Japan economic update

NAB Group Economics

November 2015

National Australia Bank

Summary & Overview

- Gross Domestic Product (GDP) fell for the second consecutive time in the September quarter. While this is often considered to indicate a country is in recession, this is not a meaningful guide for a country like Japan whose population is falling. Other indicators, in particular for the labour market, but also business surveys, trade and consumption indicators do not indicate an economy in recession. Moreover, the decline in September quarter GDP was largely driven by an inventory correction and domestic demand was stronger.
- Labour market conditions remain tight with the unemployment rate at 3.4%; wage growth though remains restrained.
- Nevertheless, it is clear that the economy has struggled to regain any strong momentum post the increase in the VAT in 2014. This weakness is disappointing particularly in the light of the strong growth (by Japanese standards) in gross national income.
- Japanese corporations have enjoyed record profit growth, which has swelled their cash and deposit holdings. For the success of 'Abenomics' it is critical for businesses to boost wages and investment, thereby setting off a 'virtuous circle' of higher activity and prices. A concern has been that the high level of corporate profits has not translated into commensurate increases in investment. However, indicators point to some possible improvement in business investment in the near term.
- While exports of goods and services grew in the September quarter by 2.6% on the previous quarter, the annual growth rate has been decelerating, and total exports have actually declined over the last six months. The large depreciation of the Yen since late 2012 has provided a large boost to the competitiveness of the Japanese tradeables sector. However, several factors have acted to hold back export growth.
- Inflation remains modest, with the core (ex fresh food) CPI measure declining by -0.1% over the year to September. The Bank of Japan (BOJ) has pushed back its forecast for Japan achieving the 2% inflation target to the second half of fiscal 2016.
- There have been record tourist arrivals – particularly from China – which has improved the current account position in 2015. Besides, a high level of FX reserves and a strong net international investment position, suggests a very strong external situation.
- The Yen has depreciated 16% over the year to November, 2015 against the greenback. However, there has been a recent surge in USD funding premiums, which will likely raise costs of Japanese banks and corporations with overseas operations.
- The BOJ maintained its policy stance at its most recent (November 19th meeting). The current low level of JGB yields will likely limit the effectiveness of further easing.
- There is a tension between the desire to use fiscal policy to support the economy and the need to improve the Government's finances. Even though fiscal policy has turned into a headwind, the government is struggling to meet its fiscal targets.

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Q3 GDP – a recession?

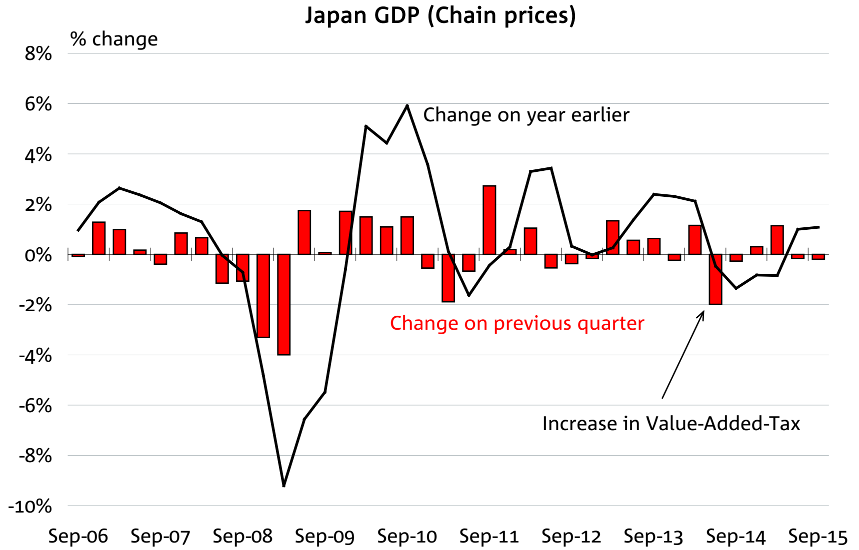
- Japan's Gross Domestic Product (GDP) fell in the September quarter for the second consecutive quarter. Two quarters of negative GDP is often described as an indicator of a 'technical' recession, but it is not a suitable gauge for an economy with a declining population as in Japan. According to the BOJ, the country has a potential GDP growth rate of only a bit over 0.1% a quarter. Statistical noise or small, transitory shocks, can produce negative GDP growth rates, even without any major underperformance in the economy.

- The decline in the September quarter in large part reflected an inventory correction, after inventory accumulation supported growth in the first half of the year. Domestic final demand was positive – growing at 0.2% (reversing the previous quarter's decline) supported by a rebound in private consumption, residential investment, and public demand. Exports also grew strongly, although the annual growth rate has slowed from double digits at the end of 2014 to around 3%.

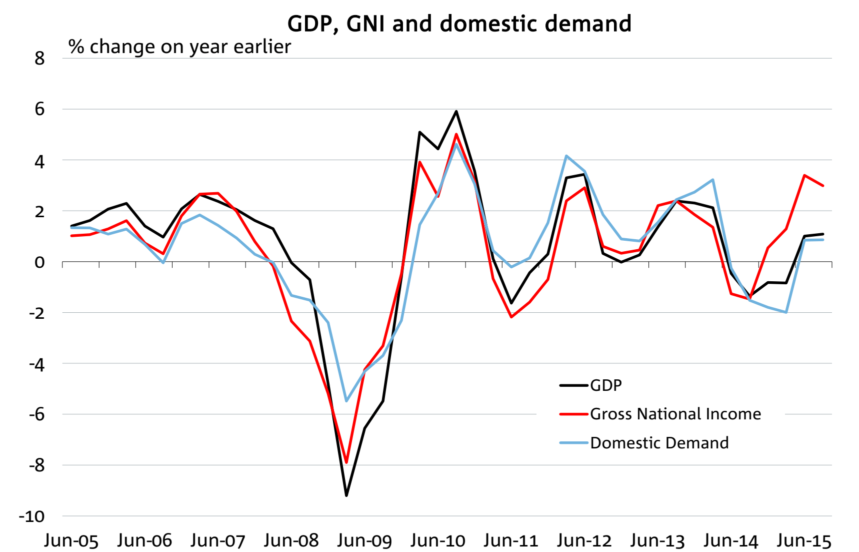
- The major negative was that business investment declined for the second consecutive quarter. This followed a strong start to the year and comes despite strong corporate profits.

