



British Embassy Tokyo

Key Points

- Government estimates that its Primary Balance will not reach a surplus in 2020
- Analysts lower Q2 GDP estimates after weaker industrial production figures
- Japanese trade deficit hits new record.
- Wages rise as demand for labour reaches highest level in 22 years.
- EU and Japan agree to speed up FTA negotiations
- SMBC Aviation Capital is to buy 115 Airbus A320 planes worth £7.5bn

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

JULY 2014: JAPAN ECONOMIC MONTHLY REPORT

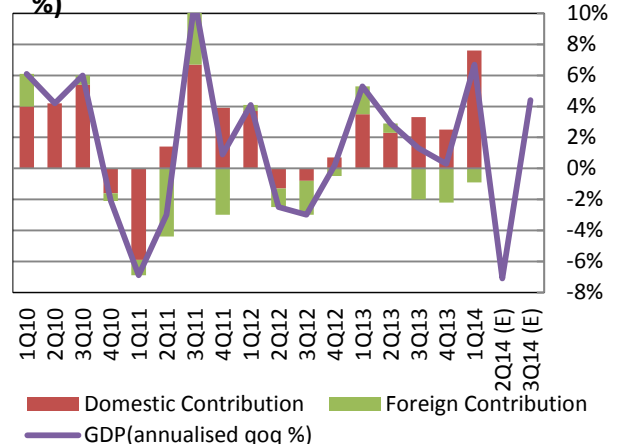
11 August 2014

1. Latest Government's estimates indicate that Japan's Primary Balance (PB) will not reach a surplus in 2020 even if Consumption tax (VAT) rises in October 2015. The shortfall is estimated to be between -1.8% and -2.9% of GDP depending on the scenario chosen. However, Japan will successfully reach its 2015 target of halving the PB deficit compared to its 2010 level.
2. The Cabinet released its basic policy for FY2015 budget drafting on 25 July. This recommends that new Japanese Government Bond (JGB) issuance should be lower than last year. However, it does not specify an expenditure ceiling as a formal decision on whether to raise VAT in October 2015 has not yet been taken. This is expected in early December.
3. The Bank of Japan (BOJ) maintained its current monetary easing policy, Quantitative and Qualitative Easing (QQE), at its July monetary policy meeting. The BOJ also kept its view on inflation unchanged when it reviewed its economic and inflation outlook report released in April.
4. The BOJ now estimates that demand in Japan now exceeds output – i.e. the Output Gap has now closed for the first time in 6 years. The IMF now expect core CPI (excluding fresh food) in Japan will reach 2% in 2016. This is a year short of the BOJ's target but it is much more optimistic than most private economists.

Economy

5. Economic analysts reduced their consensus estimate of Q2 GDP growth to -7% annualised rate (from -4.9%) after industrial projection fell -3.3%, the sharpest rate of decline since March 2011. Q2 GDP figures will issue on 13 August.

Chart A: Real GDP Growth (qoq annualised %)



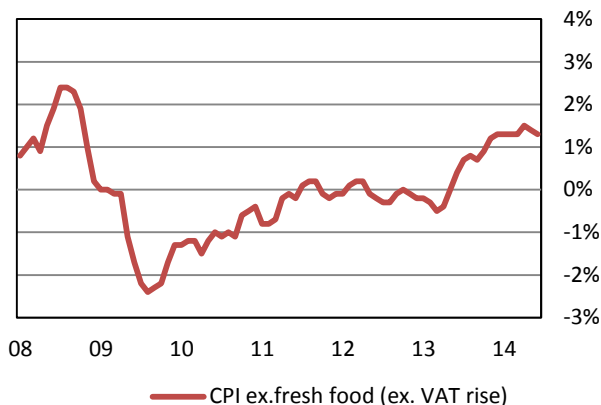
Source: Japanese Cabinet Office, Nikkei

6. Private consumption in June fell by -3%. This is a slower rate than April and May. Retail sales also fell in June by 0.6% over a year but they increased by 0.4% compared to May. The BOJ's quarterly Sakura Report, a regional economic report, noted that the negative impact of April's VAT increase has been decreasing.
7. Demand for labour remained strong in June with the job offers/applicants ratio, an indicator of labour demand, reaching its highest level (1.10) in 22 years. The number of those employed (June: 63.89 million) in Japan has now increased for 18 months. However, the unemployment rate increased to 3.7% (was 3.5%) reflecting more women entering the workforce and actively looking for work.

8. Core CPI (excluding fresh food) was 1.3% in June (May: 1.4%), excluding the impact of April's tax rise. While inflation remains stable, there are signs of increasing inflationary pressures. Construction costs are the highest in 21 years and basic wages increased (0.3%) for the first time in more than two years reflecting spring labour negotiations. Summer bonuses are expected to increase by around 8.5% according to a Nikkei survey.

