruptcy of Hokkaido Takushoku Bank in Autumn 1997 and by Yamaichi Securities, and (2) the Asian currency crisis.

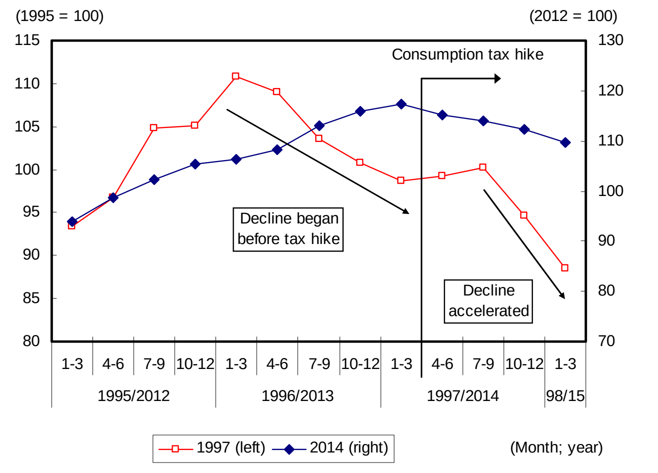
Unlike the situation in 1997, Japan's financial system is currently exceedingly sound. While the risk that China and other foreign economies will rapidly slow down deserves some consideration, as will be noted below, the likelihood that personal consumption will collapse following the consumption tax hike is limited in view of such factors as (1) the adoption of measures to ease sudden changes in purchase prices such as for automobiles and (2) prospects that domestic demand other than personal consumption will trend firmly.

Consumer Spending and Consumption Tax Hike
Chart 3



Source: Cabinet Office; compiled by DIR.
Note: DIR estimate from Jul-Sep 2013.

Public Investment and Consumption Tax Hike
Chart 4



Source: Cabinet Office; compiled by DIR.
Note: DIR estimate from Jul-Sep 2013.

Flexible fiscal expenditures can be counted on this time

Chart 4 portrays the trend of public works spending before and after raising the consumption tax. Beginning in 1995, public works spending rose, such as for reconstruction projects in the aftermath of the Great Hanshin Awaji Earthquake. Spending then rapidly declined around the time of the consumption tax hike in 1997. In addition to the decrease in consumption and housing investment from higher consumption tax, the adverse impact of decrease in public works spending placed a significant downward pressure on the economy. Currently, however, it is likely that fiscal expenditures will be made more flexibly, such as through the formation of the FY13 supplementary budget and the accelerated implementation of the FY14 budget.

Volatility of housing investment will be less than that of 1997

Currently, measures to level fluctuations in demand will have a significant effect in moderating the impact of the consumption tax hike. When the consumption tax was increased in 1997, hardly any measures were taken to mitigate the adverse effect arising from fluctuations in demand. There is no denying that the surge in demand for automobiles and housing prior to the tax hike and the downward reaction that followed were excessive.

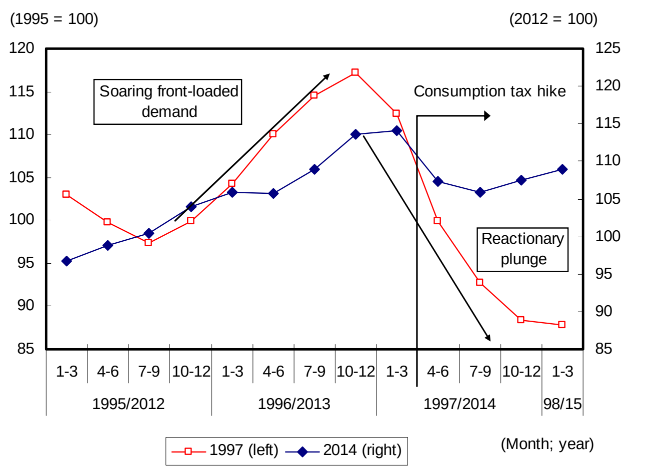
In particular, the acceleration of demand in 1997 and the downward reaction that followed were quite drastic for housing investment (Chart 5). This development did not just affect housing investment but did spread to the consumption of related construction materials and household durables, and domestic demand experienced a broad contraction.

In the current instance, however, measures are being taken to mitigate a similar surge in demand, such as expanding tax breaks for home loans and creating new subsidies for home purchases. The latest statistics indicate that housing investment pre-tax hike has not risen as rapidly as it did in 1996. While front-loaded demand is likely to accelerate to some degree before the tax hike, it is reasonable to think that the magnitude of this acceleration will be weaker than it was in 1997. Thus, a scenario where housing investment triggers the sharp reactionary contraction of domestic demand should be viewed only as a remote possibility.

