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Japan's Economy: Monthly Review

What to make of the consumption tax hike?

Japan's economy is expected to continue gradual expansion

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Summary

- **Economic outlook revised:** In light of the second preliminary Oct-Dec GDP release (Cabinet Office), we have revised our economic growth outlook. We now forecast real GDP growth of +2.2% y/y for FY13 (previous forecast: +2.3%) and +1.0% for FY14 (+1.0%). Our new outlook for FY15 is +1.5% (unchanged from previous forecast). (For further detail, see "Japan's Economic Outlook No. 180 Update (Summary)," by Mitsumaru Kumagai, 18 March 2014.) Japan's economy is expected to continue expanding in the future for the following reasons: (1) Firming up of exports due to US economic recovery, (2) Ongoing depreciation of the yen and stock price highs in response to BOJ's monetary easing, and (3) Effects of government's economic policy accompanying consumption tax hike.
- **Four major issues facing Japan's economy:** In this report we examine four major issues facing Japan's economy: (1) The need to increase wages, (2) BOJ's price stability target, (3) The current account deficit, and (4) Economic disparity.

1. Economic Outlook Revised

Economic outlook revised:

In light of the second preliminary Oct-Dec GDP release (Cabinet Office), we have revised our economic growth outlook. We now forecast real GDP growth of +2.2% y/y for FY13 (previous forecast: +2.3%) and +1.0% for FY14 (+1.0%). Our new outlook for FY15 is +1.5% (unchanged from previous forecast). (For further detail, see "Japan's Economic Outlook No. 180 Update (Summary)," by Mitsumaru Kumagai, 18 March 2014.) Japan's economy is expected to continue expanding in the future for the following reasons: (1) Firming up of exports due to US economic recovery, (2) Ongoing depreciation of the yen and stock price highs in response to BOJ's monetary easing, and (3) Effects of government's economic policy accompanying consumption tax hike.

Real GDP growth rate revised downwards from First Preliminary Estimate

The real GDP growth rate for the Oct-Dec 2013 period (second preliminary estimate) was revised downward from the first preliminary estimate (+1.0% q/q annualized and +0.3% q/q) to +0.7% q/q annualized and +0.2% q/q. Figures were down somewhat below market consensus (+0.9% q/q annualized and +0.2% q/q), but there were no surprises. We thus maintain our view on the economy.

Main scenario: Japan's economy to continue growing

After 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 policies in particular are yielding marked results. We believe Japan's economy will continue to expand steadily supported by (1) increases in exports backed by the US economic recovery, (2) ongoing depreciation of the yen and the rise in stock prices supported by the BOJ's monetary easing, and (3) economic stimulus measures to offset the effects of the consumption tax hike.

As for the outlook for the Japanese economy, the period of Jan-Mar 2014 is expected to see a major increase in the growth rate due to the effect of last minute demand on personal consumption. The Oct-Dec 2013 GDP figures have been pushed up a certain amount due to last minute demand especially in the area of housing investment and durable goods. Meanwhile, immediately before the upcoming tax hike, non-durables and semi-durables are also expected to see last minute demand, putting increasing upward pressure on growth. But then a reaction to last minute demand in the form of a downturn is thought to be inevitable, so the period of Apr-Jun 2014 will likely see a decline in real GDP. However, exports, which moved into a growth trend this time around, are expected to strengthen that trend as overseas economies, lead by the US, continue to expand, and as Japan improves its global competitiveness thanks to the weak yen. Meanwhile, increasing exports will lead to production growth and improved earnings, and this is expected to trigger more capex. This in turn should lead to an increase in wages, and could also lead to a recovery in households. We believe that the Japanese economy will be back on the growth track by the period of July-Sept 2014.

Four risks facing Japan's economy

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.

Examining 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 Fed will implement exit measures from a quantitative easing. 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.

2. Main economic scenario for Japan

Abenomics represents an appropriate set of economic policies in accord with global standards

In this section, we examine our main scenario for Japan’s economy in light of the discussion of the previous sections. After 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 policies in particular are yielding marked results. We anticipate that the economy will continue to expand, supported by (1) increases in exports based on the recovery of the US economy, (2) the ongoing depreciation of the yen and the ascent of stock prices accompanying the BOJ’s monetary easing, and (3) the effect of economic stimulus measures accompanying the increase of the consumption tax.

