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FEATURE

Japan

Consumer spending picked up, but business investment and exports weakened

Ira Kalish

External overhangs caused unfavorable—but not unexpected—economic reactions. Retail sales in Japan picked up, but it remains to be seen if the higher sales tax rate gives the government much-needed infusion and helps it achieve what it set out to.

Latest indicators

The latest data from Japan indicates bifurcation of economic growth. That is, business investment and exports have been weakened by the trade war between the United States and China, but consumer spending has been relatively strong. Yet the risk is mainly on the downside. Consumer spending likely picked up just before the increase in the national sales tax came into effect at the beginning of October. In addition, business hiring is likely to slow down as a consequence of weakness in investment and exports, which could ultimately have a negative impact on household spending. Unless there is an improvement in the external situation, growth prospects for Japan are likely poor. The weakness of business spending is evident both in the latest purchasing managers' indices and in the well-known Tankan Survey.[1] In addition, industrial production has been declining. That said, retail sales have done quite well lately—possibly due to extra shopping in anticipation of the increase in the national sales tax.

Here are details of some of the readings.

- In August, industrial production fell for the eighth time in the last 12 months, tumbling 4.7 percent from a year earlier[2] and down 1.2 percent from the month before. There were sharp declines in the production of iron, steel, and nonferrous metals and machinery. Production of vehicles was down too. The weakness of Japan's industrial sector is, in part, related to the trade war between the United States and China. Indeed, Japanese exports to China have fallen sharply, in part, due to weaker Chinese demand for inputs used in products that are reexported to the United States.[3] Likewise, industrial production in neighboring South Korea declined in August as well.[4] Both countries have been hit by the trade war and are in the midst of their own trade war. However, the conflict between Japan and South Korea is not believed to have had a significant impact on Japanese output—at least not yet.

- Retail sales soared in August—up 4.8 percent from July—as consumers spent heavily in the runup to the increase in the national sales tax. The new tax rate increase from 8 percent to 10 percent took effect on October 1.
  This pickup in retail sales was the sharpest since 2014, when the national sales tax was increased last. Retail sales were up 2 percent from a year earlier, the steepest increase since October of last year. There were especially strong increases in spending on discretionary items, such as apparel and machinery. While any acceleration in spending is welcome, the danger is that by front-loading spending, households will likely end up spending far less in the months following the tax increase, thereby leading to a slowdown in economic activity. That is precisely what had happened in 2014, when a brief recession followed the tax increase.[5] The national sales tax had increased from 5 percent to 8 percent then. The Japanese government has taken steps to alleviate the impact of the tax increase, including providing subsidies for noncash consumer purchases. The government is keen to stimulate domestic demand at a time when external headwinds are hurting the economy. Yet it is also determined to fix the imbalance between expected future

tax revenues and expected future pension liabilities. That is why the tax is being increased. Another way to fix the imbalance is to encourage greater labor market participation, especially by mothers. Thus, the government intends to use some of the extra tax revenue to fund free kindergarten and preschool education,[6] hoping that this will lead to an increase in the number of working mothers.

Increasing the national sales tax

In Japan, there is a dissonance between taxation and expected expenditures. Taxes account for about 34 percent of GDP, well below the average of developed economies. Yet government debt is 240 percent of GDP, above the average of developed economies,[7] and the government's expected spending on pensions and health care is set to rise precipitously in the coming decades. This, too, is relatively high owing to the extreme demographics of Japan. Thus, there is a problem. The government is attempting to solve this problem by raising the national sales tax. Japan's working age population has been declining since early this century, but this has been offset by rising participation, helping in employment growth. However, starting next year, employment is expected to decline and continue declining throughout the coming decade and beyond. The demographic troubles faced by Japan are only going to get worse.

Japanese companies in China

In the past two decades, many Japanese companies invested heavily in China, engaging in assembly of final products in order to take advantage of relatively cheap labor. However, in recent years, rising wages in China, combined with the trade war, have made China more problematic for some Japanese companies. The trade war, especially, is leading many such companies to reconsider their China operations. Shifting production elsewhere might help avert US tariffs. Results of a new survey conducted by *Nikkei* reveal that of 1,000 Japanese companies with operations in China, 23.9 percent say they should reduce their footprint in China.[8] Another 60.4 percent report taking a wait-and-watch approach. Even though companies are concerned about rising costs and the risk of tariffs, many see China as a market too big to ignore. The wait-and-watch approach might be predicated on the expectation that a deal between the United States and China could be reached in the near future. However, 51.3 percent of respondents expect the trade conflict between the United States and China to last as long as 10 years. Only 10.8 percent of respondents expect the dispute to be resolved in under three years. About 40 percent of Japanese manufacturers in China export more than half their Chinese output. The largest share of such exports goes to Japan, and the second largest to the United States.

Increasing role of tourism

Tourism in Japan has been growing rapidly in recent years,[9] and with the Olympics set to take place in Tokyo in 2020, tourism is of increasing importance in the Japanese economy. In 2011, for example, there were only about 6.2 million overseas visitors to Japan, but by 2018, that number rose to over 31 million. This was driven, in part, by a steep increase in the number of visitors from China (up from about 1 million in 2011 to over 8 million in 2018). The number of visitors from South Korea also rose rapidly (from 1.6 million to 7.5 million). There were also big increases in the number of visitors from Taiwan and Hong Kong. The government hopes that the total number of visitors will exceed 40 million in 2020.

Endnotes

1. IHS Markit, "PMI," accessed October 23, 2019.
2. Trading Economics, "Japan industrial production," accessed October 23, 2019.
3. *Nikkei Asian Review*, "Japan August industrial output falls amid weak exports, typhoons," September 30, 2019.
4. Trading Economics website, accessed October 23, 2019.
5. Ibid.
6. Max Sato, "Japan consumers cautious on spending despite expected limited drag from sales tax increase," *South China Morning Post*, September 30, 2019.
7. Ibid.
8. Rei Nakafuji, "Quarter of Japanese companies ready to reduce China footprint," *Nikkei Asian Review*, October 4, 2019.
9. JTB Tourism Research & Consulting Co, "Japan-bound statistics," October 9, 2019.

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