British Embassy Tokyo

OCT 2014: JAPAN ECONOMIC MONTHLY REPORT

7 November 2014

Key Points

- The Bank of Japan surprises the markets with unexpected further monetary easing
- Nikkei shoots up to a seven year high and Yen weakens to a seven year low
- IMF downgrades Japan's growth forecast
- Q3 GDP is still believed to be strong enough for the planned further VAT rise to be implemented
- Economy Minister resignation delays reform bills

[This report reflects data available up to 31 October 2014.]

Please contact Sunil Sood and Akira Maekawa with any comments or questions

BANK OF JAPAN SURPRISES

1. On 31 October, in a close vote the Board of the Bank of Japan (BOJ) unexpectedly decided to expand its QQE monetary easing policy. This increases the pace of monetary base expansion by 10-20 trillion yen (£57-115bn) to about 80 trillion yen (£457bn) per year, mainly through additional purchases of Japanese Government Bonds (JGBs). The Bank is confident in achieving its 2% inflation target with these additional measures.

2. The BOJ now expects Japan's economy to grow at 0.5% in FY2014, 0.5% point lower than its previous estimate in July. It has maintained its FY2015 growth forecast at 1.5%. The Bank downgraded its forecasts for inflation slightly but still sees its inflation target being achieved within its forecasting time horizon. Weaker-than expected domestic demand after the April VAT increase and recent sharp decline in global oil prices are the major drivers for BOJ downgrading its inflation outlook.

FURTHER VAT INCREASE

3. As 17 November (release date of Japan's Q3 GDP data) approaches, discussions about proceeding with planned further VAT increase have become tense. Views in the ruling Liberal Democratic Party (LDP) are divided although a majority still appear to be in favour. Opponents propose postponing the increase until the economic recovery is firmly established and able to bear the expected negative impact from the increase. A Nikkei survey shows that 78% of market participants believe VAT should be raised, while most other surveys reveal that the majority of the population oppose further tax increases. The Ministry of the Economy, Trade & Industry (METI) estimates that the planned VAT increase would cut domestic car sales to 4.55 million units in FY2016 from estimated 4.95 million units in FY2014.

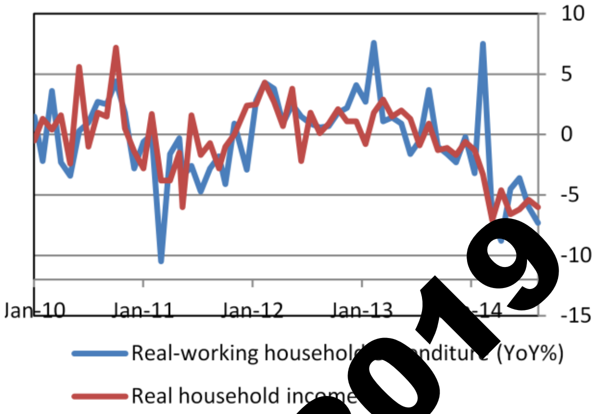
RESIGNATION OF METI MINISTER

4. Following a political funding scandal, the resignation of Ms Obuchi as METI Minister has delayed deliberation in the current Diet session on important bills such as revitalizing local economies and increasing female participation into the workforce. This could also affect METI's work on structural reforms and restarting Japan's nuclear reactors. New METI Minister, Miyazawa, who has a background in the Ministry of Finance, claims to support corporate tax cuts, even though he has previously suggested that such tax cuts should be accompanied with secured tax revenue sources.

ECONOMY

5. Consumers remain downbeat. Household expenditure declined 5.6% in September. This was the sixth consecutive monthly drop since the introduction of the April VAT increase. Car production remained weak in September, with domestic sales still depressed after the tax increase coupled with weak foreign demand. Consumer expenditure on durable goods after September is unlikely to rebound strongly. Real wages continued to fall, preventing households from increasing their spending (see **Chart A**) despite a relatively low unemployment rate (3.6% in September). Exports remained relatively flat even with a weaker yen.

Chart A: Household Spending vs. Income (YOY%)



6. Against the backdrop of weaker-than-expected domestic demand since spring, slower economic growth is expected going forward. The IMF downgraded Japan's growth forecast to 0.9% in 2014, much slower than July's figure of 1.6% (see **Table A**). For the second consecutive month the Government downgraded its own economic assessment. Private forecasters downgraded their consensus forecast for Q3 GDP to annualised 3.66% from 4.01% a month ago.

