Japanese economic activity post the GST hike – August 2014

National Australia Bank

Key Points:

- *The rise in the consumption tax rate has had the expected impact on the economy. Spending was pulled into the pre-tax months and has fallen sharply since the rate rose from 5% to 8% on April 1st. Although Japanese firms have told the central bank that the consequences of the tax rise were much as expected, June quarter's fall in consumer spending was substantial, exceeding growth reported in the two previous quarters.*
- *Although a government stimulus plan is supposed to help maintain post-tax demand, the economy's ability to absorb a fall in consumption and keep growing has been set back by the weakness of world trade. Japan repeatedly tried to export its way out of previous bouts of soft domestic demand but this time sluggish demand for its goods across key Asian markets are putting a further brake on economic activity.*
- *Partial economic data shows broad-based weakness in recent months, spreading beyond areas normally affected by a downturn in consumption. Recent disappointing monthly data for exports and investment as well as softness in some recent manufacturing surveys suggest June quarter GDP could fall by around 1½ %.*
- *Once the economy has digested the sales tax increase, modest growth should resume. The labour market had been picking up until recently with slowly rising employment, falling unemployment and more job vacancies. Despite Government efforts to boost wages, nominal wage measures remain quite flat and the pick-up in inflation is eroding both real wages and real household income. Nevertheless, the household income and employment situation is still fairly good by recent standards and profits remain high which should support a resumption in investment growth.*
- *We have revised our 2014 growth forecasts down to 1.3% (was 1.6%) while 2015 growth is still around 1.5%, above the IMF's ½% assessment of Japan's long-term potential growth.*

Figure 1: Activity struggling back to pre-tax levels – Shoko Chukin monthly business survey readings

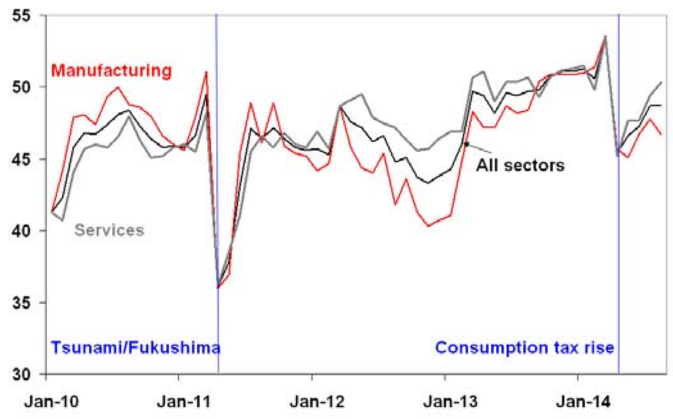

Table 1 : Recent activity indicators Quarterly % change

	Dec-13	Mar-14	Jun-14
Demand indicators			
Consumption	0.4	2.3	-4.6
Exports	1.5	-1	-1.1
Imports	1.6	4.5	-7.1
Net export index	-123	-297	-98
Output indicators			
Manufacturing			
Output	1.8	2.9	-3.8
Capital goods	4.4	4.9	-3.4
Building goods	0.2	0.2	-2
Consumer goods	1.7	3.8	-5.4
Shipments	2.6	4.6	-6.7
Inventories	-1.7	-1.1	3.1
Service activity	-0.2	1.8	-3.7

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Consumption tax hike hits spending more than expected

- The April lift in the consumption tax has had the predictable disruptive effect on normal patterns of business activity. As was the case when the consumption tax was raised in 1997, there was a rush to buy prior to the imposition of the tax followed by a hole in demand after it was implemented. Business contacts told the Bank of Japan that the post tax rise drop in demand was around expectations and sales through the quarter gradually picked up from their trough in April.
- Retail and wholesale sales fell heavily in the June quarter - by 5½% and 7% respectively - and that has flowed into a 4.6% fall in the aggregate measure of household spending. Output trends have paralleled those in spending with a drop of around 5½% in manufacturers output of consumer goods, a big fall but smaller than the 7¾% fall in shipments of these products. As a result, inventories of consumer goods have built-up and these will have to be cleared as the inventory to shipment ratio spiked upwards after April.
- The 2004 consumption tax rise led to fall in consumer spending at least as big as seen in 1997 but tracking the monthly numbers shows a slightly stronger recovery from the tax rise month this time around. Service sector firms reporting to the Markit PMI and Shoko Chukin SME business surveys have reported a gradual improvement in activity in their latest results but July/August is still below early 2014 levels.

