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Japanese report: 24 May 2019

Japan's Economy: Monthly Outlook (May 2019)

Resumption of US-China “cold war” could cause Japanese exports to suffer a maximum decline of around 1.3 tril yen

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Summary

- In light of the 1st preliminary Jan-Mar 2019 GDP release we have revised our economic growth outlook. We now forecast real GDP growth of +0.5% in comparison with the previous year for FY19, and +0.5% in comparison with the previous year for FY20. Japan's economy will most likely continue cruising at low altitude in the future, with a growth rate below that of the potential growth rate.
- Japan's economy has continued to mark time at zero growth since the end of 2017. This has been due to stagnant exports and subsequent inventory adjustment. With overseas demand lacking much movement, domestic demand has increased in importance, but this area has also been in the doldrums of late. The collapse of the price of crude oil since the autumn of 2018 brought some temporary leverage to household real income, but now that crude oil is on the way up again, that positive factor will fall by the wayside in the future. In addition, plans are to increase the consumption tax in October 2019, and this means it will be difficult to expect a full-fledged recovery for some time.
- With no hope for a recovery scenario for domestic demand, overseas demand will have to bottom out and make a comeback in order for the Japanese economy to manage a full-fledged return to a growth trend where the growth rate will exceed potential growth. Both positive and negative factors have recently appeared for exports to China, which have continued to play the role of stimulating overseas demand (exports). On the positive side, the Chinese economy can be expected to bottom out soon due to economic measures implemented by the government. Growth in financing and infrastructure investment are especially promising at this time.
- But now this positive factor has been ruined by the resumption of the US-China “cold war”. According to an estimate which includes the concept of value-added exports in its calculation model, Japan's export value can be expected to decline by approximately 0.7 tril yen due to additional US and China tariffs which have already been decided on. Meanwhile, if the US imposes additional tariffs of 25% on almost all Chinese products, Japanese exports could be forced downwards by approximately 1.3 tril yen.
- At the same time, the effects of US-China trade friction on the Japanese economy are not all bad. First of all, the imposition of tariffs increases revenue. If the US and China make use of the fiscal income which is generated to increase government expenditure, the economic shock of the tariffs may be offset somewhat. Meanwhile, if the tariffs which the US and China have imposed on each other lead to growth in substitute production in the emerging nations, including Southeast Asia, this would likely generate opportunities for Japanese corporations to expand their sales networks in these countries. This factor would be an important path to improving Japan's exports and putting Japan's economy back onto the road to full-fledged recovery.

Economic Growth Outlook Revised: +0.5% in FY19 and +0.5% in FY20

The real GDP growth rate for Jan-Mar 2019 (1st preliminary est) exhibited growth of +2.1% q/q annualized (+0.5% q/q), exceeding the upper limit of market consensus (-0.4% to +0.4% q/q).

However, most of the growth was contributed by overseas demand (+0.4%pt in comparison to the previous period) due to the decline in imports. Domestic demand's contribution to GDP also grew at +0.1%pt, but if we ignore the inventory factor (private sector inventory's contribution to GDP was at +0.1%pt) there was actually zero growth in domestic demand.

Domestic demand components which did manage to record positive growth were those considered to have been influenced by last minute demand prior to the expected increase in consumption tax, such as private sector housing investment (+1.1% q/q), and public fixed capital formation (+1.5%), which saw an increase in budget associated with disaster prevention and mitigation measures. Private sector final consumption expenditure was down by -0.1%, while private sector capital expenditure fell by -0.3%. There is essentially no change in our previous assessment, which sees the Japanese economy in a lull.

Japan's economy to continue cruising at low altitude, below its potential growth rate

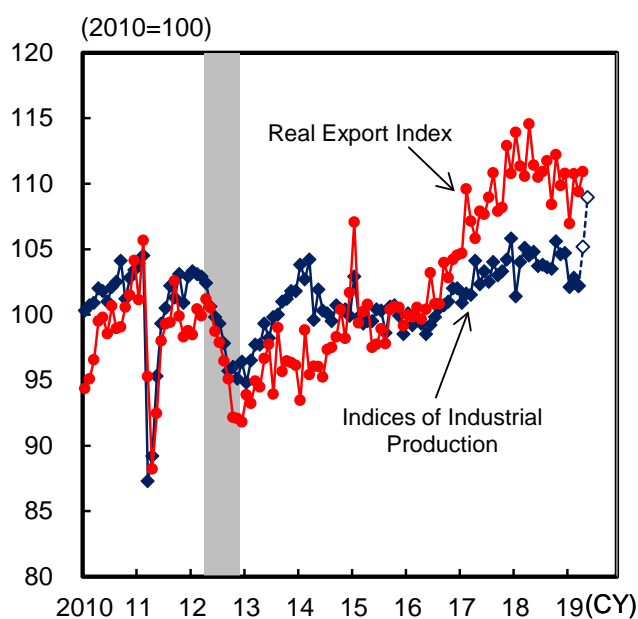
In light of the 1st preliminary Jan-Mar 2019 GDP release we have revised our economic growth outlook. We now forecast real GDP growth of +0.5% in comparison with the previous year for FY19, and +0.5% in comparison with the previous year for FY20. Japan's economy will most likely continue cruising at low altitude in the future, with a growth rate below that of the potential growth rate.

Japan's economy has continued to mark time at zero growth since the end of 2017. This has been due to stagnant exports and subsequent inventory adjustment (Chart 1 & Chart 2).

With overseas demand lacking much movement, domestic demand has increased in importance, but this area has also been in the doldrums of late. The collapse of the price of crude oil since the autumn of 2018 brought some temporary leverage to household real income, but now that crude oil is on the way up again, that positive factor will fall by the wayside in the future.