- Looking at the annual growth rate to smooth out the quarterly volatility, GDP grew by around 1% yoy. This period follows the contraction in activity caused by the value added tax increase (VAT) in April 2014 so some bounce would have been expected. So while the economy has been growing, it has struggled to regain any solid growth momentum since the VAT increase.

- This weakness is disappointing particularly in the light of the strong growth (by Japanese standards) in gross national income. As a major commodity importer, Japan has enjoyed a large boost to its terms of trade (the ratio of prices received for its exports to the price paid for imports) from the large fall in commodity prices, particularly oil. Moreover, the depreciation of the currency provides a boost, in Yen terms, to income received from abroad.



Sources: Thomson Reuters Datastream



Sources: Thomson Reuters Datastream, NAB

Business conditions and consumption

- The trend in consumption has been heavily influenced by changes to taxes. There was a spike in consumption ahead of the increase in the value-added-tax (VAT) rate in April 2014, followed by a large fall in activity. The subsequent growth in consumption has been modest. Taxes on new car registrations also increased in April this year.

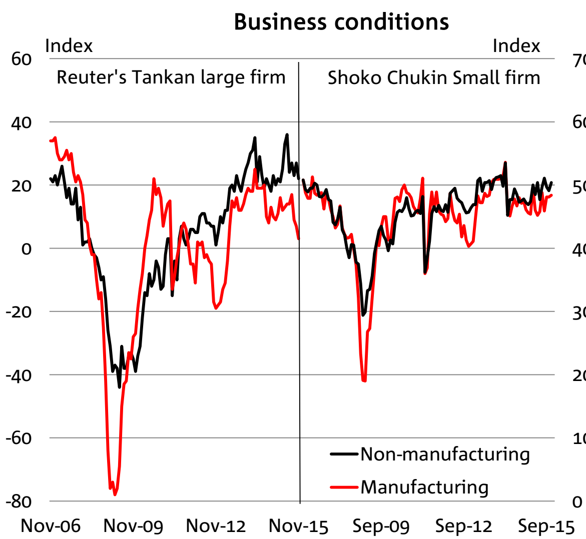
- Consumption settled at a new lower level post the VAT increase probably reflecting the fact that it represents a permanent reallocation of income from households to government. There are positive factors supporting consumption growth, however, including a strong labour market and the large fall in oil prices which increased the spending power of Japanese households. These factors, as well as wealth gains from rises in stock prices, underpinned the gradual improvement in consumer sentiment following the VAT.

- Early indicators for December quarter consumption are reasonably positive. In October, the annual growth rate for department and convenience store sales reached their highest level in around half-a-year.

- At the same time business surveys are mixed, with conditions varying between sectors, but overall they do not point to an economy in recession.

- The Reuter's Tankan monthly survey shows a decline in conditions for large firms particularly in the manufacturing sector. This survey historically appears to track profits more than output, so the decline indicates a slowdown in profit growth (which would still leave the level of profits at a high level).

- In contrast, the Shoko Chukin survey of small firms has been more resilient, although again it suggests non-manufacturing is out-performing. Moreover, the manufacturing PMI has been improving indicating that Japan may be emerging from the recent weakness in industrial production.



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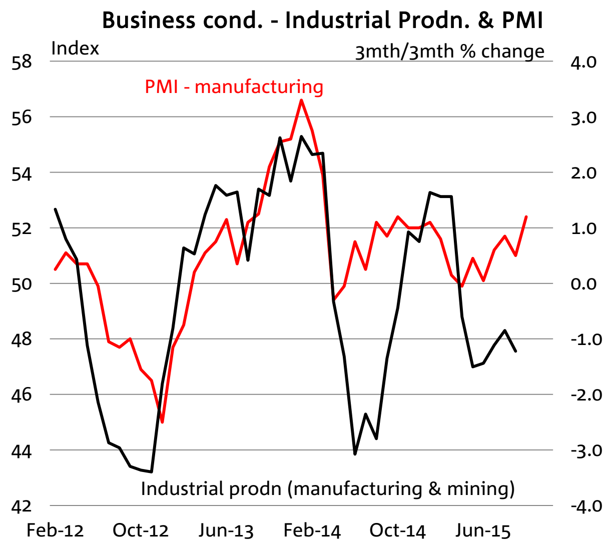

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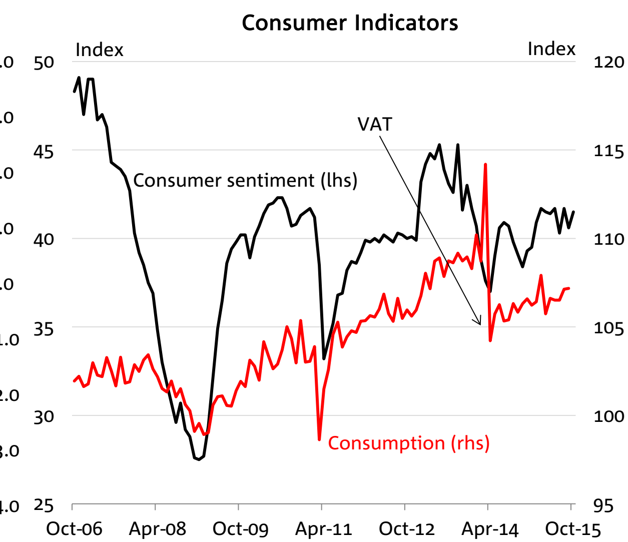
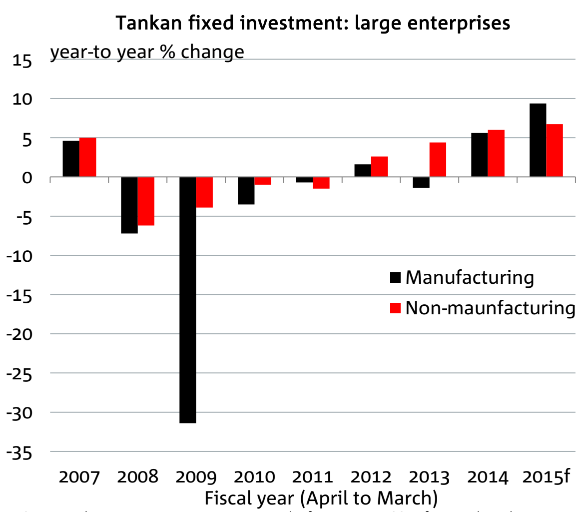