Table 2 : Post tax hike drop in activity exceeds prior build up

Quarterly % change in consumer related activity

	Sept qtr	Dec qtr	Mar qtr
Consumer spending	0.4	2.3	-4.6
Wholesale sales	1.3	3.1	-5.6
Retail sales	1.4	3.9	-7
Consumer goods output	1.7	3.8	-5.4
Consumer goods shipments	2.6	5.2	-7.7
Consumer goods stocks	-4.8	1.5	8.3

Figure 2: 2014 tax impact on consumer Spending volumes similar to 1997 tax rise

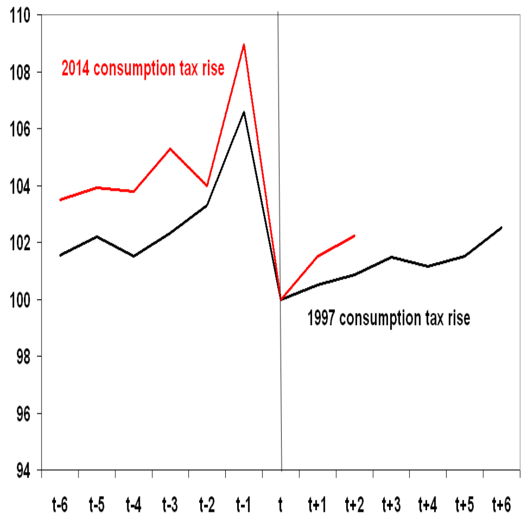
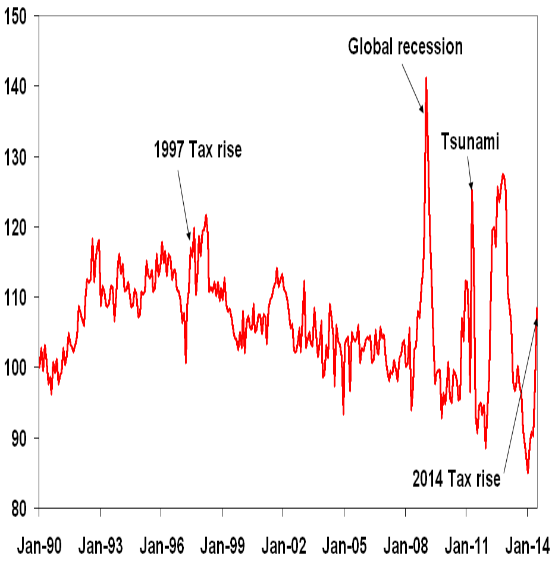


Figure 3: Consumer goods stock/sales ratio



Sluggish world trade makes it hard for Japan to export its way out of trouble

- After the 1997 consumption tax hike de-railed recovery in Japanese domestic spending, business switched attention to overseas markets in an effort to export their way out of protracted recession. This growth model became the cornerstone of government policy with the hope that higher exports would boost output, profits, investment, labour hiring and household income– finally laying the groundwork for an eventual upturn in domestic demand. Things did not work out like that, however, and the recovery in household income never arrived.
- Relying on exports to boost growth looks more difficult this time as the 2% yoy pace of growth in world trade is very sluggish. Key Japanese export markets like China have been growing faster than the global economy but that is not feeding through into faster growth in Japanese export volumes. The latter have stagnated since mid-2013 and growth in shipments to China has been only 2% yoy. A shift toward more offshore production by big Japanese multi-nationals at the expense of exports from their Japanese factories accounts for some of this weakness.
- The absence of much growth in exports feeds into the recent lacklustre performance of the manufacturing sector. Manufacturing shipments to foreign customers were down by around 2% in the 3 months to May compared to the previous 3 month period – failing to provide any offset to the slump in shipments to the domestic consumer goods market.