9. Japan's trade deficit in goods for H1 2014 hit a new record of 7.6 trillion yen (£44bn). Overall imports were 42.6 trillion yen (£246bn, 10% higher compared to H1 2013) and exports increased 3.2% to 35.5 trillion yen (£205bn). Exports of UK goods to Japan increased by 6.3% to 333bn yen (£1.9bn) while Japanese exports to the UK rose by 2.6% to 535bn yen (£3.1bn) during H1 2014.

Chart B: Core CPI (YoY %)



Source: Ministry of Internal Affairs and Communications, BOJ

Trade Policy

10. The sixth round of EU-Japan negotiations took place during 7-11 July. Both sides agreed to speed up negotiations and exchanged offers on services and investment. Japan formally signed its FTA with Australia. It also reached agreement on a new EPA with Mongolia. This will be Japan's fifteenth FTA agreement. Japan and Mexico also agreed to start negotiations on revising their existing FTA to further strengthen bilateral economic ties.

Energy and environmental issues

11. The Nuclear Regulation Authority (NRA) certified that two nuclear reactors at Sendai Nuclear Power Plant (in Kyushu, Western Japan) were in compliance with the new safety regulations introduced in July 2013. Approval to restart the two reactors is still required from local authorities. As such, they are not expected to be switched on until this winter. The Institute of Energy Economics Japan, a think-tank affiliated to the Ministry of Economy, Trade and Industry (METI), estimates that 800bn Yen (£4.6bn) increase in GDP (about 0.2%) could be achieved if all 19 reactors currently under NRA safety reviews were to restart.

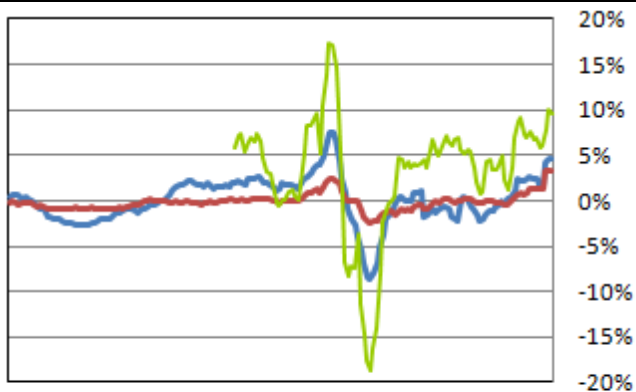
Private Sector

6. Hitachi is to triple the number of engineers it has in the UK within two years to strengthen its overseas rail businesses. KDDI plans to expand UK data businesses by investing 24bn Yen (£140 million) to meet increasing demand from the telecoms and financial industries. Nippon Life Insurance is to invest 10bn Yen (£58million) in a UK infrastructure fund.
7. SMBC Aviation Capital announced it would order 115 planes from Airbus's A320 family. At list prices, this order is worth 1.3 trillion Yen (£7.5bn) – a significant element of which will accrue to the UK. Airbus also cancelled an order for six planes from Skymark Airlines, a Japanese low-cost carrier citing the inability of the airline to secure appropriate financing.
12. The State owned New Kansai International Airport Company, which operates both Kansai and Osaka International Airports, announced plans to allow a private operator to run the two airports. The successful bidder is expected to start operations in January 2016.

Comment

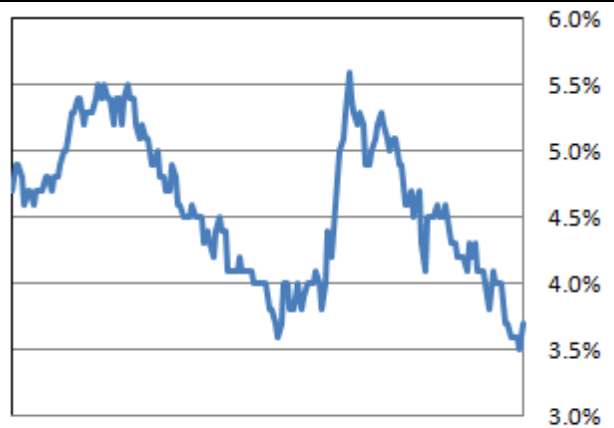
13. The Government has done well to maintain high approval rates since it came to power in December 2012. This has largely been as a result of public approval of Abe's economic policies. However, approval rates have recently fallen below 50% as the Government has given more prominence to divisive issues such as collective self-defence and nuclear energy. Abe is expected to reshuffle his Cabinet in early September.
14. The sharper than expected fall now expected in Q2 GDP will create headlines when it is released on 13 August. However, it is important to remember that this figure is heavily distorted by April's VAT rise and will not properly represent how 'Abenomics' is faring. Many Japanese consumers brought forward purchases to Q1 2014 to avoid the tax increase.
15. It is no surprise that Japan is not on track to meet its target of a primary balance surplus by 2020: Government and economist contacts have advised this for some time. The key question is whether Japan's politicians are prepared to argue for the necessary cuts in expenditure and/or increases in taxation which will be needed to address this.