Corporate sector rebounds

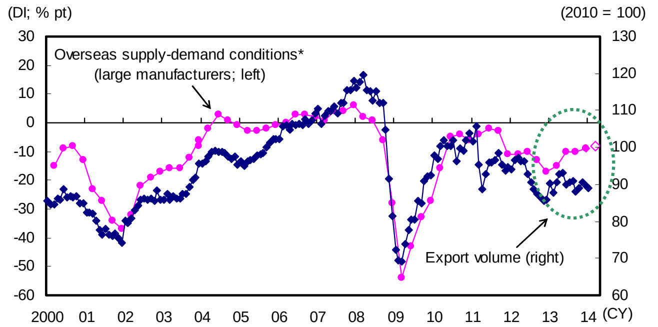
Supported in part by Abenomics, Japan’s economy is on a path toward recovery. An examination of the current economic environment reveals that major economic indicators of the corporate sector have clearly turned upward.

First, as indicated in Chart 1, the diffusion index for overseas supply and demand conditions for products (large manufacturers) in the BOJ Tankan survey of corporate sentiment, which displays a close relationship with Japan’s export volume index, is improving.

Second, Japan’s economy has rebounded sharply in terms of the inventory cycle. As shown in Chart 2, where the y/y change in shipments is plotted along the vertical axis and inventories along the horizontal axis, the y/y change in shipments has turned positive.

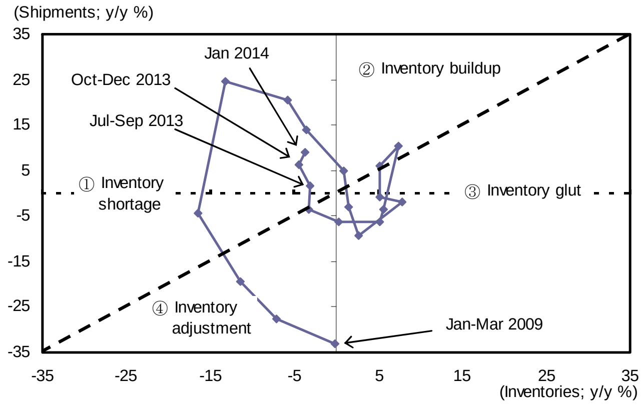
Third, as is shown in Chart 3, though somewhat belated, it is very likely that capex has hit bottom.

Overseas Supply and Demand Conditions vs. Export Volume **Chart 1**



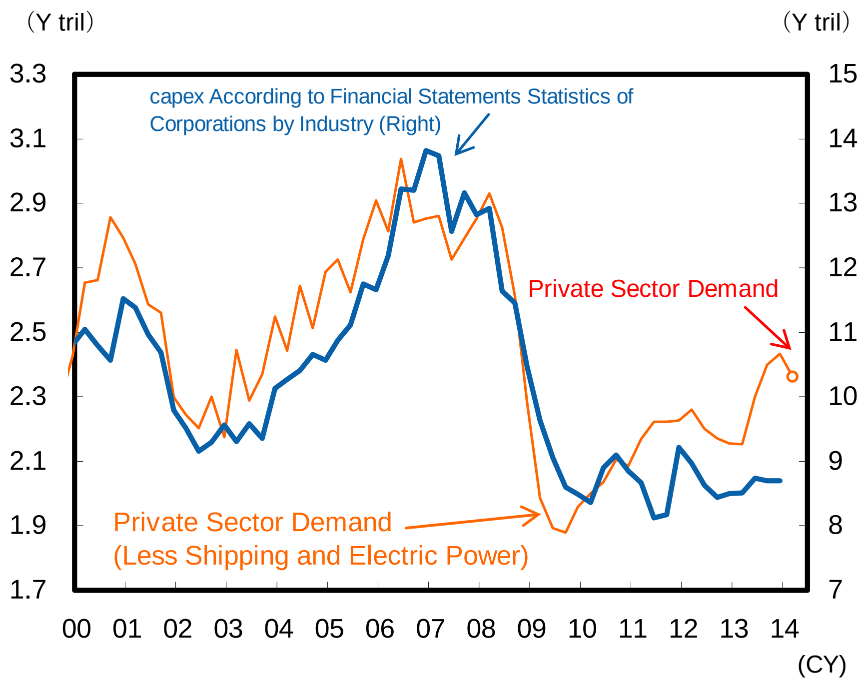
Source: Bank of Japan (BOJ), Cabinet Office; compiled by DIR.
*BOJ Tankan survey of corporate sentiment; "excess demand" minus "excess supply"; latest quarter=forecast.

