

# Japan

## Sales tax hike is storm in a teacup

Nordea Research, 20 March 2014

- The sales tax hike in April this year is the first step in adjusting Japan's unsustainable large fiscal imbalance.
- Large upswing in sales can be expected in Q1 due to frontloading of household purchases. Plunging private spending is a safe bet in Q2.
- The negative real wage growth is a darker cloud for consumption and economic growth than the consumption tax hike.
- For now, we do not expect the Bank of Japan to expand its quantitative easing programme, but more stimuli is possible if growth reacts more strongly to the tax hike than anticipated.
- We expect 1.3% GDP growth in 2014 and 1.0% in 2015. JPY is projected to land on 103 at end-2014 and 110 at end-2015.

### Overview

Japan's government debt currently stands at 245% of GDP. The ability to continue financing it domestically has become questionable, as households and corporates will likely see declining savings rate in the years ahead.

The consumption tax hike to 8% in April this year is an important first step in restoring fiscal health. The IMF expects a budget balance improvement of 2.6% of GDP this year. However, the government has passed a stimulus package equal to 1.2% of GDP to counteract the economic blow of the tax hike. Taking account the fiscal easing, the fiscal adjustment is smaller than suggested by the IMF. So the consolidation must continue, requiring additional sales tax hikes.

If history is any guide, we can expect a temporary upswing in economic activity in Q1 this year due to frontloading of household purchases. This will almost certainly be followed by a plunge in spending in Q2. Without the supplemented stimulus package of 1.2% of GDP, the economy would certainly feel the pain. But the fiscal stimulus can be fairly assumed to neutralise the economic blow from the tax hike.

We hold on to our view that for Japan's economic recovery to be self-sustaining, higher real wages are needed to change the consumption pattern for good. Unfortunately, inflation has outpaced nominal wage growth thus far, pressing real wage growth to -1%. The average consumer is likely to react with a tighter wallet, a negative for growth. We expect the economy to expand by 1.3% in 2014 and only 1.0% in 2015.

The Bank of Japan (BoJ) will likely stay put regarding its asset purchase programme. Thus, we maintain our JPY forecasts to 103 at the end of 2014 and 110 at the end of 2015.

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**Fiscal sustainability is not infinite**

With a public debt of 245% of GDP, Japan has one of the heaviest fiscal burdens in the world. According to the IMF staff estimation, a structural fiscal tightening of 11% of GDP is needed over the next decade to put the debt-to-GDP ratio firmly on a declining path.

Japan's fiscal sustainability is increasingly doubtful

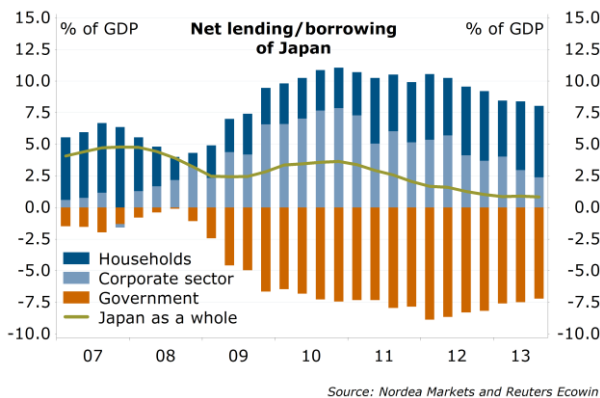
More than 90% of the public debt is financed by domestic savers through banks, which has been used as a key argument for the apparent sustainability. However, this pattern may begin to change soon. First of all, the ageing society implies a falling household savings rate as old people consume more than they save.

Secondly, as real government yields are declining and even negative, companies may begin to recycle surpluses into fixed assets investment, domestically as well as abroad, instead of Japanese government bonds, which they have done so far. With a possibility of falling household and corporate savings, Japan's ability to finance its public debt domestically is increasingly questionable.