Chart 1: CPI (%Y/Y)



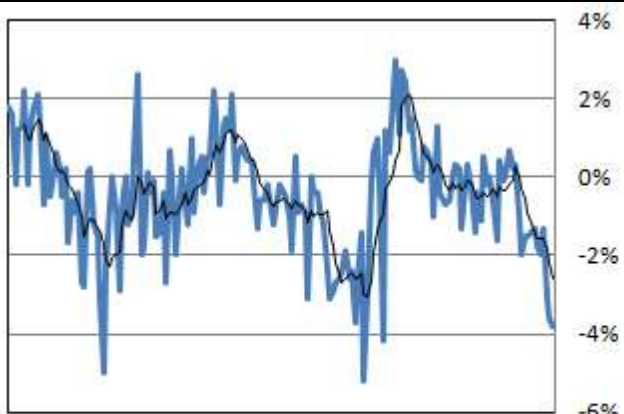
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— Corporate — Core CPI — Energy Price (Since 2006)
(ex. Fresh food)

Chart 2: Labor Market



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— Unemployment (RHS)

Chart 3: Real wage (%Y/Y)



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Chart 4: Real GDP (% Q/Q)

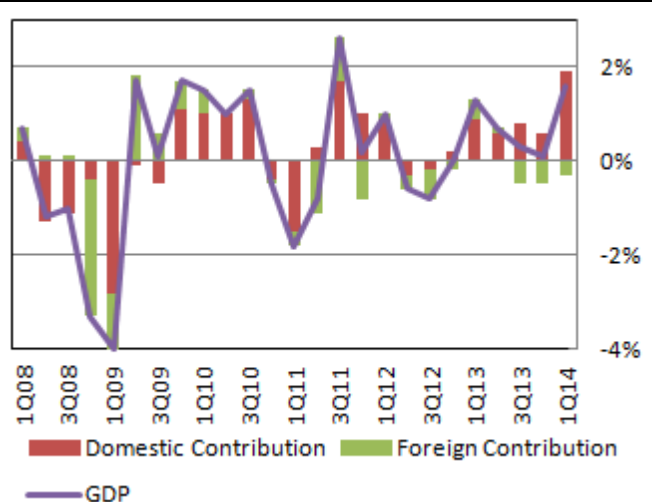
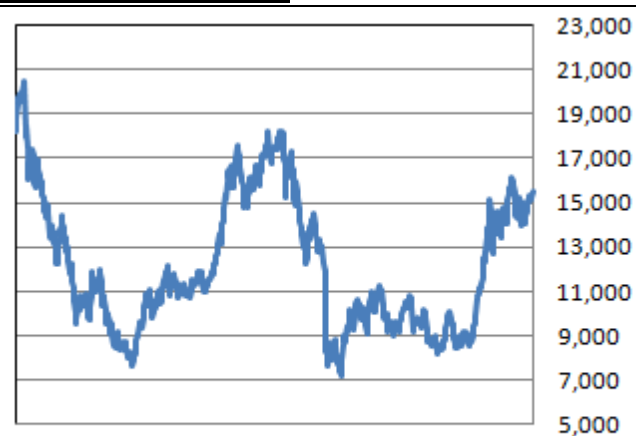
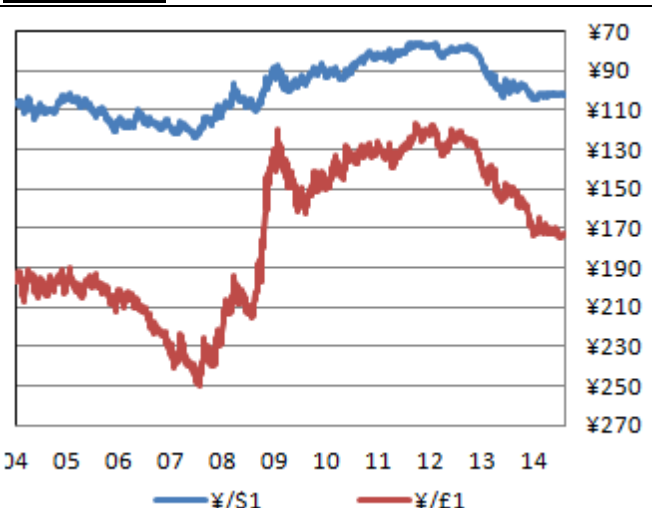


Chart 5: Stock Market



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— NIKKEI

Chart 6: Yen



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— ¥/\$1 — ¥/£1