Inventory-shipment Cycle **Chart 2**



Source: Ministry of Economy, Trade, and Industry; compiled by DIR.

Machinery Orders (Less Shipping and Private Sector Electric Power) and capex According to Financial Statements Statistics of Corporations by Industry **Chart 3**



Source: Cabinet Office (CAO), Ministry of Finance
Note: Figures are on a quarterly basis.

Foreign economies to recover centering on the US

The greatest factor that will support Japan's economy going forward is the prospect that foreign economies will recover centering on the US. Chart 4 portrays the trend of Japanese exports by trading partner. OECD Composite Leading Indicators (CLIs) for respective partners tend to lead the volume of Japanese exports to the corresponding region by two to three months. OECD CLIs of the US and Europe are currently bottoming out, a positive development for Japan.

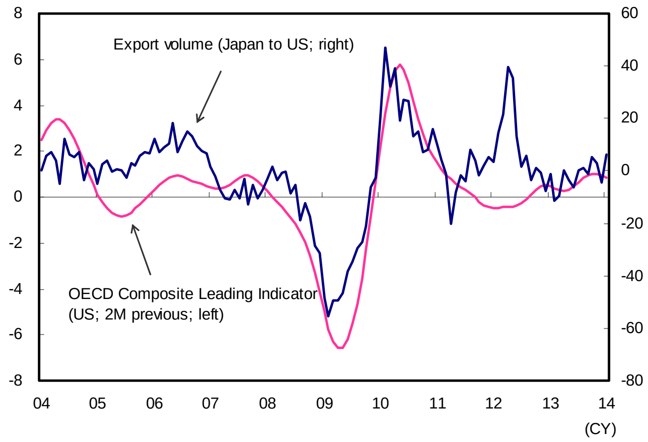
A bird's eye view of the current world economic environment shows the advanced nations performing favorably while the emerging nations are in a downturn. This means that decoupling is occurring between these economies.

Regarding the direction of the world economy, which forms the premise of our current forecast, we assume that (1) the US economy will steadily recover and drive the growth of the world economy, (2) Eurozone economies will stagnate from the sovereign debt crisis while having put the worst behind, and (3) China's economy will avoid a bottom deepening, supported for the time being by the effects of fiscal and monetary measures.

In conclusion, it is the advanced economies with the US at their helm which will determine the course of events for the world economy. We see the world economy gradually expanding in 2014, pulled along by the US.

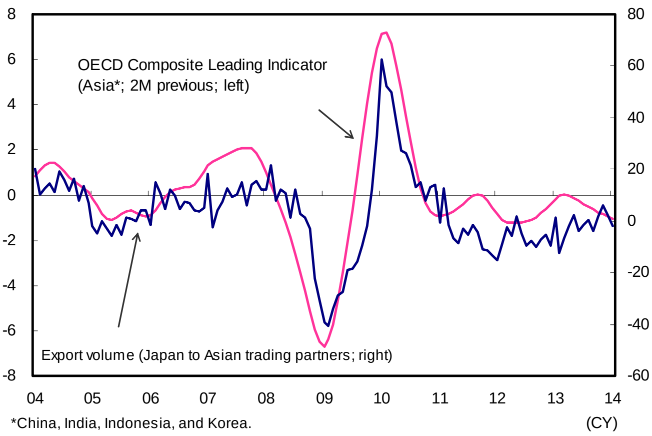
Japan's Exports by Trading Partner **Chart 4**

US Economy and Japan's Exports *(y/y %)*



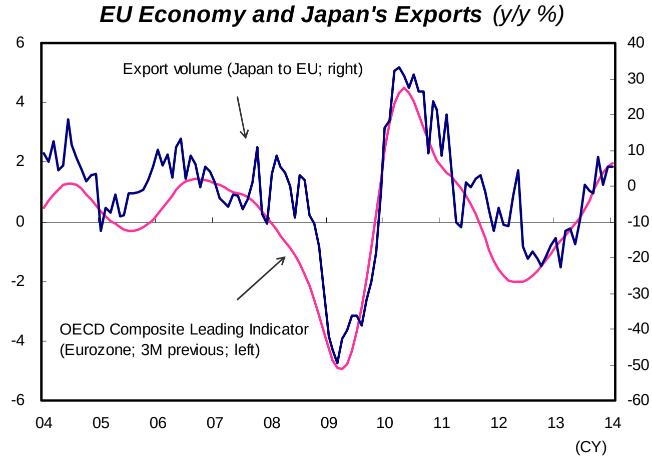
Source: OECD, Ministry of Finance; compiled by DIR.