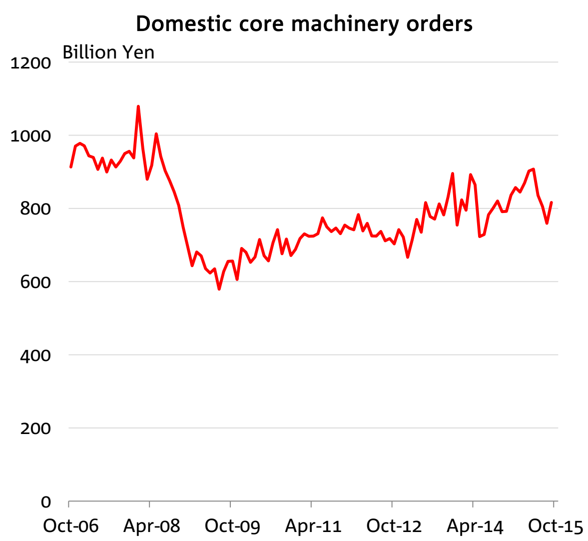
Source: Thomson Reuters Datastream

Recent economic – investment and trade

- A concern has been that the high level of corporate profits (see page 6) has not translated into commensurate increases in investment, highlighted by the decline in the September quarter. Domestic orders of core machinery (which exclude volatile utilities and shipping) have also been weak in recent months, although they increased in October possibly indicating that the trough has been reached.
- On a more optimistic note, the Bank of Japan's quarterly Tankan survey suggests that, for large enterprises, the trend in recent years for business investment has been upwards, and that based on intentions this should continue into the current fiscal year (which runs from April 2015 to March 2016).
- While exports of goods and services grew in the September quarter by 2.6% on the previous quarter, the annual growth rate has been decelerating, and total exports have actually declined over the last six months.
- The large depreciation of the Yen between late 2012 and mid-2013, and the more gradual depreciation trend since then, provided a large boost to the competitiveness of the Japanese tradeables sector.
- However, several factors have acted to hold back export growth. While the continued slowdown in the Chinese economy and modest growth in the East Asia more generally is part of the reason, other more structural factors are at play. According to the Bank of Japan, these include: emerging economies, including China, are now producing internally manufacturing parts and other goods they used to import, excess capacity and inventories is reducing the need for capital goods, and weak global IT demand.
- Moreover, research by the IMF has found a weakening in the relationship between goods trade and the exchange rate in the case of Japan, due in part to the shift of production offshore and Japan's significant involvement in global value chains. Service exports such as tourism, however, appear to have benefited greatly from the fall in the Yen (see page 10).



Sources: Thomson Reuters Datastream, Bank of Japan, NAB. 2015 forecast based on September '15 survey forecasts plus the average difference between September survey and actual outcomes in last four years.



Source: Thomson Reuters Datastream. Core excludes utilities & ships

Source: Thomson Reuters Datastream. * Measured by real effective exchange rate; a lower number indicates improved competitiveness

Corporate profits

- Japanese corporations have experienced record profits. In the June quarter, 2015 current actual profits (after interest payments) rose by 23.8% on a yoy basis to ¥20.3 trillion.

- A weaker currency, lower input costs (particularly fuel) and favorable lending conditions, assisted by the BOJ's QQE program, helped contribute to this outcome.

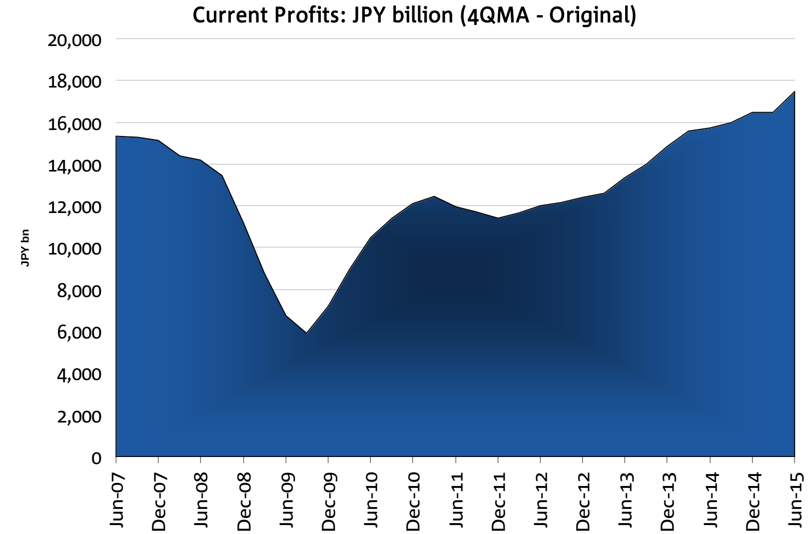
- The ratio of current profits to sales was 6.4% in the June quarter, a recent high. The ratio was particularly impressive in the real estate, electricity, services and the information & communication sectors. Conversely, profitability was somewhat muted in retail and wholesale, but still positive.

- The high levels of profits have swelled the deposits of Japanese corporations. According to the Bank of Japan's Flow of Funds survey for the June quarter, Japanese private nonfinancial corporations had cash and deposits amounting to ¥243 trillion (approximately USD 2 trillion).

