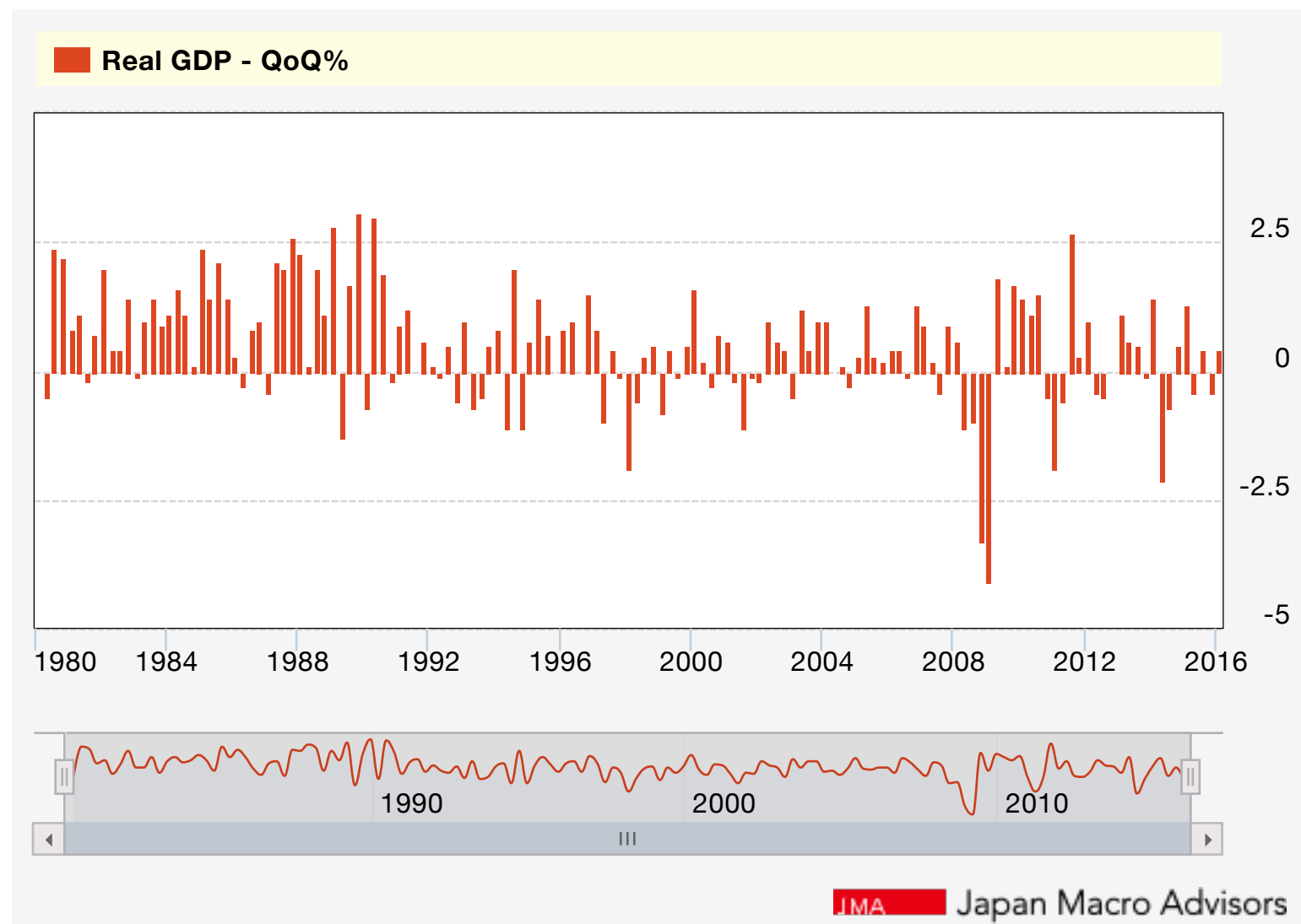


# A Delay Is Not Enough

In the January-March quarter of 2016, the Japanese economy grew by 0.4% quarter on quarter, or by 1.7% at an annualized rate. The growth is well above Japan's trend and it was also better than expected. According to a survey by Reuters, economists were expecting to see 0.1% quarter on quarter growth.



