Economics

DBS Focus

Japan: 5 challenges in the second half

Economics/Japan/Growth/Monetary

Group Research

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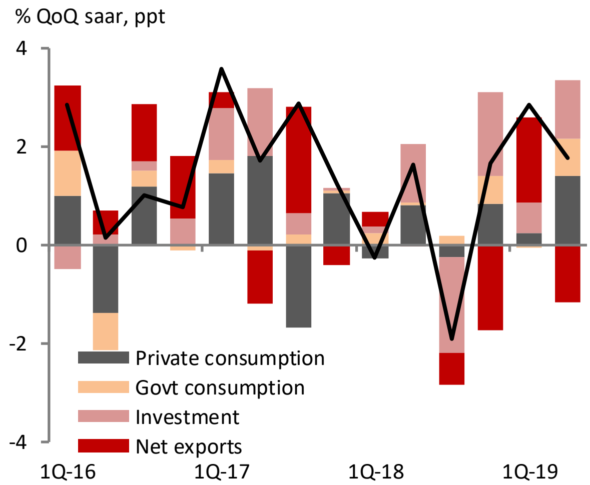
- *The economy grew faster than expected by 2.3% QoQ saar (1.1% YoY) in 1H19.*
- *But a series of challenges lie ahead in 2H19, including: 1) consumption tax hike, 2) Japan-South Korea trade tensions, 3) China-US trade war, 4) lingering threat of the US's automobile tariffs, 5) appreciation pressures on the yen due to Fed/ECB easing and global risk aversion.*
- ***Implication for our forecasts**: We maintain the 2019 GDP growth forecast at 0.7%, despite the better-than-expected 1H. Inflation forecast is lowered to 0.8% (from 1.1%) for 2019 and to 1.3% (from 1.6%) for 2020.*
- ***Implication for investors**: The chances of BOJ easing in 2H19 are on the rise. Potential options include strengthening the forward guidance, widening the 10Y yield band and directly cutting the policy rate.*

The Japanese economy has fared better than expected so far this year. GDP growth registered 1.8% QoQ saar in 2Q, slower than the 2.8% in 1Q, but still better than the potential rate of about 1%. Strong domestic demand (consumption, investment, public spending) helped to offset the decline in net exports.

In 1H19, growth averaged 2.3% QoQ saar, or 1.1% YoY, exceeding our original estimate by a significant margin. Taking into account a series of external and domestic challenges facing the economy in 2H19, however, we maintain the full-year GDP growth forecast at 0.7%.

Japan: GDP growth breakdown



Source: CEIC, DBS

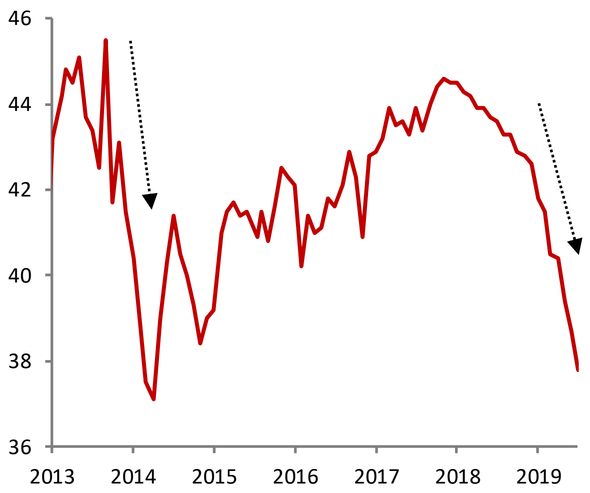
1) Consumption tax hike

The ruling Liberal Democratic Party achieved victory during the July upper house election, paving the way for Prime Minister Shinzo Abe to implement the planned consumption tax hike in October (from 8% to 10%). Tax hike may trigger a one-off decline in domestic demand in 4Q19, despite the counteracting measures prepared by the government (e.g., free education, financial assistance to low-income households).

At present, rush demand ahead of the upcoming consumption tax hike is not yet in sight, suggesting that demand may not plunge thereafter. Among the big-ticket items that attract rush demand, motor vehicle saw sales growth of 4.1% YoY in July (vs. 3.1% in Apr-Jun), while condominium sales posted a 15.3% decline in June.

However, consumer confidence index has been falling persistently through the first seven months of this year, by about 5 points cumulatively. This is identical to the pattern seen prior to the previous round of consumption tax hike in 2014 – not a good sign for the post-tax hike outlook in 2H19.

Japan: Consumer confidence index



Source: CEIC, DBS

2) Japan-South Korea trade tensions

On the external front, there are more headwinds. Japan and South Korea announced earlier this month to remove each other from the list of countries that enjoy preferential treatment in trade. Meanwhile, in light of the deterioration in bilateral ties, South Koreans have started to boycott Japanese travel and consumer goods, on a voluntary basis.

Japan's export controls imposed on South Korea are likely to slow the production activities in the latter's manufacturing sector, particularly semiconductor and display screen sectors. This would, in turn, create ripple effects on the regional supply chains including hurting the downstream Japanese electronics producers.