Real Exports and Industrial Production

Chart 1

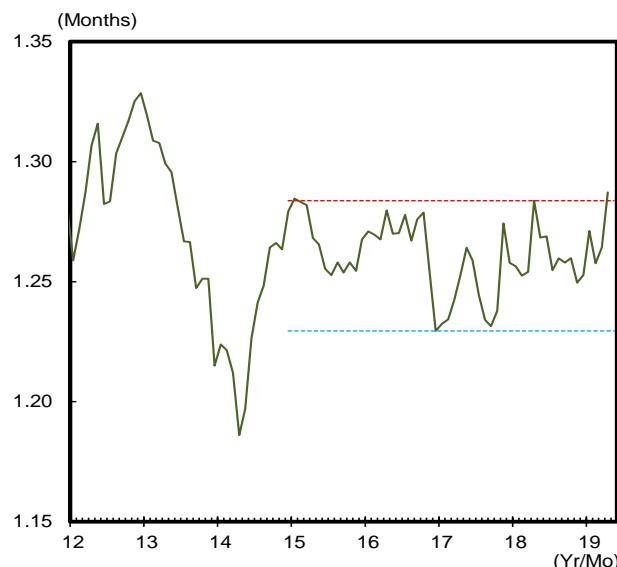


Source: Bank of Japan, Ministry of Economy, Trade and Industry, Cabinet Office; compiled by DIR.

- Notes: 1) Shaded areas represent periods of recession.
2) Latest two months of industrial production data utilizes figures from METI production forecast survey.

Number of Inventory Months: Manufacturing Industry

Chart 2



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

- Notes: 1) Inventory months = real inventory value (end month balance) / real shipment value (monthly amount, 12-month backward moving average).
2) Real inventory value and real shipment value were calculated using values from the METI Census of Manufacture (2015) and extending those figures using the Indices of Industrial Production.

Full-fledged recovery not expected for some time for either overseas or domestic demand

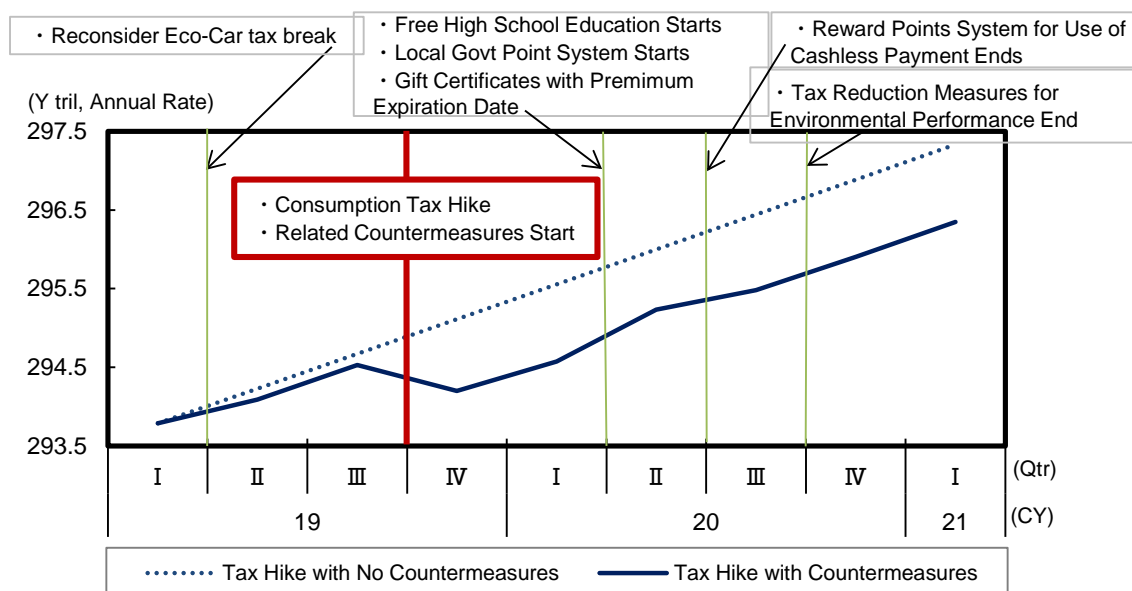
In addition, effects of the planned consumption tax hike in October 2019 are expected to become manifest¹.

The increase in the consumption tax rate is estimated to bring a total increase in tax burden of around 5.7 trillion yen considering both the central government and regional governments. Increase in burden related to financial resources from a review of the tobacco tax and income tax is expected to be around 0.6 trillion yen. But at the same time, a reduced tax rate will also be introduced, thereby reducing this by around 1.1 trillion yen, bringing the total in expected tax burden to around 5.2 trillion yen. Free preschool education and expanded social security are expected to bring an increase in benefits of around 3.2 trillion yen. The overall result is expected to bring an estimated fiscal austerity effect on a net basis of around 2.0 trillion yen.

In addition, a variety of economic measures are to be implemented. There is expected to be an overall total of around 2.3 trillion yen, and is likely to be an amount larger than the amount of growth in tax revenue provided by six-months' worth of consumption tax increase (around 1.0 tril yen between October 2019 and March 2020). However, when we look at the central factors in the consumption tax hike countermeasures, the majority is in public investment, mostly for the purpose of strengthening national resilience, such as disaster prevention and mitigation (a total of 1.35 tril yen). Hence the area that will gain most of the direct benefits is expected to be the construction sector rather than households.

Considering the above, fiscal matters will likely be somewhat of a negative factor in relation to consumption in FY2019, while at the same time public investment will have a positive effect, and may push overall domestic demand up just a bit. Of course, by FY2020 the effects of the various consumption tax hike countermeasures will have disappeared. As a result, growth led by domestic demand will come to a stop. Hence Japan's economy will most likely mark time for some time to come.

Effects of Consumption Tax Hike and Related Countermeasures on Consumption (Illustration) Chart 3



Source: Cabinet Office, Various News Outlets; compiled by DIR.

Notes: 1) Effect of local government point system expected to be the same as gift certificates with premium.

