ECO FLASH

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Japan: Consumer spending is suffering

Louis Boisset

- **The Japanese economy ended 2019 on a negative note.**
- **As has happened before, consumer spending was hit by the VAT hike introduced in October.**
- **Typhoon Hagibis also put a significant dent in domestic demand, particularly in the area of private sector business investment.**
- **The start of 2020 looks difficult given the Coronavirus outbreak and the close economic relations between Japan and China.**

Japan experienced a sharp contraction in GDP in the fourth quarter of 2019 (Figures 1 and 2). GDP fell by -1.6% (quarter-on-quarter, non-annualised), its biggest contraction since the -1.9% fall in the second quarter of 2014. This poor performance was due to falling private domestic demand. Consumer spending was hit particularly hard. Over the year as a whole, the Japanese economy grew by 0.7%.

Collapse in private consumption, significant weakness in business investment

The Japanese economy suffered from two sizeable shocks in the final quarter of 2019.

First, having delayed its implementation, the authorities decided at last to increase VAT from 8% to 10% in October 2019. This was the 3rd increase since the tax was introduced (1997, 2014 and now 2019). The last time the rate was raised, Japanese consumers significantly reduced their spending. The fall in private consumption of around 3% (q/q) in the 4th quarter of 2019 is less than the 4.8% contraction in Q2 2014 when VAT was raised from 5% to 8%.

The fourth quarter was also affected by a typhoon which did significant damage to domestic demand. Against this background, private non-residential investment fell by nearly 4% (q/q) in Q4 2019 relative to Q3. A quiet decent growth of public sector investment came nowhere near offsetting the drop in investment by private companies.

A clear dip in GDP in Q4 2019

(Real GDP, 100 = Q1 2012 and trend line)

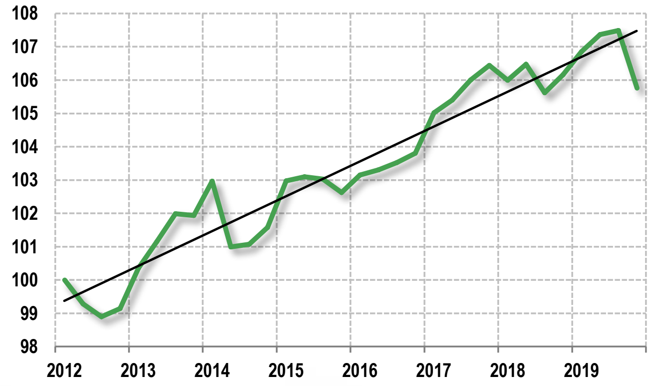

Figure 1 Source: Cabinet Office

Private domestic demand suffered in Q4 2019

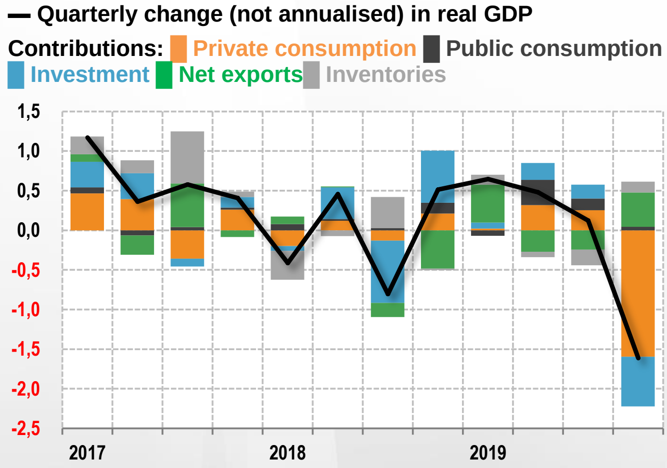

Figure 2 Source: Cabinet Office

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That being said, public sector investment is likely to remain strong over the next few quarters, given the ramping up of the investment programme (to around 2% of GDP) announced by the national authorities in December.

Although the contribution to growth from international trade, in the form of net exports, was significantly positive in the fourth quarter 2019, this was solely the result of a fall in imports in response to the deterioration of domestic demand. Exports were flat from one quarter to the next.

Japanese private consumption: a structural weakness

Private consumption accounts for a relatively small share of Japanese GDP compared with the average for other OECD countries, and particularly in comparison to the United States (Figure 3). Moreover, the share of consumption in the Japanese economy has significantly declined since 2014. Conversely, the total investment rate in Japan is relatively high compared to the OECD and the US. The latter have a level of economic openness (exports/GDP) that is also less than Japan's.

Consumer spending is seeing a structural slowdown in Japan, with virtually no growth on average since the VAT hike in 2014 (Figure 4). This trend was notably related to the downward trend in nominal wages. Since late 2013, this has reversed, but growth in real wages remains lacklustre (Figure 5).

Lastly, consumers can, in certain circumstances, bring forward purchases before the increase in VAT. However, on previous occasions when the VAT rate has been increased, the following quarter has not brought the recovery in consumer spending that this might lead one to expect. Past examples therefore suggest little in the way of positive prospects for early 2020.

Conditions will remain challenging in the early part of 2020

The economic weakness in late 2019 is already hitting the trends for 2020, with a negative carry-over growth effect. Given its close relations with China, the effect of the Coronavirus outbreak on Japan could be significant and will have two channels of transmission: trade (directly or through value chains) and tourism.

