FEATURE

Japan

Slowing economy, declining exports

Ira Kalish

Japan's economy has been cooling since 2018. External headwinds and trade overhangs persist, but the central bank remains hopeful of the inflation accelerating toward the 2.0 percent target.

Current situation and outlook

Japan's economy grew at a moderate pace in 2018, following very strong growth in 2017.[1] All major categories decelerated in 2018, including consumer spending, investment, and exports. Real GDP declined in the first and third quarters, with a sharp drop in investment in the third quarter.

Economic growth revived in the fourth quarter, after having declined sharply in the third quarter, partly due to the impact of natural disasters. In the fourth quarter, real GDP grew at an annualized rate of 1.4 percent, which is quite good in a country with a declining population,[2] but not sufficient to offset the 2.6 percent decline in the third quarter. Growth was driven by strong gains in household spending and especially strong growth of business investment. It is widely believed that businesses are increasingly investing in labor-saving technology due to a shortage of labor. Japan currently has a very low unemployment rate. Meanwhile, export growth was modest owing to weak demand in China as well as the effects of the trade war between China and the United States. Import growth was strong. Thus, the net effect of trade on GDP growth was negative.

Consumer price inflation in Japan has decelerated, largely due to the drop in energy prices. In December, consumer prices were up only 0.3 percent from a year earlier, the lowest rate of inflation since October 2017. When volatile food and energy prices are excluded, core inflation was 0.7 percent, still well below the Bank of Japan's (BOJ) target rate of 2.0 percent. For all of 2018, headline inflation was 1.0 percent, while core inflation was 0.9 percent. The failure of inflation to accelerate toward the central bank's target has been a source of frustration for policymakers. Yet the BOJ is not taking any steps to further ease monetary policy.

It appears likely that Japan will face very slow growth in 2019, reflecting some of the external negative headwinds discussed above. If the government goes through with the planned increase in the national sales tax later in the year, household spending could surge in anticipation of the increase. Of course, that would likely be followed by a sharp drop in spending in the quarters that follow. Thus, Japan is possibly at risk of a recession in 2020.

Monetary policy

The BOJ has kept interest rates historically low. This has boosted inflation above where it would otherwise be, suppressed the yen, and boosted asset prices. Moreover, the BOJ intends to keep interest rates low, at least into the next decade and only after the increase in the sales tax takes effect. However, the BOJ says it will slow the pace of asset purchases (quantitative easing) after 2020. Although the BOJ has left policy unchanged, it acknowledged that Japan faces external headwinds that are having a negative impact on growth, especially weaknesses in China's economy and the China-United States trade tensions.[3]

That being said, the bank continues to predict, as it has for the past five years, that inflation will soon accelerate toward the goal of 2.0 percent. Moreover, while not many doubt that the BOJ will likely retain an easy monetary policy, there is some uncertainty as to whether the current policy could, indeed, boost inflation or avert another recession—especially as the government intends to boost the national sales tax later this year. Rather, some analysts are asking whether a more aggressive policy might be needed. Meanwhile, if past experience is anything to go by, the rise in the sales tax will likely significantly suppress economic activity and could create a temporary recession. At the least, growth in 2020 should be very weak.

Trade[4]

With the United States having withdrawn from the Comprehensive and Progressive Agreement Trans-Pacific Partnership, Japan is keen to further cement freer trading relations with other countries. Having secured a free-trade agreement with the European Union, Japan is now intent on having such an agreement with the United States. Moreover, Japan is concerned that the absence of negotiations on such a deal exposes Japan to vulnerability should the United States choose to impose tariffs on imported automobiles and automotive parts. In September last year, President Donald Trump and Prime Minister Shinzō Abe agreed that as long as trade negotiations between the two countries are taking place, the United States would hold off on imposing new tariffs on Japan. Thus, Japan is currently seeking to commence formal negotiations as soon as possible, and especially before President Trump visits Japan in May as scheduled. The Japanese view is that once negotiations begin, the United States will not impose tariffs on Japan. Meanwhile, the two sides have already begun discussing what goods and services will be covered in upcoming trade talks. It is likely that a large focus will be on automotive and agricultural trade.

The most recent purchasing managers' index (PMI) for Japanese manufacturing indicated a significant weakening of the sector.[5] Specifically, the PMI fell from 50.3 in January to 48.5 in February, the lowest level in 32 months and a level indicating a significant decline in activity. The sub-indices for output, new orders, and export orders all fell at an accelerating pace. In addition, the sub-index for sentiment fell into negative territory for the first time in six years. Evidently, manufacturing company purchasing managers are not optimistic about the near-term future. The weakness in activity and sentiment was attributed to the slowdown in China's economy and the general weakening of global trade. Markit suggested that the report means that the likelihood of a Japanese recession in 2019 "looks set to rise."

The weakness of the economies of China and Europe was clearly manifested in the decline in Japanese exports in January. When evaluated in yen, Japanese exports fell 8.4 percent in January versus a year earlier. This was the steepest decline since October 2016. Exports to China fell 17.4 percent while exports to Western Europe were down 6.6 percent. At the same time, exports to the United States were up 6.8 percent. The weakness of Chinese imports of Japanese goods was due, in part, to weak domestic demand and, in part, to weak global trading, itself the result of trade tensions between the United States and China, which affected Chinese-led supply chains. This was evident in the fact that Japanese exports to South Korea were down 11.6 percent, to Taiwan 11.0 percent, and to Australia 18.7 percent. By product, Japanese exports of transport equipment were down 5.9 percent and machinery was down 10.7 percent. Overall, exports of manufactured goods were down 11.0 percent. The decline in Japanese exports bodes poorly for economic growth in the first quarter, especially at a time when consumer spending appears to have weakened.

Endnotes

1. Trading Economics, "Japan—Economic Indicators," accessed April 9, 2019.
2. Oxford Economics, accessed April 9, 2019.
3. Megumi Fujikawa, "Bank of Japan takes gloomier view of economy," *Wall Street Journal*, March 15, 2019.
4. Tan Khee Giap and Tan Yan Yi, "Economic and political reasons for Japan's pivot back to Asean," *Business Times*, March 27, 2019.
5. PMI, "Nikkei Flash Japan Manufacturing PMI: Stronger declines in output and new orders lead sector to first downturn for two-and-a-half years in February," press release, February 21, 2019.

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IRA KALISH is a specialist in global economic issues and the effects of economic, demographic, and social trends on the global business environment. He is a regular contributor to economics articles published on Deloitte Insights, and also writes for the annual Global Powers of Retailing and Consumer Products reports.

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