2) Figures for tax hike with countermeasures do not take into consideration last minute demand or reactionary decline.

¹ For details see the DIR Report dated 21 February 2019, *Concern should be more about approaching the growth ceiling rather than economic slowdown*, by Shunsuke Kobayashi & Yota Hirono.

Hopes were pinned on Chinese economy bottoming out, bringing recovery for Japan's exports

With lack of movement for domestic demand, overseas demand will have to bottom out and make a comeback in order for the Japanese economy to manage a full-fledged return to a growth trend where the growth rate will exceed potential growth. Both positive and negative factors have recently appeared for exports to China, which were a drag on overseas demand (exports) in the past.

On the positive side, the Chinese economy can be expected to bottom out soon due to economic measures implemented by the government². Looking back at the events of 2018, we can see that rather than the US-China trade friction, it was the change in China's own economic policies that was the most influential factor in the stalled economy. As is shown in Chart 5, Chinese exports began to decline significantly in November of 2018. In contrast, consumption and fixed asset investment began losing speed at the beginning of 2018. Consumption slowed further in October of the same year. In other words, domestic demand became distorted before overseas demand. It is difficult to associate the slowdown in domestic demand with US-China trade friction.

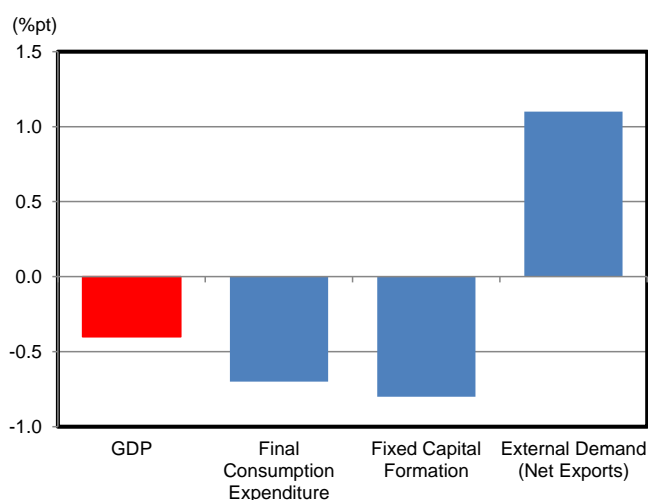
The major causes of stalled domestic demand were (1) strengthening of regulations regarding wealth management products, (2) putting the squeeze on infrastructure projects, (3) introduction of regulations regarding inter-individual consumer finance, and (4) suspension of tax reduction on automobile purchases. As for these first two policies, the government made a 180 degree turnaround after the beginning of 2019, and this is expected to encourage China's economy to bottom out.

First we look back at what was behind the strengthening of regulations regarding wealth management products. In November 2017 the authorities announced government guidance regarding standardization of asset management business of financial institutions. Legislation went into effect in April 2018. This measure prohibits "rigid redemption" and management of pooled funds.

Both of these are wealth management products. In other words, the purpose of the new ruling is to regulate shadow banking. The term "rigid redemption" indicates the practice of guaranteeing the principal. Management of pooled funds is where multiple asset management products are placed together and batch managed. When managed in this way, earnings and risk associated with individual products becomes unclear.

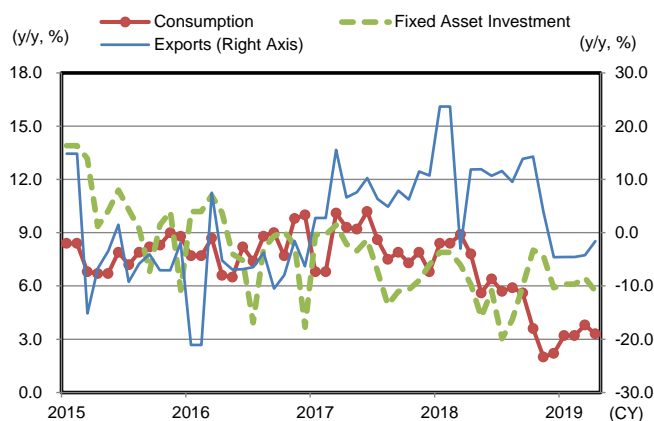
Factor Analysis of 2018 Slowdown in China's Economy

Chart 4



Changes in Key Chinese Statistics

Chart 5



Source: National Bureau of Statistics of China, China Customs; compiled by DIR.

Source: National Bureau of Statistics of China; compiled by DIR.
Note: All data based on difference between Jan-Mar and Oct-Dec periods of 2018. Rate of contribution to growth rate also included.

² For details see the DIR Report dated 23 April 2019, *Ascertaining the truth of China's economic recovery: China's economy headed for a stall or a second coming of the bubble?*, by Shunsuke Kobayashi & Yota Hirono.

There is little room to doubt that investment in wealth management products of this sort ballooned between 2016 and 2017, causing risk in the financial system to expand significantly. Sensing a crisis in the making, the authorities strengthened regulations and punished financial institutions that were carrying out compensation for losses. The authorities began to demand one-to-one correspondence in the handling of asset management products.

As a result, the growth rate in investment in wealth management products, as well as the total amount of social financing experienced a major slowdown in 2018. This generates the collapse of asset prices on the financial markets. Then the collapse in asset prices causes the circulation of funds through private equity to deteriorate, and the number of private corporations struggling with financing increases. Meanwhile, the deleveraging activity of banks due to operating losses progresses. This describes one of the important factors behind China's stalled economy in 2018.

At the same time, the strengthening of financial regulations and the slowdown in infrastructure investment are not exactly unrelated. It is not difficult to deduce that the situation was such that the banking system, whose risk tolerance had decreased, could not increase credit to provincial governments. Meanwhile, with the central government seeking debt relief and environmental measures, it became difficult to gain authorization for infrastructure investment projects in the first half of 2018.

