



# British Embassy Tokyo

## Key Points

- Abe postpones planned VAT increase and calls an election
- Moody's downgrades Japan's rating by one notch to 'A1'
- Q3 GDP contracts unexpectedly, surprising markets and putting Japan into technical recession.
- OECD revised Japan's growth forecasts to 0.4% from 1.2% for 2014
- Nikkei hits a seven year high while Yen weakens to a seven year low

[This report reflects data available up to 1 December 2014.]

## NOV 2014: JAPAN ECONOMIC MONTHLY REPORT

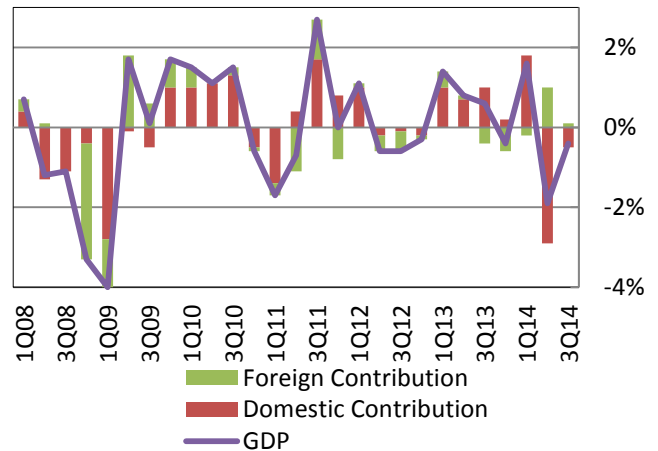
5 December 2014

1. Following worse than expected GDP figures, PM Abe dissolved the Lower House and called a general election for 14 December, leaving a number of key structural reform bills awaiting decision (including Female Workers Promotion). The planned October 2015 VAT increase was postponed for 18 months.
2. The decision affects Japan's annual budgetary processes and the FY2015 budget draft is likely to be submitted a month late, in January 2015. Tax reforms for 2015 will be affected although Abe confirmed that pledged corporate tax cuts will start in next fiscal year as scheduled. Finance Minister Aso suggested a possible stopgap budget for the early next year. Meanwhile, the current coalition agreed to try to introduce lower VAT rates on some necessities after the rate reaches 10%.
3. Japan's sluggish economic conditions have prompted expectations of another stimulus package worth about 2-3 trillion yen (£11-16bn) after the election. Most expenditure will be financed from the FY2013 tax revenue surplus and the projected surplus from FY2014, which is expected to be the largest in 17 years amid higher-than-expected corporate profits, increased salaries and April's VAT increase. Possible measures could include financial support to SMEs and households to mitigate the effect of higher energy costs.
4. Abe's decision to delay next VAT increase convinced Moody's to downgrade Japan's Government Bond rating by one notch from 'Aa3' to 'A1', as it is uncertain about Japan achieving its fiscal consolidation target by 2020. Japan's rating is now lower than China and Korea's. The IMF has urged Japan to stick to its original plan to increase VAT rates to tackle its fiscal conditions.
5. At its November meeting, the Bank of Japan (BOJ) left its monetary policy unchanged, having expanded its monetary easing policy in October. BOJ Governor Kuroda appeared less bullish on the positive impact of the weaker yen. Minutes of the latest BOJ meeting (31 October) showed a vivid difference in views among Board members on the feasibility of additional easing measures.

## ECONOMY

6. Q3 GDP unexpectedly contracted with a 1.6% annualised decline (**Chart A: GDP**). This was unexpected as most economic forecasters had predicted at least marginal growth. The revised estimate, due for release on 8 December, is expected to show an upward revision due to stronger private investment observed in Ministry of Finance's Q3 corporate survey. Market consensus estimation for the revision is -0.5% (annualised rate) with a range of +0.2% to -1.7%.

