Economics

DBS Flash

Japan: Three key growth challenges in 2019

Group Research

14 February 2019

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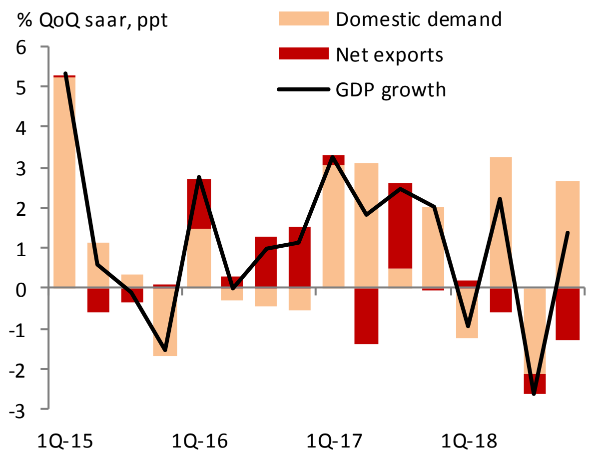
- *The Japanese economy has emerged from the natural disasters last autumn but the return to positive growth has been disappointing*
- *We have trimmed our 2019 GDP growth forecast to 0.7% from 1.0%*
- *First, the consumption tax hike in October is widely expected to hurt domestic demand but the impact will be lesser than the previous increase in 2014*
- *Second, the export slowdown has not been fully priced in, not helped by signs that manufacturing sector activities have stalled*
- *Third, the outlook has also been complicated by recent reports on the government's statistical errors, particularly those pertaining to labour and wages*
- *Against a more challenging outlook this year, the Bank of Japan is likely to maintain its short- and long-term interest rate targets at -0.1% and 0% respectively, and at the soonest, consider a rate hike in 2H 2020*

The Japanese economy has emerged from the natural disasters last autumn but the recovery was nothing to shout about. Preliminary real GDP growth turned positive to 1.4% (QoQ saar) in 4Q18 but this was not enough to offset the -2.6% decline in 3Q18. The recovery was led by domestic demand where an increase in public spending helped lead the recovery of consumption and investment from the disasters. On the other hand, external demand remained as a notable drag on headline growth (**Chart 1**). Full-year GDP growth has decelerated to 0.7% in 2018 from 1.9% in 2017 and below our 1% forecast. We have trimmed our 2019 GDP growth forecast to 0.7% from 1% previously.

Chart 1: GDP growth rebounded on domestic demand, but exports remained a drag



The consumption tax hike is largely expected

Until lately, the 2019 growth outlook debate has centered on the **consumption tax hike** scheduled in October. The tax increase will **dampen domestic demand less this time around**. First, the tax hike will be smaller at 2ppt compared to the 3ppt rise in 2014. Second, some daily necessity items, such as food and newspapers, will be excluded in order to lessen the impact on low-income households.

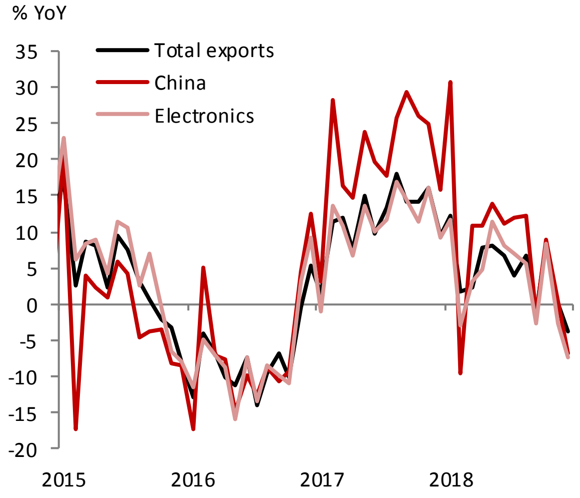
Government policies are more supportive this time. The cabinet has approved a record JPY101.5tn budget for FY19, a 3.8% increase compared to last year, and the biggest rise seen since 2011. The budget specifically allocated JPY2tn spending to counter the impact of consumption tax hike, for example, shopping vouchers to help the low-income households and higher infrastructure spending.

The motivation for policy support should be strong this year. Abe's Liberal Democratic Party intends to tout the success of Abenomics in delivering Japan's longest post-war recovery ahead of the upper house elections in July. The imperial transition in April and the G20 Osaka summit in June will also put Japan in the international spotlight this year.

Downside risks from the export slowdown…

The downside growth risks from external sources are new that have not been fully priced in. The global economic slowdown and faltering electronics demand have started to weigh on Japan's exports (**Chart 2**). Export conditions are likely to get worse before better in the coming months. Key leading indicators such as Taiwan's electronics export orders and China's manufacturing PMI have continued to point south.

