

# Japan Business Forecast Report Q4 2014

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## Abstracts

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### Core Views

We believe that Japanese Prime Minister Shinzo Abe will struggle to push through any drastic reform over the next few years, given that waning confidence of both the public and politicians in his economic policies will result in greater opposition and dilution of his initial plans for change. Consequentially, we believe a far more piecemeal approach to reforms will materialise, and as such will fail to provide the intended boost to economic growth or military might.

Prime Minister Shinzo Abe has unveiled his latest initiatives as part of his 'third arrow' of economic reforms, including cutting the corporate income tax and reforming the giant Government Pension Investment Fund to make it more equity focussed. While we believe that these reforms will be necessary in allowing the Japanese economy to avoid a fiscal crisis as a result of its huge debt load, they may not be sufficient. Furthermore, Abe may struggle to garner the political support to push through some of the more controversial elements of his plan.

The monetary stimulus measure employed over the past 18 months appear to have worked their way through the economy to a large extent, and the prospects of a self-sustaining recovery are diminishing. The collapse in wage growth is a particularly telling sign, and we continue to forecast real GDP growth of just 0.9% and 0.8% in 2014 and 2015, versus consensus expectations of 1.5% and 1.2%. More aggressive monetary stimulus will be forthcoming before end- 2014, even as the inflation rate remains well above the 2.0% target. This is likely to keep upside pressure on CPI, and we believe that the Bank of Japan's inflation target will be overshoot over the coming years, potentially by a wide margin.

While we believe the fundamental outlook for the yen is poor, it is not the only currency among its developed peers that faces downside risks, in spite of the structural headwind posed by the ongoing attempts by the government and the Bank of Japan to undermine it. The lack of historical precedent for a country in such dire fiscal position (ie, public debt to GDP of around 240%), but strong external position (ie, net external assets of around 55% of GDP) makes having a conviction call on the yen very difficult at present, and we expect a great deal of volatility to result from the opposing forces at play. On balance, however, we maintain that strength is more likely than weakness over the coming three-to-six months.

### Major Forecast Changes

We have revised up Japan's inflation outlook owing to the recent surge. The current level of CPI is a lofty 3.4% year-on-year (y-o-y), the highest level since 1991, and while the latest spike owing to the increase in the sales tax in April should work its way through over the coming months, a move back below 2.0% is looking increasingly difficult to see. We expect CPI to head to 2.7% by end-2014. We have also revised up our end-2015 CPI forecast to 2.3%, from 1.9% previously.

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BMI Political Risk Ratings

Domestic Politics

Rising Opposition To Thwart Abe's 'Third Arrow' Of Reforms

Prime Minister Shinzo Abe will be prevented from enacting his preferred economic reforms, due to rising opposition from within his ruling

Liberal Democratic Party and its New Komeito coalition partner. As with Abe's attempts at fiscal reform, the premier will also find his proposals to reform the agricultural sector and enhance Japan's military profile significantly diluted.

Table: Political Overview

Long-Term Political Outlook

Can Any Government Reverse National Decline?

Although the Liberal Democratic Party (LDP) won a landslide victory in the 2012 election, it is doubtful whether the party has the means

to deliver a sustainable recovery of the Japanese economy and address the country's structural woes. These include a colossal

national debt burden, demographic decline, and the loss of competitiveness of Japan's key industries. If the LDP fails to make progress,

it risks paving the way for a fiscal crisis before the end of the 2010s, and its eventual replacement by new political forces.

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The monetary stimulus measure employed over the past 18 months appear to have worked their way through the economy to a large

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Reform Proposals Still Leave A Lot To Be Desired

A successful implementation of Prime Minister Shinzo Abe's economic reform agenda would provide a major boost to Japan's economy and fiscal situation, but the lack of details surrounding certain key policies is a concern. Meanwhile, we view such reforms as a necessary but not sufficient for avoiding a fiscal crisis, with spending cuts likely to be crucial in reining in the deficit.

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More Easing To Come Despite Inflation Surge

More aggressive monetary stimulus will be forthcoming before end-2014, even as the inflation rate remains well above the 2.0% target.

This is likely to keep upside pressure on CPI, and we believe that the Bank of Japan's inflation target will be overshoot over the coming years, potentially by a wide margin.

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