Economics

Japan: Mixed impact of low oil prices

DBS Group Research **12 January 2015**

- **The fall in oil prices could lower the trade deficit and lift domestic demand**
- **But it also puts downward pressures on consumer prices, challenging the Bank of Japan's inflation target**
- **With price weakness accompanied by a recovery in real economic activity, the BOJ will likely refrain from further easing**
- **Things would change to the extent falling oil prices is deemed due to a drop in global demand**

Global oil prices continue to fall. The Brent crude price has fallen by more than 50% from US$110/barrel in mid-2014 to US$48.50 currently (Chart 1). In December, the US Energy Information Administration (US EIA) revised its avg-2015 forecast for Brent oil price to $68, sharply down from the November projection of $83. Since then, futures prices have continued to fall, suggesting the Brent prices will run between $50-60 through this year (Chart 2).

Trade deficit to narrow; growth to pick up

The fall in oil prices should lower Japan's trade deficit and boost domestic growth, a country that relies heavily on energy imports. The trade deficit for mineral fuels stood at JPY 24trn in the first eleven months of 2014, which more than explained the JPY 12trn deficit in overall trade during the same period (Chart 3). Looking at volumes, net fuel imports have been falling steadily through the 2000s, thanks to the improvement in energy efficiency and the weakness in domestic demand. The amount of net fuel imports has started to increase again since 2011, due to the

Chart 1: Global oil prices plunging

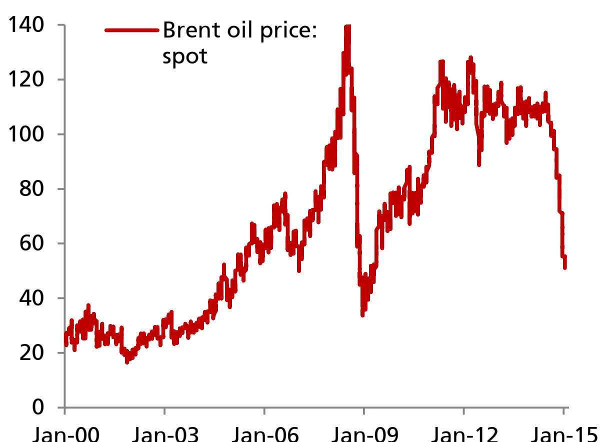
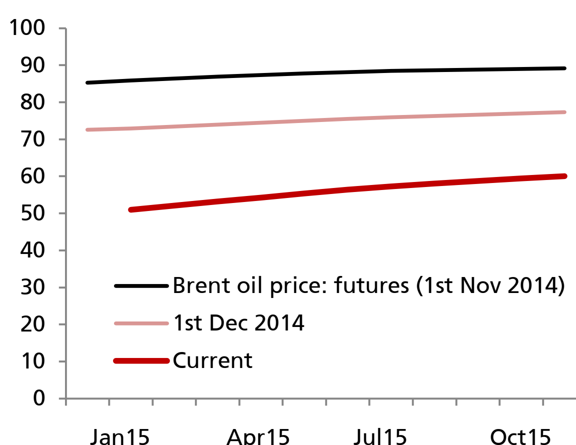


Chart 2: Price curves of oil futures



Ma Tieying • (65) 6878-2408 • matieying@dbs.com

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Chart 3: Japan's oil trade deficit is large

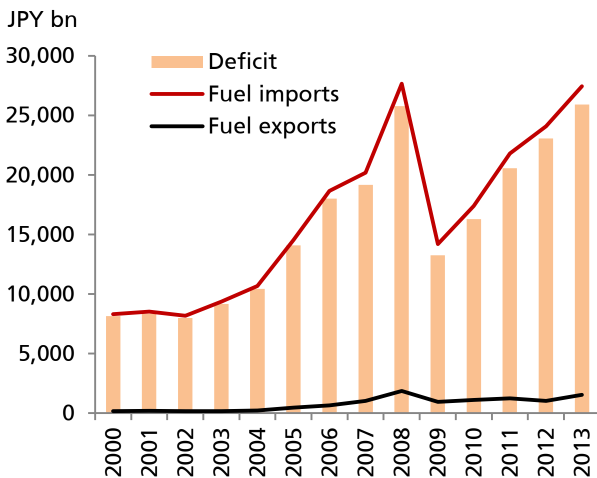
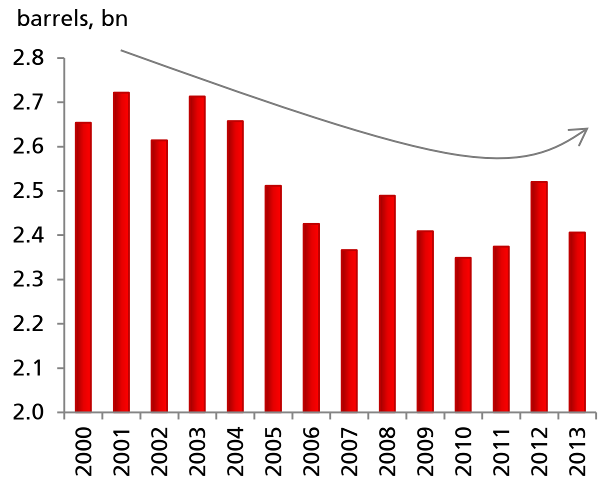


Chart 4: Net fuel imports (volume)



shutdown of nuclear power in the aftermath of the earthquake/tsunami disaster (Chart 4). In the last four years, the annual average of net fuel imports was equivalent to 2.4bn barrels.