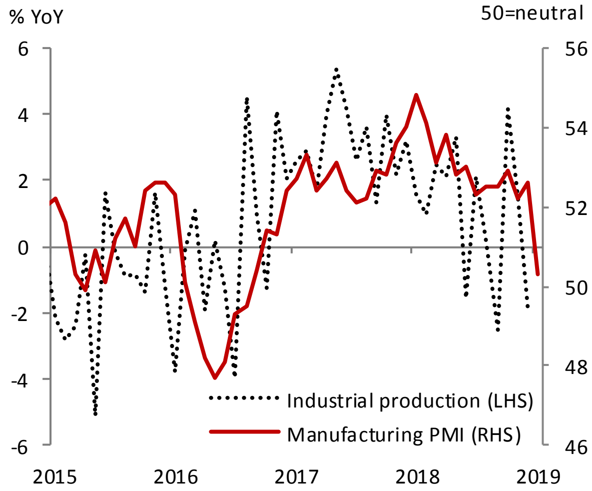
Chart 2: Export growth dragged by China and electronics



There are additional headwinds from the US-China trade disputes and the potential automobile tariffs considered by the Trump administration. These could offset the tailwinds from Japan's further trade liberalisation such as the implementation of Comprehensive and Progressive Agreement for Trans-Pacific Partnership and Japan-EU Economic Partnership Agreement in 2019.

The macro impact of export slowdown should not be underestimated. Exports of goods and services account for a small 17% of Japan's GDP. Thanks to the large swings in export cycle, the contribution of net exports to GDP growth has been more significant at an average of 38% in the last three years. There are tentative signs that the country's manufacturing sector growth has stalled in 1Q19 due to the weakness in exports. Manufacturing PMI has fallen to 50.3 in January, sharply down from 52-54 in the past 12 months, and the lowest seen since August 2016 (**Chart 3**).

Chart 3: PMI falling to the lowest since August 2016



… and official statistical errors

Recent reports on the government's statistical errors have complicated the picture. The labour ministry was found to have surveyed only a third of the country's large companies during 2004-2017 before correcting its methodology in 2018. According to a report from the internal affairs ministry, about 40% of the government's 56 key economic data releases contained errors and needed revisions.

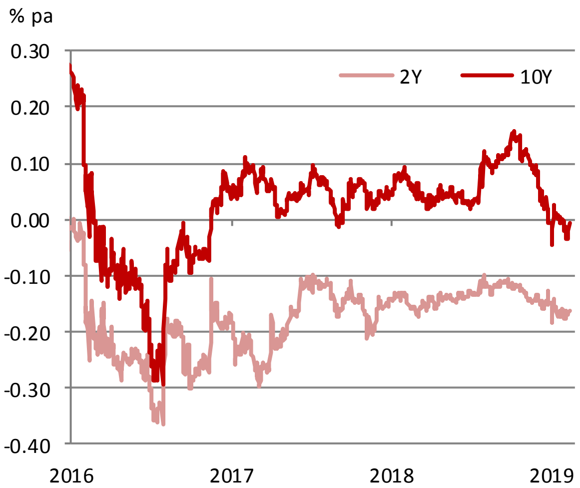
Given that large companies typically pay more than small ones, the correction in the labour survey methodology last year resulted in an artificial jump in total wage growth to 1.7% from 0.4% in 2017. The labour ministry admitted that the year-on-year wage increase in January-November 2018 was overstated by as much as 0.7ppt. Likewise, it could be inferred that wage growth during the 2004-17 period was underestimated by a similar extent. As such, the whole trajectory of wage growth needs to be reviewed to get a clearer picture about the state of economic recovery and the effects of Abenomics.

Implications for monetary policy

A weaker-than-expected 2019 growth outlook will likely hinder the Bank of Japan from normalising monetary policy. The data revisions/reviews would also prompt the BOJ to adopt a cautious stance e.g. wage data are watched closely by board members to assess the medium-term inflation outlook. The BOJ, has at the January meeting, not only slashed its FY18 GDP growth forecast sharply to 0.9% from 1.4%, but more importantly, its FY19 inflation forecast to 0.9% from 1.4%. The 10-year Japanese government bond yield has, since end-December, fallen back to the mid-point of the official target band (-0.2% to 0.2%, **Chart 4**).

Our view remains unchanged for the BOJ to maintain this year's short- and long-term interest rate targets at -0.1% and 0% respectively. The BOJ is only expected to raise rates in the second half of 2020 at the soonest.

Chart 4: JGB yield curve flattened again since Dec 2018



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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).