

Japan

Sales tax hike causes Japan's economy to contract for second month running

- **PMI signals second successive contraction in May, but rate of decline slows sharply**
- **Firms continue to take on more staff amid ongoing robust optimism for outlook**
- **Underlying price pressures still subdued**

Business activity in Japan contracted for a second month running in May, according to Markit PMI survey data. However, the drop in activity was only marginal and significantly less marked than seen in April. In a sign that the downturn may be only temporary, the decline was again attributed by many firms to the downturn in demand following April's sales tax rise. Firms also continued to take on more staff in the expectation of business rebounding in coming months after the initial impact of the tax hike passes.

The all-sector PMI Output Index rose sharply from 46.3 in April to 49.2 in May, remaining below the 50.0 neutral level to signal a second successive drop in business activity. Nevertheless, the index signals a substantial easing in the rate of decline. Output and new orders fell in both manufacturing and services alike in May, although in both cases the rate of contraction slowed substantially.

The weakness of the PMI surveys in the past two months contrasts with strong readings late last year and in the first quarter, which had been linked by companies to the twin effects of an underlying upturn in the economy as well as pre-purchasing ahead of the April tax rise.

Whereas the PMI had signalled strong GDP growth in previous quarters, correctly anticipating the 1.5% growth surge in the first three months of the year, the survey data for the second quarter so far point to a near-stagnation of GDP.¹

Chart 1: PMI & GDP compared

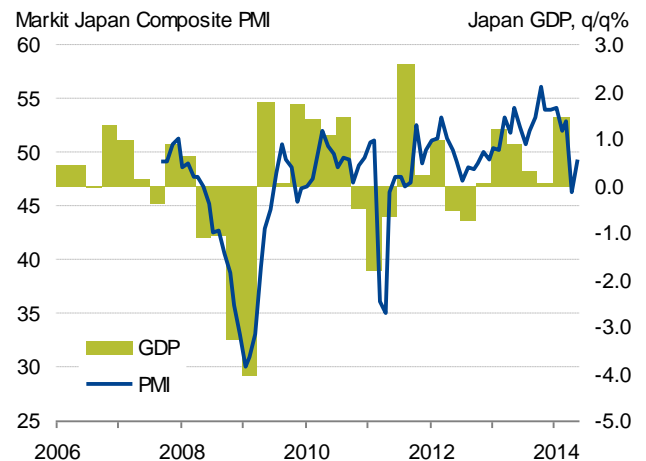


Chart 2: PMI & private consumption

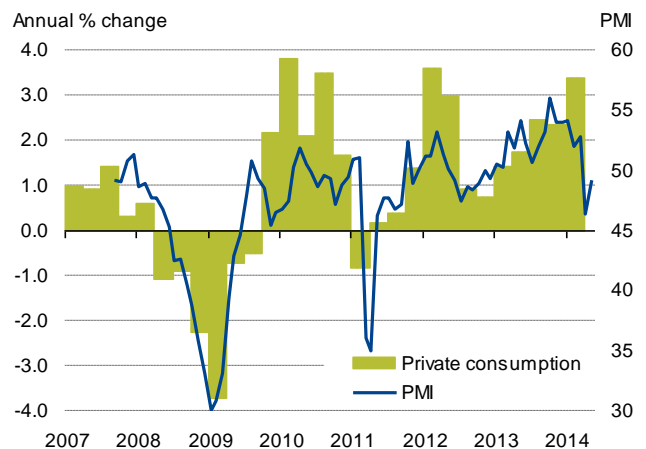
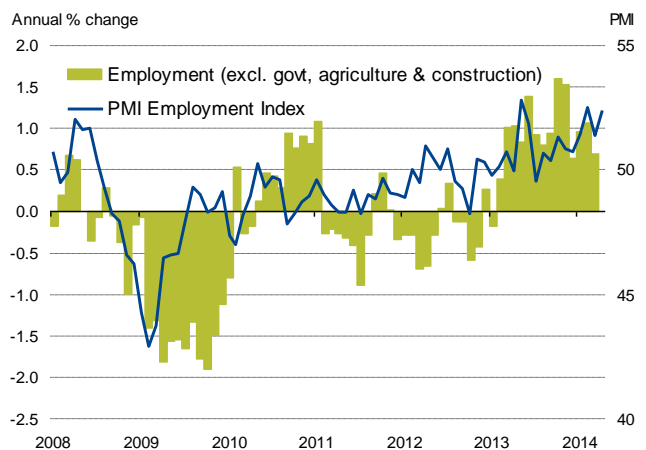


Chart 3: Employment



Sources: Markit, Ecow in.