Figure 4: Industrial shipments- index levels

Figure 5: World trade and exports % yoy

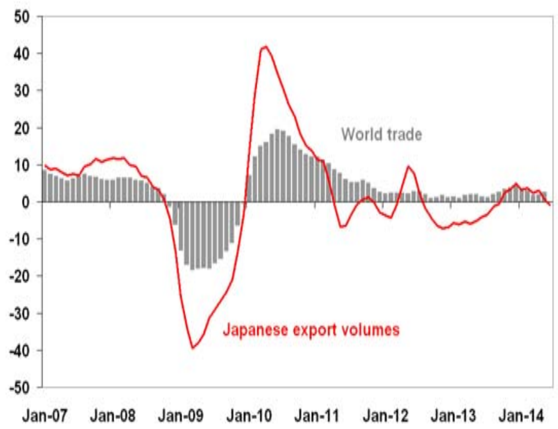


Figure 6: Japanese exports markets % share

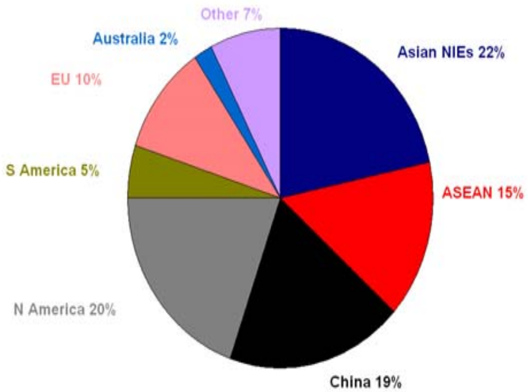


Figure 7: Exports to key Asian markets % yoy

Industrial sector hit by soft exports and consumption tax rise

- This combination of a tax-driven fall in domestic sales of consumer goods with lacklustre export demand has curbed activity across large parts of the industrial sector. The post April downturn in manufacturing output has been spread across consumer, construction, capital and intermediate goods and the latest figures showed a bigger monthly decline than expected.
- While output trends have disappointed, the recent figures for corporate earnings have been high by historical standards. Profits and profitability were high going into this softer patch and the Shoko Chukin survey shows earnings expectations gradually improving through the last few months after falling sharply in April.
- The outlook, at best, is for profit stagnation this fiscal year. The Tankan business survey shows firms expecting a drop in current profits in the current fiscal year, especially in the 6 months to September. The ESRI survey shows a similar dip in profits around now but neither it nor the Tankan show a sustained earnings downturn with a levelling out in the later months of 2014 and early 2015.
- High capacity utilisation rates should support investment and there was an upward trend in capital spending prior to the April tax rise. However, the latest monthly data and business surveys point to a more subdued outlook. Overall, there is little sign that the Japanese economy is in any position to pursue the virtuous circle of export-output-earnings-investment growth.

Figure 8: Industrial sector turning down

Figure 9: Profitability good, investment just OK

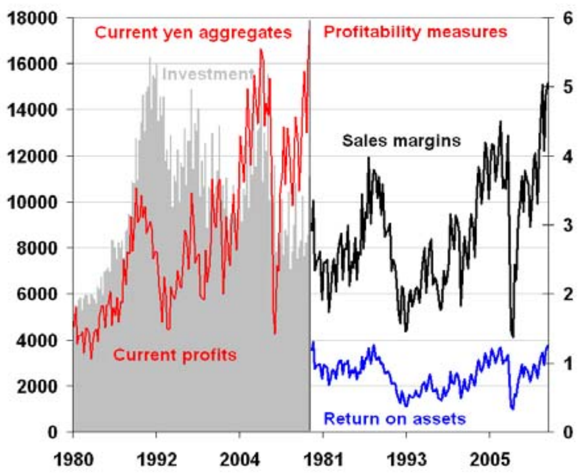


Figure 10: Investment indicators

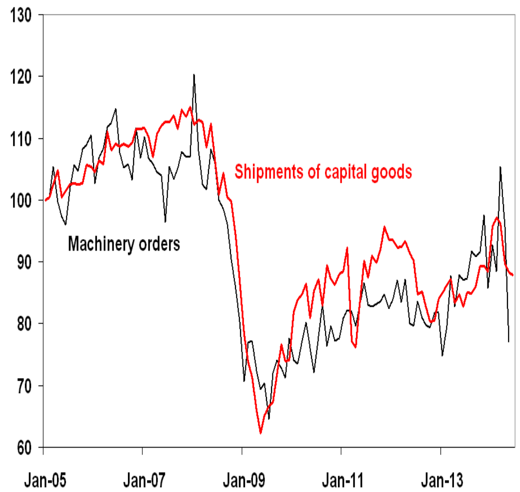


Table 3: Tankan survey results not great

Tankan quarterly business survey % yoy

	Sales	Profits	Investment
Apr 2013 -Sept 2013	2.9	36.5	5.2
Oct 2013-Mar 2014	7.9	21.7	5.9
Fiscal 2013	**5.5**	**28.4**	**5.6**
Apr 2014-Sept 2014	2.3	-8.5	11.3
Oct 2014-Mar 2015	-0.4	-2.4	-6.1
Fiscal 2014	**0.9**	**-5.4**	**1.7**

