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Global Watch

May 2014

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§ Japanese Economy

This is an abstract of our monthly reports on the Japanese Economy. The information and the views contained herein are subject to change without notice.

MUFG Mitsubishi UFJ Research and Consulting

Economic Research Department
Tel: +813 6733-1070
Ex: 9-8707-3434

§ Japanese Economy

1. Overview of the Japanese Economy
Temporary Movement toward Deterioration

By Shinichiro Kobayashi, Senior Economist

Following the hike in Japan's consumption tax rate, the forecast is for a temporary deterioration in the economy, but with a bottoming out and improvement again during the summer. However, there is a possibility that the pace of improvement will be moderate.

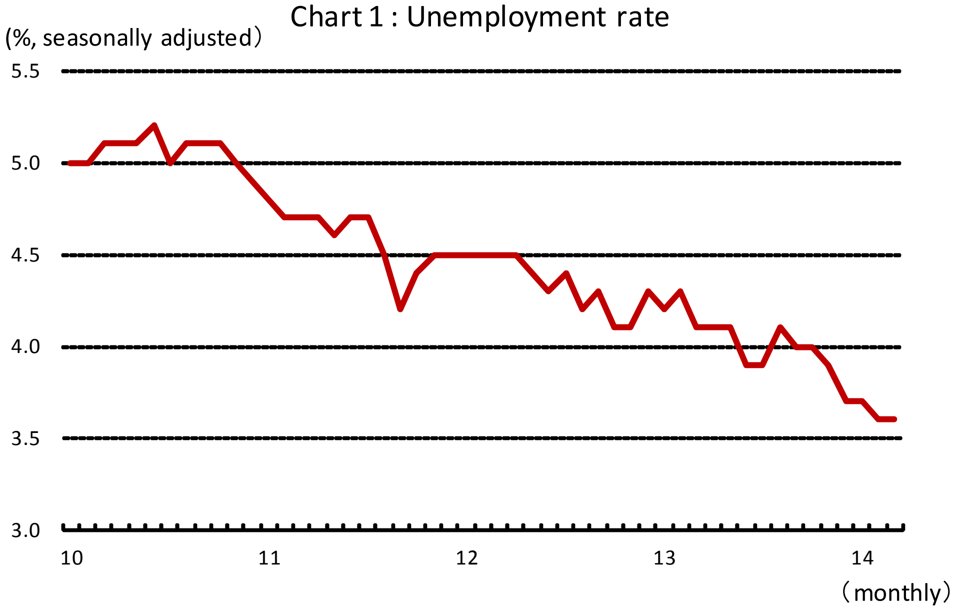
After the beginning of the new fiscal year in April 2014, the economic indicator drawing the most attention is personal consumption following the consumption tax increase. At present, though, the only indicator released so far is the number of new automobile registrations in April. Examination of this indicator shows that new registrations (excluding light vehicles) declined 11.8% year on year. As a consequence of this reactionary decline after the consumption tax hike, new registrations recorded their first drop in eight months, but this was a smaller drop than the decline of 14.0% reported in April 1997, following the previous consumption tax hike. If new registrations of light vehicles are included in the data for April 2014, the decrease in this indicator shrinks to 5.1%. (Registrations of light vehicles, in fact, increased 5.3% year on year in April, the 10th consecutive rise in this indicator.) Judging solely from these results, it appears that the impact of the consumption tax increase may not be as large some had feared. However, there is a possibility that the registrations of some vehicles purchased near the end of March were delayed into April, meaning that consumer spending may be weaker than these data suggest. In addition, to avoid a sudden slump in sales following the consumption tax increase, retailers have implemented a wide range of sales promotion measures, and this has had the positive effect of supporting consumption. For this reason, to make correct judgments and avert the risk of misjudging the underlying trends, following the tax rise, we will have to watch consumer spending in May and subsequent months.

Industrial production fell suddenly in February, and then showed a slight increase of 0.3% in March. Some observers have pointed out that there is a possibility that manufacturers put the brakes on output at an early date with an eye to conditions following the consumption tax hike. For this reason, if we also consider that the results of the survey of production forecasts call for a decrease of 1.4% in April and only a slight rise of 0.1% in May, the margin of decline is definitely not small.

On the other hand, the fact that the labor situation is continuing to improve is good news for the economy following the tax hike. The unemployment ratio in March was 3.6%, the same as in the previous month. Also, the ratio of job openings to job applications in March was above 1.0 times for the fourth consecutive month. Moreover, even though scheduled wages continued to decline, total per capita cash compensation of workers in March was 0.7% above the previous year, the first year-on-year increase in three months. This was because of a high rate of growth in non-scheduled compensation and a large increase in special compensation. During the spring labor offensive aimed at securing higher wages this year, exporting companies, in particular, made increases in base wages and increased temporary compensation payments. This trend is spreading, and there is a possibility that conditions in the income environment will take a turn for the better. Nevertheless, corporations are still adopting a cautious stance toward increases in employment costs, and there is a possibility that improvement in wage conditions of companies as a whole, including small and medium-sized enterprises, may be delayed. We cannot be optimistic at this time.

