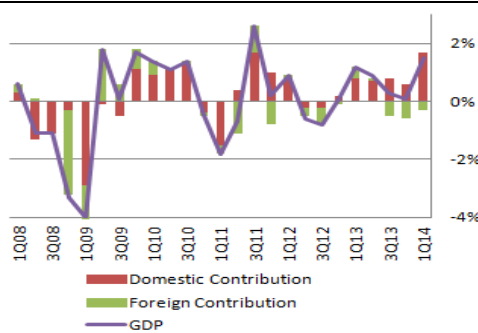




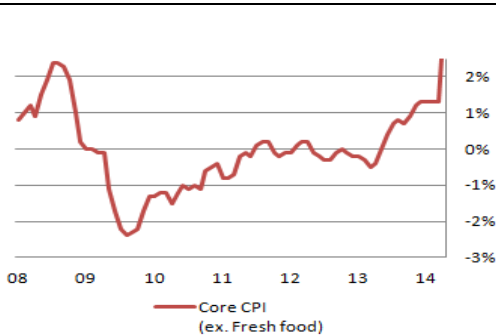
British Embassy
Tokyo

JAPAN: MAY 2014 MONTHLY ECONOMIC REPORT

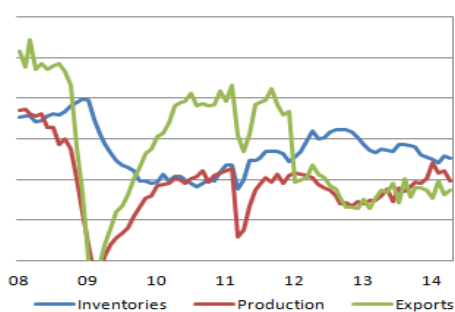
GDP



CPI (YoY%)



Production and exports



Key Points

- Consumption drops after the VAT increase as expected: Q1 GDP was robust as consumers brought forward expenditure to avoid the tax rise
- Japan's net foreign assets were £1.9 trillion in 2013, the largest worldwide for 23 years
- European Commission calls for EPA negotiations to continue; UK, Japan and Germany call for conclusion of negotiations in 2015
- Debate heats up on the Growth Strategy expected in June, which may launch labour market reform
- Sharp improvement in corporate profitability brings the largest dividend payout to investors

Main Economic Indicators

	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14
GDP (QoQ%)	0.1	1.2	0.9	0.3	0.1	1.5
	Nov-13	Dec-13	Jan-14	Feb-14	Mar-14	Apr-14
CPI (core, YoY%)	1.2	1.3	1.3	1.3	1.3	3.2
Unemployment rate (%)	4	3.7	3.7	3.6	3.6	3.6
Industrial production (YoY%)	4.8	7.1	10.6	7.0	7.4	4.1
Exports (YoY%)	18.4	15.3	9.5	9.8	1.8	5.1
Imports (YoY%)	21.1	24.7	25.0	9.0	18.1	3.4

(This report reflects data available up to 30 May 2014.)

ECONOMY

1. The impact of the 1 April VAT increase on Japan's economic activities has been less severe than many had feared. Nonetheless, April household expenditure fell 4.6% year over year (the largest drop since March 2011 when the earthquake hit) following robust demand in March (7.2%) due to advanced purchases ahead of the tax increase.
2. Inflation has risen steadily in line with Bank of Japan predictions. April core CPI (excluding fresh food) rose 3.2% (1.3% in March), at the fastest pace since February 1991: without the impact of the VAT hike, it would have risen 1.5%. The output gap (an indicator whose negative figure indicates downward pressure on prices) narrowed from minus 1.6% in Q4 2013 to minus 0.3% in Q1 2014, reflecting strong growth in the first quarter (5.9% annualised). This implies less downward pressure on prices in the latest quarter than in the previous one.
3. Japan continues to invest overseas despite the weaker Yen. Japan's FDI (stock) reached the 100 trillion Yen mark in 2013 for the first time, driven by investment to Europe, US and South East Asia. But FDI to China fell. As a result, its net foreign assets were 325 trillion Yen (£1.9 trillion), the largest ever. This places Japan as the largest net foreign asset holder in the world for the 23rd consecutive year.
4. The trade deficit reduced to 808.8 bn Yen (£4.7bn) in April from 877.3 bn Yen a year ago. By value, exports and imports increased by 5.1% and by 3.4% respectively over the previous year. Current account figures show a 789.9bn Yen (£4.6bn) surplus in FY2013. This is the smallest recorded since 1985.
5. Summer bonuses are expected to rise 5.9% compared to a year ago for large companies, reaching 800,000 Yen (£4680) for the first time in 6 years, according to a Nikkei survey.
6. Aging in both population and manufacturing capital equipment is a longer-term challenge. Measures to tackle both are overdue. According to private estimates, half of the 1800 local communities in Japan will face difficulty maintaining their existence by 2040 due to an aging local population. This would have major implications for local economies. In addition, manufacturers' capital equipment age is estimated to be 16.4 years old, which is much higher than other developed nations and may provide opportunities if large corporate cash piles are used to invest.