Capex to bottom out

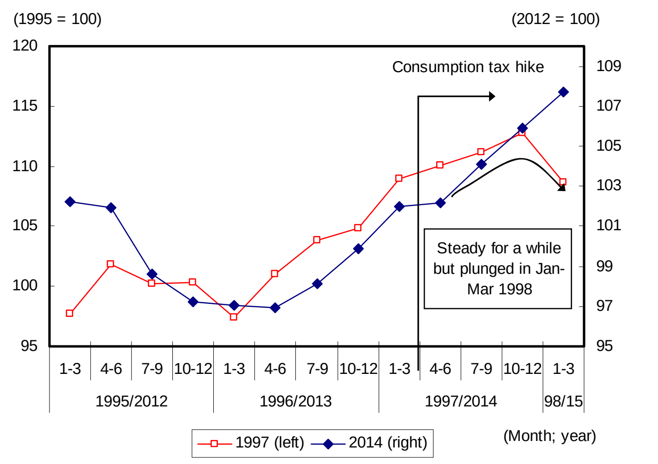
Chart 6 portrays the trend of capex before and after raising the consumption tax. Although capex continued to grow after the tax hike, it declined in Jan-Mar 1998, affected by the Asian currency crisis and uncertainties in the financial system in Japan.

Housing Investment and Consumption Tax Hike
Chart 5



Source: Cabinet Office; compiled by DIR.
Note: DIR estimate from Jul-Sep 2013.

Capex and Consumption Tax Hike
Chart 6



Source: Cabinet Office; compiled by DIR.
Note: DIR estimate from Jul-Sep 2013.

While it is true that the current capex trend is similar to that of 1997, does this mean that capex will collapse again after the increase in the consumption tax rate as it did before? Our answer to this question is No.

In 1997, Japanese companies devoted a large share of cash flow to capex, and the proportion of investments going into expanding production capacity was large. Hence, once the economy began slowing down, there was considerable scope for reducing capex. In contrast, as will be discussed below, current capex has fallen to its lower limit and there is hardly any space to further reduce capex. Also, in terms of the capital stock cycle, capex is moving towards an expansionary phase.

Housing starts remain low compared to potential demand

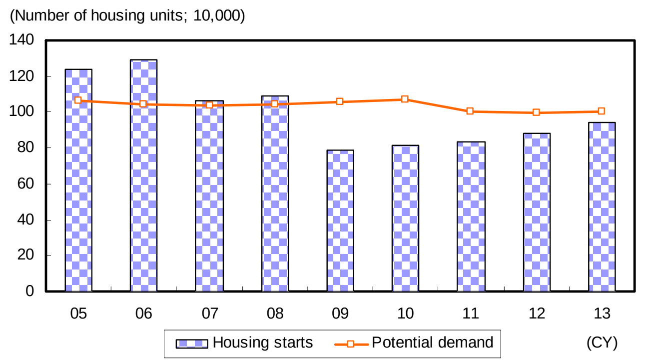
In the paragraphs to follow, we present a more detailed analysis on housing investment and capex.

Housing investment is continuing to trend at a level below its full potential. As indicated in Chart 7, compared to our estimate of potential demand, housing starts have been stuck at an excessively low level since the Lehman crisis. Thus, it is reasonable to think that pent-up demand will be a factor supporting housing investment following the consumption tax hike.

Housing reconstruction picks up in disaster-affected areas

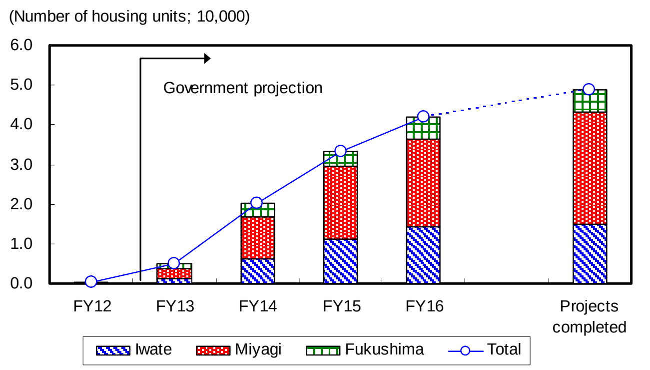
Housing reconstruction in disaster-affected areas will also be a factor supporting housing investment (Chart 8). According to the Reconstruction Agency, there are plans to build around 50,000 housing units in disaster-affected areas through reconstruction projects such as public housing. While this is a small figure compared to housing as a whole, it should still mitigate some of the decline in housing construction.