Table A: Latest IMF Forecast (Oct 2014)

	IMF		Change from July 2014	
	2014	2015	2014	2015
Japan	0.9	0.8	-0.7	-0.2
USA	2.2	3.1	0.5	0.0
UK	3.2	2.7	0.0	0.0
Euro	0.8	1.3	-0.3	-0.2
China	7.4	7.1	0.0	0.0
World	3.3	3.8	-0.1	-0.2

7. Inflation figures have softened as energy costs contributed less to data. Core CPI (excluding fresh food) rose by 3.0% YOY in September (including the impact of the April's VAT increase), compared to 3.1% YOY in August.

8. Positive signs in the economy included: three consecutive months of increased machinery orders suggesting a recovery in investment; imported cars sales having increased for the first time since April; and tourism expanding in Japan as visitor numbers reached 9.73 million by September and forecasts are for it to possibly reach 13 million by December (10.36 million in 2013 was the record). Tourists have been supporting domestic retail sales.

TRADE ISSUES

9. The 7th round of EU-Japan EPA negotiations was competed in Brussels with some progress on a variety of topics but especially on resolving the Rail procurement issue, which has created better atmospherics on the Japanese side and encouraged the speeding up negotiations to reach an agreement in principle by December 2015. The EPA with Australia is likely to be in effect by the end of 2014. Due to differences between Japan and the USA on key sectors, progress on TPP negotiations has been slower than expected although critical issues requiring Ministerial level decision could be resolved by the end of 2014.

ENERGY-RELATED

10. The Government is considering setting a new CO2 emission reduction target. This could be challenging as the government has yet to decide how much nuclear power should contribute to Japan's energy supply mix. METI Minister Miyazawa stated that the Government intends to proceed with nuclear reactor resumption [as long as reactors pass safety clearance by Nuclear Regulation Authority (NRA)]. Even so, it is unlikely

that nuclear will again contribute the pre-2011 level of 30% of the total energy mix. We expect the figure to be closer to 15-20% in 2030.

PRIVATE SECTOR

11. Japanese railway operators and manufacturers have been increasing their efforts to sell their systems overseas. This supports PM Abe's export initiatives as part of his third arrow of "Abenomics".

12. The Japanese Trade Union confederation (Rengo), the Japan's largest labour organization, is expected to ask for an increase in base-salaries of over 2% at its collective bargaining sessions next spring. It reasons that on-going inflation justifies this demand.

MARKETS

13. The Nikkei 225 equity index hit a seven year high and the Yen weakened to a seven year low against the US dollar, following the BOJ's further QQE scheme. Some market commentators expect a further weakening of the Yen: possibly to 120 Yen to the US$1 by the end of 2014.

COMMENT

14. Japan's economic fundamentals have not changed despite the boost given to the markets at the end of the month by the BOJ's decision. The momentum of growth does not yet appear to have been strong enough to absorb the negative impacts from the April's VAT rise. The weaker Yen will most likely boost Japan's manufacturers' profit margins but could hurt general households' purchasing power and SMEs through higher import costs.

15. Although the deflation mindset that has dogged Japan for many years has seemingly been banished, Japan's risk adverse companies are still waiting to see what the next phase of "Abenomics" - structural reform with clear implications and metrics - will bring, before they start spending on their cash piles. The Government only has a comparatively short window of opportunity to introduce significant reform before the campaigning starts for the next election and political inertia sets in sometime in 2015. Failure to deliver structural reform by late spring could seriously impede market confidence in the Government's ability to deliver radical economic change and put the economy into a sustainably higher ground.

Chart 1: CPI (%Y/Y)