Labour market still buoyant – only a small impact of tax rise so far

- The Japanese authorities are relying heavily on the trend improvement in the labour market to ensure that the April tax hike does not repeat the experience of 1997 and crush growth in domestic demand.
- Employment has been trending up through the last few years but that growth has been fading recently, as reflected in the slippage in year on year job growth since late 2013. The Ministry of Labour survey shows full time employment has not suffered since April, it actually rose sharply in June. Part time employment, on the other hand, has turned down slightly.
- The labour market is very tight by historical standards. The number of vacant jobs offered is back around its pre-GFC peak while the number of job applicants has been trending down and there are now more vacancies than applicants. The number of people placed in jobs has, however, dipped since the start of the year- so uncertainty over the outlook could well have had some impact on hiring patterns.
- Until recently, there had been a trend decline in the unemployment rate – from 5½% in mid-2009 to 3½% in May but the rate rose slightly to 3¾% in June. The monthly data is volatile but the 110000 rise in June in the number of people unemployed needs to be watched closely in case it – and the decline in job placements – are early signs of a weakening in the labour market whose previous strength has been seen by the authorities as vital for solid growth.

Figure 11: GDP and employment % yoy

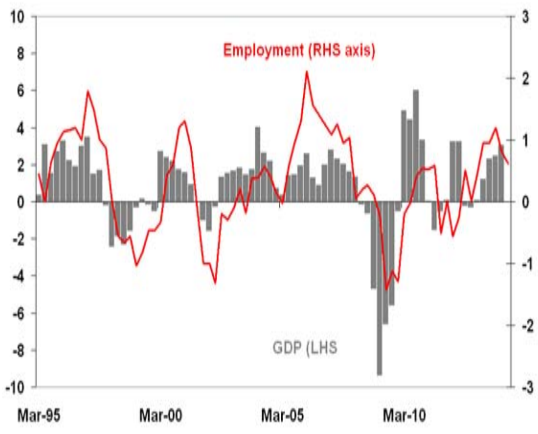


Figure 12: Employment holding up well - index

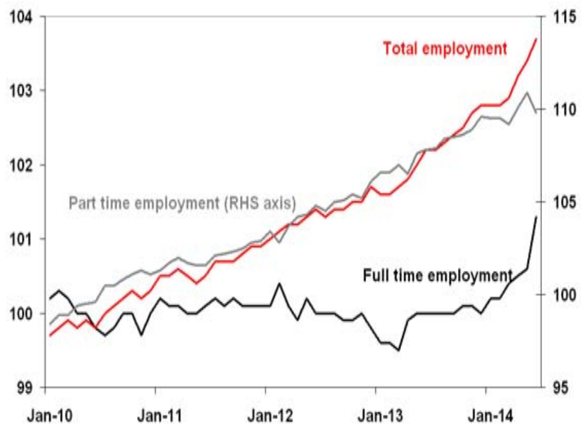


Figure 13: Fewer job seekers, more job offers

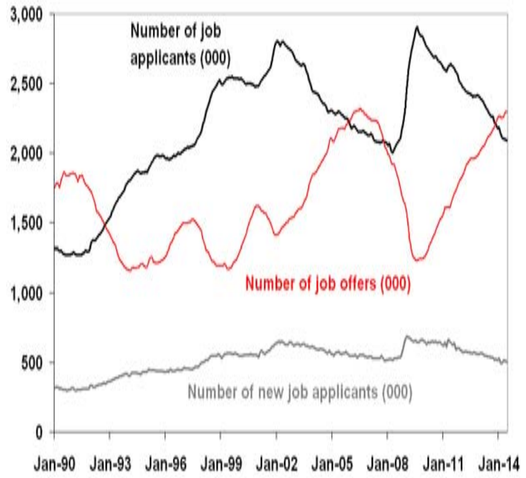
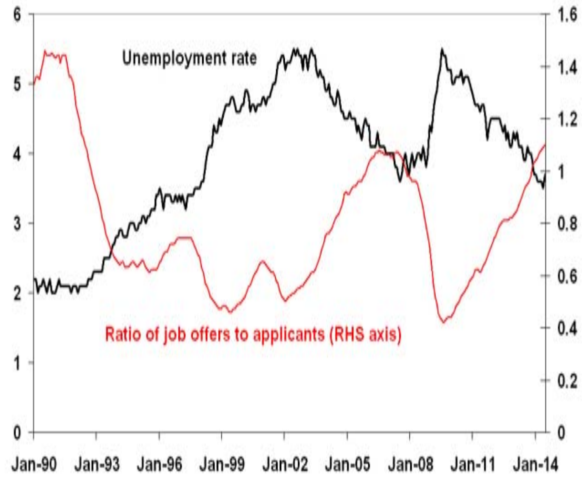