Housing Starts and Potential Demand for Housing Chart 7



Source: Ministry of Land, Infrastructure, Transport and Tourism; compiled by DIR.
Notes: 1) Jan-Jun figures annualized for 2013 housing starts.
2) For potential demand, we first estimated that for owner occupied housing by multiplying the prospective number of households by the housing acquisition rate by generation and aggregating results. Then we estimated that for housing for rent based on difference between number of households and that of owner occupied housing. And finally, we added the prospective number of scrap/build housing for both.

New Housing from Government Reconstruction Projects Chart 8



Source: Reconstruction Agency; compiled by DIR.
Note: Public housing for disaster affected households and private-sector housing relocated to newly-developed residential sites.

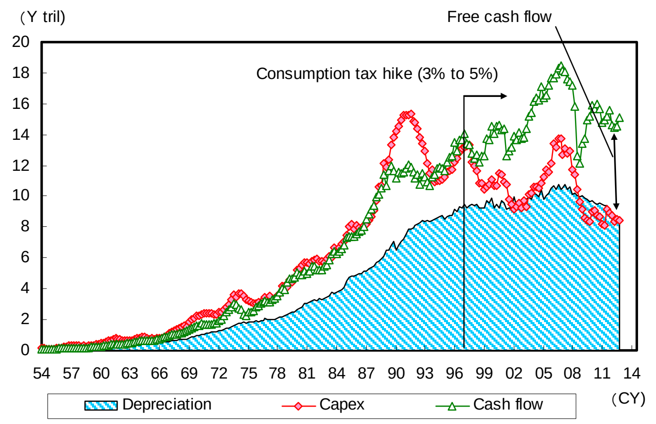
Capex has fallen to nearly its lower limit

Companies are currently devoting only about 60% of their cash flow to capex, and capex is trending at a level below depreciation (Chart 9). Looking back over the last 60 years, it is unusual to find a situation where capex is less than depreciation—in other words, where net investment is negative. With corporate profits improving from the effects of Abenomics, it is difficult to imagine capex contracting even further. Rather, should expectations strengthen for future economic growth, there is substantial room for capex to increase.

Capital stock cycle suggests capex is moving toward an expansionary phase

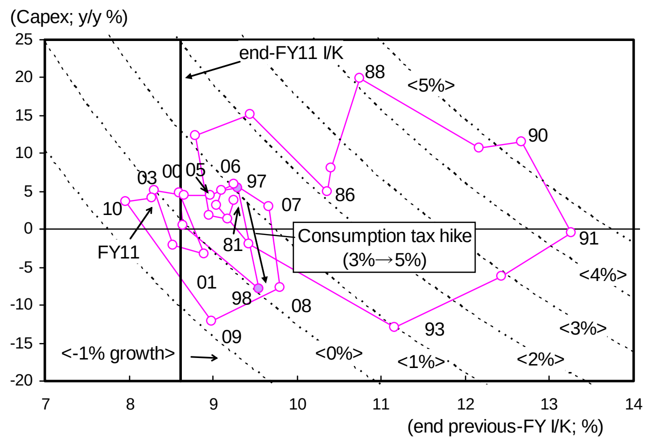
Chart 10 portrays Japan's capital stock cycle. In 1997 and 1998 around the time when the consumption tax was raised, the sharp decline in the expectation for economic growth led to the contraction of capex. Currently, however, the adjustment of capital stock has for the most part completed. Even if companies expect the economy to grow by around 0%, capex will still increase y/y. Should the expectation for economic growth rise further driven by Abenomics, capex has the potential of gaining further momentum.

Capex and Cash Flow **Chart 9**



Source: Ministry of Finance; compiled by DIR.
Note: Cash flow = Recurring profit / 2 + depreciation. Seasonally adjusted by DIR.

Capital Stock Cycle **Chart 10**



Source: Bank of Japan.

