

Daiwa's View

Can Japan's economy weather consumption tax hike (household version)?

- Risk is further decline in consumption propensity after tax hike

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On 4 July, the House of Councillors election was officially announced. The voting and vote counting are set for 21 July. Although the possibility of a double election for the upper and lower houses had attracted a lot of attention, it will not be held. The consumption tax hike to 10% slated for October 2019 is included in the campaign pledges of the ruling parties. We thus can say that the likelihood of a tax hike postponement has almost disappeared.

Currently, the government assesses Japan's economy as "recovering at a moderate pace while weakness in exports and industrial production continues." The short-term scenario is that "weakness remains for the time being, but the economy is expected to continue recovering, supported by the effects of policies, while employment and the income situation is improving¹." Specifically, the economy in 1H FY19 is expected to be supported by consumption partly on last-minute demand, while "growth of the global economy is expected to pick up again from 2H." The driver is thus anticipated to shift to external demand.

At the G20 summit in Osaka as well, the scenario that "the global economy will recover in 2H 2019" was maintained. However, participating nations shared the recognition that downside risks were increasing. At the US-China summit meeting on the sidelines of the G20 summit, tail risks of trade talks breaking down and the introduction of a fourth round of tariffs were avoided. However, uncertainty over trade has not been resolved at all. Can Japan's economy weather the consumption tax hike in this uncertain situation?

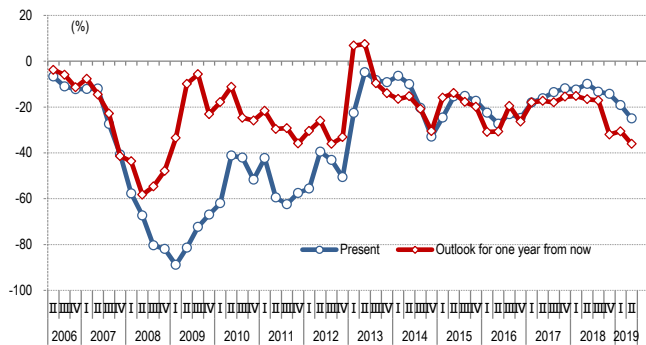
We previously discussed this point from the viewpoint of corporate business sentiment. However, the most important factor in checking the impact of the consumption tax hike is household trends. Household sentiment (consumer sentiment) is sending a more severe message than corporate sentiment.

In the BOJ's Opinion Survey on the General Public's Views and Behavior conducted in June, the Economic Conditions DI declined to -25, worsening for four consecutive quarters. The reading was the lowest level since June 2016. The BOJ attributed this to "an increasing number of media reports (such as US-China trade war) that fan concerns about the economic outlook."

Another background factor behind the cooling household sentiment is increasing budget-minded awareness due to a rash of markup-related news. In fact, inflation expectations in both one year and five years (estimated by this survey) are on an uptrend.

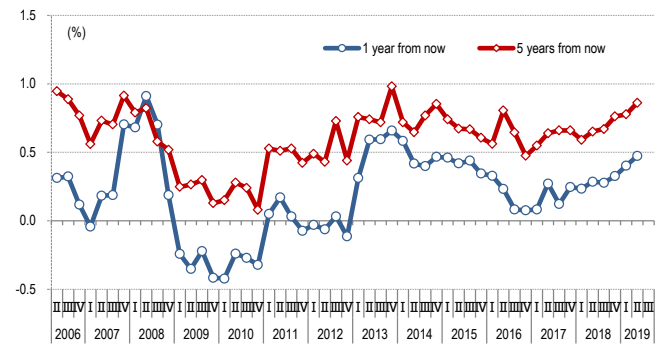
¹ Monthly Economic Report (Jun 2019).

Chart: Economic Conditions DI



Source: BOJ; compiled by Daiwa Securities.
 Note: Economic conditions DI = Proportion of respondents who answered that economic conditions "have improved/will improve" – Proportion of those who answered that they "have worsened/will worsen."

Chart: Household Inflation Expectations

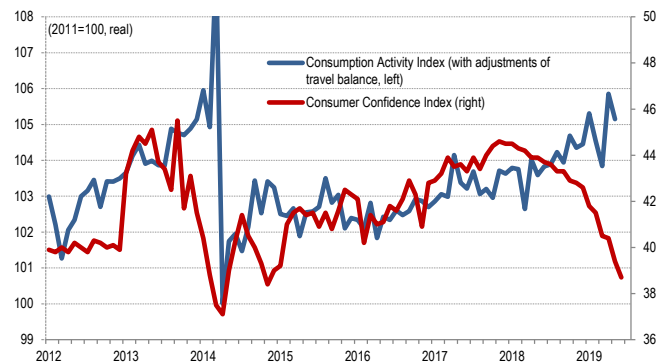


Source: BOJ's Opinion Survey on the General Public's Views and Behavior; compiled by Daiwa Securities.
 Note: Estimated by the modified Carlson-Parkin method.