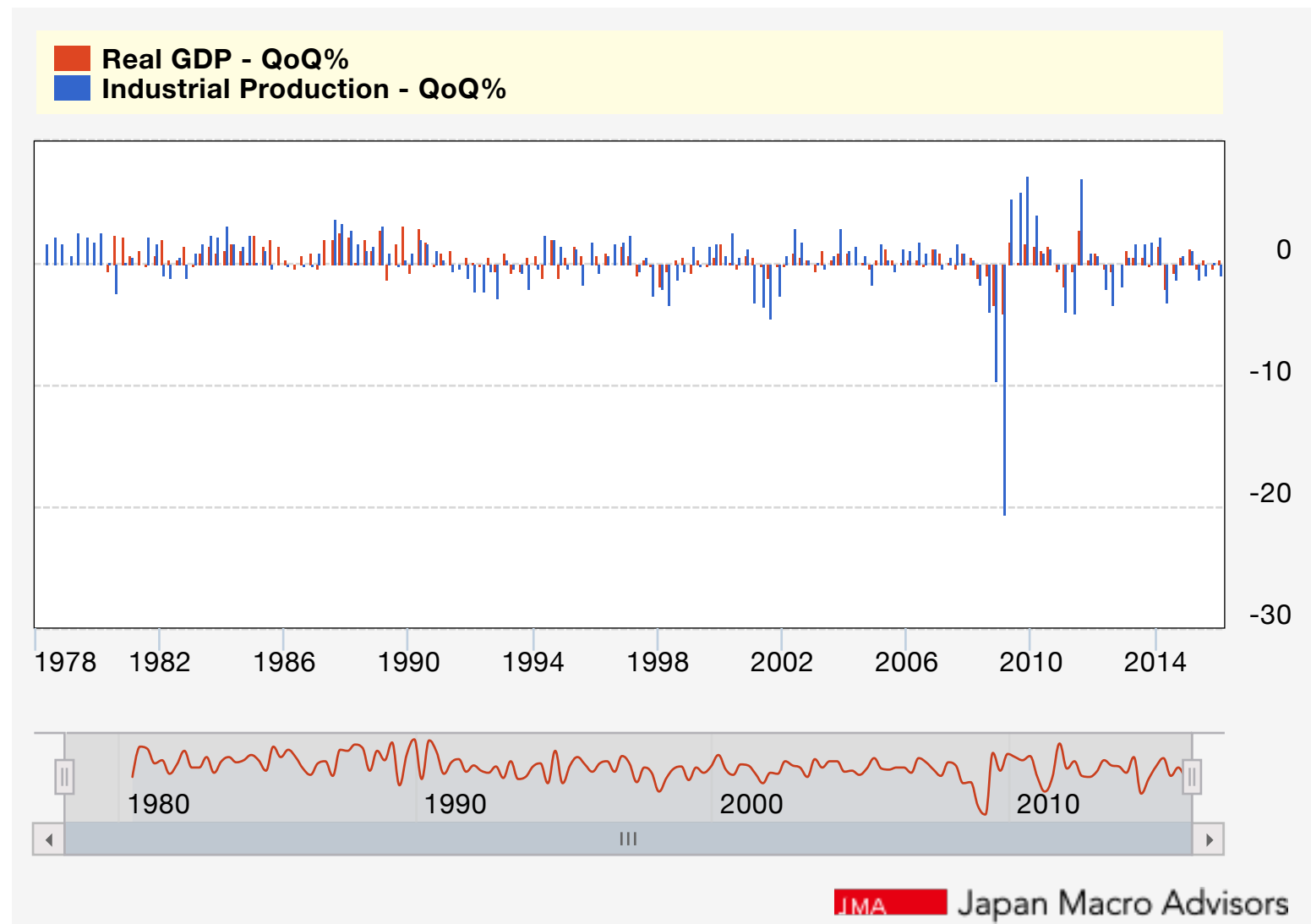
Source : Cabinet Office, JMA

Prime Minister Shinzo Abe may not have been particularly happy to see the better than expected result though. Various leaks appearing on the media in the last few weeks suggest that PM Abe now prefers to delay the consumption tax rate hike currently scheduled for April 2017 by a few years. A weak GDP result could have provided him with a political cover for the delay. If PM Abe is to announce a delay, it will not be the first time. In November 2014 when he announced his intention to delay the timing of the tax rate hike from 2015 October to 2017 April, he pledged that he would not delay it again unless there is a Lehman shock-sized economic crisis or a catastrophic natural disaster. If he is to announce a delay, he would be criticized to be going back on his words.