Figure 14: Jobless rate trending down



Waiting for household income to finally grow

- The Achilles Heel of previous efforts to get a sustained upturn in domestic demand in Japan has been the failure to deliver much increase in pay to people likely to spend it. The export-led growth strategy did boost output, corporate profits and investment but the link that was supposed feed into higher household income, spending and domestic demand broke down. Hence successive upturns have petered out.
- The current government are well aware of the benefit that boosting nominal wages could give to lifting domestic demand and permanently ending deflationary risks. Hence the pressure put on business in this years "Shunto" wage round to lift basic pay, not just one-off bonuses. Several big auto and electronics firms did indeed increase wages but the impact on aggregate pay has been limited.
- This is because Japan now has a two-tiered labour market with a core of unionised employees in big corporations while 35% of workers are in less regular jobs with less bargaining power, entitlements and wages.
- Economy-wide measures of average nominal pay suggest that it has levelled out rather than increased and the return of inflation has brought falling real earnings. The monthly family income and expenditure survey also shows falling average nominal and real incomes for worker households – recent results being exacerbated by the tax-rise driven spike in inflation. Although it was rising up to early 2014, nominal employee compensation remains well below its pre-GFC level.

Figure 15: Wage rate indices still weak
Regular employees average earnings

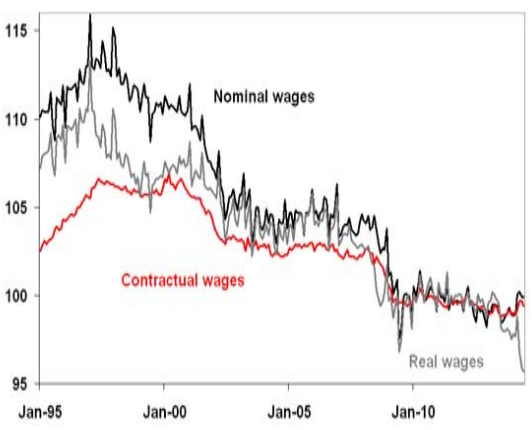


Figure 16: Workers income falling recently
% change year on year

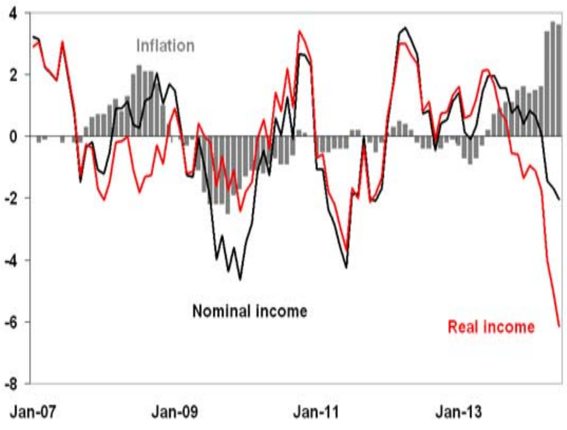


Figure 17: Employee earnings had been rising
Level Billion yen quarterly

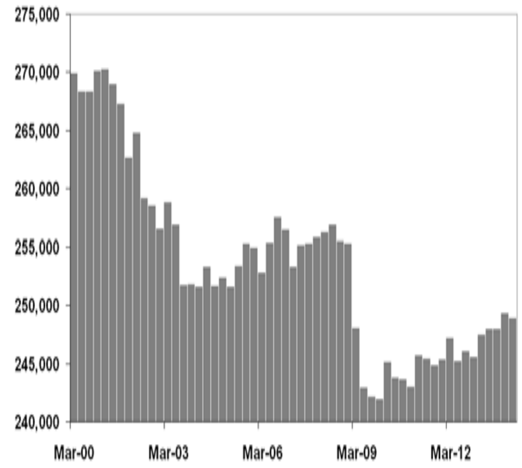
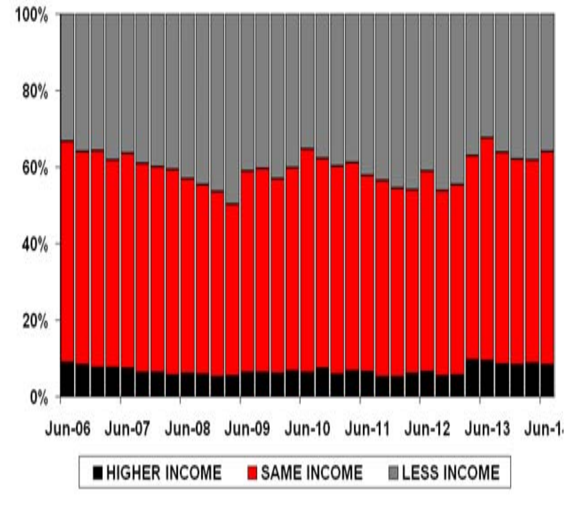


Figure 18: Income next year % those asked



Australian exports to Japan

- Japan is Australia's second largest export market with goods exports in 2013/14 of A$48 Billion, beaten only by China with $A101 Billion. Australian trade is quite specialised with coal and iron ore accounting for almost half of the value of all goods exports.
- Japan buys both steaming and coking coal with 2012/13 steam coal shipments of 77 million tonnes, the largest to any single market in that year, and coking coal exports of around 40 million tonnes, again ranking first. The Japanese steel industry is the biggest single customer of Australian exports as, besides the coking coal, there is another 75 million tonnes of iron ore that is usually shipped annually.
- Japanese demand for Australian raw materials follows the industrial cycle with a clear parallel between movements in industrial output or steel production and Japanese import volumes of raw materials.
- Bulk commodity prices are the other big driver of Australian export revenues to Japan, especially given the extent to which these prices have tended to move together.
- The outcome of these price and volume drivers has generally been a disappointing export value growth outcome. The surge in bulk commodity prices in 2008 inflated export earnings for a while but that soon passed and export earnings have been going sideways to down since 2010. Goods exports reached $53 Billion in 2008/9 and have never regained that peak.