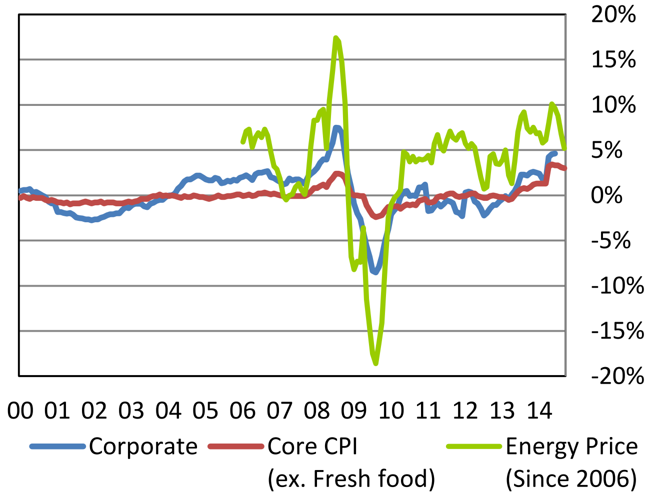


Chart 2: Labour Market

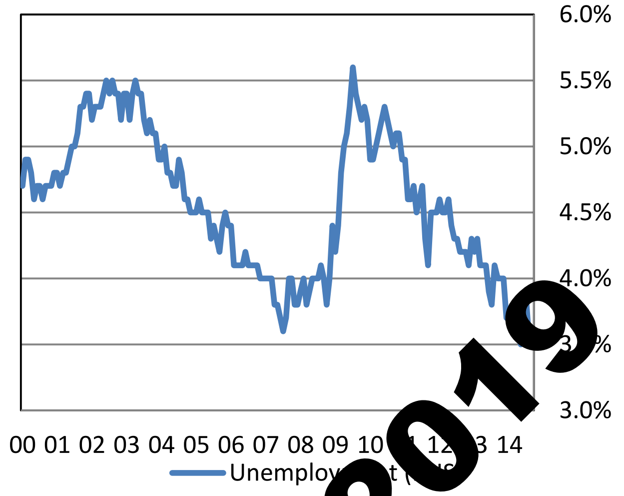


Chart 3: Real wage (%Y/Y)

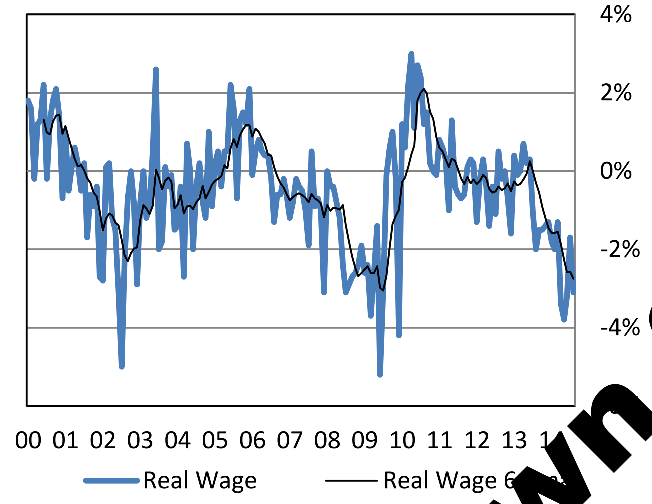


Chart 4: Real GDP (% Q/Q)

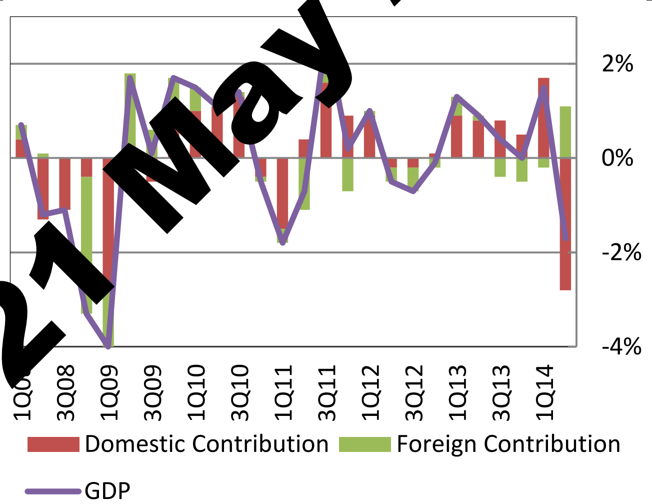


Chart 5: Stock Market

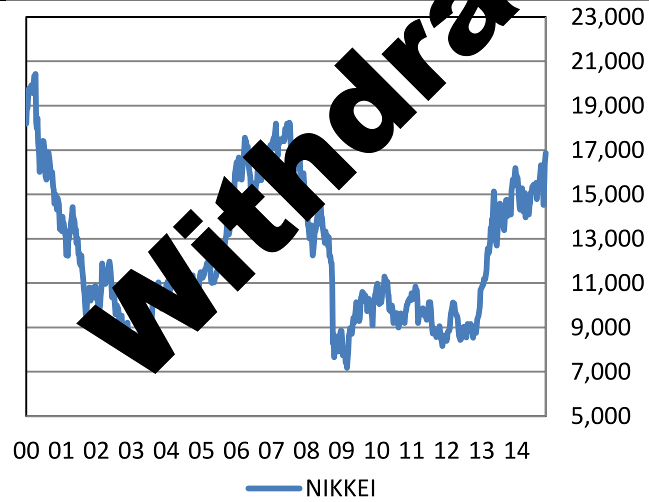


Chart 6: Yen