Markit Economic Research

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Japan

Japan's economy slows as confidence slides ahead of sales tax rise

- **PMI surveys point to slower economic growth in Q1, but paint a rosier picture than GDP data**
- **Data add to concerns that the economy was slowing prior to April's sales tax rise**

Although PMI data indicate that Japan's economy is growing faster than recent official data have indicated, the surveys also suggest that the economy has started to slow even before April's sales tax rise.

The all-sector PMI Output Index rose from 52.0 in February to 52.8 in March, but this largely represented a rebound in the services sector from extreme weather in February. Worryingly, manufacturing output growth slowed sharply for a second successive month, down to the weakest for six months and, looking at how the two sectors collectively fared over the first quarter, growth slowed compared the final quarter of last year. The all-sector index averaged 53.0 in the first three months of 2014 against 54.7 in the closing quarter of last year.

Impending sales tax rise

The slowing in first quarter growth signalled by the PMI will raise worries that Japan's economy was already weakening ahead of April sales tax rise from 5% to 8%, boding ill for whether the recovery could be scuppered by this fiscal tightening. There is a concern that "Abenomics", and particularly the vast quantitative easing programme designed to double the country's monetary base, has achieved little more than an unsustainable growth spurt fueled by a surge in Japanese equity prices and a sharp fall in the value of the yen.

However, the recent weakening of the PMI data needs to be looked at in the context of the high levels the surveys have been running at. The fourth quarter had seen the strongest increase in service sector activity since PMI data were first available for the sector in 2007, while goods producers reported the largest increase in output in the manufacturing PMI survey's 12½ year history at the start of 2014.

Chart 1: PMI & GDP compared

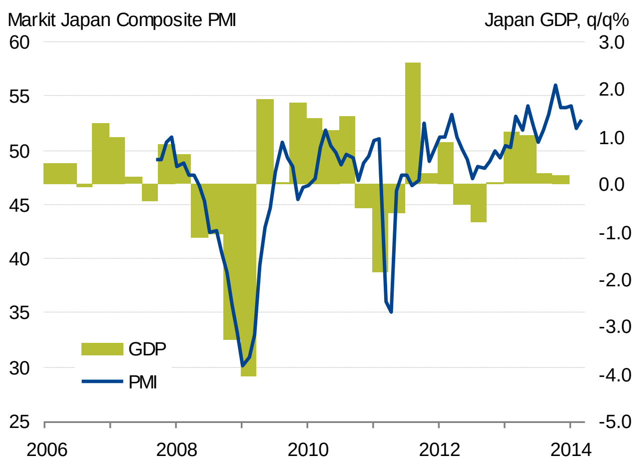


Chart 2: PMI & Tankan (manufacturing) surveys

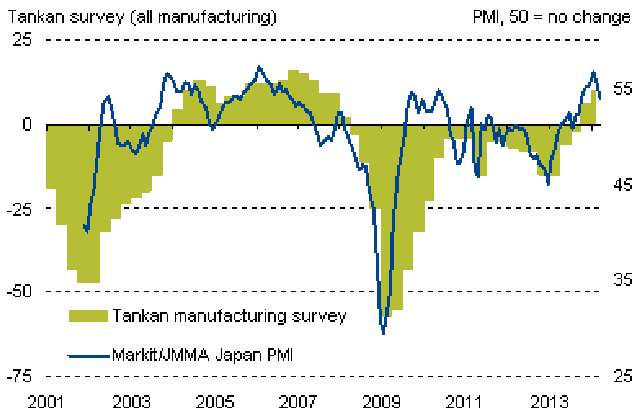
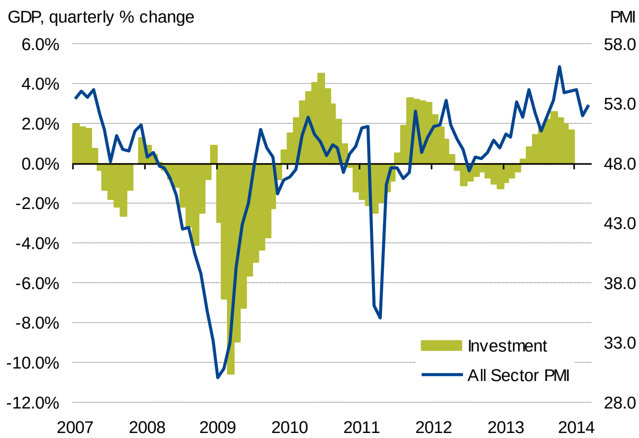


Chart 3: Business investment and the PMI



Sources: Markit, Ecowin.

The PMI surveys in fact paint a very different picture to the gross domestic product numbers (see chart 1), the latter having sent a worrying signal of economic growth losing momentum late last year. Having surged 1.1% in the first quarter of last year and 1.0% in the second quarter of last year, buoyed by the initial optimism that accompanied the introduction of Abenomics in December 29012, GDP growth suddenly slumped to just 0.2% in both the third and fourth quarters.