¹ Note that in recent years the PMI has mapped closer with private consumption data in Japan than the official GDP statistics (see charts 1 and 2). This is largely due to the huge imports of energy since the Fukushima disaster causing GDP to now be a misleading indicator of domestic demand and economic growth. Imports subtract from GDP.

The question remains as to the extent to which the Japanese economy will recover from the hit to demand caused by the sales tax rise. Here, the survey provides mixed indications, though in general the expectation among firms is that the upturn will resume in the second half of the year.

Sustained hiring amid ongoing optimism

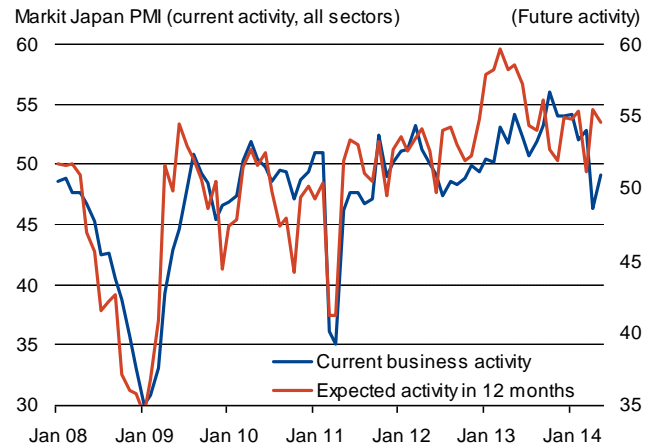
Encouragingly, firms across both sectors continued to take on more staff on average in May, commonly linked to the anticipation of demand for goods and services picking up again. The year to date has so far seen the strongest continuous period of employment growth since 2007 (see chart 3). The rate of job creation nonetheless eased slightly in May, suggesting some renewed caution in relation to hiring at some firms.

Expectations about the year ahead (measured only in the services economy) also slipped back slightly in May. Although remaining well below the peaks seen a year ago (when the introduction of ‘Abenomics’ boosted sentiment), the PMI index of business expectations remained elevated by pre-Abenomics standards, suggesting firms have retained an optimistic view of the year ahead despite the sales tax rise (see chart 4).

Sustained hiring

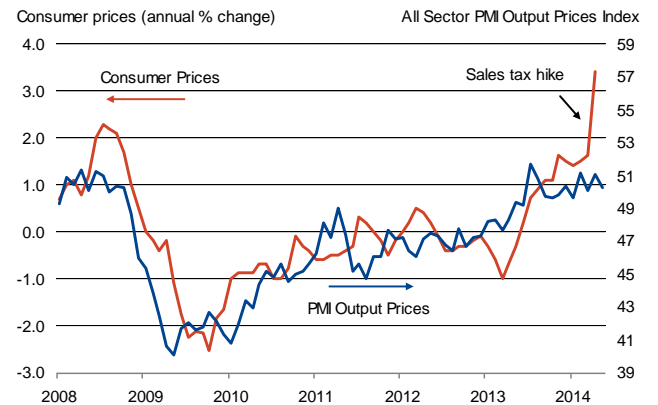
The survey brought mixed news on prices in May. Official data showed that consumer price inflation surged to a 23-year high of 3.4% in April as the higher sales tax took effect, but the PMI survey index of average prices charged for goods and services remained close to the 50 no change level, suggesting underlying price pressures remain weak. On the other hand, the recent stabilisation of prices signalled by the PMI represents a marked contrast to the trend of falling prices seen throughout much of the survey’s prior history. Underlying price trends may not be anything like as strong as signalled by the official inflation data, but at least prices are no longer falling.

Chart 4: Service sector confidence



Source: Markit.

Chart 5: Consumer prices



Sources: Markit, Ecowin.

Chris Williamson

Chief Economist

Markit

Tel: +44 207 260 2329

Email: chris.williamson@markit.com

[Click here](#) for more PMI and economic commentary.

For further information, please visit www.markit.com