Japan's Timing *Disaster*

By Yoshihiro Sakai

A second tax hike followed by the coronavirus crisis.

Japan, the world's third-largest economy, has enjoyed the fruits of Abenomics for seven years. But the risk of a deep recession looms for the first time under the Abe administration.

Japan's GDP in the fourth quarter of 2019 contracted 1.6 percent, almost double the market forecast of 1.0 percent, after growth in the previous quarter of 1.8 percent. This was the largest drop after the 4.8 percent contraction in the first quarter of 2009 following the Lehman shock and the 1.9 percent contraction in the second quarter of 2014 when Prime Minister Shinzo Abe raised the consumption tax from 5 percent to 8 percent in April of that year.

The Abe administration carefully prepared for last October's consumption tax hike from 8 percent to 10 percent. It introduced measures to alleviate the burden of the hike, including a reduced tax rate of 8 percent for food and newspapers and a 5 percent rebate for consumers who use credit cards and electronic money. These measures will expire in June of this year.

Because of these measures, both the government and the Bank of Japan were optimistic, expecting a smaller negative economic impact than the previous hike. Governor Haruhiko Kuroda of the Bank of Japan said on November 1 at a regular press conference that we should not be so pessimistic due to the lower last-minute demand in comparison with the last time consumption taxes were raised. And on January 22, Kuroda announced that consumption of non-durable goods had been steady, and that of durable goods such as electric appliances had recovered.

However, the magnitude of the negative impact of Abe's second tax hike was not different from the previous experience, nor from the 1996 tax hike from 3 percent to 5 percent.

NO EXCUSE

Japan faced negative GDP growth when the consumption tax was introduced in 1989 and each time it was raised—in 1997, 2014, and 2019.

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Measures to alleviate the tax hike burden will expire in June 2020.

We can determine the impact of the tax on economic growth in each quarter when it began by subtracting the four-year average trend of economic growth from the quarterly GDP growth. We use a four-year average because a five-year average would include the impact from the previous consumption tax hike in 2014.

The answer is a negative impact of 5.4 percent in 1989, 2.55 percent in 1997, 2.9 percent in 2014, and 2.75 percent in 2019. We can easily imagine that the negative impact is greatest during the year the consumption tax is introduced. But it is important to understand that the negative impact of the tax hike on the fourth quarter of 2019 is almost as large as was the impact on the second quarter of 2014. None of the measures to alleviate the impact this time worked—and they will expire soon in June.

BLUNDER OR INESCAPABLE RESPONSIBILITIES?

The two consumption tax hikes by Abe in 2014 and 2019 were the result of a three-way agreement among the Liberal Democratic Party, the Komei Party, and the Democratic Party of Japan (the ruling party at the time) under Prime Minister Yoshihiko Noda in June 2012.

At the time, Japan had experienced a prolonged decrease in tax revenue from ¥60.11 trillion in 1990 to ¥42.83 trillion in 2011. The average annual GDP growth rate from 1990 through 2011 was 1.16 percent. The outlook for future tax revenue was quite uncertain when Noda asked for an agreement on future increases in the consumption tax from the LDP and the Komei Party.

The tax hike was needed to reduce Japan's enormous national debt, amounting to 237 percent of GDP in 2018, in order to normalize the government finance situation.

Tax revenue rose from ¥43.93 trillion in 2012 to ¥60.35 trillion in 2018, the biggest increase in three decades. The average rate of tax revenue increase during those six years was 5.6 percent, or ¥2.73 trillion. Only during 2014 did revenue drop by 0.15 percent—the year the consumption tax increased under Abe administration. The annual economic growth rate in 2014 was 0.38 percent, almost one-third of the average.

The effect of consumption tax hike this time around has been to increase tax revenue by ¥5.6 trillion per year, according to the Ministry of Finance. Almost half the increase is due to citizens taking advantage of the measures to reduce the tax burden before they expire. Therefore, the actual effect of the consumption tax hike is almost equal to the amount of average increase in revenue in the recent six years.

The Abe administration should have considered the impact of a record typhoon season, with twenty-nine typhoons causing considerable damage and disruption in 2019. Under these conditions, was it necessary for Abe to raise consumption tax?

CAN JAPAN AVERT AN ECONOMIC CRISIS?

The Bank of Japan enhanced its quantitative easing in November 2014 with the so-called "Second Kuroda Bazooka," hoping to erase the negative impact of the previous consumption tax hike.

However, as Governor Kuroda said, negative GDP growth this time is not due to the recoil from the sharp increase in last-minute demand. Maybe Japanese consumers have already bought more goods than they need under Abenomics. The current economic downturn is more due to structural problems.

Furthermore, the Japanese economy has begun to suffer from the strong negative impact of the coronavirus pandemic. Japan was late in closing its doors to Chinese travelers on March 9, and delayed until March 21 in imposing strong measures to prevent the epidemic from spreading further.

Although many Japanese budget tourist resorts suffered due to the ban on package tours to foreign countries by the Chinese government, total inbound tourism was not hurt until March 9.

The coronavirus has spread rapidly in Japan. Many events have been canceled, and the Tokyo Olympics and Paralympics have been postponed.

CORONAVIRUS MAY DEVASTATE THE JAPANESE ECONOMY

The Bank of Japan has conducted economic relief operations such as increasing the volume of ETF purchases and introducing urgent short-term lending, even though the impact of these actions is minimal. A "reversal rate" situation, meaning interest rates reach the level where lenders cease lending, may be very close.

The Japanese government can stimulate the economy through urgently needed fiscal spending. Japan needs to imitate the $2 trillion rescue package by the U.S. Congress and the unprecedented market stabilizing measures taken by the U.S. Federal Reserve.

Perhaps the Japanese government has been hesitant because fiscal stimulus measures would wipe out the effect of its recent tax hike. It goes back and forth. As of March 31, no economic stimulus package has been announced.

Japan's economy is on the ropes, and no one knows if it will recover or sink catastrophically. ◆