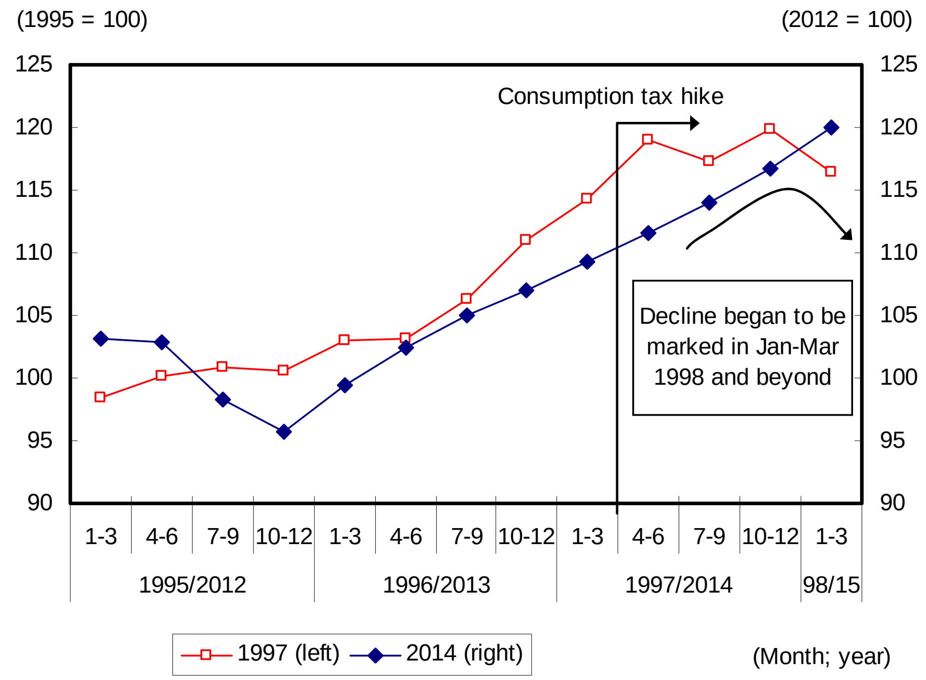
Domestic demand anticipated to be firm overall

As discussed above, components of domestic demand such as personal consumption, public works spending, housing investment, and capex are expected to trend firmly going forward. Should robust domestic demand bolster corporate activity represented by industrial production, which in turn improve business results, employee income would also rise. A positive cycle where improving income environment provides further support to vigorous domestic demand is desirable.

Risk of a downswing by China and other foreign economies will need careful monitoring

There will be a need, however, to carefully monitor the risk of a downswing in China and other foreign economies. The Asian currency crisis of 1997 resulted in the sharp contraction of exports to Asia. Currently, there are concerns that the money flow to emerging economies will subside, which will in turn place downward pressure on such economies, as the Federal Reserve Board considers an exit from QE3. It is not an overstatement to say that China represents the greatest risk to Japan's economy. Concerns about the collapse of a credit bubble continue to cast a shadow on China, as seen in the attention being paid to the shadow banking problem. Should these risk factors actually materialize, the impact on the Japanese economy will be enormous. In conclusion, it is unquestionable that the state of China and other foreign economies will need to be carefully looked at on an ongoing basis.

Exports and Consumption Tax Hike — Chart 11



Source: Cabinet Office; compiled by DIR.
Note: DIR estimate from Jul-Sep 2013.

Economic impact of raising the consumption tax will differ by how it is raised

Summarizing the above, while there will be a need to carefully monitor the risk of a downswing in China and other foreign economies, given the firmness of domestic demand, we believe that a proper environment has come for raising the consumption tax as scheduled.

The Abe administration is examining how to go about raising the consumption tax in the process of deciding whether to do so. Chart 12 shows the results of using our short-term macroeconomic forecasting model to analyze how different cases of consumption tax hikes would affect GDP. In each of the cases, the economy will contract sharply the year the positive effect on the economy of increased demand pre-hike wears out. However, in FY19, when the successive increase in the consumption tax rate ends, GDP will be about 0.7% less in all cases compared to the case where the consumption tax is not raised. Thus, whatever approach is taken to increasing the consumption tax, there will be little difference on its impact to the economy in flow terms.

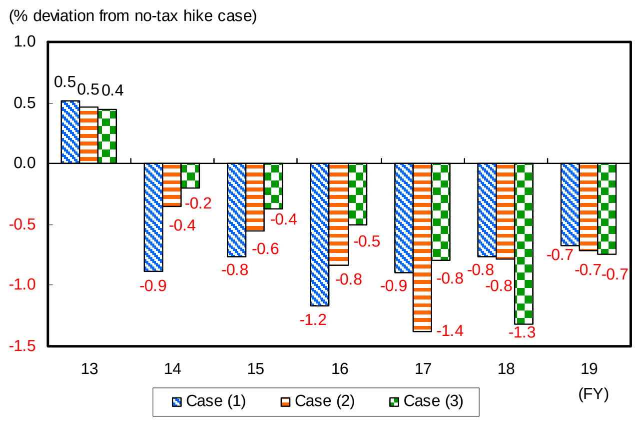
A trade-off between adverse impacts on the economy and higher tax revenues