The fact that corporate performance is continuing to improve and that there are expectations that exports, which have weakened, will begin to rise again as conditions in overseas economies improve suggests that the risks of the economy falling into a downturn following the consumption tax hike are minimal. However, data indicate that real exports were down 3.3% from the previous month in March, and, at present, exports on average are virtually level, thus suggesting that there are no signs of recovery at this time. Even if domestic demand is showing surprising firmness, if the weakness in exports continues, the timing of the improvement in the economy after the consumption tax hike may well be delayed. (2014.5.14)

Chart 1 : Unemployment rate



Source: Ministry of Internal Affairs and Communications, *Labour Force Survey*

2. *Topic of the Month*

Consumer Prices after the Consumption Tax Hike (Wards of Tokyo)

By Shumpei Fujita, Economist

The consumer price index (CPI) for wards of Tokyo (comprehensive index excluding fresh food, the core CPI) for April 2014, announced by the Ministry of Internal Affairs and Communications, was 2.7% above the level for the same month of the previous year. This was the highest year-on-year increase since April 1992. However, this figure includes the boosting effect of the increase in the consumption tax rate. To capture the underlying trends in prices, it is necessary to exclude the effect of the tax rate hike.

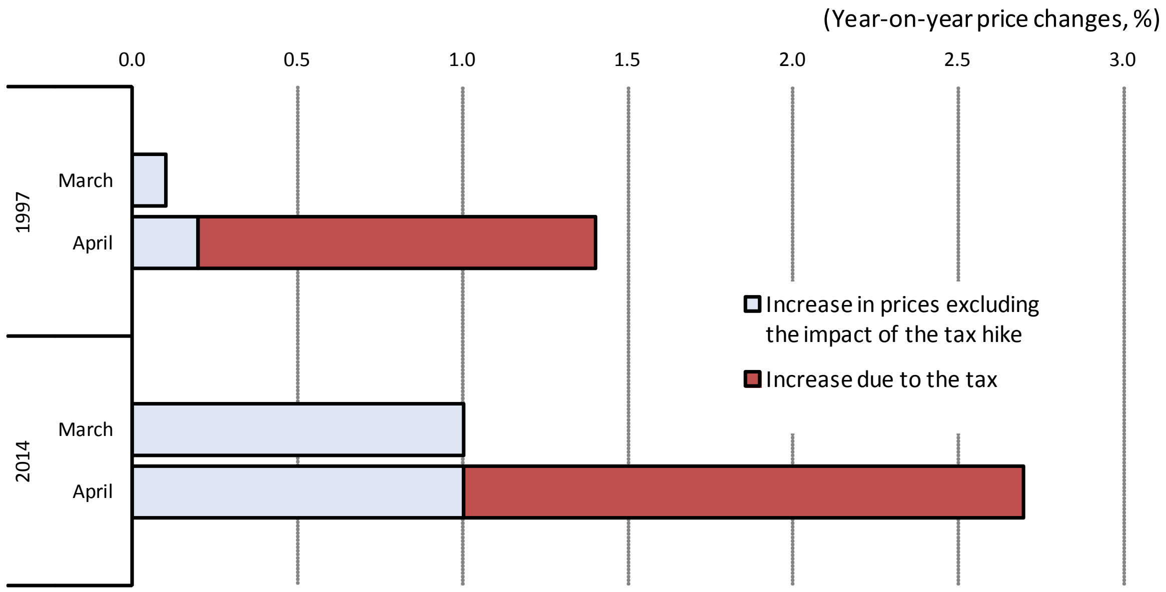
This time, the consumption tax rate was increased 3 percentage points from 5% to 8%. Since about 30% of the items included in the CPI (for the wards of Tokyo) are not subject to consumption tax and another 10% are still being taxed at the previous rate of 5% as a temporary measure, the new tax rate as of April 2014 was applicable to about 60% of the items included in the index. For this reason, if we suppose that the additional 3 percentage points was fully passed on to final sales prices that consumers pay, according to a trial calculation prepared by the Bank of Japan (BOJ), the rise in the tax would increase the CPI by 1.7%.

Even if the increase in the tax was fully passed on, the underlying increase in the core CPI (wards of Tokyo) year on year in April would have been 1.0%. This is the same as the rate of increase in March, and it suggests that the alleged trends discussed in the media of opportunistic price increases (in excess of the rise in the consumption tax rate) and concerns about possible decreases in prices because of the cooling off of demand following the tax hike do not appear to be spreading through the economy from a macroeconomic perspective (Chart 2). Note that there were similar movements following the previous consumption tax rate increase in 1997.

