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Excessive Concern Over Japan's Tax Hike

*Based on an October 2013
client bulletin.

■ Japanese economy may well shake off drag from tax hike

The Abe government recently took a step toward fiscal tightening by deciding to go ahead with the 2014 consumption tax hike. Japan's tax hike, although not a positive development, is unlikely to have the dire consequences of tax increases during the past 20 years because private sector balance sheets are now in a vastly different state.

Japan's Tax Hike—Not Positive, But Not Alarming

Effective April 2014, Japan's consumption tax rate will rise from the current 5% rate to 8%. The increase in the consumption tax rate is reminiscent of 1997, when the rate was raised from 3% to 5%. The 1997 tax increase aggravated Japan's contained depression, sparked a recession, and precipitated the economy's slide into deflation. Many Japan watchers are worried that the tax hike may nip Japan's fledgling recovery in the bud.

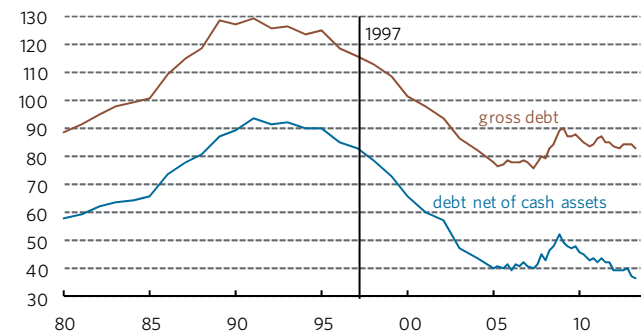
However, the two tax hikes are not entirely comparable. In 1997, Japan's private sector balance sheets were bloated and still in the early stages of a retrenchment, banks were in parlous shape (having put off recognizing mounting bad loans), and private fixed investment was weighed down by massive overinvestment in the previous decade, credit tightening, and the weak economy. Large government deficits were needed to support the economy as private profit sources were deeply depressed. Currently, the circumstances are substantially different. Japan's private sector debt ratios, especially the nonfinancial corporate sector debt ratio, are at or near record low levels (chart 1), and banks are well-capitalized. Moreover, with private net fixed investment having been depressed for years (chart 2), the capital stock has aged and pent-up demand for fixed investment has been building. As we have long argued, private fixed investment in Japan is poised for a secular recovery that has the potential to power robust economic perfor-

mance. Lastly, the Japanese government has announced plans for fiscal stimulus that will partially, perhaps substantially, offset the drag from the tax hike—at least for a while.

Granted, the tax hike is not a positive development. However, the Japanese economic expansion may have gathered enough steam to spark more fixed investment that could overcome the impact of the tax hike. Japan's economic growth at 3.9%,

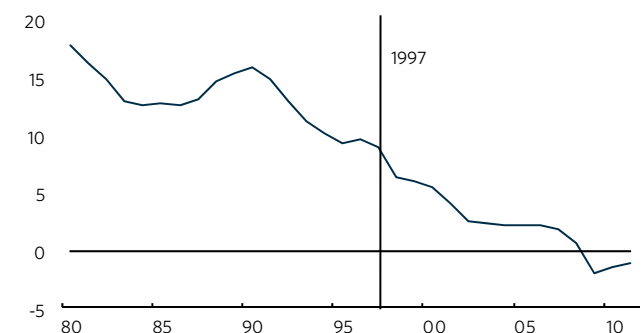
Debt Ratios At or Near Record Low Levels CHART 1

Bank of Japan: Private NF Corp. Loans and Securities Other Than Shares as % of GDP, fiscal years 1980-2005, quarterly data Q1 2005 to Q2 2013



Depressed Net Fixed Investment CHART 2

Japan: Fixed Capital Formation Net of Capital Consumption as % of GDP, annual data, calendar years, through 2011



annual rate, in the first half was among the fastest in the developed world, and the evidence strongly suggests continued economic vitality in the next few quarters (see July 8, 2013 client bulletin). In fact, Japan is one of the few places where

analysts' earnings expectations have been revised up over the course of 2013. The biggest threat to a secular revival in Japan remains the potential for global economic and financial disruption.



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