In a complete turnaround from 2018 when factors contributing to economic slowdown were piled high one on top of the other, 2019 saw the Chinese government launch policies to support the economy in rapid succession beginning early in the year. Soon after entering the year 2019, the total amount of social financing was increased significantly. The government adopted the stance that they would not be averse to the fact that most of that would likely flow into the shadow banking market. Meanwhile, China commenced infrastructure investment, in addition to implementing a monetary easing policy. Amount of issuance of local government special bonds reached a net amount of 2.15 tril yuan, growth of 800 bil yuan in comparison with the previous year.

Overview of China's Economy				Chart 6	
China GDP Growth Rate					
Peak	Jan-Mar Period 2018		6.8%		
Bottom	Oct-Dec Period 2018		6.4%		
Extent of Slowdown in Growth Rate					▲0.4%pt
Left: Rate of Contribution to Real Growth Rate Right: Nominal Growth Rate (Y/y)					
Final Consumption Expenditure (Qtr, Real)			Amount of Retail Sales (Monthly, Nominal)		Reason for Stalled Growth
Consumption	Jan-Mar Period 2018		5.3%pt	Peak Jan-Feb Period 2018	8.4%
	Oct-Dec Period 2018		4.6%pt	First Bottom May, 2018	5.6%
	Rate of Contribution to GDP Growth Rate				Suspension of tax reduction on automobile purchases (7.5% to 10%, starting Jan. 2018)
				Extent of Slowdown in Growth Rate	
					▲2.8%pt
				Second Bottom Nov, 2018	2.0%
				Extent of Slowdown in Growth Rate	
					▲3.6%pt
				Strengthening of regulations related to P2P consumer financing (Aug. 2018 to end 2018)	
Fixed Capital Formation (Qtr, Real)			Fixed Capital Formation (Monthly, Nominal)		Reason for Stalled Growth
Investment	Jan-Mar Period 2018		2.1%pt	Peak Jan-Feb Period 2018	7.9%
	Oct-Dec Period 2018		1.3%pt	Bottom July, 2018	3.0%
	Rate of Contribution to GDP Growth Rate				Strengthening of financial regulations makes it difficult for regional governments to get financing. Fiscal austerity measures ensue (puts the squeeze on infrastructure projects)
				Extent of Slowdown in Growth Rate	
					▲4.9%pt
Overseas Demand (Qtr, Real)			Exports (Monthly, Nominal)		Reason for Stalled Growth
External Demand	Jan-Mar Period 2018		▲0.6%pt	Peak Jan-Feb Period 2018	23.7%
	Oct-Dec Period 2018		0.5%pt	Bottom Jan-Feb Period 2019	▲4.6%
	Rate of Contribution to GDP Growth Rate				US raises tariffs on a wide range of products (June, July, and September of 2018)
				Extent of Slowdown in Growth Rate	
					▲28.3%pt

Source: National Bureau of Statistics of China, Haver Analytics, Other Data Sources; compiled by DIR.

Notes: Real figures used for GDP only. Others are nominal figures. Retail sales amount is amount of sales for major retail outlets.

Path to export-driven economic recovery grows more distant due to resumption of US-China “cold war”

Now this positive factor has been ruined by the resumption of the US-China “cold war”. The US raised its additional tariff rate on approximately 250 billion dollars in imports from China to 25% on May 10. Then on the 13th, the USTR (United States Trade Representative) announced that a maximum of 25% in additional tariffs might be applied to the remaining products (the equivalent of 300 billion dollars), and published a list of products³. Meanwhile, China has announced a maximum of 25% in additional retaliatory tariffs on 60 billion dollars worth of products imported from the US to be imposed as of June 1⁴.

Using the DIR macro model, we estimated the economic effects of tariffs on the US and Chinese economies. Results are shown in Charts 8-13. Though the raising of tariffs will not have an especially significant effect on either the US or Chinese economy, it has reached a scale which can no longer be ignored. According to the model, the effects on Japan’s economy will be extremely limited. It should be noted, however, that the model does have a certain weakness, in that it does not give us an idea of secondary effects or the substitution effect. Hence these results should be taken purely as estimated values.

The main problem which the US-China tariff fight brings to the Japanese economy is the concern that the production of electronic parts used in products exported from China to the US will be effected, such that exports of components and capital goods manufactured in Japan and exported to China could suffer a decline. According to OECD estimates, of products exported to the US from China, items given added value enhancements in Japan totaled 24 billion dollars as of 2011. A total of 15.2 billion dollars of these items are accounted for by the manufacture of computers and electronic parts (Chart 7).

Amount in Japanese Exports to US, Including Via Third Countries (2011)

Chart 7

Gross Exports to US (US Dollar, Millions)

	Total	Direct	Via Third Country		
			China	Mexico and Canada	Other
Total	209,725	151,191	24,003	9,406	25,126
Food products, beverages and tobacco	970	551	58	53	309
Textiles, textile products, leather and footwear	2,861	877	1,288	52	644
Chemicals and chemical products	11,268	8,699	589	123	1,858
Rubber and plastics products	4,357	2,908	615	110	725
Basic metals	7,382	5,580	220	253	1,329
Fabricated metal products	2,187	1,072	311	147	656
Machinery and equipment, nec	18,613	14,626	1,404	558	2,025
Computer, Electronic and optical equipment	50,741	24,991	15,248	2,218	8,284
Electrical machinery and apparatus, nec	7,862	4,115	2,059	675	1,013
Motor vehicles, trailers and semi-trailers	35,567	27,906	681	4,278	2,703
Other transport equipment	3,198	2,361	131	103	604

