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Will It Be Déjà Vu for Japan?

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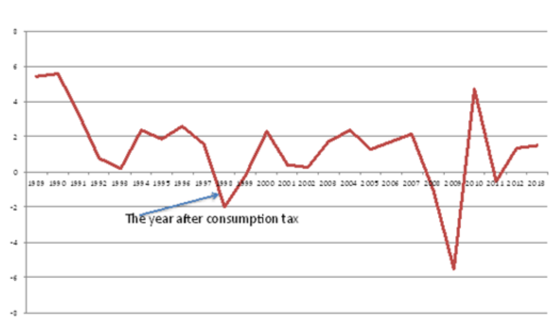
The Last Time Japan Raised Taxes

In 1997 the Japanese government decided that the time was right to impose a higher consumption tax on its citizens. The economy appeared to be emerging from a devastating economic recession that lasted on and off for most of 7 years and left the country's financial assets in tatters. GDP growth had picked up in 1996 and was responding positively to government programs; the Tankan survey had produced a healthy increase. Then the government raised the consumption tax.

GDP Growth y/y Slumped in 1998



Now another consumption tax increase

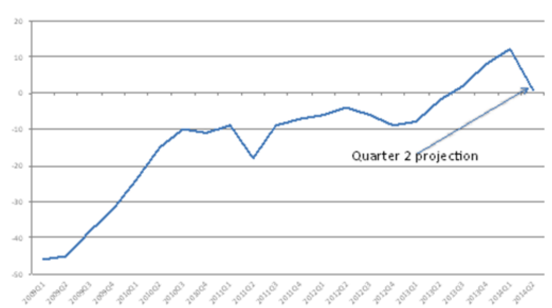
Seventeen years later and just 18 months after Abe economics was formally implemented, the Japanese government decided to address its looming government debt problem and pay for some of its new fiscal programs with a 3 percentage point increase in the consumption tax. The government's public debt totals about 250% of GDP, the highest debt ratio in the world.

The current effect could be quite large

The effect on real economic growth will be profound. It already stimulated massive buying of large ticket items late in Q4 and through Q1 2014. Such accelerated spending will probably leave a huge hole in consumption activity in Q2 and Q3 2014 since some of the accelerated purchases would probably have occurred later in 2014.

The more critical question is what will happen to consumer and business psychology later in 2014 and 2015. The latest Tankan survey foretold a tremendous loss in business confidence in Q2. The index is expected to plunge to 1 in Q2 from a five year high of 12 in Q1 2014 (see chart 2).

Tankan index Expected to Plunge in Q2



A real dent in purchasing power

Households in Japan will find their purchasing power severely crimped in fiscal 2014. Recent auto industry wage negotiations with the unions ended with a settlement of less than 1% increase industry wide. This trend setting settlement will place an upward constraint on wage increases throughout Japan for the 2014 fiscal year. Moreover, inflation has finally accelerated growing by 1.5% y/y in February after years of deflation.

The creation of inflation has been an important goal of the Abe economic plan. Abe convinced the BOJ to create a formal 2% inflation target. However, with inflation rising faster than wages real income will decline. In addition, the 3% tax increase will reduce household affordability further.

Consumers do learn from the past

Consumers have reacted rationally by increasing their purchases in Q4 2013 and Q1 2014 ahead of the planned tax increase thus boosting GDP growth substantially over the past 6 months. The spending splurge probably took away some planned spending from the present and future quarters. Recent consumer surveys have shown that more consumers intend to advance spending decisions into the preceding quarters than the surveys indicated that were taken back in 1997. Thus, consumers learned from the past, too. Consequently, there is a palpable risk that the recent acceleration in Japan's GDP growth could be very short lived.

The total government plan

The government is counting on some tax givebacks to neutralize the contractionary effects from the increase in this year's consumption tax similar to the government's plan in 1997. Then, the consumption tax was raised from 3% to 5% and generated an additional 4.8 trillion yen in government revenues. Sensing economic danger in 1997 the authorities cut social security taxes and corporate taxes in an unsuccessful attempt to boost consumer psychology. Although the sum of all the government's reactive tax reductions equaled the amount raised from the consumption tax, the economy stayed mired in recession and below potential growth for several years.

This year's government plan

This year's tax increase is structured to raise taxes in two stages: a 3-percentage point increases this year, and by 2 percentage points next year. The total tax increase is forecast to generate 13.5 trillion yen. Thus far, the government's planned tax cuts and spending stimulus package will offset only 6.3 trillion yen, leaving a fiscal drag on economic growth of 12.7 trillion yen over the next two years.

What's Different This Time?

What is different this time that could moderate the deterioration in economic activity that occurred following the tax increase in 1997? First, the present government has the benefit of history and can presumably learn from the events that followed the last hike in the consumption tax rate and endeavor to counter some of its negative effects.

Second, many prominent economists have written extensively about the policy errors made during the 1990s in Japan, most notably former FOMC chairman Bernanke. In an analysis for the Institute for International Policy he wrote that much of Japan's economic dilemma in 2000 was due to its poor monetary policy over the prior 15 years. It was in this article that he recommended that the BOJ should engage in what is now known as Quantitative Easing.

In another article that focused on Japanese fiscal policy in the 1990's Adam Posen argues that fiscal policy was too dominated by traditional budget and debt orthodoxy and too disengaged from its role as a balance wheel for the economy.