That said, a noteworthy point is the outlook for the Economic Conditions DI one year from now. The figure worsened by 5.5 points from -30.6 in the previous March survey to -36.1, the lowest level since September 2012. It is highly possible that this is being affected by the tax hike in October 2019, in addition to recent events. For reference, the outlook for the Economic Conditions DI one year from now plunged in the survey in December 2018 when there was less than a year left until the tax hike.

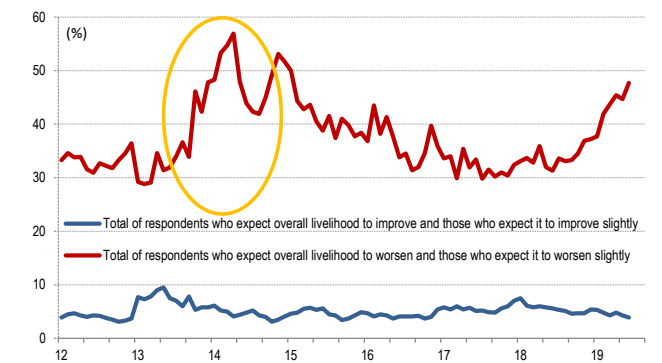
Similarly, the Consumer Confidence Index, a representative survey for household sentiment, continues to worsen. According to the Consumer Confidence Survey for June, the Consumer Confidence Index (for households of two or more persons) declined by 0.7 points m/m, falling for nine months in a row. The results show that the index was pushed down by a rise in the ratio of respondents who expect the overall livelihood to worsen. Such a trend was seen also before the consumption tax hike in April 2014.

Chart: Consumer Confidence Index and BOJ's Consumption Activity Index



Source: BOJ, Cabinet Office; compiled by Daiwa Securities.

Chart: Consumer Awareness on Overall Livelihood (all households)



Source: Cabinet Office; compiled by Daiwa Securities.

Despite the deterioration in consumer sentiment, actual personal consumption data (hard data) has recently been solid, posting the picture of decoupling. The Apr-May average for the BOJ's Consumption Activity Index (real, with adjustments of travel balance) increased by as much as 0.9% vs. the Jan-Mar data. Looking at the breakdown of private consumption, non-durable goods remained weak (down 0.3% q/q), while services were solid at +0.9% and durable goods posted a 4.1% surge.

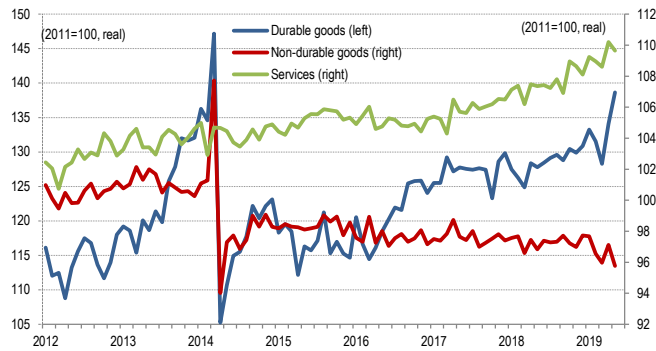
We think that the solid environment for employment and income is contributing to a recovery of private consumption. However, we attribute this to two special factors.

First is an increase in service consumption thanks to travel/outing during the unusual ten-day holiday. The festive mood due to the change in the era name and the new emperor's ascension to the throne appears to have partially contributed to related

consumption. Second is last-minute demand ahead of the tax hike, which is symbolized by the surge in durable consumption goods.

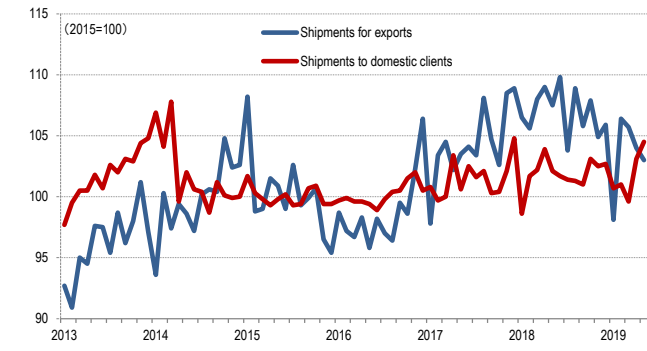
Given last-minute demand ahead of the previous tax hike in 2014 and the subsequent decline in consumption, the government plans to implement various measures to abate the negative impact for the upcoming tax hike. However, last-minute demand is still expected to some extent, and we presume that it has partially emerged².

Chart: BOJ's Consumption Activity Index (by type)



Source: BOJ; compiled by Daiwa Securities.

Chart: Breakdown of Industrial Production (by destination)



Source: Ministry of Economy, Trade and Industry; compiled by Daiwa Securities.

In fact, indices for industrial production and shipments in April and May were solid for a second straight month, centering on transport machinery. Sectorial data indicates that drivers are durable consumption goods. Here, we confirm the breakdown of industrial shipments to check the destinations. While shipments to domestic clients rose for two months in a row, those for exports declined for a third straight month, showing that drivers are products for domestic users.