Figure 19: Australian exports to Japan 2013 %

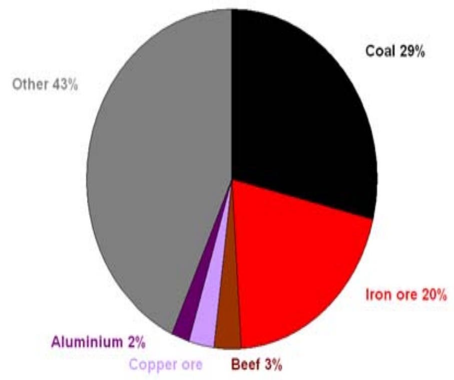


Figure 20: Imports and the business cycle % yoy

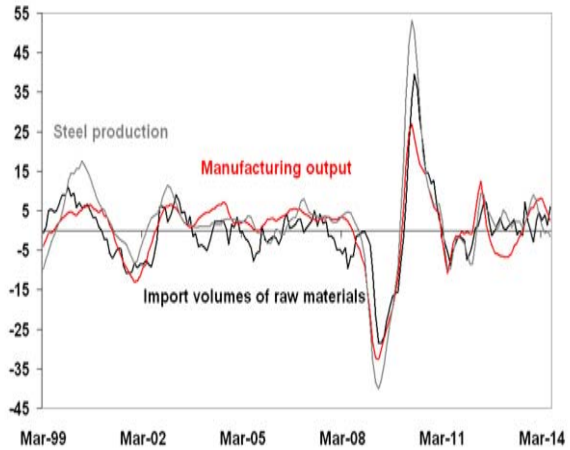


Figure 21: Bulk commodity export prices $A/t

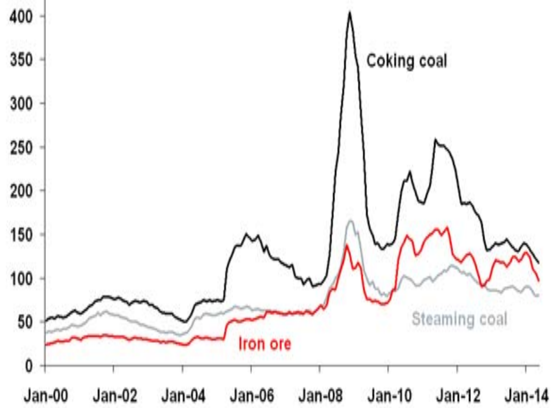


Figure 22: Monthly Australian exports $ Mill

New Zealand exports

- Japan is the fourth largest export market and trade is also dominated by shipments of commodities. Dairy, forest products and kiwifruit are important export trades alongside items like aluminium and beef.
- While the product mix differs, the trade outcome for New Zealand exports to Japan has been disappointing as well. After being above $NZ 3 Billion through the previous decade, New Zealand annual exports to Japan fell under that benchmark in 2012/13 and then fell further in 2013/14.
- Although activity levels in Japan's steel industry are not the central driver of New Zealand export activity, the importance of aluminium and forest products means that the industrial cycle is still of importance. Building products account for a large proportion of the forest product trade and several of the indicators of housing industry activity have been quite soft in recent years.