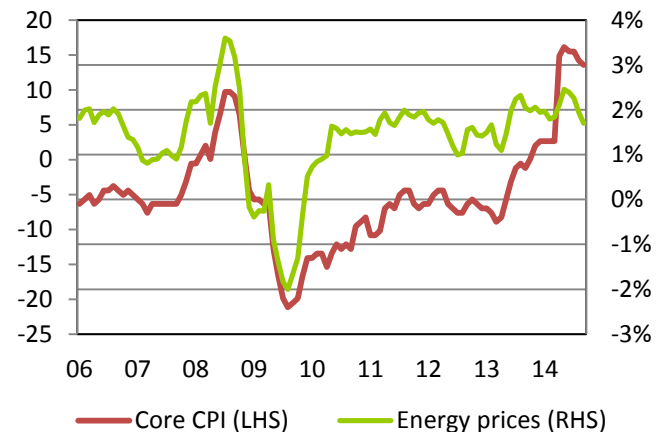
**Chart A: GDP (QOQ %)**



7. The OECD revised down Japan's growth forecast. The organization now sees Japan's economy growing at 0.4% (down from 1.2%) in 2014 and 0.8% (1.2%) in 2015. The organization said that the revision reflected sluggish private consumption after April's VAT increase and the postponement of the next VAT increase. The Government's monthly economic report maintained its assessment of the current economy unchanged, but highlighted downside risks around household consumption.

8. Driven by falling energy prices, inflation has fallen below 1% for the first time since October 2013 (**Chart B: CPI**). Continued sluggish consumption for 7 consecutive months compounded softening prices. The unemployment rate improved to 3.5% but has not helped consumption as real wages continue to fall. The Economic Watchers' Survey (a sentiment survey) showed that sentiment fell three months in a row, reflecting negative real wage growth.

**Chart B: CPI (YOY %)**



9. Japan's trade balance recorded a 28<sup>th</sup> consecutive monthly deficit in October. The monthly deficit shrank due to the increased value of Japanese exports. The trade figures showed exports volume increased 4.7% YOY for the second consecutive month.

10. Income surplus increased to the largest ever level with 9.1 trillion yen (£49bn) in the first half of Fiscal 2014 (April-September). This offset the remaining robust trade deficit (including goods and services trade) of more than 6 trillion yen (£32bn). Nonetheless, the current account surplus in H1 FY2014 was the smallest ever in H1.

## TRADE

11. The EU finalized the 2<sup>nd</sup> list of non-tariff measures to submit to the Japanese side before the next negotiation round in Tokyo from 8<sup>th</sup> December. The list mainly focused on Automotives, Food additives and Food safety. A new area is Cosmetics. As for the TPP, no significant progress has been made following the last negotiations in Beijing during the APEC summit. Parties agreed to postpone the deadline for conclusion to the end of 2015.

## **ENERGY**

12. Japan's CO2 emissions hit a record high in the year to March 2014, due to the shutdown of Japan's nuclear reactors and heavy reliance on fossil fuels. As the first step towards resuming domestic nuclear power supply in Japan, two reactors at Sendai Nuclear Power Plant got local community clearance to restart and the government is finalising the political approval process to enable operations to resume early next year (Feb-Apr).
13. The latest OPEC decision not to cut its oil supply and the subsequent sharp drop in prices has boosted business confidence in Japan, given expected further falls in energy input costs. In turn this helped the Nikkei reach a 7 year high but further weakened the Yen.

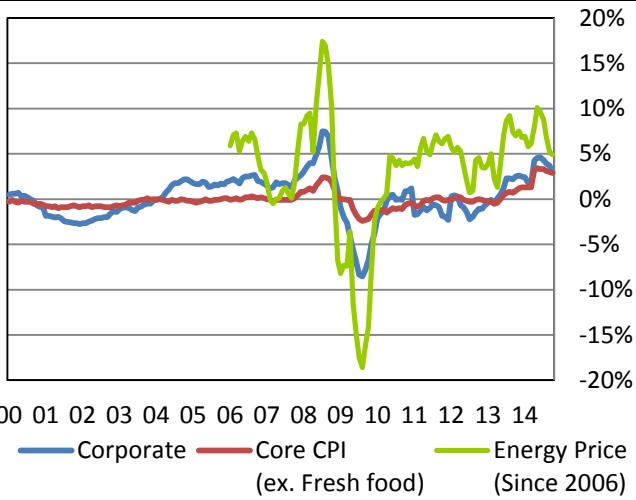
## **PRIVATE SECTOR**

14. Earnings of publicly-listed companies in FY 2014 are expected to be close to an all-time high of 30 trillion Yen (£162bn). Manufacturers have profited from the weaker Yen raising foreign earnings. H1 2014 earnings are to increase 10%, surpassing pre-Lehman levels. The Kaidanren (CBI equivalent) urged its member companies to take advantage of this situation to raise wages in the next spring wage negotiations, echoing Government initiatives.
15. Declining populations in regional communities have resulted in reduced deposit bases and business opportunities for regional banks. A recent survey found that about 40% of regional banks consider a merger with others as a likely option. The latest announcement about the merger of Bank of Yokohama and Higashi Nippon Bank will create the largest regional bank in Japan.
16. Recent major private investment activities include: Citibank's Japanese retail businesses are reportedly to be sold to Mistui Sumitomo Bank for 30-40bn yen; Hitachi is to buy an Italian railroad business with 200bn yen; and UK CVC Capital Partners is to invest in Marubeni's telecom businesses with 17bn yen.

