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FEATURE

Japan

The economy has rebounded but obstacles remain

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Japan's economy rebounded in the first quarter, despite external headwinds, especially the trade war and its effects. Domestic dynamics, such as sagging spending and monetary policy, remain an overhang.

The latest indicators

Japan's economy surprised by performing relatively well in the first quarter of this year.[1] Specifically, real GDP grew from the previous quarter at an annualized rate of 2.1 percent, after posting 1.6 percent growth in the last quarter of 2018. The economy had contracted in the first and third quarters of 2018. In Q1 of 2019, growth was driven by strong gains in public sector investment as well as housing. However, consumer spending fell slightly, down 0.3 percent, business investment fell modestly, and both exports and imports fell sharply. The decline in imports, however, had a positive impact on GDP. Still, declining imports are a reflection of weak domestic demand. The fact that GDP mainly grew due to a strong increase in public sector investment suggests that the private sector remains quite weak. The decline in trade volumes suggests that the on-again, off-again trade war between the United States and China is taking a toll on the Japanese economy. The boost in public sector spending also indicates that the government has loosened fiscal policy, especially due to increased spending on disaster relief. The government remains intent on raising the national sales tax later this year to improve the solvency of the public pension system. This is expected to have a big, negative impact on consumer spending, as was the case the last time the tax was increased.

Although Japan's economy rebounded in the first quarter, signs of trouble continued as the second quarter unfolded. Japanese exports declined for the fifth consecutive month in April, falling 2.4 percent from a year earlier.[2] The decline was disproportionately driven by a drop in exports of chip-making equipment to China, likely a result of the growing trade war between the United States and China. Indeed, Japanese exports to China were down 6.3 percent in April versus a year earlier. Specifically, exports to South Korea fell 4.2 percent, but exports to the United States were up 9.6 percent and to Vietnam 10.4 percent.

As for Japan's manufacturing sector, the Purchasing Managers' Index from IHS Markit fell to 49.3 in June, indicating continued declining activity.[3] The index was weak because of softness in several subindices, such as output, new orders, export orders, and employment. This, in turn, stemmed from weak overseas demand, especially from China, as well as overall weakness in the global automotive sector.

As for Japan's household sector, spending increased 4.0 percent in May versus a year earlier.[4] This was the sixth consecutive month of rising spending and the fastest increase since May 2015. It was driven by strong spending on housing, education, and other services. Yet the sustainability of the boost in spending is not certain, especially given that wages have risen only modestly—indeed, in May, sales at chain retailers were down 4.0 percent from a year earlier. The government, however, is keen to see spending rise, especially as Japan's export sector is at risk from the growing trade war between the United States and China. Another potential risk to spending is the government's plan to raise national sales tax from October to improve the solvency of the nation's pension system (more on this in the next section).[5]

Factors that will influence Japan's future path

Japan is vulnerable to a number of external factors. Among these is the current US-China trade war which, as of this writing, is experiencing a pause in that new tariffs have been put on hold. Still, as talks take place under the threat of future tariffs, uncertainty remains about the future trading relationship between the world's two biggest economies. Thus, from the perspective of Japanese companies, it is hard to plan supply chains. Add to that the weakness in the growth of business investment, both in Japan and elsewhere, which is likely related to this uncertainty. Moreover, the United States has threatened to impose tariffs on imports of all automobiles, especially vehicles produced in Europe and Japan, which adds to the uncertainty of global trade.[6]

Japan is also vulnerable to the performance of the global electronics and automotive industries—both face headwinds. In the case of electronics, global demand is weakening,[7] possibly due to consumers reevaluating the need to upgrade their devices. At the same time, investment in the industry has stalled owing to uncertainty about the future of global supply chains. In the case of the automotive industry, a combination of weakening global demand and trade uncertainty is an overhang.

The Japanese government continues to affirm its commitment to raise the national sales tax later this year. This is expected to have a negative impact on consumer spending, as was the case in the past. The major area of uncertainty is whether the government will implement increases in spending that are sufficient to offset the negative impact of tax increases.

Finally, there is the issue of monetary policy. The Bank of Japan (BOJ) has maintained a historically easy monetary policy for several years with the goal of boosting inflation toward the 2.0 percent target. Yet this policy has not succeeded in generating significantly higher inflation. Moreover, the latest data indicates that investors expect inflation to ease. The so-called "breakeven" rate, which is an excellent measure of investor expectations of inflation, has lately dropped to 0.20 percent. In other words, investors expect almost no inflation in the next several years.[8] This is despite the fact that core inflation (overall inflation minus the impact of volatile food and energy prices) is currently running at 0.8 percent. Thus, investors evidently expect inflation to abate from current levels, even as the BOJ maintains an easy monetary policy. This likely reflects investor pessimism about the economic outlook. The question, then, is whether the BOJ will do anything to further ease monetary policy. For now, there is no indication that such a step is imminent. At the least, this likely means no further downward pressure on the value of the yen and possibly upward pressure. A rise in the value of the yen will hurt export competitiveness and exacerbate the problem of low inflation.

Endnotes

1. Megumi Fujikawa, "Japan surprises with 2.1% growth, but it's not all roses," *Wall Street Journal*, May 20, 2019.
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3. Jibun Bank, "Softer manufacturing conditions continue in June," press release, July 1, 2019.
4. Trading Economics, "Japan household spending," accessed July 15, 2019.
5. Kaori Kaneko and Tetsushi Kajimoto, "Japan household spending rises but wages fall in March," *Japan Today*, May 10, 2019.
6. Levi Winchester, "Trump warning to EU: President 'serious' about car tariffs that would shock Germany," *Daily Express*, June 18, 2019.
7. Enda Curran, "Warning shot to world economy as Singapore slumps, China exports drop," Bloomberg, July 12, 2019.
8. Macrobond's official website, accessed July 15, 2019.

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