Asian Economy and Japan's Exports *(y/y %)*



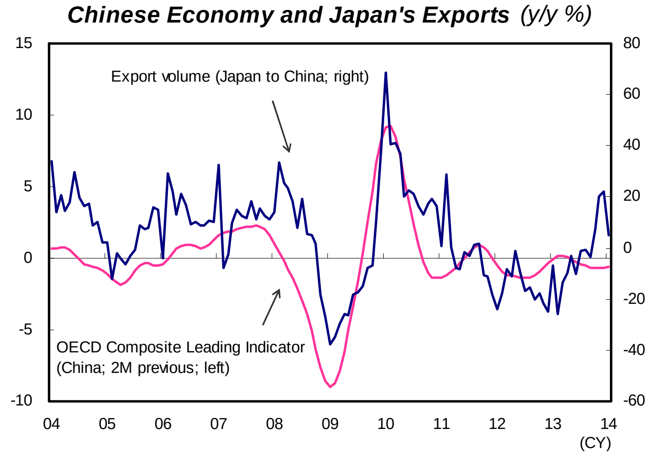
Source: OECD, Ministry of Finance; compiled by DIR.

EU Economy and Japan's Exports *(y/y %)*



Source: OECD, Ministry of Finance; compiled by DIR.

Chinese Economy and Japan's Exports *(y/y %)*



Source: OECD, Ministry of Finance; compiled by DIR.

Last minute demand has already appeared in the area of automobiles and housing

The major factor influencing the economy in the immediate future is the consumption tax hike which goes into effect in April 2014. Here we examine a phenomenon which is expected to arrive before the actual tax hike takes place, that of last minute demand.

One of the areas where obvious last minute demand can already be seen is that of automobiles. Unit sales of new automobiles are maintaining a level exceeding that experienced the last time there was a tax hike (April 1997). The number of new cars sold is around the same level as occurred as a result of last minute demand in August 2010 when sales rose dramatically just before government subsidies for eco-friendly car purchases came to an end. Therefore it is not an overstatement to say that last minute demand is already manifest in the area of automobiles. Automobile sales are expected to maintain their current level until March this year, then are likely to fall dramatically in April and beyond.

Last minute demand has also been observed in other areas. Housing is one of these. In this case, the requirement is that contracts must be signed by September 2013, while move-in must take place by the end of March 2014. Because of these parameters, condominium sales grew dramatically in September 2013 and then declined in October. Even so, the reactionary decline experienced at that time was slight in comparison to the last time a tax hike was enforced. Looking at housing starts the same pattern can be discerned, the numbers peaking in October during the last tax hike, and then entering a downtrend immediately after. However, at this point there is still no sign of a reactionary decline after the period of last minute demand. Performance continues its firm undertone. A reactionary decline should be unavoidable for housing investment as well, and the expectation is that possibilities are high that it will occur. However, this time around the government plans on implementing measures to ease possibly abrupt fluctuations in the market, such as housing benefits and special tax breaks to stimulate the market. Another tax hike is planned in 2015, but reactionary decline is expected to be less dramatic.

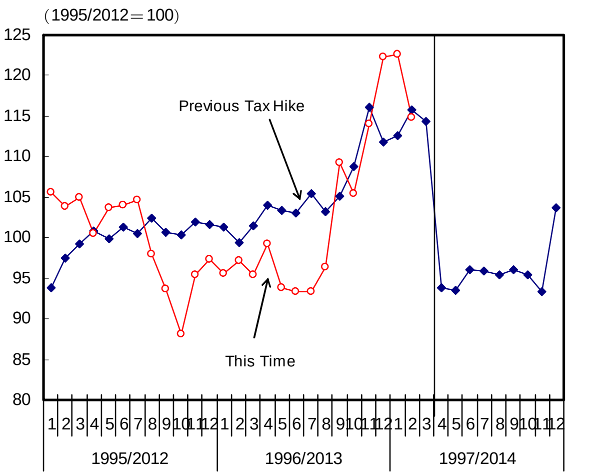
Looking at the trend in home appliances, the growth trend is gradual in comparison to the last time a tax hike was implemented. Of course, with the increase in housing investment, sales of air conditioners and other major appliances are also favorable. As for other home appliances, such as televisions, it is possible that some last minute demand will be seen, but it is expected to be at a relatively low level in comparison to other items. Home appliances overall continue at a fairly weak level in comparison to the last time there was a tax hike.