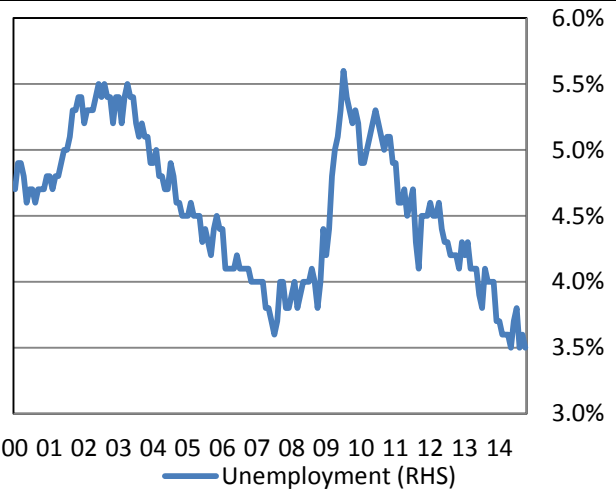
## **MARKETS**

17. The Nikkei hit a seven year high, as better-than-expected business investment data, falling oil prices and a weaker Yen have made investors' more optimistic about profits. The Yen reached a 7 year low. As a result of this healthier market environment, IPOs increased for the fifth year in a row.
18. 10 year JGB yields hit a one-year-and-8-month low of 0.415% amid latest expansion of BOJ purchases. There has been limited impact on the markets so far from Moody's downgrade.

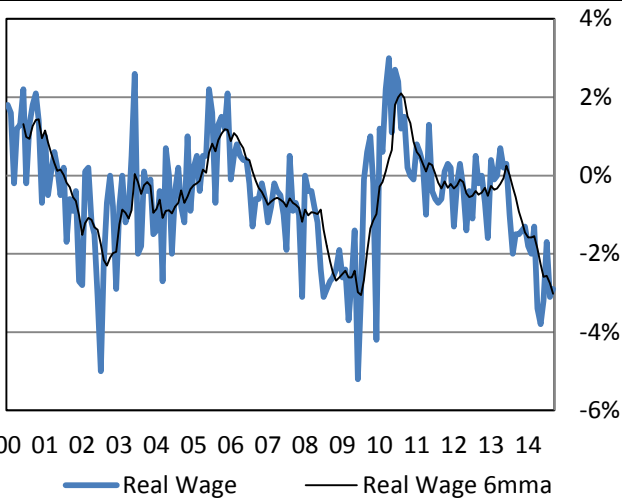
**Chart 1: CPI (%Y/Y)**



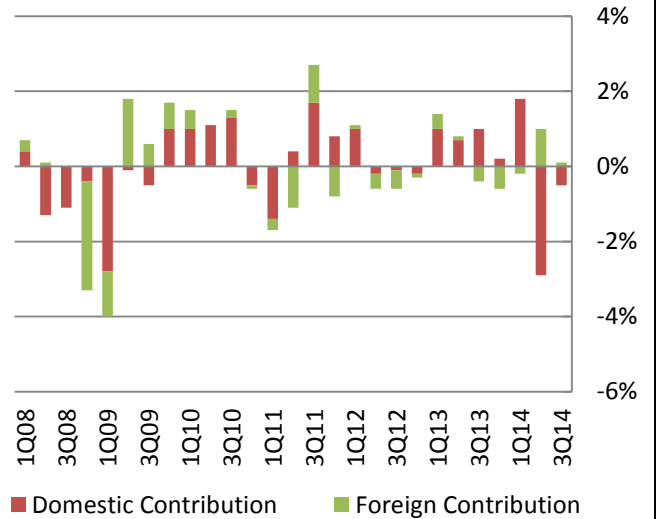
**Chart 2: Labour Market**



**Chart 3: Real wage (%Y/Y)**



**Chart 4: Real GDP (% Q/Q)**



**Chart 5: Stock Market**



**Chart 6: Yen**