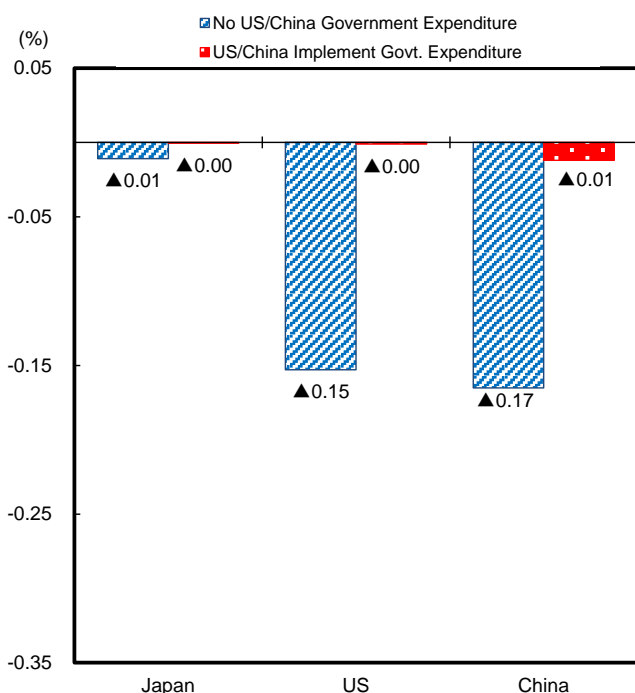
Source: OECD; compiled by DIR.

Note: Only major items are shown.

³ USTR “[Request for Comments Concerning Proposed Modification of Action Pursuant to Section 301: China’s Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation](#)” A public hearing is to be held between June 17 and June 24. The actual tariff rate is yet to be determined, along with the question of whether or not talks between President Trump and Xi Jinping will materialize at the planned June 28-29 G20 summit.

⁴ Announced by Ministry of Finance of the People’s Republic of China

Estimation of Effects of Tariffs (Summary)
Chart 8



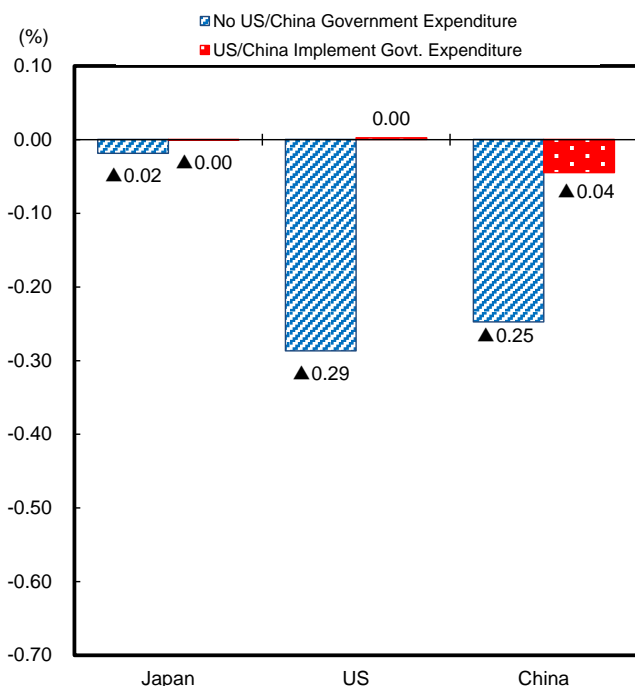
Source: Estimates produced using the DIR macro model.
Note: All figures are real. Rate of deviation from actual value.

Effects of Tariffs on Japan, US, and China (Detailed Version)
Chart 9

Effects on Chinese Economy		Real GDP	Personal Consumption	Capex	Government Expenditure	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.17	▲0.34	▲0.06	0.00	▲0.30	▲0.32
	Contribution Rate		▲0.13	▲0.03	0.00	▲0.06	0.06
US/China Implement Govt. Expenditure	Deviation Rate	▲0.01	▲0.34	▲0.00	0.93	▲0.22	▲0.20
	Contribution Rate		▲0.13	▲0.00	0.13	▲0.04	0.03
Effects on US Economy		Real GDP	Personal Consumption	Capex	Government Expenditure	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.15	▲0.26	▲0.20	0.00	▲0.09	▲0.47
	Contribution Rate		▲0.18	▲0.03	0.00	▲0.01	0.08
US/China Implement Govt. Expenditure	Deviation Rate	▲0.00	▲0.26	▲0.00	1.08	▲0.07	▲0.05
	Contribution Rate		▲0.18	▲0.00	0.18	▲0.01	0.01
Effects on Japan's Economy		Real GDP	Personal Consumption	Housing Investment	Capex	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.01	▲0.00	▲0.00	▲0.08	▲0.12	▲0.11
	Contribution Rate		▲0.00	▲0.00	▲0.01	▲0.02	0.02
US/China Implement Govt. Expenditure	Deviation Rate	▲0.00	▲0.00	▲0.00	▲0.00	▲0.00	▲0.00
	Contribution Rate		▲0.00	▲0.00	▲0.00	▲0.00	0.00

Source: Estimates produced using the DIR macro model.
Notes: 1) Estimated effects assuming US imposes tariff of 25% on 50 billion dollars' worth of Chinese imports, plus another 10% on 200 billion dollars' worth of Chinese products, and China imposes tariff of 25% on 50 billion dollars' worth of imports from the US, and 7.4% on \$60 billion worth.
2) All figures are real. Rate of deviation from actual value (%) and rate of contribution to GDP (%pt).