- Commodity prices are also a key driver of export earnings and the long term weakness in aluminium prices has hit New Zealand's biggest single product going into the Japanese market. Forest product prices have not shown much of a trend in the last few years while $NZ dairy prices have been high by historical standards but are now weakening.

Figure 23: Monthly NZ Exports NZ$ Million

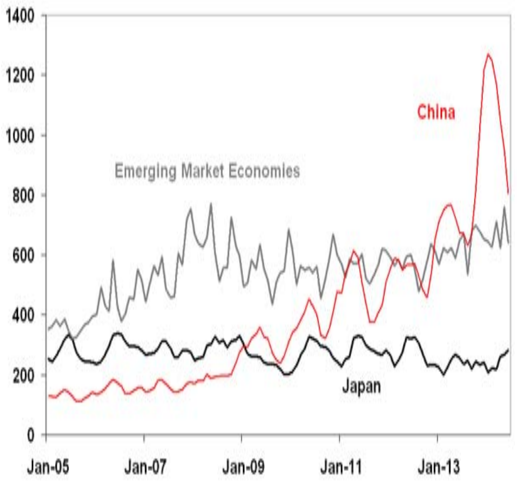


Figure 24: Commodities dominate export mix

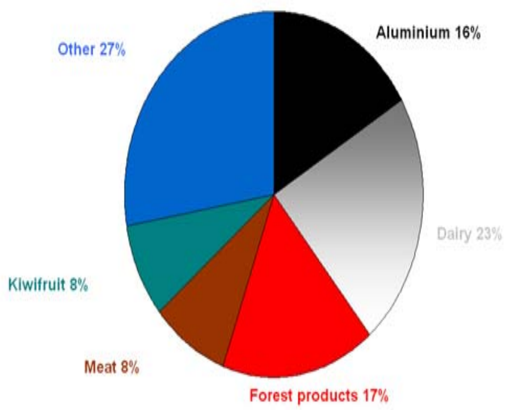
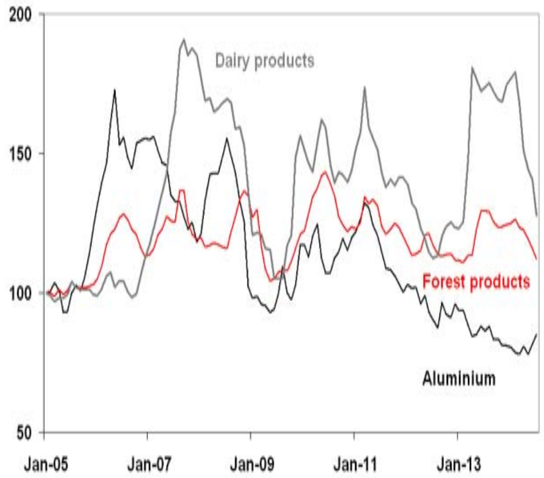


Table 4: Main exports to Japan NZ$ Million

	2011	2012	2013
Aluminium	662	487	461
Cheese	322	310	321
Kiwifruit	301	318	225
Beef	186	197	186
Fibreboard	119	150	138
Casein	111	104	102
Logs	90	91	97
Plywood	75	73	56
Wood pulp	94	69	53
Sheepmeat	68	45	49
Particle board	37	38	36
Milk powder	23	26	35

Figure 25: ANZ NZ$ Commodity price index



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