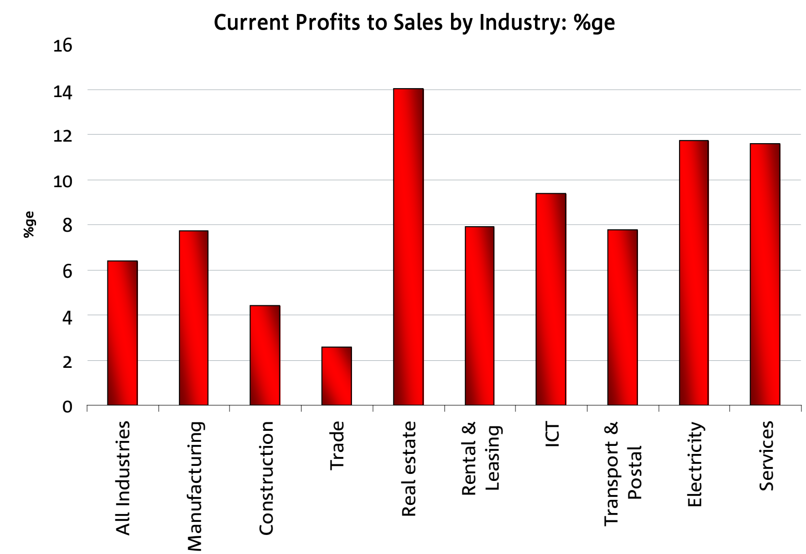
- A survey by Nihon Keizai Shimbun expects pre-tax profits for Japan's listed companies to rise by 8% over the fiscal year to March, 2016. The automotive, electrical and chemical sectors are anticipated to record stronger growth compared with the rest.

- Some of these trends are already visible. High end automobiles are enjoying rising demand in the US market, benefitting Fuji heavy industries who own Subaru. Chemicals company, Sumitomo Chemical, recorded its first interim profits in nine years, and electronics firm Murata manufacturing, which produces components for high speed communications, recorded an increase in its share price.

- High levels of corporate profits do afford Japanese companies the financial space to raise wages and/or capital investment spending – although they might be cautious due to concerns regarding China and Emerging market economies. Measures to reduce the corporate tax rate from the 2016 fiscal year might provide some fillip to wages and investment.



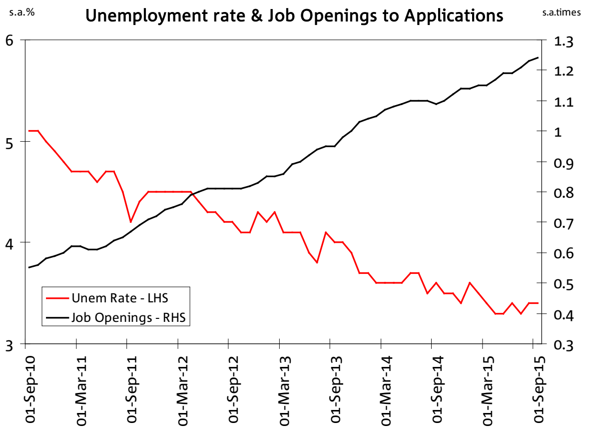
Source: Ministry of Finance



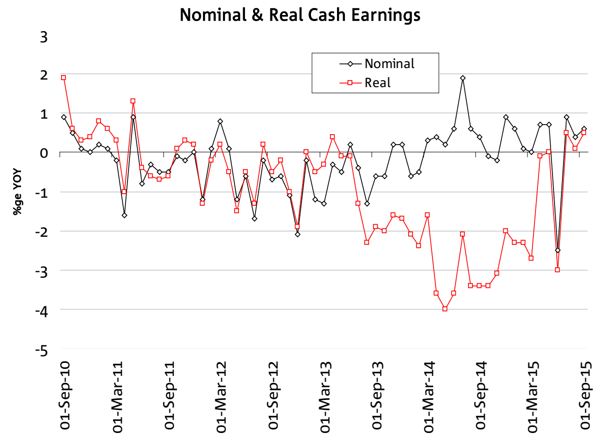
Source: Ministry of Finance

Labour market

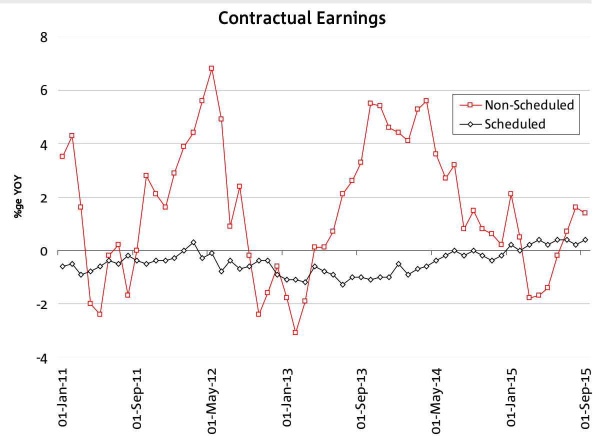
- Japan's labour market has been showing positive momentum. The unemployment rate (seasonally adjusted) is currently at a low 3.4% as at September, 2015. Further, the ratio of job openings to applications, a measure of labour market tightness, is at a high of 1.24.
- Encouragingly, the relatively low level of unemployment has also been accompanied by an increase in the participation rate, which rose to 60.2% in September 2015, a level not seen since September, 2010. The female participation rate too has increased, and this has been one of the structural reform objectives of Abenomics. The increase in the female labour force participation has been particularly pronounced among the 35-39 year age cohort: it increased to 73.5% in September, 2015.
- Labour income has increased, but not as strongly as suggested by the tight labour market. Nominal cash earnings rose by 0.6% over the year to September, 2015. Real (inflation adjusted) increased by 0.5%. The composite figure includes earnings of both full-time and part-time employees, with the latter tending to earn less. According to statistics from the Ministry of Health, Labour and Welfare, the number of part time employees increased by 3.3% yoy to September, 2015, and full time employees by 1.5%; this change in workforce composition is dragging down the recorded average wage increase.
- Turning to nominal earnings, base pay (scheduled earnings) rose by 0.4%, whilst over-time related pay increased by 1.4% (non scheduled). Another critical element in pay relates to bonus payments.
- The winter bonus for employees of large corporations is anticipated to be ¥910,000/employee, according to preliminary results released by Keidanren (Japan Business Federation). This amounts to a 3.1% increase on last year. Car companies and machinery metals manufacturers are expected to record the highest level of bonus payments. Overall, ten of the twelve industry groups survey indicated an increase in bonus payouts.
- In a recent speech, Governor Kuroda highlighted the close nexus between wages and inflation, suggesting they were both sides of the same coin. In other words, if prices were to rise without a commensurate increase in wages, consumers might restrict their spending due to falls in real incomes. This, in turn, will lead to lower future price growth.
- Prime Minister Abe too has been pressing business leaders to raise wages and thereby generate a 'virtuous circle' in which higher wages lead to more spending and rising prices, helping Japan achieve its growth and inflation objectives.