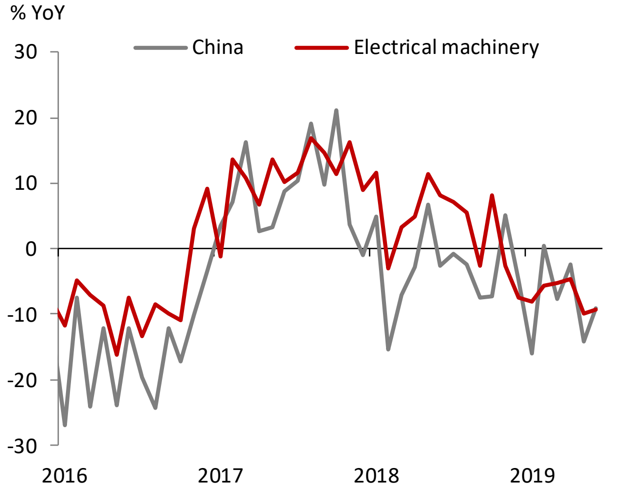
South Korea's retaliatory measures are likely to hurt Japan more directly. South Korea is currently Japan's third largest export destination (7% of total exports), and second largest tourism market (24% of total visitor arrivals). A 10% decline in exports to South Korea, together with a 20% decline in the number of South Korean visitors, are estimated to cut Japan's GDP growth by 0.15ppt.

3) China-US trade war

The re-escalation of China-US trade war poses another challenge for the exports outlook in 2H19. US President Donald Trump said earlier this month that his government will impose 10% tariffs on the remaining USD 300bn Chinese goods entering the US, effective from September 1. This new tariff list includes a wide range of consumer electronics products, which carries the risk of seriously disrupting the regional supply chains and trade flows.

Japan actively participates the China-centered electronics supply chain today, ranking as China's third largest import market of electrical machinery and equipment. Japan's exports to China and exports of electronics products have already been falling continuously so far this year, feeling the pain from the slowdown of the Chinese economy and the cyclical downturn in the global tech sector. Things may get worse instead of better, if the China-US trade war continues to escalate and spread.

Japan: Exports to China & Electronics exports



Source: CEIC, DBS

4) The US's automobile tariffs

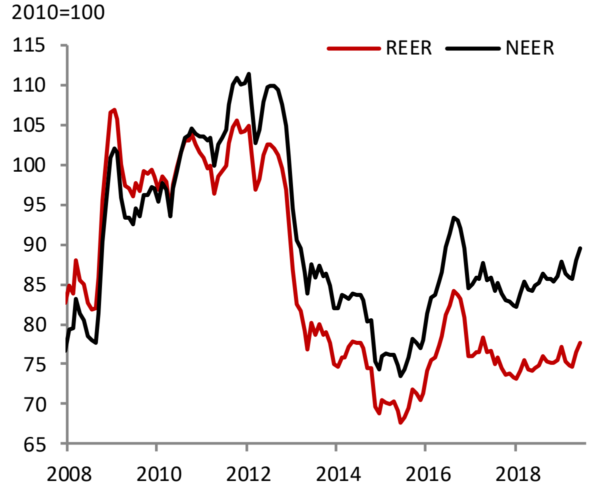
In addition, as far as the Japan-US trade relations are concerned, the threat of the US's automobile tariffs still lingers. The US is set to decide whether to impose steep tariffs on automobile imports from its trade partners by November. Whether Japan can be exempted will depend on the results of the ongoing Japan-US trade negotiations. It was recently reported that the two countries target a bilateral trade deal by September. To achieve that, Japan would need to agree to open up its politically sensitive agriculture sector, including lowering tariffs on US beef imports.

Potentially, higher automobile tariffs imposed by the US could hurt Japan's exports badly. The US is currently Japan's largest automobile export market, accounting for a share of about one third. Japan is also the US's third largest source of automobile imports. Assuming a price elasticity of 1.0, a 25% tariff on Japan's automobile exports to the US is estimated to cut Japan's GDP growth by 0.25ppt.

5) Yen's appreciation

Last but not the least, in the financial markets, the Japanese yen is facing the pressure to appreciate. This is against the backdrop of the Fed's monetary easing, the ECB's strong signal for monetary easing, and the resultant broad-based decline in DM yields. Periodic appreciation pressures on the yen also come from the rise in global demand for safe haven assets, in the context of the China-US trade war, and the geopolitical risks related to Brexit, Iran and recently, Hong Kong.

JPY effective exchange rates



Source: CEIC, DBS

The yen has gained 4% against the US dollar and more than 6% against the euro so far this year. On the trade weighted basis, the yen remains cheap compared to the level before Abenomics was introduced in 2013. Still, a sharp, one-way rise in the yen would be a warranted concern, as it erodes exporters' corporate earnings, hurts capex/wage outlook in the manufacturing sector, and importantly, dampens public inflation expectations.

Rising chances of BOJ easing

The chances of Bank of Japan easing in 2H19 are on the rise. The BOJ has showed a clear bias towards easing at the latest meeting in July, adding a line in the policy statement to say that it will take additional easing measures without hesitation if there is a risk that the economy will lose momentum for hitting the price target.

There will be three scheduled BOJ board meetings in the remainder of this year, in September, October and December respectively. An actual move of policy easing could come as early as the September meeting, depending on how the key economic data and financial market conditions pan out in the next several weeks.

In terms of the possible policy options, one is to strengthen the forward guidance by pledging to maintain the extremely low interest rates through 2020 (instead of "spring 2020"). Another is to widen the range of the 10Y yield band, probably from ±0.2% to ±0.3%. The BOJ also has the room to further cut the policy rate, e.g., from the current -0.1% to -0.2%. This would be done together with some complementary measures to mitigate the side-effects on banks' profits, such as offering negative lending rates to banks, or slicing and dicing banks' reserves to reduce the portion subject to negative deposit rates.

Recent publications

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