Estimation of Effects of Tariffs (Summary)
Chart 10



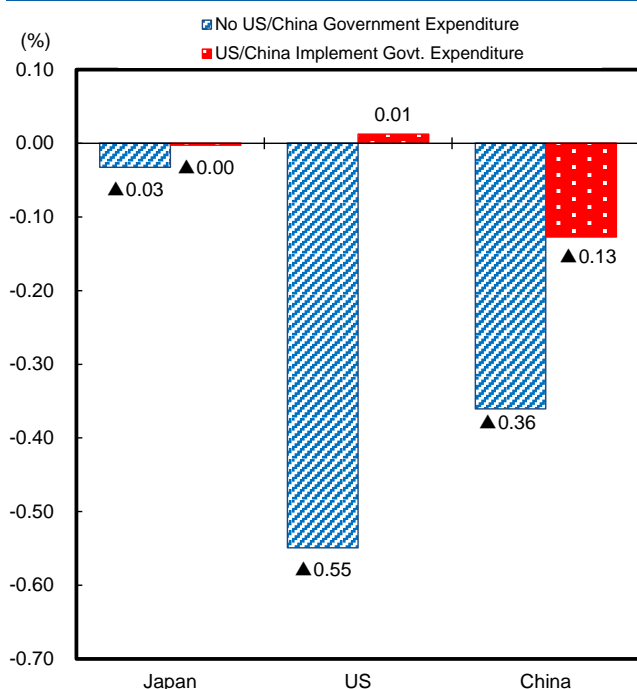
Source: Estimates produced using the DIR macro model.
Note: All figures are real. Rate of deviation from actual value.

Effects of Tariffs on Japan, US, and China (Detailed Version)
Chart 11

Effects on Chinese Economy		Real GDP	Personal Consumption	Capex	Government Expenditure	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.25	▲0.43	▲0.09	0.00	▲0.57	▲0.43
	Contribution Rate		▲0.17	▲0.04	0.00	▲0.12	0.08
US/China Implement Govt. Expenditure	Deviation Rate	▲0.04	▲0.43	▲0.02	1.16	▲0.41	▲0.27
	Contribution Rate		▲0.17	▲0.01	0.17	▲0.09	0.05
Effects on US Economy		Real GDP	Personal Consumption	Capex	Government Expenditure	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.29	▲0.50	▲0.38	0.00	▲0.13	▲0.88
	Contribution Rate		▲0.35	▲0.06	0.00	▲0.02	0.14
US/China Implement Govt. Expenditure	Deviation Rate	0.00	▲0.50	0.00	2.07	▲0.09	▲0.08
	Contribution Rate		▲0.35	0.00	0.35	▲0.01	0.01
Effects on Japan's Economy		Real GDP	Personal Consumption	Housing Investment	Capex	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.02	▲0.01	▲0.00	▲0.14	▲0.20	▲0.19
	Contribution Rate		▲0.00	▲0.00	▲0.02	▲0.04	0.03
US/China Implement Govt. Expenditure	Deviation Rate	▲0.00	▲0.00	▲0.00	▲0.01	▲0.01	▲0.01
	Contribution Rate		▲0.00	▲0.00	▲0.00	▲0.00	0.00

Source: Estimates produced using the DIR macro model.
Notes: 1) Estimated effects assuming US imposes tariff of 25% on 250 billion dollars' worth of Chinese imports, and China imposes tariff of 25% on 50 billion dollars' worth of imports from the US, and average 14.5% on \$60 billion worth.
2) All figures are real. Rate of deviation from actual value (%) and rate of contribution to GDP (%pt).

Estimation of Effects of Tariffs (Summary)
Chart 12



Source: Estimates produced using the DIR macro model.
Note: All figures are real. Rate of deviation from actual value.

Effects of Tariffs on Japan, US, and China (Detailed Version)
Chart 13

Effects on Chinese Economy		Real GDP	Personal Consumption	Capex	Government Expenditure	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.36	▲0.43	▲0.12	0.00	▲1.11	▲0.51
	Contribution Rate		▲0.17	▲0.05	0.00	▲0.23	0.09
US/China Implement Govt. Expenditure	Deviation Rate	▲0.13	▲0.43	▲0.05	1.16	▲0.81	▲0.35
	Contribution Rate		▲0.17	▲0.02	0.17	▲0.17	0.06
Effects on US Economy		Real GDP	Personal Consumption	Capex	Government Expenditure	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.55	▲0.98	▲0.73	0.00	▲0.14	▲1.69
	Contribution Rate		▲0.68	▲0.12	0.00	▲0.02	0.28
US/China Implement Govt. Expenditure	Deviation Rate	0.01	▲0.98	0.02	4.03	▲0.11	▲0.14
	Contribution Rate		▲0.68	0.00	0.68	▲0.01	0.02
Effects on Japan's Economy		Real GDP	Personal Consumption	Housing Investment	Capex	Exports	Imports
No US/China Govt. Expenditure	Deviation Rate	▲0.03	▲0.01	▲0.00	▲0.24	▲0.35	▲0.33
	Contribution Rate		▲0.01	▲0.00	▲0.04	▲0.06	0.06
US/China Implement Govt. Expenditure	Deviation Rate	▲0.00	▲0.00	▲0.00	▲0.02	▲0.03	▲0.03
	Contribution Rate		▲0.00	▲0.00	▲0.00	▲0.01	0.01

Source: Estimates produced using the DIR macro model.
Notes: 1) Estimated effects assuming US imposes additional tariff of 25% on all Chinese imports excluding pharmaceuticals and rare earth, and China imposes tariff of 25% on 50 billion dollars' worth of imports from the US, and average 14.5% on \$60 billion worth.
2) All figures are real. Rate of deviation from actual value (%) and rate of contribution to GDP (%pt).

Resumption of US-China “cold war” could cause Japanese exports to suffer a maximum decline of around 1.3 tril yen

The limitations to the macro model discussed in the previous section can be resolved by introducing the concept of value-added exports using the OECD’s TiVA database. This allows us to consider the secondary effects of tariffs. Results are shown in Chart 14. Effects on exports and effects on GDP are each estimated, and results are significantly larger than on the model used in the previous section.

