

Japan Economics Weekly

The BoJ's view turns more nuanced

- **The BoJ changed its economic assessment meaningfully** — The BoJ's view on the economy turned more nuanced over the past week. First, the BoJ explicitly revised down its assessment regarding exports in its policy statement published on last Friday. Second, policymakers tweaked the section regarding consumer spending in its Monthly Financial and Economic Report for August. Given that the BoJ's view on the economy tends to change only slowly and gradually, we figure that the BoJ's true view may be even more cautious than it appears.
- **The atmosphere of Mr. Kuroda's press briefing also changed** — At the press briefing last Friday, there were a number of times when Mr. Kuroda did not answer questions directly or struggled to answer in a succinct manner. This also suggests that gaps may be appearing in the BoJ's bullish economic scenario. The dominant view in recent months in the financial markets has been that the BoJ is unlikely to take further easing measures. Given the latest change in the economic assessment and Governor Kuroda's press briefing, however, the probability of additional easing appears to have somewhat increased.
- **We now expect only 0.4% growth for FY2014** — We revise our economic forecasts for Japan in the wake of the release of the second quarter GDP report this week. We now expect real GDP growth of +1.2% for CY2014 and +0.9% for 2015. At the last forecast round in late July, we had expected +1.4% and +0.9%, respectively. On a fiscal year basis, we anticipate 0.4% for FY2014 and 1.2% for FY2015 versus our previous forecasts of 0.6% and 1.2%.

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The BoJ's view turns more nuanced

The Bank of Japan's (BoJ) view on the economy turned more nuanced over the past week. First, the BoJ explicitly revised down its assessment regarding exports in its policy statement published on last Friday. Second, policymakers tweaked the section regarding consumer spending in the Monthly Financial and Economic Report for August. Given that the BoJ's view on the economy tends to change only slowly and gradually, we figure that the BoJ's true view may be even more cautious than it appears. We expect the BoJ will eventually revise down its economic assessment in a way that warrants additional monetary easing in coming quarters.

In the BoJ's Monthly Financial and Economic Report published on this Monday, policymakers revised down their assessment regarding exports (from "exports have recently leveled off more or less" to "exports have shown some weakness"). Also notably, they tweaked the section regarding consumer spending: the language "[the drop-off after rush demand ahead of the tax hike] is in line with expectations," a boilerplate in recent months, has been removed.

In July, the Monthly Report stated, "According to anecdotes by firms and other information, however, the scale of the subsequent decline in demand following the increase in durable goods to date seems to have been basically within the scope that was previously projected," and "In all of these sectors, many firms have voiced that the degree of the subsequent decline following the frontloaded increase in demand has been generally within the scope previously projected..." These statements were eliminated in August, and instead the latest report said, "given the large frontloaded demand increase [for durable goods], the setback is also expected to be significant both in size and duration." The report went on to say, "In all of these sectors, many firms have voiced that the degree of the subsequent decline following the frontloaded increase in demand has been gradually easing. However, partly due to the adverse impact from unfavorable weather, some have indicated that the pace of recovery has slowed somewhat recently and that the pace of improvement has not been uniform across products and regions." These statements acknowledge spots of weakness. At any rate, we think these changes suggest the likelihood that the BoJ has become uncomfortable with its mantra, "in line with expectations," as consumption-related data fell sharply and has shown only a modest pickup.

Meanwhile, Governor Kuroda did not answer directly when asked by a journalist whether the negative impact from the tax hike was in line with expectations, even in light of June data that generally surprised to the downside. Instead, he responded with a lengthy statement, "I believe there is lots of room for argument about to whom the "expectations" belong. That aside, basically, the frontloaded demand increase was considerable, and thus the subsequent drop was also substantial. However, the adverse impact has been decreasing month by month with the drop-off gradually diminishing. I believe this trend will continue in the months to come. In this sense, I think we can say nothing unexpected has been happening."

As for a question about a drop in real wages, which we believe is an important culprit for the sharp drop in consumer spending, Governor Kuroda said, "The decrease in real wages is mostly, or totally attributable to the consumption tax hike. This impact is tentative and one-off, and will disappear after 12 months. I do not expect the current fall in real wages caused by the tax hike to continue permanently." This is tantamount to switching the focus of argument from a permanent drop in real wages due to the tax hike to the YoY change in wage growth.