As far as trade is concerned, China receives 20% of total Japanese exports of goods. Given the scale of its manufacturing sector (20% of Japanese GDP), this could suffer from a slowdown in demand from China. In addition, the content of Japanese added value in Chinese domestic demand (and vice versa) is far from marginal.

As far as the tourism channel is concerned, Chinese visitors are an important factor, accounting for more than a quarter of all tourist visits to Japan last year.

All in all, there are significant threats to the macroeconomic scenario. It now looks possible that Japan's economy will contract this year.

Louis Boisset
louis.boisset@bnpparibas.com

Private consumption is relatively low (% of GDP)

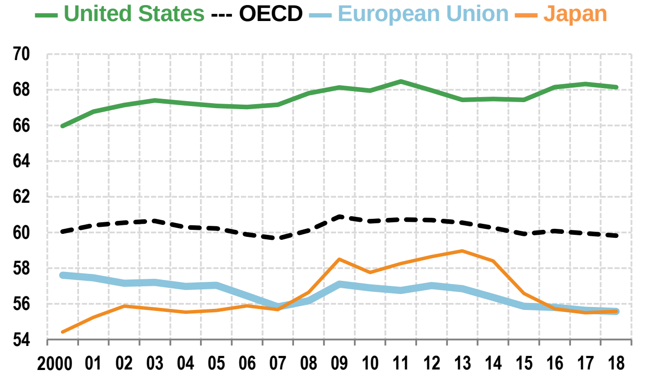

Figure 3 Source: World Bank

The uneven pattern of private consumption

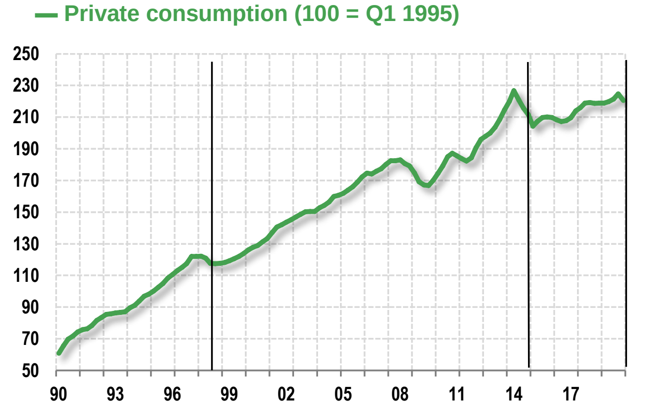

Figure 4 Source: Eurostat

Little support from real wages

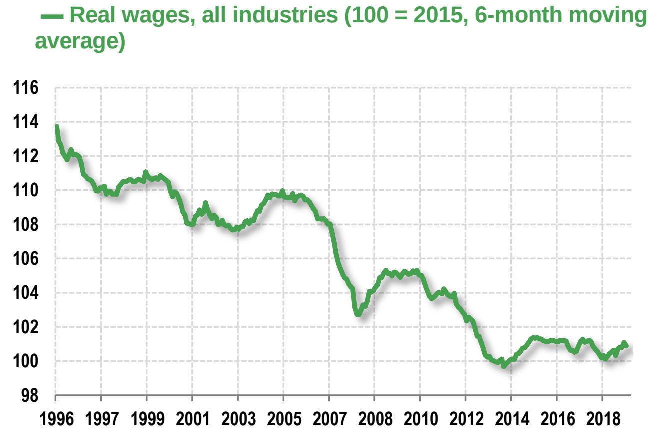

Figure 5 Source: Ministry of Health, Labour and Welfare

Group Economic Research

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com
ADVANCED ECONOMIES AND STATISTICS		
Jean-Luc Proutat Head – United States, United Kingdom	+33 1 58 16 73 32	jeanluc.proutat@bnpparibas.com
Hélène Baudchon France – Labour markets	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Louis Boisset European Central Bank watch, Euro area global view, Japan	+33 1 57 43 02 91	louis.boisset@bnpparibas.com
Frédérique Cerisier Euro area (European gouvernance and public finances), Spain, Portugal	+33 1 43 16 95 52	frederique.cerisier@bnpparibas.com
Raymond Van Der Putten Germany, Netherlands, Austria, Switzerland – Energy, climate – Long-term projections	+33 1 42 98 53 99	raymond.vanderputten@bnpparibas.com
Tarik Rharrab Statistics	+33 1 43 16 95 56	tarik.rharrab@bnpparibas.com
BANKING ECONOMICS		
Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Laure Baquero	+ 33 1 43 16 95 50	laure.baquero@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+ 33 1 40 14 30 77	thomas.humblot@bnpparibas.com
EMERGING ECONOMIES AND COUNTRY RISK		
François Faure Head – Argentina	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam, South Africa	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Stéphane Colliac Turkey, Ukraine, Central European countries	+33 1 42 98 26 77	stephane.colliac@bnpparibas.com
Sara Confalonieri Africa (Portuguese & English-speaking countries)	+33 1 42 98 43 86	sara.confalonieri@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot Korea, Thailand, Philippines, Mexico, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Johanna Melka India, South Asia, Russia, CIS	+33 1 58 16 05 84	johanna.melka@bnpparibas.com
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Prepared by Economic Research – BNP PARIBAS
Registered Office: 16 boulevard des Italiens – 75009 PARIS
Tel: +33 (0) 1.42.98.12.34 – Internet :
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