Generally speaking, last minute demand tends to appear in the major appliances (i.e. durables) which have a long service life and are therefore easier for the consumer to store up. However, taking a look at the content of personal consumption during the last tax hike, it appears that last minute demand occurred for semi-durables and nondurables. Meanwhile, this time around not much last minute demand is seen at all for either semi-durables or nondurables. However, there is still a very good chance that last minute demand will appear for these kinds of items once March rolls around, and is expected to push the numbers up for personal consumption during the Jan-Mar 2014 period.

Now perhaps we should stop and consider what kind of effect this last minute demand has on the supply side. What kind of effect will this have on production? During the last tax hike, production of consumables tended to climb just before the implementation of the tax hike just like the last minute demand for purchasing the items. However, unlike demand, production did not experience as major a decline afterwards. It is assumed that manufacturers rely more on existing inventory to absorb the extreme ups and downs caused by last minute demand and reactionary decline. In this way they can avoid excessive fluctuation in their business. In conclusion, production is expected to experience major growth just before the new consumption tax comes into force, but a major downturn in production immediately after the tax goes into effect is not likely.

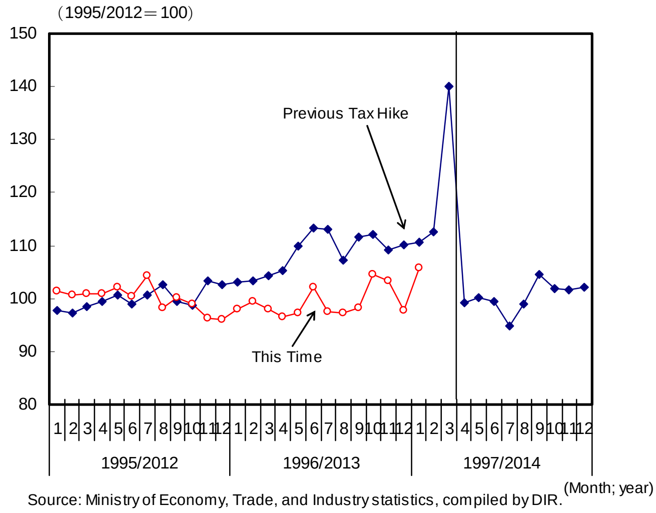
Effects of Consumer Tax Hike on Japan's Economy — Chart 5

Comparison With Previous Tax Hike: New Car Sales
(Seasonally Adjusted)



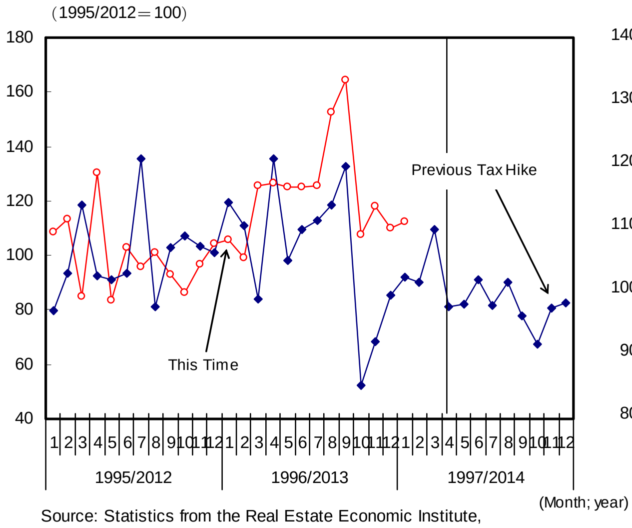
Source: Japan Automobile Dealers Association statistics, compiled by DIR.
Note: Seasonally adjusted figures supplied by DIR.