There were a number of times at this press briefing when Mr. Kuroda did not answer questions directly or struggled to answer in a succinct manner. This suggests to us that gaps may be appearing in the BoJ's bullish economic scenario. The dominant view in recent months in the financial markets has been that the BoJ is unlikely to take further easing measures. However, given the latest Monthly Report and Governor Kuroda's press briefing, the probability of additional easing appears to have increased significantly. We are sticking to our view that the BoJ will act in late October when policymakers update a semi-annual economic outlook report ("Tembo Report"). But the timing may be delayed until January 2015 when they do an interim review of the Tembo Report.

Updating economic forecasts for Japan

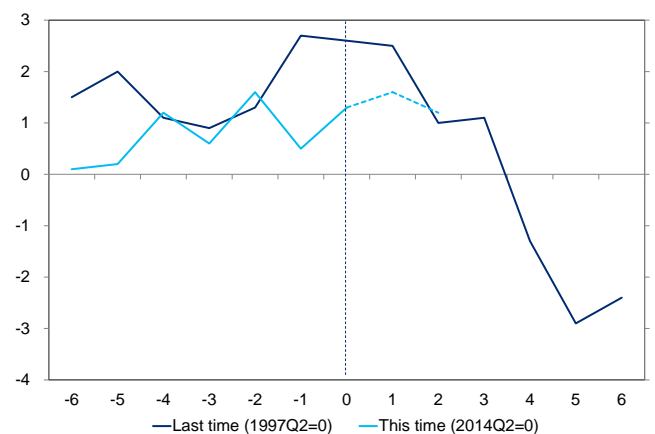
In the wake of the release of the second quarter GDP report this week, we revise our economic forecasts for Japan. We now expect real GDP growth of +1.2% for calendar 2014 and +0.9% for 2015 (see Figure 3). At the last forecast round in late July, we had expected +1.4% and +0.9%, respectively. On a fiscal year basis, we anticipate 0.4% for FY2014 and 1.2% for FY2015 versus our previous forecasts of 0.6% and 1.2%.

In the first preliminary print, Japan's real GDP in Q2 contracted 1.7% QoQ and 6.8% QoQ annualized. While this is close to the median market projection (-1.8% QoQ, -7.1% QoQ annualized), digging into the data further suggests greater weakness than would appear true from the headline numbers. First, private inventory added 1.0ppt to the QoQ GDP growth rate, a larger contribution than the market had expected. We figure that inventory accumulated unintentionally at some sectors as final demand—mostly consumer spending and exports—surprised to the downside. Second, private consumption logged a sharper-than-expected 5.0% QoQ drop, with notable weakness in areas less susceptible to the dropout of rush demand (i.e., goods and services other than durables). We think declining real income has likely taken a toll.

In our view, the most interesting aspect of the GDP report was weakness of private consumption in other areas than consumer durables: -18.9% QoQ in durables (+13.0% QoQ in Q1), -12.3% QoQ in semi-durables (+6.9% QoQ), -7.0% QoQ in nondurables (+1.8% QoQ), and -0.9% QoQ in services (-0.1% QoQ). The sharp drop in nondurables after only a modest rise in Q1 suggests that a large drop in real income weighed on consumer spending in addition to a payback to rush demand, in our view. Furthermore, spending on services, regarded as resilient, has decreased for two quarters in a row.

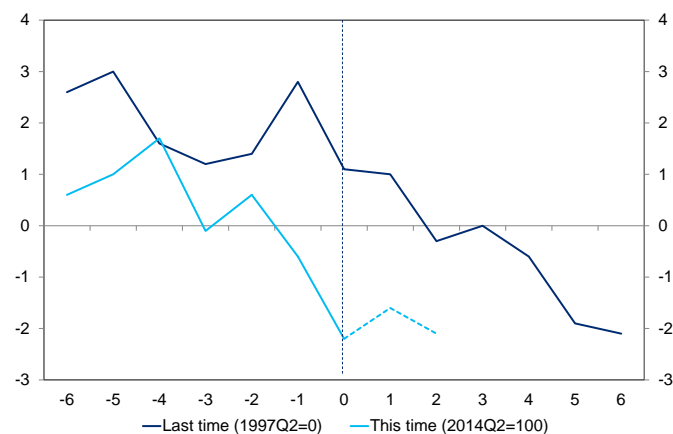
If we look at the income situation as a background factor, nominal employment income (per capita wage multiplied by the number of employees) gathered momentum to a 1.3% YoY gain in the second quarter from a 0.5% YoY rise in the first quarter. However, employment income in real terms dropped 2.2% YoY (-0.6% YoY in Q1) as the household consumption deflator (excluding imputed rent) rose 3.4% YoY (see Figure 1 and Figure 2). A path in real total employment income under the current phase has been even weaker than around the 1997 consumption tax hike.

Figure 1. Nominal Total Employment Income (YoY, Percent)



Note: The dashed line shows our estimates for 2014 Q3 (+1 on the horizontal axis) and Q4 (+2).
Source: Cabinet Office, Citi Research.

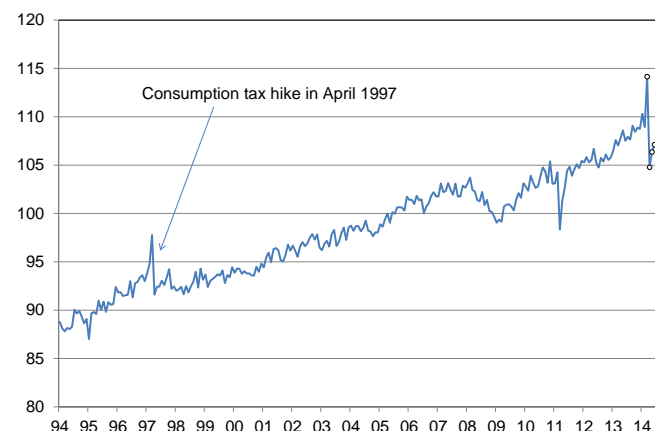
Figure 2. Real Total Employment Income (YoY, Percent)



Note: The dashed line shows our estimates for 2014 Q3 (+1 on the horizontal axis) and Q4 (+2).
Source: Cabinet Office, Citi Research.

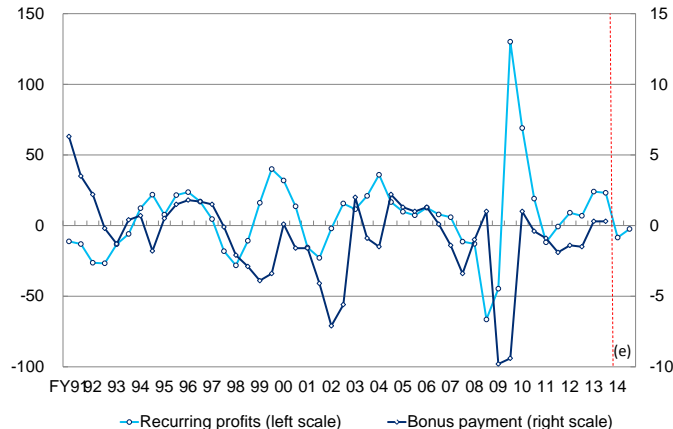
Going forward, we expect a clear turnaround to a 4.2% QoQ annualized gain in the third quarter GDP (Figure 5). First, the private consumption integrated estimates compiled by the Cabinet Office posted a 1.0% rise in June from the second quarter average, securing a positive carry-over effect into the third quarter (see Figure 3). Given this, we expect private consumption to increase over 1% QoQ in the third quarter. Second, according to the customs-clearance trade data for the first 20 days in July, exports rose 4.7% YoY and imports dropped 2.8% YoY, which suggests the likelihood of a positive contribution to GDP from net exports in the third quarter. Third, we expect public investment to increase 5.7% QoQ in the third quarter, as the impact from the FY2013 supplementary budget and frontloaded implementation of FY2014 initial budget materializes as suggested by the leading indicator (i.e., public works contracts). Finally, private business investment will likely return to a moderate growth path in the quarter, in our view, while there remains some uncertainty over this point.

Figure 3. Cabinet Office's Comprehensive Consumption Index (Real Term) (CY2005=100)



Source: Cabinet Office, Citi Research.

Figure 4. Historical Relationship between Recurring Profit and Bonus Payments (Semi-annual, YoY, %)



Note: 1. Recurring profits are for all companies excluding financials. 2. The figures for profits in FY2014 are based upon the corporate outlook in the June Tankan.
Source: Ministry of Finance, Ministry of Labour, Health and Welfare, Citi Research.