In our view, PM Abe need not be beholden to the pledge, as delaying the consumption tax rate hike would be a correct decision in terms of economic management. An outright cancelation of the tax hike would be even better. Restoring fiscal sustainability by raising tax is often a treacherous path, and it is too risky for

Japan where a tighter fiscal policy could start a deflationary spiral. Instead, Japan should for now aim to improve its fiscal balance through growth and reflation.

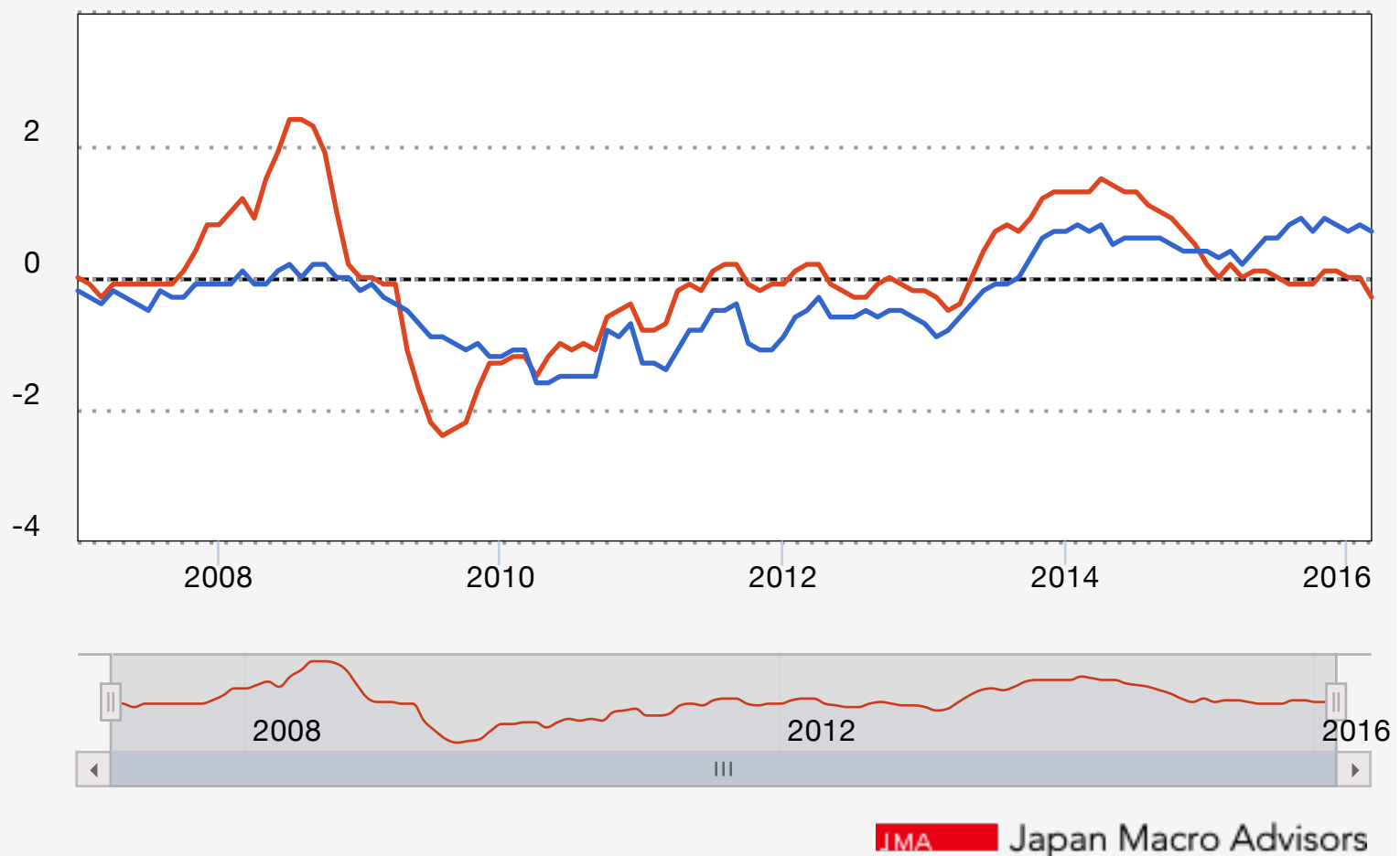
Japan has in fact already made the mistake of a premature tax hike in 2014. The Japanese economy was on a sustained growth path through 2013 till the first quarter of 2014. However, the negative shock from the tax hike in April 2014 seemed to have derailed Japan from such growth path.