Comparison With Previous Tax Hike: Home Appliance Sales
(Seasonally Adjusted)



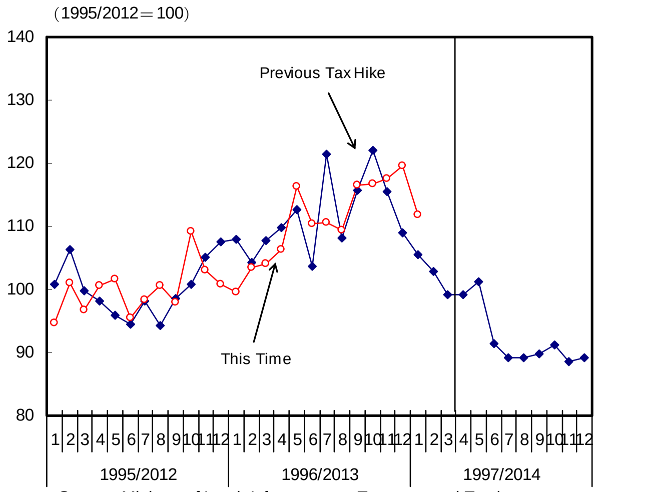
Source: Ministry of Economy, Trade, and Industry statistics, compiled by DIR.
Note: Data from the machinery and appliances retail industry, nominal sales amount

Comparison With Previous Tax Hike: Tokyo Metropolitan Area New Condominium Units Released (Seasonally Adjusted)



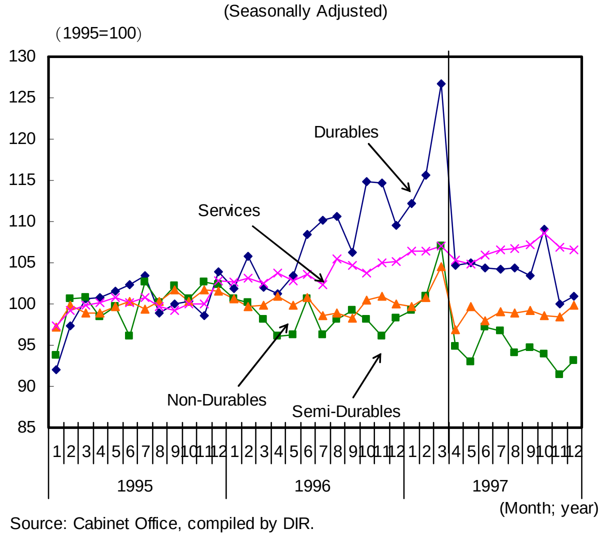
Source: Statistics from the Real Estate Economic Institute, compiled by DIR.
Note: Seasonally adjusted figures supplied by DIR.

Comparison With Previous Tax Hike: New Housing Starts
(Seasonally Adjusted)



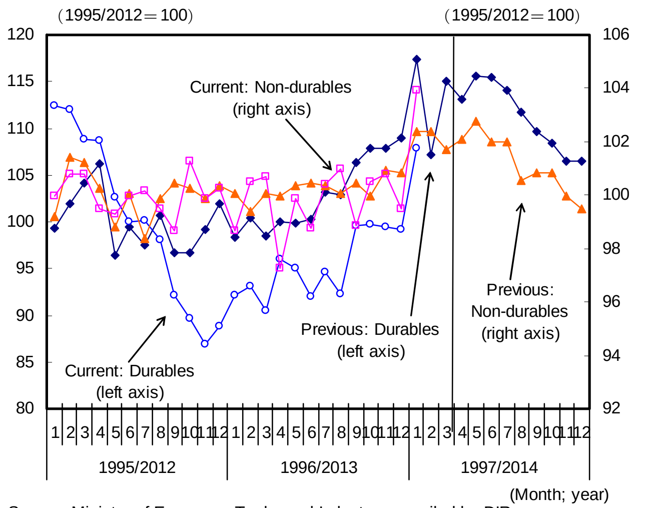
Source: Ministry of Land, Infrastructure, Transport and Tourism, compiled by DIR.

Previous Tax Hike: Consumer Trend by Type of Goods
(Seasonally Adjusted)



Source: Cabinet Office, compiled by DIR.

Comparison With Previous Tax Hike: Consumer Goods Production
(Seasonally Adjusted)



Source: Ministry of Economy, Trade, and Industry, compiled by DIR.

Effects of the consumer tax hike on Japan's economy

In this section we examine the effects of the consumer tax hike on Japan's macroeconomic situation in light of trends associated with last minute demand (see Chart 6).