GOVERNMENT POLICY

7. Discussions continued across government on the new Growth Strategy planned in June. This is expected to include measures on corporation tax, labour market reform, female workforce participation, immigration, reform of the Government Pension Investment Fund and innovation. Critics comment that, as last year, the Strategy may include little practical

detail on implementation. But the GPIF reforms could provide a welcome fillip for the markets. The UK has encouraged ambition in our bilateral contacts.

8. Japan's NIH (National Institute of Health) related bills passed in the Diet. These should accelerate practical applications of cutting-edge medical technologies. This is part of Government efforts to link academic research and practical product development in the private sector more seamlessly and efficiently to promote science innovation. Informed commentators suggest that similar initiatives in other sectors should be included in the upcoming new Growth Strategy.
9. The Bank of Japan (BOJ) kept its current monetary policy unchanged. It maintained its view that the economy was 'moderately recovering', pointing to stronger business capital investment figures. It noted that other advanced economies were also recovering, boosting demand for Japanese exports. The initial economic data following the consumption tax rise in April is within their forecasts.
10. Encouraging start-up businesses is another focus for the Government to activate Japan's economy. As for special strategic zones (reflected in the June 2013 Growth Strategy), it is considering measures to promote businesses by foreigners easing regulation on their entry to Japan. The Government is also said to extend current 'Angel tax policy' (i.e. beneficial tax treatment) to encourage investment for venture businesses.
11. The Government is considering setting a population target of 100 million for 2060. This would require a birth rate of 2.07, compared to 1.41 in 2012, unless there is a radical immigration policy change. This would be a bold target for Japan, whose birth rate has been on a downward trend. The population shrank by a record 244,000 in 2013.

TRADE POLICY

12. The TPP Ministerial discussion was held in Singapore on 19-20 May. No breakthroughs to hasten the agreement, but negotiations have been re-engaged by members.
13. The European Commission submitted a one-year review report to EU member states, calling for continuation of EPA negotiations with Japan. The Commission is expected to make a final decision after discussion by the Member states. During PM Abe's visit to Europe, the UK, Japan and Germany all called for negotiations to conclude in 2015.

ENERGY AND ENVIRONMENTAL ISSUES

14. Fukui District Court ruled the restart of two Oi reactors, which are currently under safety inspection, should not go ahead. This was the first time since the Fukushima accident in

2011 that a Japanese court has blocked a utility bringing a nuclear power plant online. The Government said the ruling would not change its stance on nuclear reactor restarts (i.e. restart reactors as long as they pass Nuclear Regulation Authority [NRA] safety inspections).

15. The Government has nominated two academics to replace two of the current NRA commissioners – one of those to be replaced has been described in the media as delaying nuclear restarts due to his approach on seismicity. The appointments will be officially announced later this month following approval by the Diet.
16. TEPCO is to start selling electricity outside of its traditional service areas in October, to prepare itself for retail market liberalisation in 2016. The firm is said to be aiming for 3.4bn Yen (£20 mil) in sales outside of the Greater Tokyo area in the first year and 34 bn Yen in 2016.

PRIVATE SECTOR

17. Some major public listed companies reported the highest profits for FY2013 or are expected to do so this year including firms such as Toyota, Hitachi, and Toshiba amid weaker Yen and stronger demand. Toyota reported record net earnings of 1.82 trillion Yen (£10.4bn) for FY2013, of which about 900 bn Yen reflected the weaker Yen. Hitachi made operating profits of 533 bn Yen (£3.1bn), a record profit. Toshiba is expected to make 330 bn Yen for FY2014, which would be its highest ever profit.
18. Against the backdrop of a favourable earnings environment, equity dividend payouts have increased 20% from the previous year to a record 6.9 trillion Yen (£40bn) in FY2013. This should boost household expenditure further along with the moderately improving wage situation. However, some other major manufacturers such as Panasonic and Sony are not performing as strongly.