Source: Bloomberg/BOJ



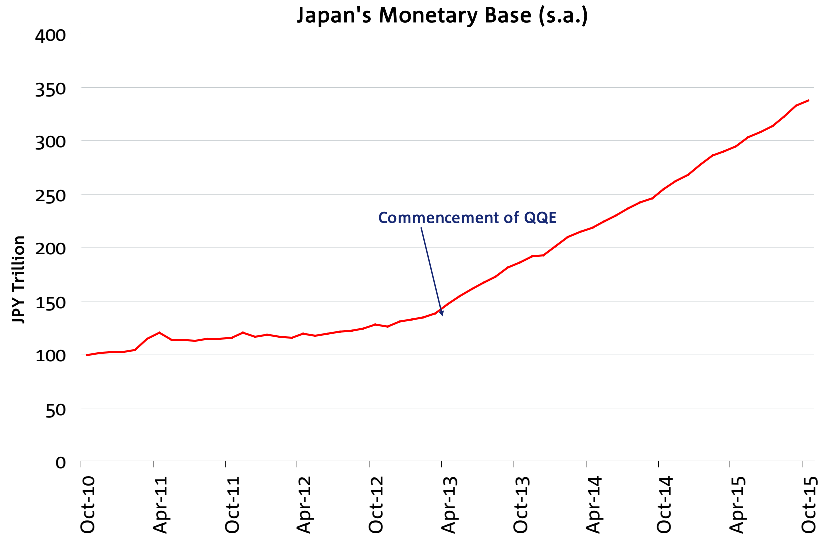
Source: MHLW



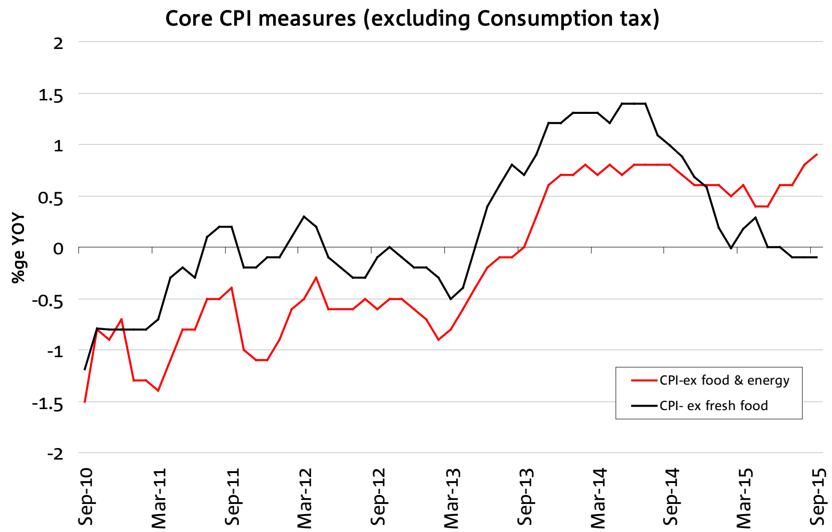
Source: MHLW

Monetary policy & inflation

- The Bank of Japan launched its Qualitative and Quantitative Easing (QQE) program in April 2013. The aim was to achieve a 2% inflation target, and get Japan out of its deflationary situation. It is one of the 3 arrows of ‘Abenomics’.
- In October, 2014 the BOJ expanded its QQE program, by targeting a ¥80 trillion annual increase in the monetary base, up from ¥60-70 trillion, partly to mitigate against the negative impacts of the consumption tax rise in April, 2014.
- The program consists largely of purchase of JGB (Japan Government bonds), but also includes purchase of ETFs (exchange traded funds) and J-REITs (Japan real estate investment trusts) to reduce risk premia.
- Japan’s monetary base was ¥336.7 trillion in October 2015.
- As highlighted by BOJ Board member, Yutaka Harada, this program has generated positive impacts through portfolio rebalancing effects: boosting demand for risky assets, which has lowered the Yen and raised equity prices.
- On the inflation front, actual outcomes have improved since the launch of QQE, but are still well short of 2%.
- Core CPI (ex fresh food) actually declined by -0.1 % over the year to September, 2015. The BOJ has highlighted the role played by weak energy prices. This is also confirmed by the core-core price indicator (CPI ex food and energy) which rose 0.9% yoy in September, 2015. This measure has risen consistently since the recent lows (0.4%) in April and May.
- The BOJ maintained its monetary policy stance in the November meeting, as well as deferred the expected date for achieving the 2% inflation target. It now expected the target to be achieved by the latter part of fiscal 2016 (around January-March 2017). Crucially, this rests on the assumptions of improving economic activity and rising oil prices.
- One key objective though is to raise inflation expectations. Market based measures such as the 10 year Break even rates (calculated as the difference between real and nominal JGB’s) indicate inflation long-term expectations of around 0.8%, well below the 2% target. Further, forecasts from the Japan Centre for Economic Research indicate that CPI ex food is expected to rise by a modest 1.2% yoy in the first quarter of 2017.
- The revised inflation forecast track has allowed the BOJ more time to observe price developments. However, if the BOJ fails to sufficiently raise inflation expectations, it may consider expanding the pace of its easing program in the future.