Notwithstanding this, the examination of price movements by individual items included in the index, excluding the impact of the tax rate hike, reveals a wide range of variation. Chart 3 shows the movements in the CPIs (wards of Tokyo) for individual items. According to this chart, the margin of increase expanded after the tax hike for certain items, including “culture and recreation” (March: +1.8%, April: +2.2%) and “transportation and communication” (March: +0.9%, April: +1.0%). On the other hand, the margins of increase diminished for other items, including “food (excluding fresh food)” (March: +1.0%, April: +0.6%) and “furniture and household utensils” (March: +1.9%, April: +1.4%). In addition, certain items showed prices declines, including “clothes and footwear” (March:

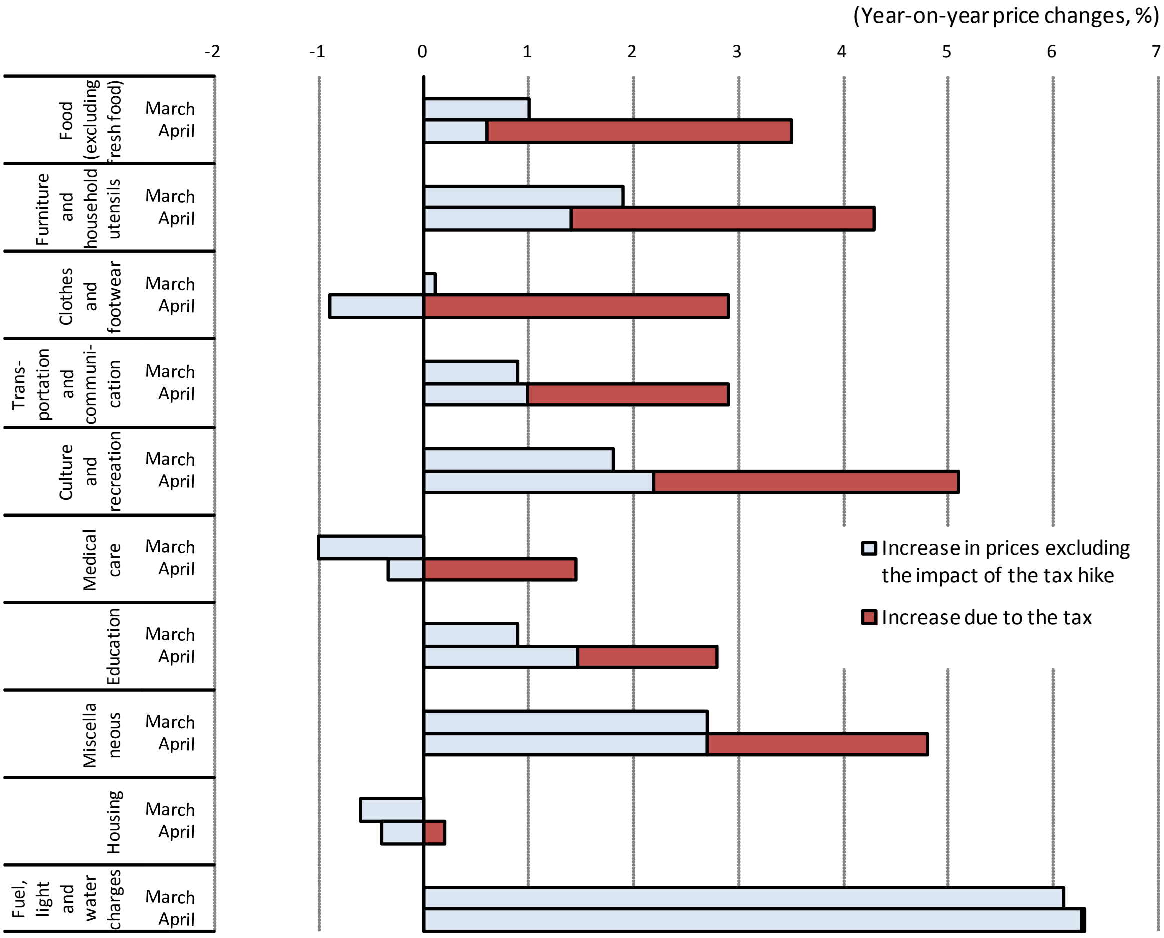
+0.1%, April: –0.9%). Therefore, the pattern of price movements is not uniform across all items. Overall, although it appears that there were no changes in the rate of price increase even in April, the apparent lack of change in the rate of increase in prices after the tax hike appears to be the result of the averaging out of movements for items where prices moved upward at a higher percentage than the tax hike and items where the higher tax rate was not fully passed on to consumers. (2014.5.14)

Chart 2: Movements in the Core CPI (Wards of Tokyo) before and after the Consumption Tax Rate Increase.



Note: Estimates were based on the assumption that the increase due to the tax hike was fully passed.
Source: Ministry of Internal Affairs and Communications, Statistics Bureau, *Consumer Price Index Monthly*

Chart 3: Movement in the CPI (Wards of Tokyo) before and after the Consumption Tax Rate Increase in 2014 (Intermediate Level Classification)



Note: Estimates were based on the assumption that the increase due to the tax hike was fully passed.
Source: Ministry of Internal Affairs and Communications, Statistics Bureau, *Consumer Price Index Monthly*