Northern Trust

ECONOMIC UPDATE

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• Japanese Recession and the Referendum on Abenomics

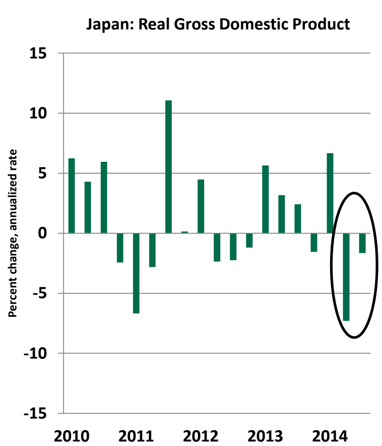
Early this week, Japanese Prime Minister Shinzo Abe announced that he will delay to April 2017 from October 2015 the next phase of his country's consumption tax hike. In addition, he dissolved the lower house of Parliament and announced that elections will be held on December 14.

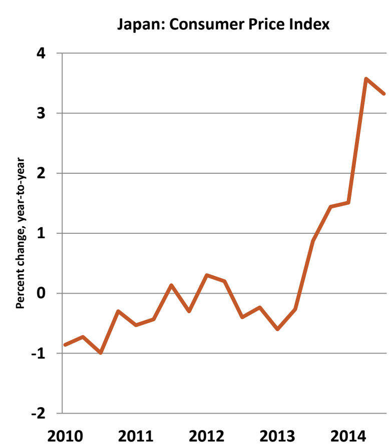
Ostensibly, the balloting is being held to seek support for his decision to delay the scheduled tax increases, but in reality the prime minister is seeking to consolidate power by forcing a referendum on his entire economic program. Abe will almost certainly return to power on the back of expected low voter turnout and opposition disarray; however, a loss of his coalition's super-majority could weaken his position internally.

Economically, the decision to delay the tax increase will have minimal impact on debt metrics. In addition, the virtually nonexistent recovery in private demand points to the necessity of delaying the tax in order to achieve the more-important goals of overcoming deflation and realizing sustainable economic growth.

- Preliminary data on third-quarter Japanese gross domestic product (GDP) surprised to the downside by contracting 1.6% on an annualized basis. The nearly universal consensus was that the economy would expand by 2% – 3%. The contraction means that Japan is in technical recession for the fourth time since 2008.

- The GDP figures highlight the difficulty the economy has had in adjusting to a three-percentage-point hike in consumption taxes in April. Although first- and second-quarter results followed predicted trajectories – strong growth followed by a steep decline – third-quarter figures threw the government for a loop. Indicators had pointed to a recovery strong enough to justify implementing the second phase of income tax increases next year.





Source: Haver Analytics

- Private consumption remains very weak, as households feel the pain of a weaker yen, rising inflation and higher taxes without any significant wage increases. Fixed investment was also down, led by a steep contraction in residential investment. However, the main drag was stock building in the third quarter, as companies chose to offload unsold inventory left from the crash in consumer demand in the second quarter. Net exports improved marginally; however, the export-led boost envisioned by the Abenomics engineers has yet to materialize.
- While disappointing, the third-quarter figures do not signal a death knell for Abenomics. However, they highlight the difficulty in defeating deflation and fostering growth while simultaneously pursuing fiscal reform. The government's decision to delay the sales tax increase means that it has decided to prioritize economic growth and inflation. A sizable fiscal stimulus package to encourage growth is probably in the works.

Deferring the second round of Japanese tax increases is a wise choice.

- The delay in the tax increase could damage international perceptions of Japan's dedication to tackling its public debt, which stands at more than 225% of GDP. However, there is little risk of a spike in yields, since more than 90% of debt is held locally and the Bank of Japan is the largest stakeholder. In addition, there is little chance of a sovereign credit downgrade because fiscal concerns in Japan are already built into the ratings, and the country did make some progress by implementing the first phase of the increase.
- Abe's decision to seek a new mandate less than two years after a dominating poll victory presents some risks. However, calling elections now will permit the prime minister to pursue thornier issues such as nuclear restarts without the specter of elections in 2015 or 2016.
- Victory at the polls will fail to overcome the prime minister's biggest challenge – building support for his economic program within his own party. The Liberal Democratic Party's traditional support base is hostile to a number of structural reforms, including measures needed to join the Trans-Pacific Partnership.

While certainly disheartening for proponents of the "Japan is back" narrative, recent GDP data do not spell the end of Abe's grand economic experiment. It is more a signal that the government was trying to do too much, too fast by attempting to jump-start growth while pursuing fiscal consolidation. In this case, delay of the second phase of the tax increase is not denial, but rather a practical decision based on an assessment that the Japanese economy is too fragile to withstand another tax increase.

Abe will almost certainly return to power, but the risk is that the chinks in his armor will only get more visible. This may be a disadvantage as he turns his attention to structural economic challenges that could place him in conflict with members of his own party.