Source: BOJ

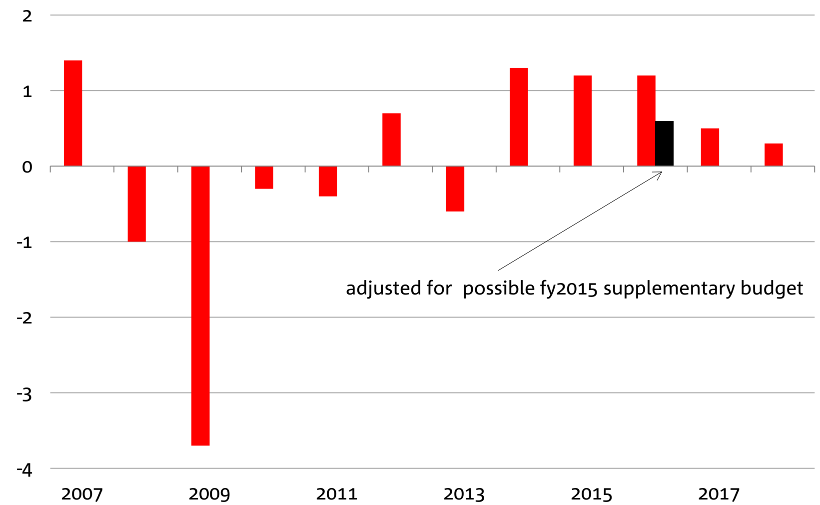


Source: Statistics Japan

Fiscal policy

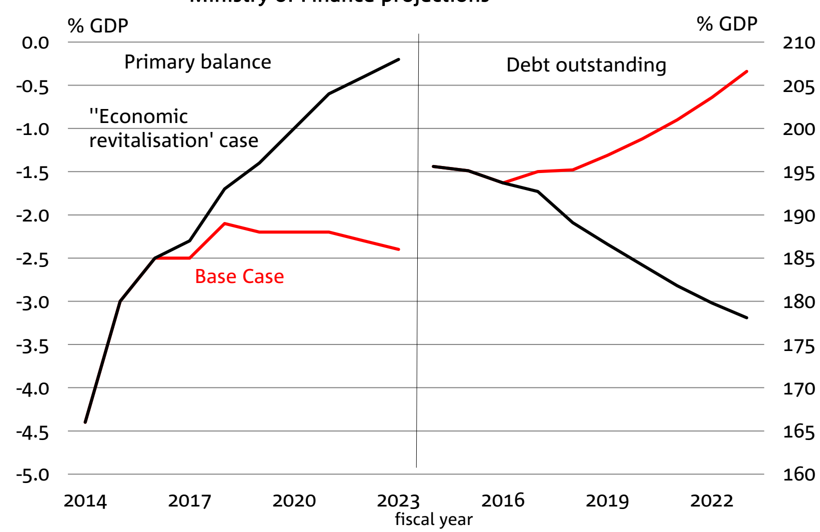
- One of the ‘three arrows’ of Abenomics was ‘flexible fiscal policy’. True to its description fiscal policy has been pushed and pulled to meet competing goals.
- The main tension has been the desire to get the economy growing and to end Japan’s long deflation. At the same time the Government wants to reduce Japan’s large budget deficit. This is in order to stop the increase in its already high, by international standards, debt levels.
- The change in the cyclically adjusted budget balance, as estimated by the IMF, provides one measure of the stimulus to the economy coming from fiscal policy. It suggests in the first year of Abenomics – 2013 – the budget was used to provide a stimulus to the economy. However, it has since been a headwind to growth, starting in 2014 with the increase in the VAT.
- According to press reports, the Government is considering a supplementary budget for fiscal 2015 (which would be introduced in 2016) of at least 3 trillion Yen (around 0.6% of GDP). This would reduce the extent of fiscal constraint on the IMF’s estimates or, on the basis of Ministry of Finance estimates, leave fiscal policy roughly neutral.
- This tension between trying to support growth but improve the budget position is likely to continue. The government currently has the following fiscal targets: (1) to halve the ratio of the primary deficit of the central and local governments to GDP by FY2015 from the ratio in FY2010; (2) to achieve a primary surplus by FY2020, and (3) thereafter steadily reduce the public debt to GDP ratio.
- The Japanese Ministry of Finance publishes medium-term fiscal projections. It provides two estimates – a baseline where the economy grows at around its current potential and inflation remains below the Bank of Japan’s 2% target and a ‘economic revitalization’ scenario where potential growth is raised by economic reform and the inflation target is achieved. Growth in the revitalisation scenario is consistently over 2% - suggesting very high productivity growth for an advanced economy. Even though the Japanese government has announced reforms such as the TPP trade agreement, privatisation of Japan Post, a reduction in the corporate tax rate and the creation of special economic zones, the revitalisation scenario appears very optimistic.
- While the fy2015 target is likely to be achieved, not even with the most optimistic estimates is the fy2020 target for a primary balance achieved. This suggests that pressure for further consolidation measures will remain and there is still the issue of the proposed VAT increase in 2017.

Change in cyclically adjusted general govt. primary balance: % GDP



Sources: IMF, NAB. A decrease (increase) in the budget balance indicates fiscal stimulus (contraction)