Assuming global oil prices remain at the level of $50 this year and the USD/JPY exchange rate remains at 120, Japan's oil trade deficit could fall by as much as JPY 11trn. This would just about bring Japan's overall trade into balance.

As a percentage of GDP, the JPY 11trn savings from oil import bills will come to 2%. Corporate profits will increase due to lower production costs and household real incomes will improve due to cheaper living costs. Depending on how well these income gains are utilized in the domestic economy – translated into higher spending by corporates and consumers, GDP growth will rise proportionally.

The BOJ's inflation target will face more challenges

Plainly, the fall in oil prices will challenge the BOJ's goal of reflating the economy. Indeed, the pace of oil price declines has surpassed that of yen depreciation in the last few months, resulting in a drop in the yen-denominated oil import prices and the retail gasoline prices in Japan (Chart 5-6). More recently, the fall in the yen has come to a halt whilst energy prices have continued to tumble, along with the deterioration of risk appetite in the global financial markets.

Chart 5: Oil prices vs. the yen

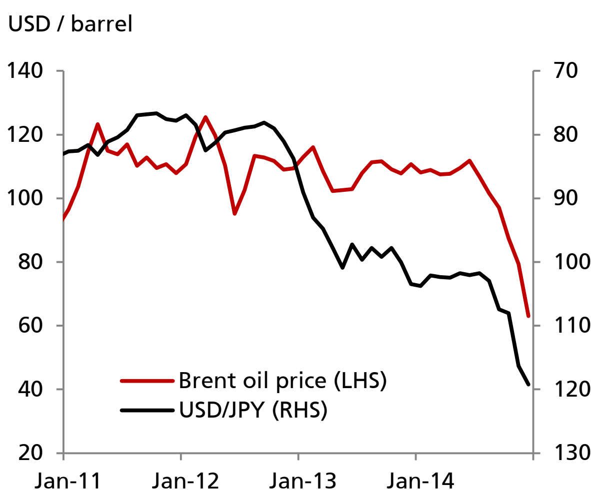
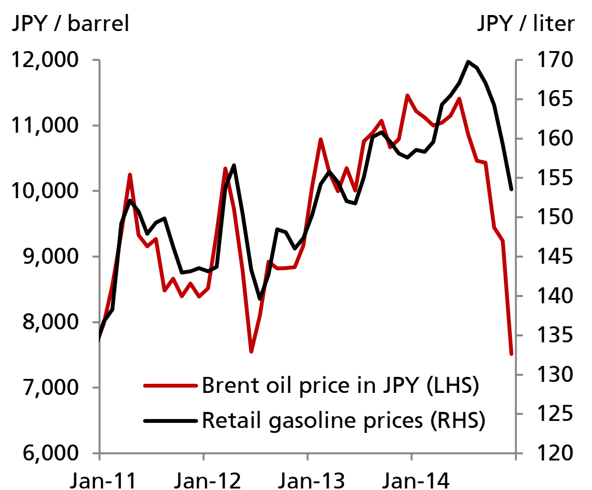


Chart 6: Fuel prices falling in Japan



Based on the correlation between oil prices and the CPI, inflation could be 0.5ppt lower this year than it otherwise would have been (oil prices=$50, USD/JPY=120). This would put annual inflation at about 0.5% compared to the current consensus of 1% (excluding the impact of sales tax). Considering the time lag involved, downward pressure on inflation will be especially strong in 1Q15.

Policy implications

Weak inflation in the coming months may stoke market expectations for additional policy easing. A possible recovery in real economic activity, however, will likely prevent the BOJ from doing so. When the BOJ surprised the markets with QE expansion in October last year, it considered not only the deflationary impact of falling oil prices, but also the contraction of real economic growth. Back then, the economy slipped into a technical recession as the disruption impact of the sales tax hike far exceeded expectations.

A key difference this time is that the economy is recovering from the slump caused by the tax hike. Importantly, the government has postponed the second sales tax hike by 18 months. It has also proposed a JPY 3.5trn stimulus package and a 2.5ppt cut in corporate tax for this fiscal year. Consensus currently expects GDP growth to accelerate to 1% in 2015 from 0.2% in 2014. Moreover, this does not fully take into account the boost to domestic demand from lower oil prices. If economic growth picks up as forecasted, the labor market could tighten and underlying prices would be supported accordingly.

Unsurprisingly, BOJ Governor Kuroda has highlighted the benefits of low oil prices in recent speeches, saying the long-term impact of lower oil prices will be positive. At the upcoming meeting on 21st January, the BOJ is expected to trim its FY2015 inflation forecast, but maintain the longer-term inflation forecast and revise upward its estimate of GDP growth. The size and the composition of BOJ asset purchases are expected to remain unchanged.

A key question remains as to whether falling oil prices reflect demand factors or supply factors. To the extent they owe to weak global demand, Japan's exports and overall growth outlook would be dampened. Moreover, the downturn in oil prices would be more protracted if it were associated with weakness in demand. This could have lasting impact on people's psychology and expectations. Under such a scenario, the Bank of Japan would face greater pressure to ease policy in order to support growth and prevent a return of deflation expectations.

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