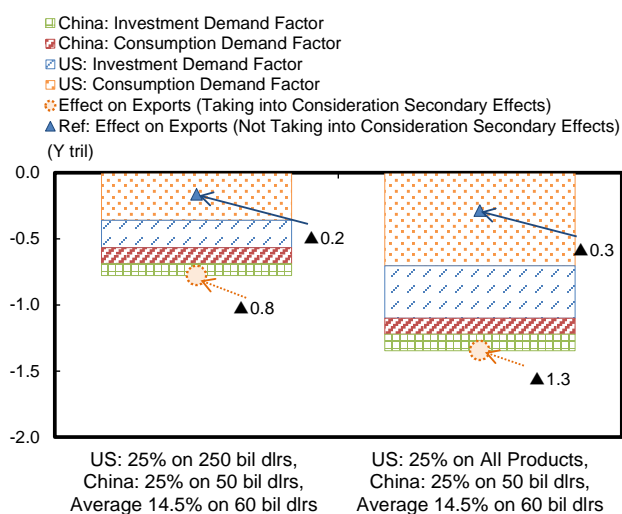
First we look at the effects on exports. The negative effect of additional US and Chinese tariffs which have already been decided on is expected to be -0.96%, or in monetary terms, as much as -0.8 tril yen. (The results obtained using the macro model were only -0.20% as shown in Chart 11. Comparing with these results we can see that the newer estimate suggests there will be around 5x more influence than previously estimated.) Then, if the US imposes additional tariffs of 25% on almost all Chinese products (this would be the fourth round of tariffs) the results would be -1.66% in exports, while on a monetary basis, Japanese exports would be forced downwards by approximately 1.3 tril yen.

As for the effect on GDP, this too is expected to be fairly big. The effects on Japan’s GDP of additional US and Chinese tariffs which have already been decided on is expected to be -0.13%, or in monetary terms, -0.7 tril yen. If the US imposes additional tariffs of 25% on all Chinese products the results would be -0.22%, or as much as -1.2 tril yen⁵.

⁵ The reason the effects on GDP are smaller than on exports is because imports of raw materials required to produce export oriented goods would decline. Domestic demand components such as consumption and capital expenditure would also suffer from downward pressure as a result of the decline in domestic production.

Effects of Additional US & Chinese Tariffs on Japan's Economy: Real Exports

Chart 14

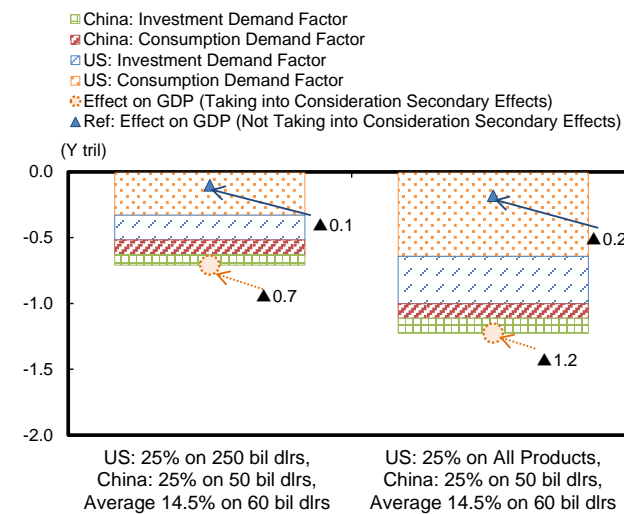


Source: OECD, IMF, National Bureau of Statistics of China, BEA, Haver Analytics; compiled by DIR.

- Notes: 1) Amount of deviation from situation with no US & Chinese additional tariffs.
 2) Consumption demand = govt consumption + household consumption, investment demand = private sector fixed capital formation + public fixed capital formation + housing investment.
 3) US: 25% on All Products excludes pharmaceuticals and rare earth.

Effects of Additional US & Chinese Tariffs on Japan's Economy: Real GDP

Chart 14



Source: OECD, IMF, National Bureau of Statistics of China, BEA, Haver Analytics; compiled by DIR.

- Notes: 1) Amount of deviation from situation with no US & Chinese additional tariffs.
 2) Consumption demand = govt consumption + household consumption, investment demand = private sector fixed capital formation + public fixed capital formation + housing investment.
 3) US: 25% on All Products excludes pharmaceuticals and rare earth.

Looking on the bright side of the “US-China cold war”

At the same time, the effects of US-China trade friction on the Japanese economy are not all bad. Something which is often overlooked is the factor of the substitution effect. The US and China tariffs will likely lead to the increase in substitute production in other Asian countries. The phenomenon is expected to eventually become manifest in the emerging nations, for the most part in Southeast Asia. Taking the long-term view, this would likely generate opportunities for Japanese corporations to expand their sales networks in these countries.

Another often overlooked factor is the increase in fiscal income from tax revenues brought by the tariffs. If the US and China make use of the fiscal income which is generated to increase government expenditure, the economic shock of the tariffs may be offset somewhat. These factors would be an important path to improving Japan's exports and putting Japan's economy back onto the road to full-fledged recovery.

In addition, from a political point of view, a short-term positive factor for Japan's economy is that the risk of tariff rates being raised by an ally will be on the wane.

The area in which Japan could experience the most lethal risk from this situation would be the raising of tariffs on automobiles. The investigation regarding imports of automobiles and automobile parts based on Article 232 of the Trade Expansion Act of 1962 has now been completed, and risk that tariffs could be raised on automobiles has not yet receded. The tariff rate of 2.5% currently applied to passenger vehicles could increase to as much as a maximum of 20% or even 25%. Passenger vehicles, with a current tariff rate of 2.5%, have an export value of 4.5 tril yen, while automobile parts total 0.9 tril yen (figures based on 2018 performance). If the above scenario plays out it could mean an additional 5.5 tril yen in tariffs on Japanese automobiles. If a 25% tariff rate were imposed on these items across the board, the increase in tariffs is estimated to increase by 1.2 tril yen (Chart 15).

However, this concern is expected to recede, since the more serious the “US-China cold war” becomes, the more important becomes the alliance between the US and Japan⁶. In addition to the factors discussed above – the substitution effect and expectations of fiscal expansion – this should also become an important point allowing us to think in terms of a kind of fishing in troubled waters as the “US-China cold war” intensifies.