Rather than slumping in the second half of the year, the PMI surveys went from strength to strength, reaching a new all time high in October and signalling quarterly GDP growth of at least 1% in the third and fourth quarters. Even the lower PMI readings in the first quarter are historically consistent with the economy growing by as much as 1%.

Interestingly, the trend in the PMI has been followed by the Tankan survey, though the latter is available only quarterly and tends to lag behind turning points in the PMI (see chart 2).

Particularly encouraging has been the all-important feed-though of the stimulus to business investment and the jobs market (see charts 3 and 4 respectively).

Although the PMI surveys showed the rate of job creation easing in March, the first quarter has witnessed the most aggressive pace of hiring since the financial crisis. The strong employment index readings bode well for a continuation of the upturn in non-government employment growth seen late last year, which accelerated to the highest since 2007 in year-on-year terms, more or less mirroring the PMI hiring trend.

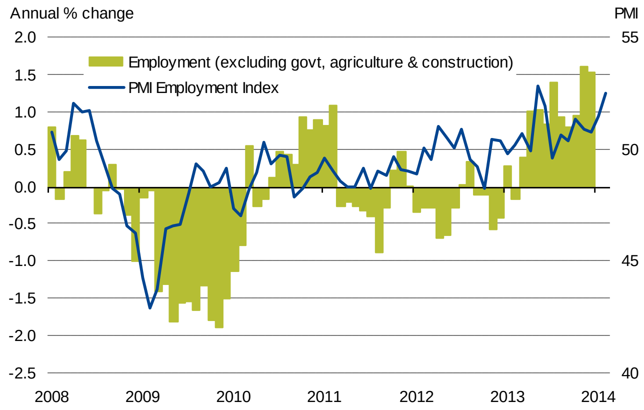
Official data meanwhile show that business investment jumped 1.7% in the final quarter of last year, building on similarly strong increases seen in the second and third quarters.

PMI and GDP divergence

So why have the GDP data been weaker than the PMI readings in recent months? The divergence may lie to a large extent in Japan's need to import energy after domestic nuclear energy plant closures in the aftermath of the March 2011 Fukushima incident. Imports are of course subtracted from economic growth in the GDP calculation.

Imports of goods and services rose to a record high in real terms in the final quarter of 2013, with the share of

Chart 4: Employment



Sources: Markit, Ecow in.

Chart 5: imports

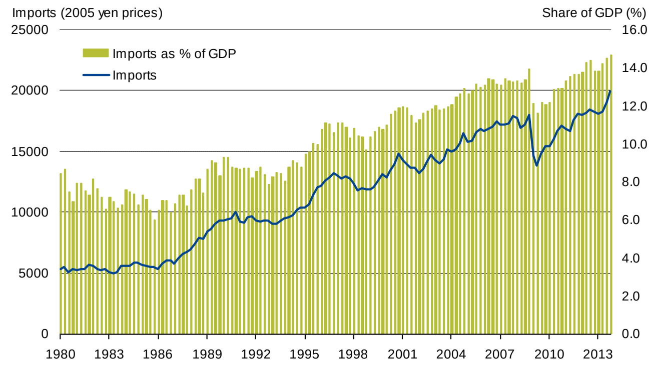
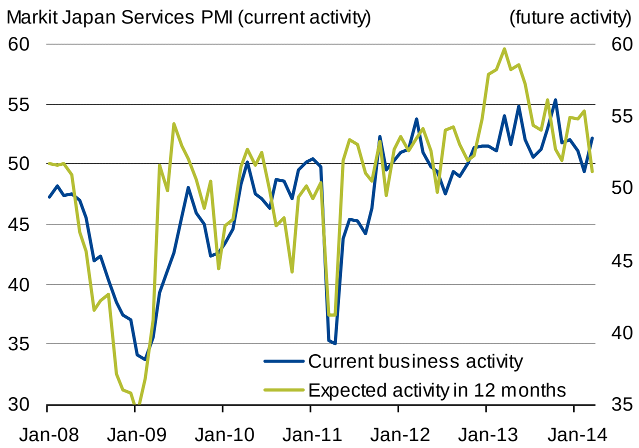


Chart 6: Service sector confidence



GDP also hitting an all-time high of 14.9%, up from just under 13% prior to Fukushima (see chart 5).

It is not likely to be just an import issue though. We also believe that the official GDP data, which in Japan are notorious for revisions, are simply understating growth and are eventually likely to be revised higher.

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Confidence hit

Thus, while the PMI provides encouraging news in that growth late last year and in the first quarter was strong, the surveys also provide evidence to suggest that some waning in growth is now underway, which will no doubt be exacerbated by April's sales tax rise. In fact, the PMI index measuring services sector firms' confidence for the year ahead fell in March to its lowest since June 2012.

However, while this fall in confidence was in many cases attributed to the impending sales tax rise, there is an accompanying concern (see our manufacturing research note) that the recent fall in equity prices could also be hitting confidence, and subdue economic growth at the same time as the sales tax hits.

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