MARKETS

19. Ten major securities firms held the largest ever level of financial assets of 257 trillion Yen (£1.5 trillion) from investors at the end of March 2014. The introduction of NISAs (Nippon Individual Saving Accounts) and a firm equity market supported this. There has been a sign of shifting toward riskier assets. But, among Japan's total household financial assets of 1645 trillion Yen (£9.6 trillion), a small portion (only 14%) has been invested in such risky assets as equity and mutual funds.

Chart 1: CPI

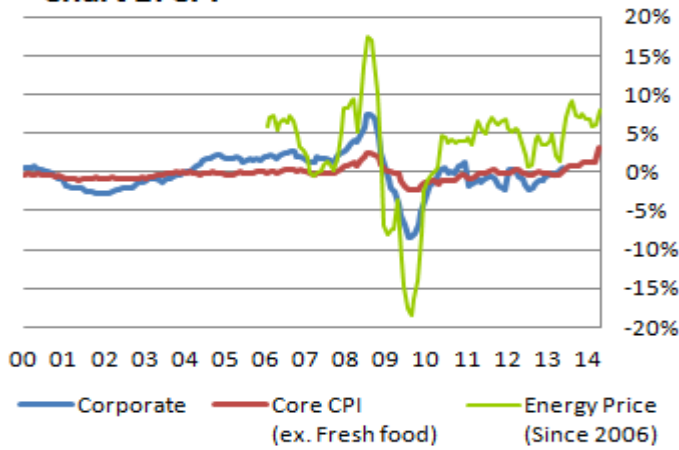


Chart 2: Labour Market

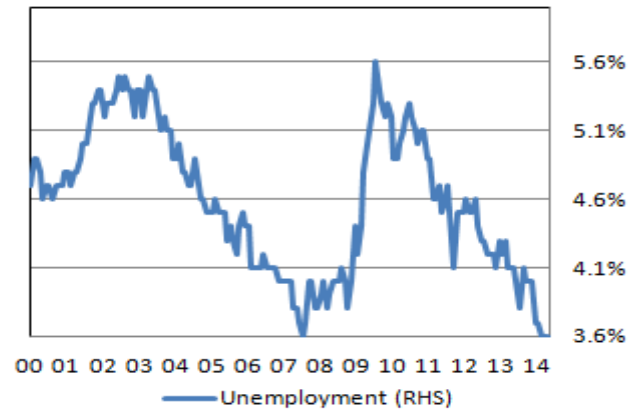


Chart 3: Wages

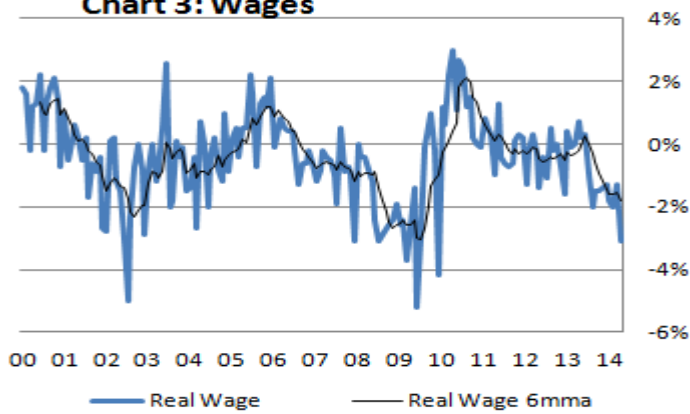


Chart 4: GDP

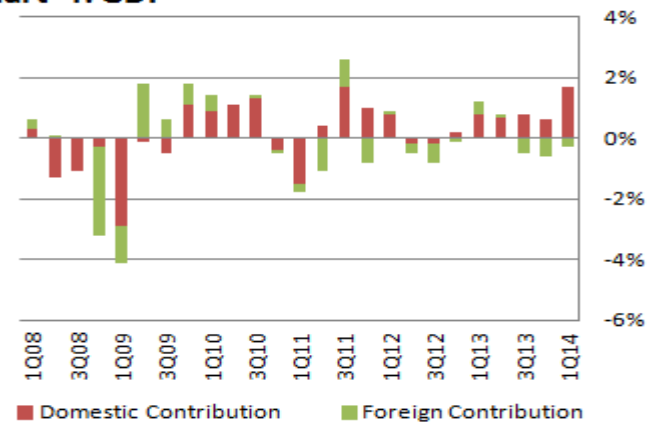


Chart 5: Stock Market



Chart 6: Yen