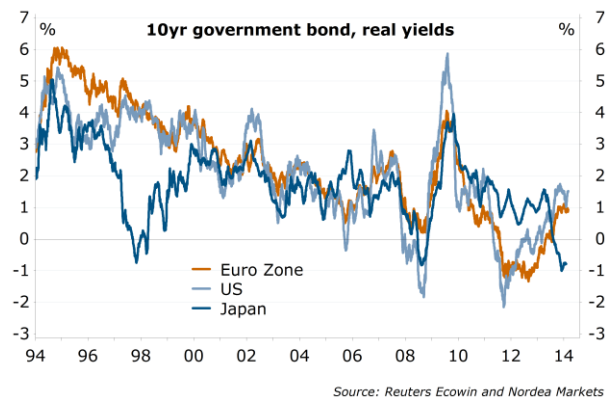
The European style of austerity is a no go in Japan

When talking about fiscal consolidation, the first solution crossing one's mind (at least in Europe) is to slash public spending. However, non-social security spending is relatively small and provides little room for further cuts. The largest and fastest growing component in government expenditure is social security, which is likely to hit the roof with the rapidly ageing

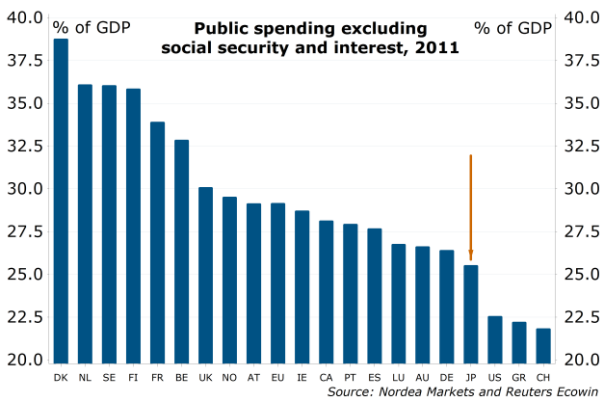
Domestically financed public debt



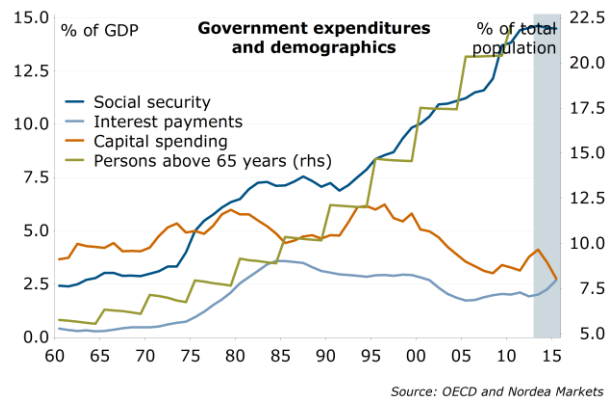
Domestically financed public debt



Little room to cut non-social security spending



Social security expenses are untouchable



Raising sales tax is the best solution

population. The obstacle is that reducing pension and health care spending would be political suicide and very unlikely for a prime minister who relies on public support to achieve his non-economic ambitions.

Japan has three major tax sources: corporate tax at 37% (effective tax rate), individual income tax at 47% (top marginal tax) and consumption tax at 5%. The first two tax rates are already very high and above the OECD average. This leaves consumption tax hikes as the best remaining option. It is preferred because it has the least distortionary effects, it is a stable source of revenue in an ageing society (contrary to personal income taxes) and fairly easy to administer.

**Sales tax has smaller consumption impact than wages**

Last autumn Prime Minister Abe gave the green light to raise the consumption tax rate from 5% to 8% in April this year. This was seen as an essential first step in restoring fiscal health, although the increase in itself is insufficient to adjust Japan’s fiscal imbalance.

Consumption tax was introduced in Japan in April 1989 at a rate of 3% which was later raised to 5% in April 1997. In both cases, the economy reacted negatively in the quarter when the policy change occurred, preceded by a quarter with a consumption rally. In Q2 1989, private spending fell by 7% and triggered a drop in real GDP growth of 5%. In Q2 1997, households restrained themselves even more, leading to a plunge in spending of 13%, prompting a 3.7% fall in GDP growth.