In the BOJ's Regional Economic Report (*Sakura Report* announced 8 Jul) as well, comments from corporations indicate an increase in production to cope with last-minute demand prior to the tax hike.

Chart: Major Comments from Companies in BOJ's Regional Economic Report (*Sakura Report*; consumption tax hike-related)

| | | Remark |
|---|--|---|
| 1 | Manufacturing lines likely to remain busy in the near term due to responses to cope with last-minute demand before the consumption tax hike in Japan, in addition to high level of production of new models both for domestic and overseas markets | Nagoya (Auto-related) |
| 2 | Orders for PC equipment are favorable owing to last-minute purchases prior to consumption tax hike ahead of end to support for basic software | Matsumoto (Information & telecommunication machinery) |
| 3 | Production of air-conditioners is increasing thanks to recent last-minute demand before the consumption tax hike, in addition to stronger demand driven by upgraded functions | Shizuoka (Electrical machinery) |
| 4 | As items such as air-conditioners are bought ahead of the consumption tax hike, more sales staff are allocated before start of full-scale summer sales season | Mito (Retail) |
| 5 | After start of new fiscal year, orders for passenger cars remain solid. Recently, we have started to see last-minute purchases of popular models with long delivery time, but momentum is weaker than expected. | Nagoyo (Auto sales) |
| 6 | Last-minute demand before the consumption tax hike is limited as measures to abate consumer burdens (such as review of automobile taxes) are taken. Going forward, demand around tax hike is unlikely to fluctuate substantially. | Sendai (Auto sales) |
| 7 | Full-fledged last-minute demand before the consumption tax hike is expected from August. As drop after tax hike is unavoidable, we plan to implement aggressive sales promotion before tax hike, aiming to attract all demand in FY19. | Akita (Sales of home appliances) |
| 8 | Amid ongoing launches of new models, we have recently started to see last-minute demand ahead of the consumption tax hike | Fukuoka (Auto sales) |

Source: BOJ; compiled by Daiwa Securities.

² According to *Sankei Shimbun* article on 5 May 2019, peak of sales of items that tend to be bought by grandparents (e.g., school satchels for elementary students) is usually summer vacation when people return home, but this year such items bought earlier due to impact of ten-day holiday.

The minutes of Monetary Policy Meeting in April include an interesting opinion regarding the outlook for private consumption.

◆ Minutes of MPM on 24-25 Apr 2019

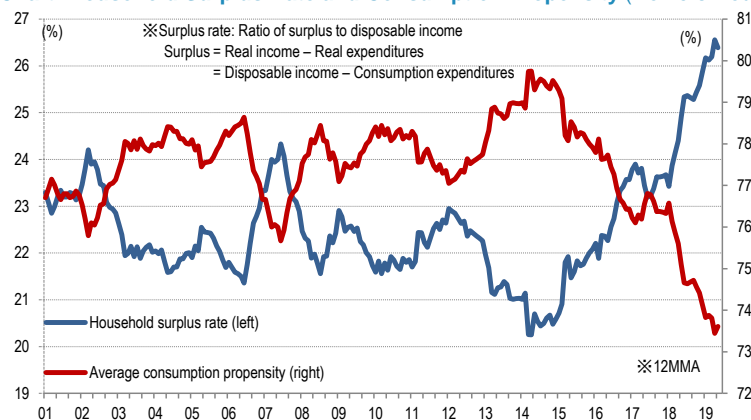
• One member noted that, considering that a significant amount of the increase in employee income had been allocated to savings, it seemed to take some time for the recent decrease in production to lead to that in consumption; on the other hand, there was a possibility that the scheduled consumption tax hike would bring forward the decline in consumption. This member added that a rise in the savings rate for households amid a decrease in the fiscal deficit suggested room for fiscal expansion.

I noticed this because I have recently been monitoring saving rate trends. As “one member” pointed out, the saving rate (surplus rate) on a household survey basis has been on an uptrend since 2014 when the previous tax hike was conducted. The surge over the past year is partially caused by the revision to the survey sheets in January 2018³. Still, the Ministry of Internal Affairs and Communications says that the surplus rate has been on an uptrend, while consumption propensity at households has been on a downtrend.

If such expenditure/saving behavior at households is caused by frugality and worries about the future, such moves may accelerate after the tax hike. Excluding last-minute demand and the subsequent decline in consumption (substitution effect), the logical impact of the tax hike on personal consumption is the income effect—i.e., a decline in real income due to a rise in prices via a higher tax rate.

However, the precondition of the logic is that consumption propensity will not change after the tax hike. If consumption propensity declines further (rise in saving rate) after the tax hike as in the previous case, we need to keep in mind the possibility that the degree of curbed consumption will be greater than that of reduced real income.

Chart: Household Surplus Rate and Consumption Propensity (workers' households)



Source: Ministry of Internal Affairs and Communications; compiled by Daiwa Securities.

³ Survey method reviewed in Jan 2018—specifically, format of household accounts (core of survey sheets) revised at full scale to reduce burdens at respondent households and prevent incomplete answers.

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[Standard & Poor's]

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* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

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