Automobiles sales have surpassed the momentum seen during the last tax hike and continue to maintain positive performance. In contrast, home appliances have not experienced much last minute demand. This leads us to conclude that impact on personal consumption overall will be about the same as it was the last time there was a tax hike. Meanwhile, in the area of home sales, reactionary declines are expected to be limited throughout the year 2014.

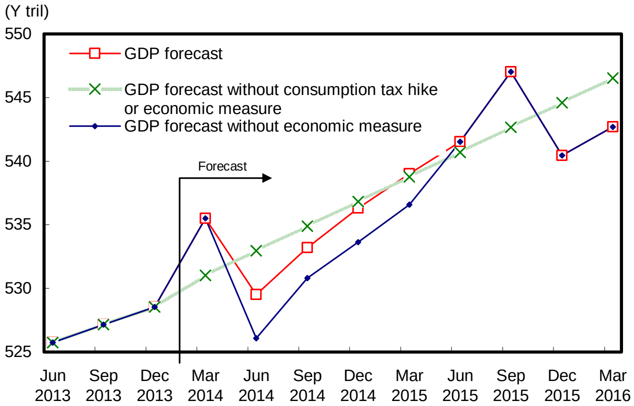
A second tax hike is planned to go into effect in October 2015 when the consumption tax is to be increased from 8% to 10%. Since a large number of households will already have purchased durables before the April 2014 tax hike, the magnitude of reactionary decline on personal consumption is expected to be relatively small. However, since a certain level of last minute demand will no doubt occur in the areas of services, semi-durables and nondurables, personal consumption is expected again to see a surge in last minute demand during the Jul-Sep 2015 period.

Some households may actually find it more advantageous to purchase a home after the April 2014 tax hike rather than before. In contrast, the purchase of a home after the October 2015 tax hike will actually be disadvantageous for most households. Hence housing investment after the October 2015 tax hike may very well suffer a decline. As a result, housing investment as recorded in GDP statistics on a progressive basis is expected to suffer a major decline after the Oct-Dec 2015 period.

Considering these various effects together, we see the consumption tax hike pushing the real GDP growth rate up by 0.67% pt in FY 2013, but then pushing it downward by 1.03% pt in FY 2014, and finally pushing the real GDP growth rate back up again by 0.35% pt in FY 2015.

Effect of Consumer Tax Hike on GDP **Chart 6**

Effects of Consumer Tax Hike and Economic Policy on GDP



Source: Cabinet Office (CAO), Compiled by DIR.
*Simulation result based on DIR macroeconomic model.

Effects of Consumer Tax Hike on Economy

	Change in level (%)			
	FY13	FY14	FY15	FY16
Real GDP	0.68	-0.32	0.02	-0.15
Real personal consumption	0.70	-0.87	-0.13	-0.18
Real housing investment	5.83	3.00	-0.61	-8.18
	Change in growth rate (% pt)			
	FY13	FY14	FY15	FY16
Real GDP	0.67	-1.03	0.35	-0.18
Real personal consumption	0.71	-1.57	0.75	-0.05
Real housing investment	5.90	-2.59	-3.45	-7.50

Source: Compiled by DIR.
*DIR estimates based on DIR short-term macroeconomic model.

Japan's Economy and Interest Rate Outlook

Chart 7

Indicator	2013	2014				2015	FY12	FY13	FY14	FY15
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
	Actual	DIR estimates					Actual	DIR estimates		
Real GDP										
Q/q %, annualized	0.7	5.3	-4.4	2.8	2.4	2.0				
Y/y %	2.6	2.7	0.6	1.1	1.4	0.7	0.6	2.2	1.0	1.5
Current account balance SAAR (Y tril)	0.2	-2.2	-0.3	1.1	2.6	3.9	4.4	1.9	1.8	5.8
Unemployment rate (%)	3.9	3.8	3.8	3.8	3.8	3.8	4.3	3.9	3.8	3.7
CPI (excl. fresh foods; 2010 prices; y/y %)	1.1	1.3	3.2	2.9	2.8	2.9	-0.2	0.8	3.0	1.5
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; %)	0.64	0.70	0.75	0.80	0.80	0.85	0.78	0.71	0.80	1.00

Source: Compiled by DIR.

Note: Estimates taken from DIR's Japan's Economic Outlook No. 180 Update.