Consumption will likely overshoot in Q1, followed by a plunge in Q2

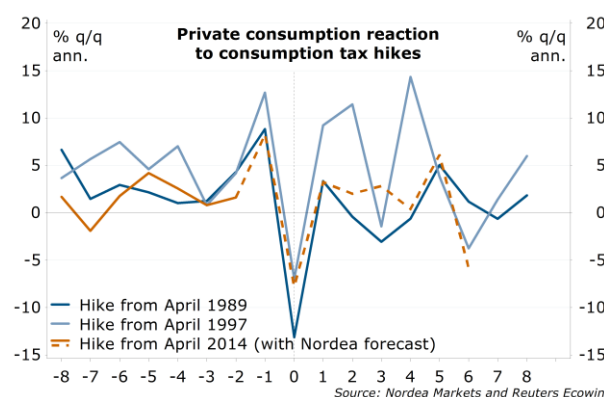
If history is any guide, we can expect a considerable but temporary upswing in economic activity in Q1 this year due to frontloading of household purchases of durable goods. Plummeting private spending is a safe bet in Q2, when we expect the overall economy to contract by 4.5% annualised q/q.

The 1997 tax hike has been unreasonably blamed for Japan’s lost decade

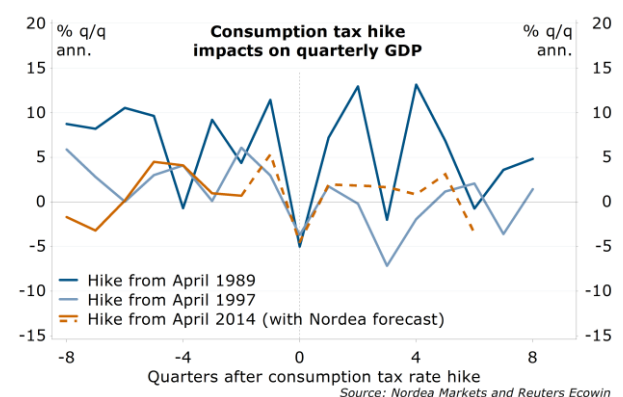
In order to form an opinion about the tax hike’s impact on growth in 2014 as a whole, private consumption data in Q3 are critical. In 1989, the consumers came back strongly in the July-September period, lifting annual growth to 6.4%. In contrast Japanese shoppers kept their wallets closed the same period in 1997, which caused annual growth to decline to 0.2%. In fact the economy slipped into recession in 1998. To this day, some Japanese still blame the 1997 tax hike for having started Japan’s decade-long recession, even though it should perhaps be attributed to the Asian crisis in July 1997.

The opponents fret that the upcoming hike in April will strangle Japan’s

Very negative reaction from private spending



Temporarily negative growth in Q2 this year



The economic blow will be neutralised by a fiscal stimulus package

Negative real wage growth is a worse medicine for private consumption

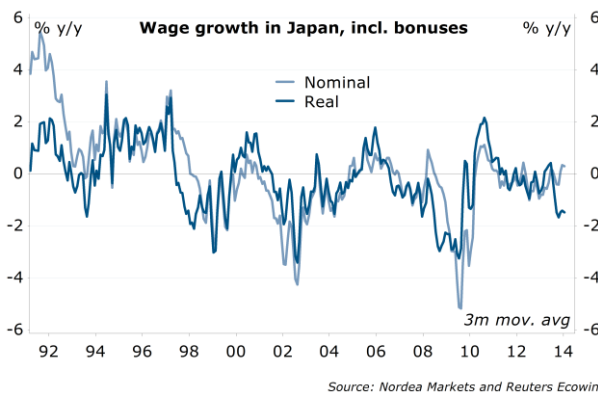
fragile recovery at birth. Their concern is overstated. The [cabinet office expects](#) the tax hike to subtract 0.6% point growth in fiscal 2014/15. It can be fairly assumed to be neutralised by a stimulus package of JPY 6 trillion (USD 59 billion) or 1.2% of GDP, earmarked to cushion the economic blow of the tax hike. The package includes cash hand-outs to low-income families and tax breaks for companies.