Source : Cabinet Office, JMA, METI

Similarly, the inflationary momentum building up in the Japanese economy through 2013 to 2014 was deflated by the negative shock from the consumption tax rate hike in April 2014.

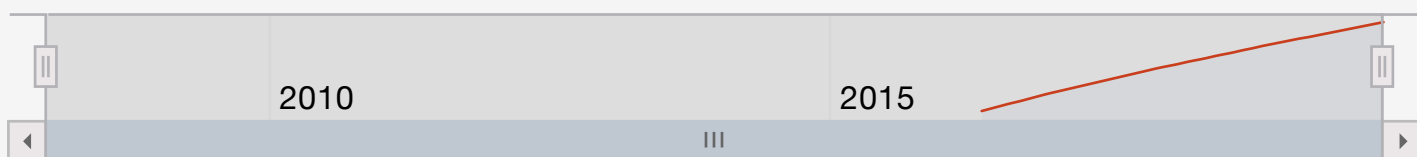
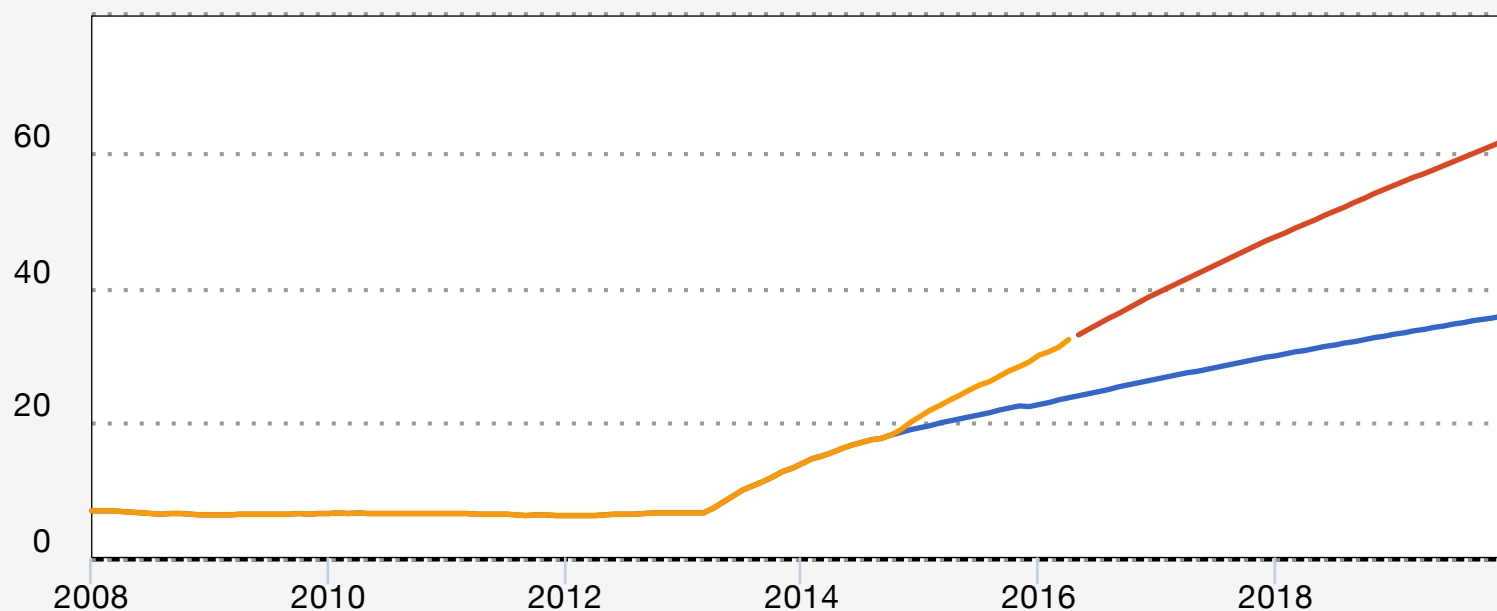
— National CPI Excluding Fresh Food - YoY%, Excluding Tax Effects  
 — National CPI Excluding Food and Energy - YoY%, Excluding Tax Effects