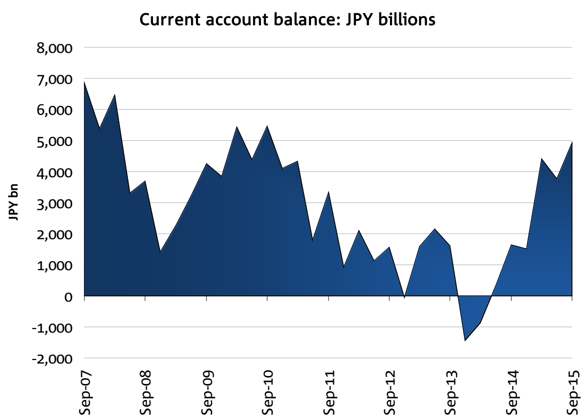
Ministry of Finance projections



Sources: Ministry of Finance: central & local govt projections , NAB

Current account

- Japan's current account surplus for the April to September 2015 was ¥8,693.8 trillion, four times the size of the corresponding surplus in 2014.
- There was a sizeable 90% decline in the goods deficit, driven by improving exports and declining imports, with the latter impacted by falling energy prices.
- The services deficit fell by 55% over the April to September period compared with year-ago levels. Fees for the use of intellectual property rose by a solid 64% to ¥1,171billion; financial services also grew strongly.
- Tourism related services have recorded a remarkable improvement. Over the 6 months to September 2015, the net balance on tourism was a surplus ¥608.5bn. This is in contrast to the -¥12.8bn deficit over the same period in 2015.
- Overseas inbound arrivals rose by a very strong 51% over the 6 months to September, 2015 in yoy terms. This was driven largely by a staggering 122.4% increase in visitor numbers from China. The Abe administration has highlighted tourism as one of the critical sectors in boosting Japan's nominal GDP. This improving trend has continued into October, 2015 with 1.82 million arrivals, a 43.8% yoy increase.
- Despite notable improvements in both the goods and services balances, both these segments in fact recorded deficits. The current account surplus was largely accounted for by a positive primary income balance category – i.e. income Japan earns from overseas investment. The primary income balance was ¥10.8 trillion for the April-September 2015 period: an 18.1% increase over the previous corresponding period in 2014.
- The returns from overseas stem from Japan's position as a net external creditor. Japan's net International Investment position (net foreign asset position) relative to GDP was 75.2% as at the end of 2014. In fact, Japan's net International Investment position has risen consistently since 2010.
- While estimates for 2015 are not yet available, it is likely that this ratio would have increased. In a bid for higher returns overseas – driven partly by unfavorable demographics and their large cash holdings – Japanese corporations have continued acquiring overseas corporations. The Nikkei group's purchase of Financial Times, Sumitomo Life's purchase of Symetra Financial in the United States and Japan Post's purchase of Australian logistics operator, Toll Holdings, are among noteworthy overseas acquisitions.
- The IMF is forecasting a 3% current account surplus for 2015, considerably higher than the 0.5% outcome in 2014.



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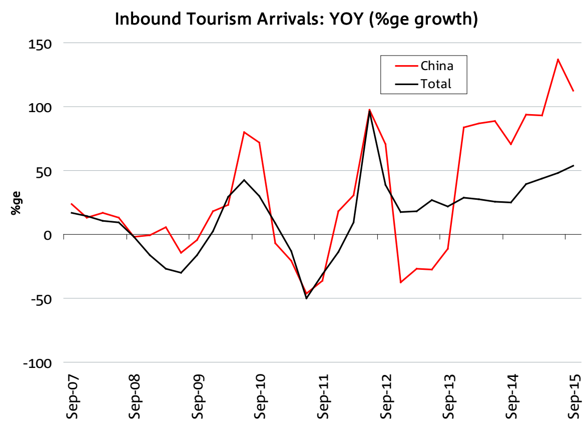

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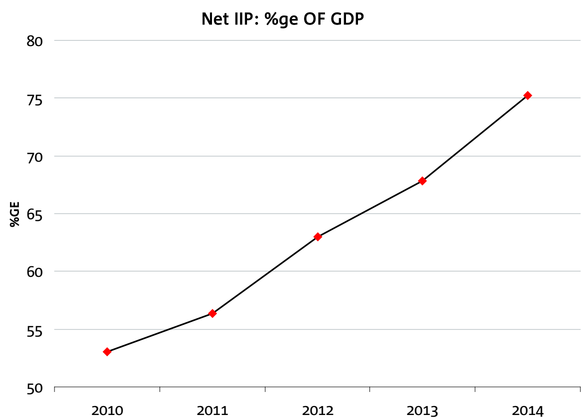
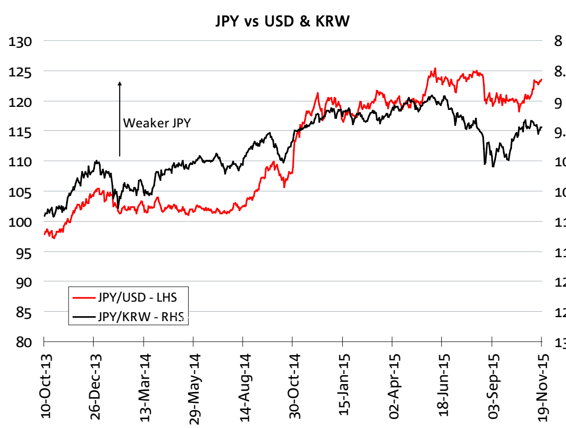


Source: Ministry of Finance

FX: Currency and Reserves

- The currency has been last trading at around 123 Yen to the USD. A weaker (and more competitive) currency has been one of the consequences of the Bank of Japan's QQE operations. Over the past year, the Yen has depreciated 16% against the USD. That said, there has not been a continuous period of depreciation over the past year. The Yen did in fact appreciate over the August-September 2015, as investors sought the 'safe haven' refuge of the Yen due to ructions in EM stocks and currencies. However, this appreciation trend has reversed since mid-October onwards.
- The Yen's decline over the past year against the Korean Won has been comparatively modest: falling by 5%. Japan and South Korea share a number of similar characteristics: they compete across a number of common export categories (.e.g. electronics and machinery) and are both ageing societies. With a slowdown in global trade, exchange rate competitiveness is likely to assume increased significance.
- There has been a recent rise in USD funding premiums. This reflects reduced USD supply from American financial institutions due to regulatory requirements, as well as expectations of a Federal Reserve rate hike, with NAB Economics expecting a Fed lift-off in the December meeting.
- One year premiums – as evidenced from the cross currency basis swaps – have risen from about 0.25% a the beginning of the year to around 0.7% currently. These higher premiums - if sustained - will raise the funding costs of Japanese banks and businesses with overseas operations, and potentially limit the scope for further overseas expansion.
- Japan's FX reserves are very high at USD1.24 trillion. It has the second highest stock of FX reserves in the world, with only China surpassing it. This level of reserves has been brought about, in part, through consistent surpluses in its current account.
- Overall, Japan's current account, net international investment position and stock of FX reserves do indicate a very strong external position.



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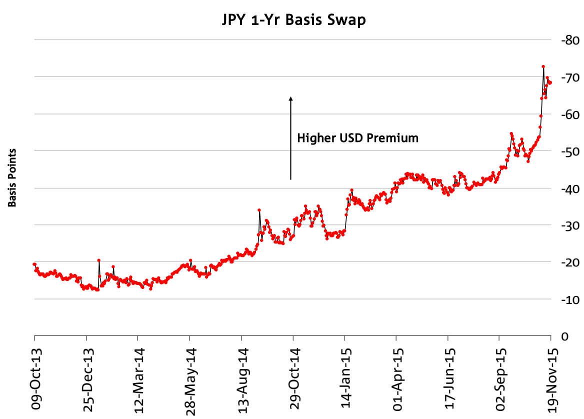

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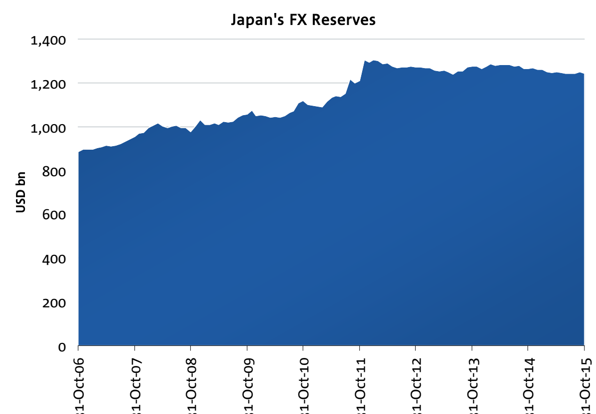
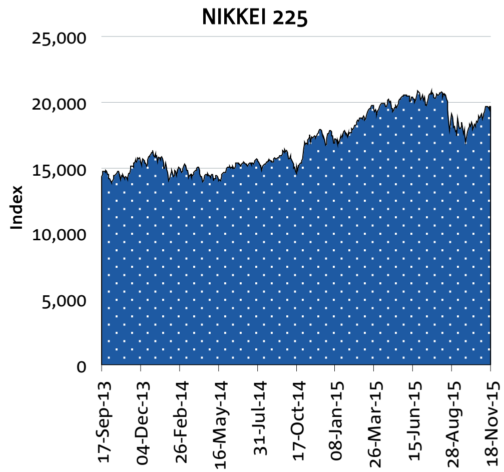


Source:Bloomberg

Financial markets

- Japan's Nikkei 225 equity index has retraced some of its recent losses, and is once again approaching the 20,000 mark due to increased overseas interest.
- An increased risk off environment during September and October surrounding concerns in China and its impact on other emerging economies led to a sell-off from overseas investors, dragging down Japanese equities. This period also witnessed a surge in equity market volatility, which has subsided since.
- There remains strong investor demand for highly recognised Japanese corporations. The IPO for *Japan Post* Holdings on the 4th of November, was heavily oversubscribed. The parent company, along with its banking and insurance subsidiaries surged following their stock exchange debut.
- Looking ahead, some of the factors likely to impact equities include: corporate earnings; the Yen; as well as potential 'risk-off' events from emerging markets and geopolitical concerns.
- JGB bond yields remain contained, and were last trading around 0.3%. These low yields have been driven largely by large scale purchases by the BOJ. According to *Ministry of Finance* data, the BOJ accounted for 28.5% of outstanding JGBs and T-Bills as at the end of June, 2015.
- Short term (2-year) yields recently turned negative, driven in part by demand from overseas investors wishing to avail of commissions by providing dollars (see discussions on previous page).
- While lower yields reduce borrowing costs for businesses, low to negative yields could present challenges for the BOJ in conducting monetary policy effectively. For example, negative yields could prevent the BOJ from purchasing the required quantity of short-term JGBs.
- Finally, JGB futures volatility – a measure of uncertainty – has eased to around 1.6%, after spiking slightly around August-September. This suggests a broadly stable environment in the JGB market.



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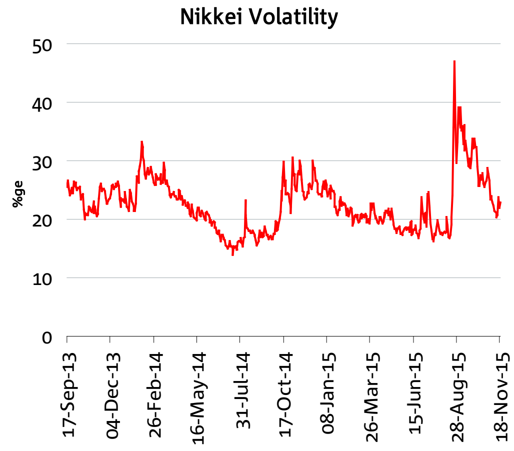

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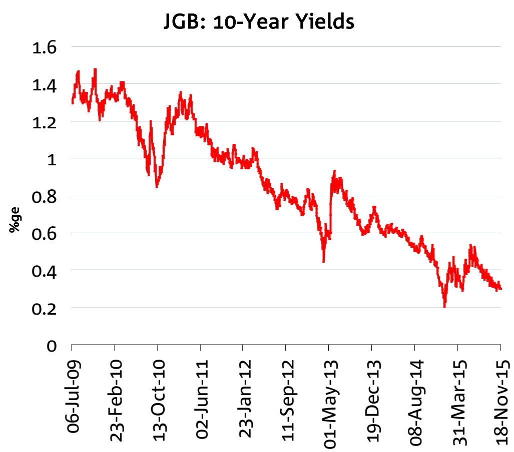
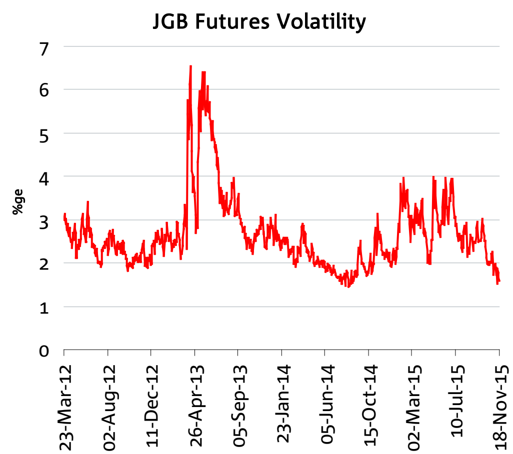


Source: Bloomberg



Source:Bloomberg

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