That said, we emphasize that the likely positive growth will be helped by technical factors. The April consumption tax hike generated frontloaded demand in the first quarter and the drop-off of such demand pushed consumption down in the second quarter. Therefore, private consumption is expected to show fairly strong growth simply as it returns toward the underlying level. Just as the second quarter GDP underestimates the real state of the economy, GDP in the third quarter will likely overstate the underlying strength, in our view. As a result, it will be difficult to determine the real state of the economy before the fourth quarter of this year.

Meanwhile, we expect a 1.2% QoQ annualized increase in the fourth quarter GDP (Figure 5). The economic downturn in the second quarter will likely affect household income formation by way of slowing corporate profit growth, in particular at small firms, in our view. Specifically, we expect bonus growth (YoY) to hit a peak in summer and moderate somewhat in winter (see Figure 5). If we are correct, this would be a constraint on consumer spending growth.

The Abe Administration intends to make the final decision on whether or not to implement the next consumption tax hike (to 10% from 8% currently, slated in October 2015) after having scrutinized a GDP report for the third quarter (due on November 17). Based upon our expectations of 4.2% growth annualized in the quarter, PM Abe is very likely to go ahead with the tax hike. In that case, a negative impact on households' real income will probably be meaningful again, leading to a continued bumpy ride in consumer spending. Political discussions regarding stimulus measures to offset the negative impact from the tax hike are also likely to emerge this autumn and winter.

Figure 5. Economic Forecasts Summary, 2013–2015E

	CY			FY			2013	2014				2015F				2016F
	2013	2014F	2015F	2013F	2014F	2015F	4Q	1Q	2QF	3QF	4QF	1Q	2Q	3Q	4Q	1Q
Real GDP (QoQ %)	1.5	1.2	0.9	2.3	0.4	1.2	0.0	1.5	-1.7	1.0	0.3	0.3	0.1	1.1	-1.5	1.1
(SAAR %)							-0.2	6.1	-6.8	4.2	1.2	1.4	0.5	4.5	-5.7	4.7
(YoY %)							2.4	2.7	0.0	0.7	1.1	-0.1	1.8	1.9	0.1	0.9
Domestic Demand (QoQ %)	1.8	0.9	0.4	2.6	-0.4	0.9	0.5	1.7	-2.8	0.7	0.3	0.3	0.2	1.2	-2.0	0.9
Note: Private Domestic Final Sales	1.6	0.9	0.7	2.7	-1.1	1.6	0.6	3.0	-4.8	1.0	0.6	0.5	0.6	1.3	-2.4	1.2
Private Consumption	2.0	-0.6	0.1	2.5	-2.3	0.9	0.4	2.0	-5.0	1.2	0.3	0.4	0.3	1.5	-3.1	1.3
Business Investment	-1.4	8.6	4.1	2.2	5.9	4.9	1.4	7.7	-2.5	1.3	1.5	0.9	1.5	1.2	0.8	1.2
Residential Investment	8.8	-3.6	-3.8	9.5	-9.5	-1.8	2.4	2.0	-10.3	-5.0	1.1	1.5	1.4	-1.1	-5.1	-0.9
Government Consumption	2.0	0.6	1.0	1.8	0.7	1.0	0.2	-0.1	0.4	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Public Investment	11.5	3.8	-8.7	14.6	-0.6	-9.1	1.4	-2.5	-0.5	5.7	-7.4	-4.1	-3.7	4.6	-5.2	-3.7
Inventories (Contribution)	-0.3	0.0	0.1	-0.4	0.3	-0.1	-0.1	-0.5	0.8	-0.3	0.1	0.0	-0.1	0.0	0.1	0.1
Net Exports (Contribution)	-0.2	0.4	0.5	-0.2	0.8	0.3	-0.5	0.1	0.8	0.3	0.0	0.1	-0.1	-0.1	0.5	0.3
Exports of Goods & Services	1.5	8.0	4.4	4.8	6.7	4.4	0.3	6.5	-0.4	1.6	1.4	1.6	0.3	1.1	0.9	1.6
Imports of Goods & Services	3.3	6.3	1.7	7.0	1.7	2.8	3.7	6.4	-5.6	-0.5	1.4	1.3	1.0	1.7	-2.2	0.2
Nominal GDP (QoQ %)							0.3	1.6	-0.1	0.7	0.5	0.3	0.4	0.7	-0.4	1.1
(YoY %)	0.9	2.5	1.6	1.9	2.1	1.6	2.0	2.9	1.9	2.5	2.7	1.4	1.9	1.9	1.0	1.8
GDP Deflator (YoY %)	-0.6	1.3	0.6	-0.4	1.7	0.5	-0.4	-0.1	2.1	1.8	1.6	1.5	0.1	0.0	0.9	0.9
CPI (YoY %)	0.4	2.8	1.7	0.9	3.1	1.5	1.4	1.5	3.6	3.2	2.8	2.9	0.9	0.9	2.3	2.1
Core CPI (YoY %)	0.4	2.7	1.7	0.8	3.1	1.5	1.1	1.3	3.3	3.2	3.0	3.0	0.9	0.9	2.3	2.1
Core CPI excluding the impact from the consumption tax hike (YoY %)	-	1.2	0.9	-	1.1	0.9	-	-	1.4	1.2	1.0	1.0	0.9	0.9	1.0	0.8
Current Balance (¥trn, SAAR)	3.3	1.9	3.4	1.0	4.2	3.9	0.0	-5.5	4.3	4.5	4.1	3.7	3.1	2.2	4.5	5.6
Note: Pct. of GDP	0.7%	0.4%	0.7%	0.2%	0.8%	0.8%	0.0	-1.1%	0.9%	0.9%	0.8%	0.7%	0.6%	0.4%	0.9%	1.1%
Trade Balance (¥trn, SAAR)	-8.7	-10.2	-9.2	-10.7	-8.5	-8.7	-11.2	-15.6	-8.7	-8.0	-8.4	-8.8	-9.4	-10.3	-8.0	-6.9
Yen/US\$ (Average)	97.5	104.3	109.0	100.2	105.6	109.5	100.4	102.8	102.3	105.0	106.0	108.0	108.0	109.0	110.0	110.0
Landed Crude Oil Price (US\$/Barrel)	97.3	99.1	94.9	98.6	98.8	93.9	99.2	98.0	102.2	99.2	97.1	96.7	95.4	94.2	93.5	92.6
Industrial Production (QoQ %)							1.8	2.9	-3.8	-0.5	1.0	0.6	0.7	1.9	-2.1	0.9
(YoY %)	-0.6	2.6	1.1	3.2	-0.1	2.1	5.8	8.2	2.7	0.4	-0.5	-2.7	1.9	4.3	1.0	1.3
Unemployment rate	4.0	3.6	3.4	3.9	3.5	3.3	3.9	3.6	3.6	3.6	3.5	3.4	3.4	3.3	3.3	3.3

E: Citi Research estimates as of August 15.

Source: Cabinet Office, Ministry of Finance, Ministry of Internal Affairs and Communications, Ministry of Economy, Trade and Industry, Citi Research.

Figure 6. Economic Indicators

Aug. 20 (Wed) 8:50 a.m.	Customs-Clearance Trade Balance (Jul)	Forecast: -¥668.3n NSA; -¥618.4bn SA Previous: -¥823.2bn NSA; -¥1,080.8bn SA
	The customs-clearance trade balance likely came to a ¥668.3bn deficit before seasonal adjustment and a ¥618.4bn deficit after it in July. We estimate exports increased 4.0% YoY in July (-1.9% YoY in June), for the first monthly rise in three months, while imports dropped 1.8% YoY (+8.4% YoY) for the first gain in two months. Exports expanded 4.7% YoY in the first 20 days of July, possibly reflecting a special factor. Media sources are reporting that production of a new smartphone model, to be rolled out in autumn, has shifted into high gear in Asia since last month. We will scrutinize the breakdown of exports by region and products to determine the potential staying power of the apparent export recovery. If our forecasts are correct, real exports (the seasonally-adjusted export value divided by the seasonally-adjusted export price index) would increase 2.1% MoM in July for the second consecutive monthly gain, while real imports (the seasonally-adjusted import value divided by the seasonally-adjusted import price index) would decrease 4.3% YoY for the first fall in two months.	
Aug. 20 (Wed) 1:30 p.m.	All Industry Activity Index (Jun)	Forecast: -0.1% MoM; -0.7% YoY Previous: 0.6% MoM; -1.6% YoY
	We expect a 0.1% MoM drop (-0.7% YoY) in the all industry activity index for June. This would be the first fall in two months. If we look at already available indices which constitute the all industry activity index, the industrial production index declined 3.4% MoM in June along with a 0.1% MoM fall in the tertiary industry activity index and a 0.1% MoM climb in the government services, etc. index. The construction activity index, due out at the same time, will likely rise 0.2% MoM on the back of growth in public works. If we are on the mark, the all industry activity index would decrease 3.4% QoQ in the second quarter, indicating a slow recovery of domestic industrial activity after the consumption tax hike.	

Source: Ministry of Finance, Ministry of Economy, Trade and Industry, Citi Research.

Figure 7. Recent economic indicators (YoY % or units as indicated, ¥bn)

	Apr	May	Jun	Jul
PRODUCTION				
Industrial Production	3.8 %	1.0 %	3.2 %	%
Shipments	2.4	-0.8	2.2	
Inventories	-1.9	0.8	2.7	
Private Machinery Orders, Excl. Ships and Power	17.6	-14.3	-3.0	
Contracted Public Works Orders	10.0	21.1	14.3	
CONSUMPTION				
Retail Sales (METI)	-4.3 %	-0.4 %	-0.6 %	%
All Household Consumption, Nominal	-0.7	-3.9	1.3	
New Motor Vehicle Registrations	-11.4	-5.6	-0.7	-2.5
New Housing Starts	-3.3	-15.0	-9.5	
LABOR MARKET				
Employment	0.4 %	0.9 %	0.9 %	%
Unemployment Rate (Level)	3.6	3.5	3.7	
Job Offers/Seekers Ratio (Level)	1.08	1.09	1.10	
New Job Offers	10.0	4.0	8.1	
Cash Earnings (5 Workers or More)	0.7	0.6	0.4	
PRICES				
Nationwide Consumer Prices	3.4 %	3.7 %	3.6 %	%
•Excl. Fresh Food	3.2	3.4	3.3	
Domestic Corporate Goods Prices	4.2	4.4	4.6	4.3
MONEY AND CREDIT				
Monetary Base	48.5 %	45.6 %	42.6 %	42.7 %
M2	3.5	3.3	3.0	3.0
M3	2.8	2.7	2.5	2.4
L (Broadly-defined Liquidity)	3.3	3.0	3.0	3.1
Bank Lending	2.0	2.2	2.3	2.2
TRADE, CAPITAL FLOWS, AND CURRENCIES				
Trade Balance, Customs Clearance Basis, SA	-¥880.5	-¥861.3	-¥1,080.8	
Export Value Growth (Yen Basis)	5.1	-2.7	-2.0	
•Volume	2.0	-3.4	-1.7	
Import Value Growth (Yen Basis)	3.4	-3.6	8.4	
•Volume	-1.3	-4.0	7.2	
Current Account, (SA, Billion yen)	130.5	384.6	125.6	
Yen/US Dollar Spot Rate	¥102.58	¥101.60	¥101.30	¥102.78

Source: Bank of Japan, government and industry association statistics, Citi Research.

Figure 8. Net buying/selling of Japanese stocks on Tokyo & Nagoya exchanges by all 50 incorporated securities firms (¥bn)

	Individual			Corporate		Investment	Securities	
	Cash	Margin	Total	Financial	Nonfinancial	Trusts	Foreign	Firms
April	-273.2	3.2	-270.0	-1777.9	-25.7	51.2	424.4	4.8
May	-490.1	-84.2	-574.3	6367.0	192.0	76.3	-82.5	-39.4
June	-974.8	31.7	-943.2	2124.5	34.6	-248.9	564.9	-55.8
July	-669.2	79.1	-590.1	580.5	192.2	-106.7	497.6	-45.2
07/14-07/18	-91.6	-24.6	-116.1	-29.2	67.3	-29.8	86.9	-6.0
07/22-07/25	-158.3	-15.0	-173.3	-20.3	18.2	-10.3	153.4	-12.6
07/28-08/01	-200.4	39.9	-160.5	-0.9	-7.3	-18.8	134.2	-14.4
08/04-08/08	240.5	210.3	450.9	21.9	98.9	73.3	-457.1	30.3

Note: Data based on net buying by 50 major securities firms with seats on the exchanges.
Source: Tokyo & Nagoya Stock Exchanges, Citi Research.

Appendix A-1

Analyst Certification

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