Source : MIAC, JMA

The consumption tax rate hike in 2014 did not turn into a deflationary spiral partly thanks to the intervention by the Bank of Japan. The QQE2 announced by the Bank of Japan in November 2014 succeeded in restoring some growth and inflation back to Japan. However, the QQE2 was implemented at a great cost to the sustainability of the QQE policy. Under the QQE1, the market share of the BoJ in the JGB market would have risen to only 36% even when it maintained the policy till 2020. Under the QQE2, the BoJ would own over 50% of the market by the end of 2018 and over 60% by the end of 2019. In our view, the risk from the increasing illiquidity in the JGB market would damage the effectiveness of QQE in the next several years. Now that the BoJ has also implemented the negative policy rate and the JGB yield curve has almost completely flattened out, the capacity of the monetary policy to soften the blow from another negative economic shock is increasingly limited.

— BoJs share of the JGB market - Duration Risk Adjusted (%) - Current Projection  
— BoJs share of the JGB market - Duration Risk Adjusted (%) - QQE 1.0 Projection  
— BoJs share of the JGB market - Duration Risk Adjusted (%)



JMA Japan Macro Advisors

Source : JMA

## Is the delay enough to revive Abenomics?

Thus, delaying the tax hike should help restore some confidence to both Japanese households and corporate sectors. Consumers need not worry about the loss of real purchasing power, and companies can remove the uncertainty arising from the consequence of a tax hike. Japan should have much better chance of enjoying a sustained growth through 2016 to 2017, or 2018, depending on the length of the delay. However, is the delay or a possible cancelation of the tax hike enough to revive Abenomics? We have been arguing that Abenomics has already failed. Are we to change our view if PM Abe cancels the tax hike?

Unfortunately, a delay, or even a cancelation, of the consumption tax rate hike is not enough to revive Abenomics. The ultimate source of failure of Abenomics is in its failure to implement structural reforms. By failing to tackle Japan's numerous structural problems such as labor market rigidity, unfunded national pension system, uncompetitive and heavily regulated industries such as health care and agriculture, Abenomics has failed to change the perception that the Japan is, and will remain, a stagnant economy. The proponent of Abenomics may argue three years are not enough to make such drastic changes. Not so. In our view, three years would have been enough to change the expectation, if the government implemented enough changes to show where the future is headed. However, reform efforts under Abenomics were mostly superficial, and in some cases, charade. Womanomics, one

of the poster-child of Abenomics, was a PR campaign directed mostly toward international audiences. Beyond some publicity events, Japanese government hardly took any serious fiscal or legal measures to promote the goal. Abenomics was neither friendly toward business innovation. In 2013, the Japanese government set an explicit goal to raise its position in the World Bank ease of doing business ranking. In our view, there was no concerted efforts to raise its ranking. Instead of improving, Japan's ranking has fallen in the last three years from 24th to 34th. Japanese households and corporate managers were no fools. They correctly maintained their pessimistic outlook on the economy and kept their deaf ears from the government's urging to expand their investment and spending. In our view, unless the government shows a renewed determination to implement structural reforms, fiscal policy or monetary policy, however drastic, are not enough to change the long term future course of the economy. And we see no chance of any serious reforms implemented under the current government.

### **Political implication of the delay in consumption tax rate hike**

Prime Minister Abe's decision to delay the tax hike will play well to the public opinion, bolstering his chance of winning in the upcoming Upper House election. In our view, there is a good chance that he may also call a snap election of the Lower House, either this summer or in the next 12 months. If he manages to win both Upper and Lower House election in 2016, he can avoid facing a national election until the summer of 2019.

### **Delay to what year?**

In our view, one year delay in the tax hike to 2018 may be most convenient for PM Abe. Postponing to 2019 is tricky, as 2019 is the year of Upper House election. Postponing to 2020 would smack of being fiscal irresponsible and PM Abe would probably want to avoid it.