While it does appear that raising the consumption tax in steps of 1% will have a smaller impact on the economy, such a case will be accompanied by a corresponding decrease in tax revenues (Chart 13). Comparing all the cases in FY19 when the consumption tax reaches 10%, cumulative tax revenues would be larger by around Y10 trillion in Case 1 than in Case 3. However, the cumulative adverse impact on real GDP would be larger by about Y6 trillion in Case 1 than in Case 3. In other words, a trade-off relationship exists between higher tax revenues and an adverse impact on GDP. Given a situation where economic growth and improving government finances must occur together, there will be a need to determine the right approach to increasing the consumption tax through careful cost-benefit analysis.

Existence of administrative costs makes increasing the consumption tax in small steps unrealistic

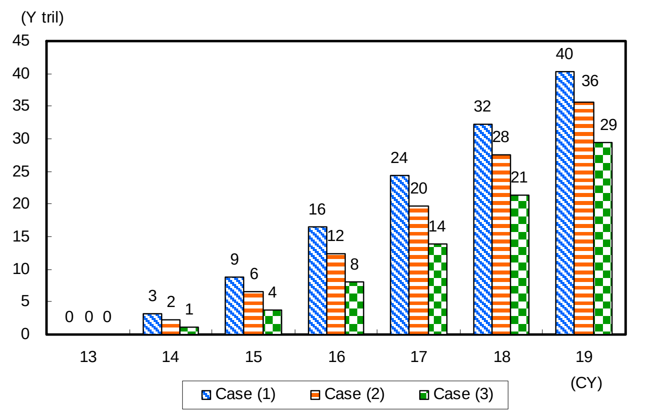
The above estimation does not factor in the administrative costs associated with increasing the consumption tax. There are in fact many problems with raising the consumption tax in small increments, such as higher costs for retailers, companies that must reprogram computer systems, and the increased volatility of the capacity utilization rate from the boost and decline of demand before and after each tax hike. Moreover, problem of tax-related profiteering—in other words, large companies forcing their suppliers to take on the difference in price—is an issue that cannot be ignored. To conclude, in practical terms, raising the consumption tax by small increments each year will prove to be an extremely difficult task.

Impact on Real GDP by Consumption Tax Hike Pattern — Chart 12



Source: Compiled by DIR.
Note: Estimates based on Daiwa short-term macroeconomic model:
Case 1: Consumption tax to rise from 5% to 8% in Apr 2014 and to 10% in Oct 2015.
Case 2: Consumption tax to rise from 5% to 7% in Apr 2014 and to 10% by 1% pt every April from 2015.
Case 3: Consumption tax to rise to 10% by 1% pt every April from 2014.

Cumulative Tax Revenue by Consumption Tax Hike Pattern — Chart 13



Source: Compiled by DIR.
Notes: 1) Central government general account basis.
2) Estimates based on Daiwa short-term macroeconomic model:
Case 1: Consumption tax to rise from 5% to 8% in Apr 2014 and to 10% in Oct 2015.
Case 2: Consumption tax to rise from 5% to 7% in Apr 2014 and to 10% by 1% pt every April from 2015.
Case 3: Consumption tax to rise to 10% by 1% pt every April from 2014.

Outlook for Japanese Economy, Interest Rates — Chart 14

	2012	2013				2014	FY11	FY12	FY13	FY14
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
Indicator	Actual			DIR estimates			Actual		DIR estimates	
Real GDP										
Q/q %, annualized	1.0	3.8	2.6	4.1	4.7	5.9				
Y/y %	0.4	0.3	0.9	2.9	3.8	4.2	0.3	1.2	3.0	1.2
Current account balance SAAR (Y tril)	4.3	3.1	8.5	8.7	9.6	10.1	7.6	4.4	9.2	15.0
Unemployment rate (%)	4.2	4.2	4.0	4.0	4.0	3.9	4.5	4.3	4.0	3.9
CPI (excl. fresh foods; 2010 prices; y/y %)	-0.1	-0.3	0.0	0.4	0.6	0.7	-0.0	-0.2	0.4	2.9
Unsecured overnight call rate (period end; %)	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
10-year JGB yield (period average; %)	0.76	0.66	0.77	0.80	0.90	0.95	1.05	0.76	0.86	1.05

Source: Compiled by DIR.
Note: Estimates taken from DIR's *Japan's Economic Outlook No. 178*.