The key uncertainty for consumption this year remains real wage growth, which has become even more negative because inflation outpaces nominal wage increases. This has damaged consumer confidence. Although large corporations have agreed to raise base salaries, this will not benefit 70% of the workforce, which is employed by small and medium-sized enterprises. The SMEs have not benefited from Abenomics and the weaker yen, so they will remain reluctant to raise salaries.

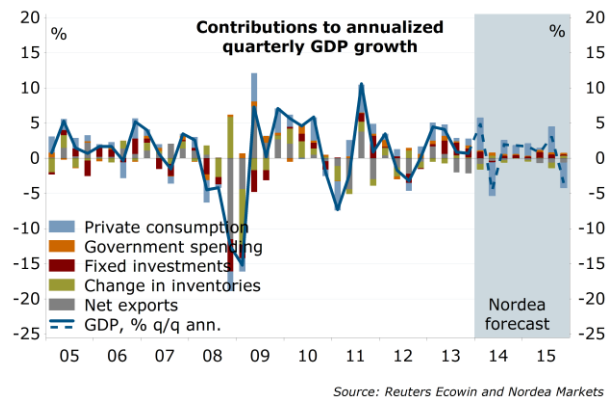
[According to BoJ board member Takahide Kiuchi](#), there is no overly tight demand for regular workers, so it would be difficult to see a significant increase in wages. Japanese consumers face a double whammy and may start to tighten their belts. Thus, we expect Japan to deliver growth of only 1.3% for 2014 and 1.0% for 2015.

Given the fiscal stimulus of 1.2% of GDP, the net adjustment to the budget balance is likely to be smaller than the 2.6% of GDP this year expected by the IMF.

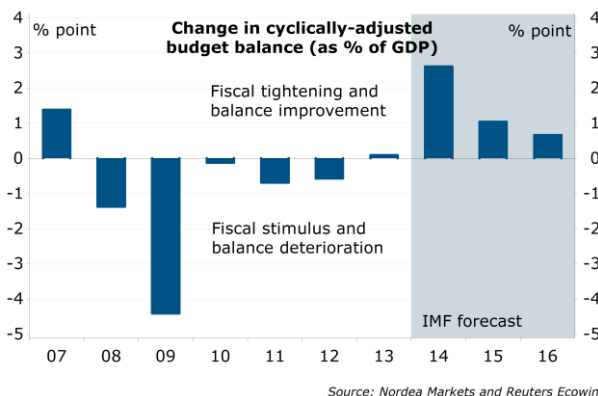
Real wage growth is negative



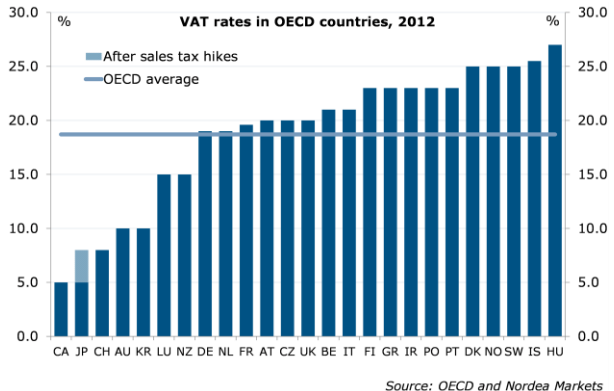
No bright growth outlook



Encouraging fiscal adjustment this year



Post-hike consumption tax rate is still low



Japan should continue raising the sales tax, to 20% in 2020

So Japan must continue the fiscal adjustment process by raising the sales tax rate to 10% in October 2015 as planned. At the moment, Abe is expected to honour the deal, but the ultimate decision is conditional on the growth reaction to the upcoming tax hike. Even after hiking it to 10%, Japan still has one of the lowest sales tax rates among OECD countries. Thus, the government should consider raising it further to 15% or even 20% between 2015 and 2020. The government's own calculation suggests that a sales tax of 16% is needed to achieve fiscal balance.