Third global economic conditions are different. The consumption tax in Japan was immediately followed by the Asian currency crisis, which arguably had to intensify the contractionary effects from the consumption tax in Japan. All of Asia was affected and economic growth slowed appreciatively throughout the region and in Japan.

Fourth, the banking system in Japan today is in significantly healthier condition than it was in 1997 when the banks were carrying a sea of non-performing bad loans. The banks' loan portfolios have been cleaned up and the banks improved their capital position and are poised to extend loans to business. The big risk today is the mountain of Japanese government debt that all the banks own.

A few options left

The government has a few options. It can decide not to impose the second round of tax increases in October 2015, and probably will if economic conditions fail to revive. The government has already legislated a second round of tax increase that would raise the consumption tax from its new 8%

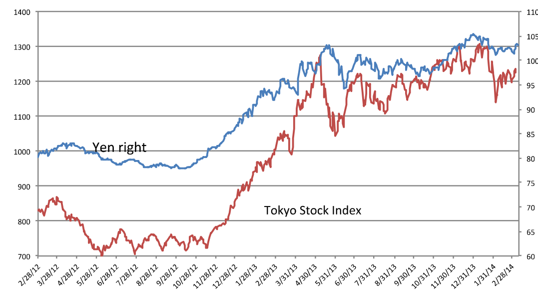
level to 10%. The government is presently also considering a reduction in corporate income taxes. However, this strategy didn't work in 1997.

The third arrow from Abe's original economic proposal has yet to be legislated. Japan's households are still saving too much, and in low yielding postal savings accounts. They need inducements to change their behavior and so do the professional investment managers. Savings in Japan needs to be channeled into more risky investment vehicles such as stocks that will finance new rounds of capital investment in Japan. The ideas are present the legislative will is not.

Is Present Momentum Enough?

We can't predict whether there will be another external shock to the global economy as there was in 1997, but one thing is certain - the Japanese economy will have to weather a substantial internal fiscal shock in the next two years. GDP growth will probably decelerate significantly in fiscal 2015. However, the critical issue is whether sufficient economic momentum has built up in the past 18 months to carry the economy through this fiscal drag.

Japan's Monetary Stimulus Stalled

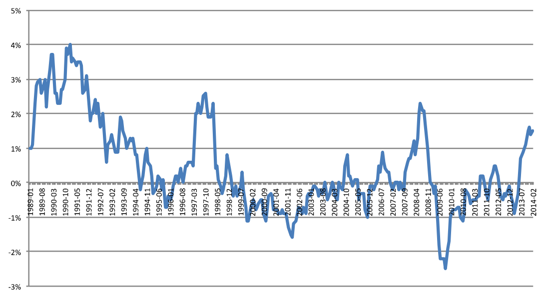


Investors are Skeptical

Investors have already decided to reduce risk in Japanese equities just in case there isn't enough momentum. The S&P Japan 500 index has depreciated 13.3 % this year in advance of the tax hike. Moreover, the BOJ seems to be resting as the Yen has stopped depreciating. The BOJ could be waiting to see if the consumption tax contracts the economy enough to instigate them to cause another serious weakening of the yen.

It was one year ago in the first monthly CAMRI Global Perspectives, March 2013, that I wrote an enthusiastic critique of the sea change in Japanese economic policy: the new Abe economic plan. Many favorable developments have proceeded from the initial initiative: GDP growth accelerated, Business confidence improved, and the rate of inflation turned positive.

Inflation is Back (CPI y/y)



Conclusion: Politics is Necessary for Structural Change

I believe that the Abe government's commitment to producing more economic growth and inflation will propel him to do what it takes politically to convince reluctant Diet members of the benefits from economic growth. Thus, Abe will be able to push through more economic reform legislation and make politically difficult structural change. Therefore, the economy should weather the present economic storm, and return to significant economic growth in 2016.

*Ben Bernanke 2000 'Japanese Monetary Policy a Case of Self Induced Paralysis'.

Ben Bernanke and Marc Gertler 1999 'Monetary Policy and Asset Price Volatility' Federal Reserve Bank of Kansas City.

Adam Posen 1998, 'Restoring Japan's Economic Growth; Institute for International Analysis'.

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	KEY INDICATORS TABLE (AS OF 16 April 2014)							
INDEX	**LEVEL (LC)**	**%1MO (LC)**	**%1MO (USD)**	**%1YR (LC)**	**%1YR (USD)**	**INDEX**	**LEVEL**	**%1YR**
S&P500	1862.31	1.28%	1.28%	20.78%	20.78%	3MO LIBOR	0.23	-17.77
FTSE	6584.17	1.10%	2.16%	8.66%	18.91%	10YR UST	2.63	52.59
NIKKEI	14417.68	1.29%	0.43%	10.76%	5.69%	10YR BUND	1.49	16.26
HANG SENG	22696.01	5.39%	5.56%	8.56%	8.67%	10YR SPG	3.07	-35.18
STI	3253.20	6.07%	7.27%	1.79%	0.55%	10YR SGS	2.42	72.86
EUR	1.38	-0.70%		4.85%		US ISM	53.70	4.30
YEN	102.23	0.86%		4.81%		EU PMI	53.00	13.20
CMCI	1509.11	1.91%		2.66%		JP TANKAN	12.00	250.00
Oil	103.76	4.92%		16.95%		CHINA IP	8.80	-1.10

Source: Bloomberg

APPENDIX

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)
S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIPI)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers' index for the 17-country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China's Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency