Japan Business Forecast Report Q2 2014

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Abstracts

Core Views

Japanese corporates continue to maintain a cautious stance despite the improvement in current business conditions. We do not expect many businesses to heed Prime Minister Shinz? Abe's calls to raise wages given the limited upside potential for profits. As such, together with the negative effects from the consumption tax hike and the rising import bill (due to the weakening currency), we project real GDP growth to slow to a subdued pace of 1.3% in 2014.

Even as Abe reiterates his pledge to maintain reform efforts to various sectors, we believe that actual implementation is still some way off. We believe that both the Bank of Japan (BoJ) and the government are likely to enact more expansionary policies (even though they will not produce any long-lasting or significant impacts) while reforms take a backseat.

We maintain our concerns with regards to the permanence and sustainability of 'Abenomics' and highlight the growing pressure on the BoJ to expand its monetary stimulus, both from an inflationary perspective as well as given the need to stabilise yields in the government bond market.

The massive changes in Japan's current account dynamics continue to push the country's current account balance towards zero and into the red beyond 2018. A downside risk to our current account forecast would be possible delays in Australian liquefied natural gas supply, which has so far suffered from cost overruns and shortages in skilled labour.

Long-term household savings rates will continue to decline as a progressively ageing society and a shift towards lower-paying contract (non-regular) employment forces more

Japanese households to consume a greater proportion of their income. Consequently, this will place significant downward pressure on Japan's net international investment position, although a shift from positive to negative territory will very likely take more than 30 years.

We remain concerned about the increasing pressure on longer-dated interest rates. Higher inflation, together with a greying population, suggest that deposits will decline over time. Moreover, we maintain that the country's large stock of debt could be a destabilising force for both the economy and the banking system, especially since Japanese banks hold a significant portion of government bonds. Indeed, given that significant cuts to fiscal expenditure remain unlikely, a fiscal crisis, with more apparent monetisation of debt, looks increasingly unavoidable.

Major Forecast Changes

We have raised our estimate for 2013 real GDP growth, and now expect it to come in at 2.4% owing to stronger-than-expected private consumption growth over the first three quarters of the year.

We believe that the central bank is likely to ramp up its monetary stimulus sometime after the Q413 GDP print is released and around the time that fiscal year 2014 begins (April-March).

Key Risks To Outlook

The main risk to Japan's economy comes from a fiscal crisis that could result from the increase in debt issuance as welfare expenditures increase. The recent volatility in debt markets and the growing debt burden of the central government further highlight that the growing possibility of a failed bond auction could lead to a severe loss in confidence.

Another major risk to our economic outlook comes from a collapse in external demand as was seen during the height of the global financial crisis. This would come at the worst possible time for the economy, which is suffering from subdued domestic demand growth.

While unconventional quantitative easing, including the purchase of risk assets such as exchange-traded funds and real estate investment trusts, may help to stem deflation over the next few quarters or even years, the risk of the sudden onset of hyperinflation over the longer term has increased considerably. Indeed, the government is determined

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to push the BoJ to commit to indefinite easing and a 2.0% inflation target.

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key obstacle for Prime Minister Shinz? Abe, especially given that corporate Japan once again revised down its projected capital expenditure for fiscal year 2013. This suggests that an increase to workers' base wages is highly unlikely despite the Abe administration's numerous pleas to the business community. In our view, there is a possibility of private consumption contracting in 2014 as the consumption tax hike is implemented.

Table: ECONOMIC ACTIVITY

Fiscal Policy

Reduced Bond Issuance Built On Shaky Foundations

The Japanese legislature has adopted the largest ever fiscal budget for FY2014/15 (April-March), confirming, in our view, the lack of political will to undertake real steps towards fiscal consolidation. This leads us to maintain our bearish outlook for Japan's fiscal accounts and economy. We maintain that the government's revenue projections are too optimistic and that the reliance on increasing taxes, rather than curbing expenditure, will prove ineffectual in reining in the budget deficit. We further note that the supportive forces from the Bank of Japan's easing mandate may be not be sufficient as structural and market conditions come to the fore.

Table: FISCAL POLICY

Monetary Policy

Growing Pressure From All Sides To Force BoJ To Raise JGB Purchases

In view of the slow pickup in core consumer price inflation and weakening economic growth, we believe that the Bank of Japan (BoJ) will be forced to expand its easing measures in 2014 to signal its commitment to its 2% inflation target. Even if inflation pressure does start to materialise, the fiscal trajectory and the likely offloading of private sector holdings suggest that the central bank will have to buy an ever-greater amount of public debt, which inevitably will lead to monetisation of the government's colossal debt load. We maintain that the BoJ's inflationary policies will not fix the economy's problems, but rather hasten the need for some form of debt restructuring.

Table: MONETARY POLICY

Balance Of Payments

Structural Factors To Drive Further Surplus Declines

We maintain a dim outlook on Japan's external balances, as we see a host of short- and long-term factors that will continue to erode its current account surplus. We forecast the surplus to narrow to 0.5% of GDP in 2014, from an estimated surplus of 0.6% of GDP in 2013. In 2014, we believe that there is little room for the weakening yen to sustain export expansion at the pace recorded in 2013, as much of the low-hanging fruit has been picked. Meanwhile, structural factors, such as the aging population, will continue to pose downward pressure on the income account, although the recovery in global markets in 2014 will mitigate some of these forces.

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