Effects of US Automobile Tariffs on Japanese Automobile Sales

Chart 15

		Volume (Units)	Amount (¥100 Mil)	Amount of Tariff Hike (¥100 Mil)
①	Japanese cars sold in domestic US	6,623,908		
②	Japanese cars produced in domestic US	3,773,993		
③	Japanese cars exported from factories in domestic US	423,415		
④	Direct exports from Japan (excluding parts)	1,742,307	44,903	9,946
① - [② - ③] - ④ = ⑤	Exports from third countries	1,531,023	39,458	
⑥	Exports Automobile Parts from Japan		9,295	2,091
④ + ⑤ + ⑥	Total Automobile Related Exports of Japanese Corporations to US		93,656	12,037

Source: Automotive News, Haver Analytics, JAMA, Ministry of Finance; compiled by DIR.

Notes: 1) Figures in (1), (4), and (6) based on 2018 results, while (2) and (3) are based on 2017 results. However, export amount from third countries estimated by multiplying unit price of direct exports with number of units.

2) Third countries are primarily Canada and Mexico, but since these are USMCA member countries, it is assumed that additional tariffs as described in (5) would not apply.

3) Amount of tariff hike assumes the following rate of increase (4): 2.5% ⇒ 25% and (6): 2.5% ⇒ 25%.

⁶ As of this time the decision on whether to impose additional tariffs on Japanese auto parts has been postponed. According to news reports, which came in at the time this report was being written, a 180-day grace period will be applied. (Bloomberg report May 17, 2019 (updated May 18, 2019): <https://www.bloomberg.com/news/articles/2019-05-17/trump-delays-auto-tariffs-on-eu-japan-for-180-days-to-negotiate>)

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	FY18	FY19 (Estimate)	FY20 (Estimate)	CY18	CY19 (Estimate)	CY20 (Estimate)
Main economic indicators						
Nominal GDP (y/y %)	0.5	1.4	1.2	0.7	1.3	1.3
Real GDP (chained [2011]; y/y %)	0.6	0.5	0.5	0.8	0.6	0.5
Domestic demand (contribution, % pt)	0.7	0.4	0.5	0.8	0.5	0.5
Foreign demand (contribution, % pt)	-0.1	0.2	-0.0	-0.0	0.1	0.1
GDP deflator (y/y %)	-0.2	0.8	0.7	-0.1	0.6	0.8
Index of All-industry Activity (y/y %)*	0.9	0.4	0.7	1.0	0.6	0.5
Index of Industrial Production (y/y %)	0.2	-0.1	1.2	1.1	-0.9	1.5
Index of Tertiary Industry Activity (y/y %)	1.4	0.7	0.5	1.2	1.3	0.3
Corporate Goods Price Index (y/y %)	2.2	1.7	3.0	2.6	1.0	3.4
Consumer Price Index (excl. fresh food; y/y %)	0.8	0.6	0.4	0.8	0.6	0.5
Unemployment rate (%)	2.4	2.4	2.4	2.4	2.4	2.4
Government bond yield (10 year; %)	0.04	-0.04	-0.04	0.07	-0.04	-0.04
Balance of payments						
Trade balance (Y tril)	1.8	4.8	5.0	1.2	4.6	5.1
Current balance (\$100 mil)	1,794	2,135	2,157	1,741	2,099	2,164
Current balance (Y tril)	19.9	23.4	23.7	19.2	23.0	23.7
(% of nominal GDP)	3.6	4.2	4.2	3.5	4.1	4.2
Real GDP components (Chained [2011]; y/y %; figures in parentheses: contribution, % pt)						
Private final consumption	0.4 (0.2)	0.2 (0.1)	0.5 (0.3)	0.4 (0.2)	0.1 (0.1)	0.4 (0.2)
Private housing investment	-4.3 (-0.1)	2.4 (0.1)	-1.8 (-0.1)	-5.7 (-0.2)	2.8 (0.1)	-2.0 (-0.1)
Private fixed investment	3.2 (0.5)	1.0 (0.2)	0.8 (0.1)	3.9 (0.6)	1.1 (0.2)	1.0 (0.2)
Government final consumption	0.8 (0.2)	0.8 (0.2)	0.8 (0.2)	0.8 (0.2)	0.7 (0.1)	0.8 (0.2)
Public fixed investment	-3.8 (-0.2)	3.3 (0.2)	0.7 (0.0)	-3.2 (-0.2)	1.4 (0.1)	1.9 (0.1)
Exports of goods and services	1.4 (0.2)	-0.5 (-0.1)	1.0 (0.2)	3.1 (0.6)	-1.4 (-0.3)	1.3 (0.2)
Imports of goods and services	2.0 (-0.4)	-1.4 (0.2)	1.0 (-0.2)	3.3 (-0.6)	-2.0 (0.4)	1.0 (-0.2)
Major assumptions:						
1. World economy						
Economic growth of major trading partners	3.7	3.4	3.4	3.9	3.4	3.5
Crude oil price (WTI futures; \$/bbl)	62.9	62.8	62.8	64.9	60.8	62.8
2. US economy						
US real GDP (chained [2012]; y/y %)	3.0	2.3	1.9	2.9	2.6	1.9
US Consumer Price Index (y/y %)	2.3	2.3	2.3	2.4	2.1	2.4
3. Japanese economy						
Nominal public fixed investment (y/y %)	-2.1	4.6	1.3	-1.6	2.9	2.8
Exchange rate (Y/\$)	110.9	109.6	109.6	110.4	109.7	109.6
(Y/€)	128.3	123.2	123.2	130.0	123.7	123.2

Source: Compiled by DIR.

Note: Due to rounding, actual figures may differ from those released by the government.

* Excl. agriculture, forestry, and fisheries.

Estimate: DIR estimate.