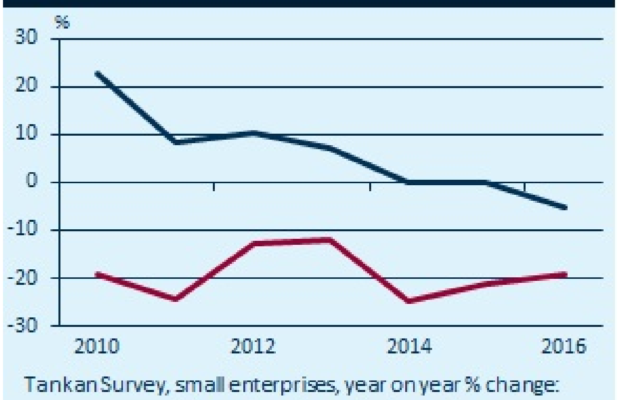
The mask slips

There is a growing perception that the best of Abenomics may be behind us. Not only has the domestic economy stalled but overseas demand trends have turned sour. Industrial production slumped 6.2% month-on-month (m/m) in February, the weakest reading since November 2011, with the deterioration in the inventory-to-shipment ratio firmly pointing to a contraction in industrial output in the first quarter. The news from the BOJ's flagship corporate survey provided little reassurance either. Japan's export-sensitive large manufacturers reported a significant deterioration in business conditions, with the headline index plunging to +6 from +12 in the previous quarter.

For a better assessment of domestic demand conditions, it is useful to look at the SME sector. Here, the news of late has been less downbeat. The Shoko Chukin Index pointed to greater resilience in the smaller company sector, rising in March for a second consecutive month to 48.8. The Tankan too pointed to a less severe downturn in business conditions among smaller companies, with manufacturers and non-manufacturers experiencing a -4 and -1 point decline respectively. However, the more forward-looking elements of the survey suggest that these companies may simply be lagging their larger peers. Small enterprises plan to reduce capex by a disappointing 19.3% y/y in FY2016, while profit expectations fell into negative territory at -5.4% (see Chart 8). Firms have a habit of revising these measures as the year progresses but, even factoring that in, the outcome is underwhelming. **If the breadth of disappointment in the BOJ's Tankan Survey is upsetting, the timing is even more galling. We are three years into to the BOJ's unprecedented monetary stimulus and the desired virtuous circle has failed to materialise**. Yes, both basic wages and corporate profits have risen but risk-averse household and corporate sectors have saved, rather than spent, rising incomes. This has raised justifiable concerns about whether monetary policy can dispel Japan's deflationary mindset. We have written extensively about the challenges to policy transmission, including weak wealth and credit effects, as well as the impact of non-price competitiveness concerns on the currency channel. However, **we still believe higher inflation remains the best hope for Japan**. Indeed, the fact that the BOJ Tankan shows that proxies of the output gap – such as the production capacity, diffusion index, and employment conditions – have started treading water, augurs for a further monetary policy response (see Chart 9).

Whether other economies in the region also merit a more aggressive monetary response is a more controversial question. In Korea, central bank Governor Lee Ju-yeol recently attacked claims from ruling party members that monetary policy should be eased further to support growth, citing structurally higher inflation and growth. The robust defence is clearly aimed at defusing a potentially explosive issue ahead of upcoming parliamentary elections. However, the more important consideration for the BOK will be the composition of growth rather than the level. The Bank appears cautious about stoking further credit growth in the household sector, fuelled by a strong property market. However, with industrial output growth remaining tepid, averaging just 0.3% m/m in the first two months of the year, the Bank may be forced to act in the absence of a sustained acceleration in trade.

Chart 8: Further into negative territory



Source: Tankan, Haver (as of March 2016)

Chart 9: Output gap proxies tread water

Source: Tankan,, Haver (as of Q1 2016)