**No QE2 from the BoJ**

Inflation target will be achieved

Regarding monetary policy, the CPI inflation is rising in line with official expectations and the BoJ remains confident in achieving the 2% inflation target by 2015. Hence, inflation does not warrant a change in policy at this moment. The bank's latest assessment of the economy sounded positive, indicating the BoJ will stay put for now.

BoJ Governor Kuroda has made it crystal clear that he is ready to act if growth appears to react more strongly to the consumption tax hike than anticipated. Given the possibility that the negative impacts are counteracted by fiscal stimulus, monetary assistance will probably not be necessary. Prime Minister Abe will do his bit to push for "QE2", as his support rating could benefit from the subsequently weaker yen and higher stock prices.

No expansion of asset purchase programme from the BoJ

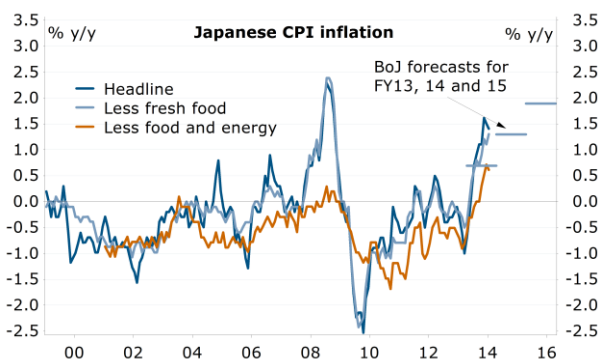
Thus, we hold on to our previous view that the BoJ will maintain status quo regarding its quantitative easing programme, so the monetary base will grow at an annual pace of about JPY 60-70tn to JPY 270tn at the end of 2014, about 55% of GDP. Domestic government bonds will still account for the lion's share.

We maintain our JPY forecast of 103 at the end of 2014 and 110 at the end of 2015.

**Conclusion**

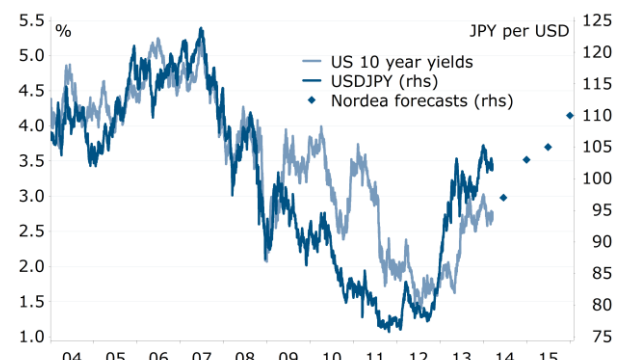
Japan's government debt as share of GDP is the highest in the world and the ability to continue financing it domestically has become questionable. The consumption tax hike to 8% in April this year is an important first step in restoring fiscal health. The IMF expects a budget balance improvement of 2.6% of GDP this year, but it is without taking into account the 1.2% of GDP fiscal easing that accompanies the tax hike. Therefore, the fiscal adjustment process needs to continue in the years ahead, requiring additional

BoJ inflation target is achievable



Source: Reuters Ecowin and Nordea Markets

JPY prone to more weakness vs USD



Source: Reuters Ecowin and Nordea Markets

sales tax hikes.

If history is any guide, we can expect a temporary upswing in economic activity in Q1 this year due to frontloading of household purchases. This will almost certainly be followed by a plunge in spending in Q2. Without the supplemented stimulus package of 1.2% of GDP, the economy would certainly feel the pain. But the fiscal stimulus can be fairly assumed to neutralise the economic blow from the tax hike.

Unfortunately, the sales tax hike is not the only negative factor on consumption. Consumer spending may remain sluggish this year due to negative real wage growth. Our growth projections are 1.3% for 2014 and 1.0% for 2015.

We expect the Bank of Japan to maintain status quo regarding its quantitative easing programme. Thus, we maintain our JPY forecasts of 103 at the end of 2014 and 110 at the end of 2015.

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