

Short-run Impact of Brexit (UK's exit from EU) on Japan's Economy

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1. The Real Economy

Leave won the UK Referendum on June 23. Definitive impact on Japanese economy will depend on the direction of the upcoming exit negotiation. As a first step of the discussion, we forecast how the slowdown of UK and EU economies as well as yen's appreciation due to risk aversion among investors will impact on Japan's exports, corporate earnings, and capital expenditures in the short-run.

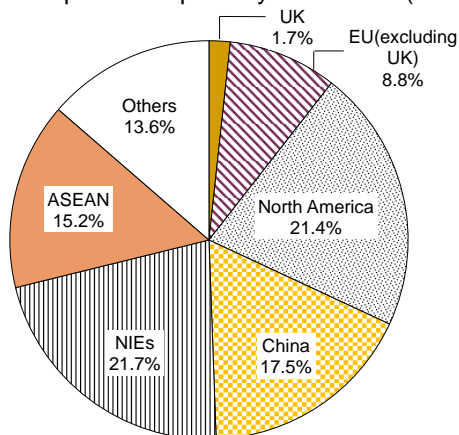
First, looking at exports, it is expected that the direct impact of decreasing demands in UK and EU will be limited since Japan's exports to UK only account for 1.7% of total exports as of 2015, even to EU as a whole, only 10.6% (Chart 1). Stronger JPY will not cause a sharp drop in exports owing to the recent Japanese corporations' tendency to stabilize local selling prices at export destinations, which weakened the relation between foreign exchange and real exports. The impact on real exports will be -0.3% in FY 2016, -0.4% in FY 2017, respectively, which is only minor decline.

On the other front, it is estimated that one yen's appreciation against the USD will result in the approximately 0.7% decline in annual current profit of Japanese corporations. If the JPY exchange rate continues at roughly its current level compared to last fiscal year's average of 120 yen against USD, it will push down the corporate earnings by 10% or more YoY. Some exporter is expected to experience a not negligible decrease in capital expenditures although there is little possibility that decreased corporate earnings will directly raise the questions over the sustainability of total capital expenditures as capital expenditures are rather linked to business conditions than current profit which is more sensitive to the fluctuation of exchange rates. Furthermore, there is a risk which requires attention that the rapid yen's appreciation might cause the deterioration of corporate sentiments more than estimated, and the hypercautious stance to investments of companies (Chart 2). We forecast that the negative impact on real capital expenditures will be -0.2% in FY 2016, -0.3% in FY 2017 respectively.

Brexit should be great difficulty for Japanese corporations to be forced to review their strategies including restructuring of business hubs in Europe. Nevertheless, the Brexit will not lead to the credit impairment or financial crisis, and we expect that it would cut the real GDP

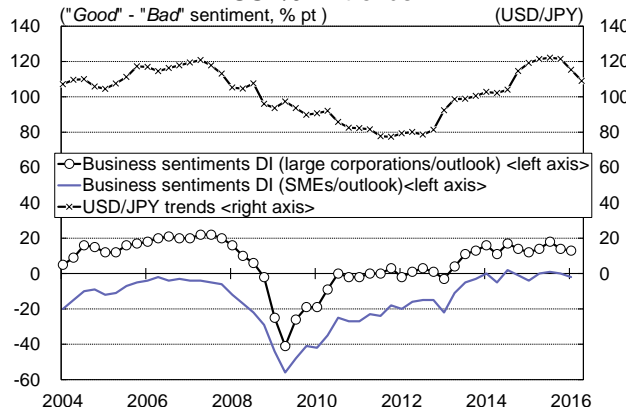
growth rate only by 0.1% in FY 2016 and FY 2017 respectively. There is little possibility that the Brexit will give significant downward pressure on Japan's economy as a whole.

Chart 1: Japanese exports by destination (2015)



Source: Compiled by BTMU Economic Research Office from Ministry of Finance data

Chart 2: Business sentiments DI and USD/JPY trends



Source: Compiled by BTMU Economic Research Office from Bank of Japan, Bloomberg data

2. Monetary Policy and Financial Markets

(1) Foreign exchange rate and long-term interest rate

The Brexit in fact destabilized the global financial market. According to the poll conducted prior to the voting, *Remain* was holding a tiny lead over *Leave*, and JPY weakened to USD/JPY 106.84 immediately after the start of vote counting. However, as the vote counts progressed, it heightened the possibility of reversed outcome, and investors strengthened risk aversion stance. JPY temporarily hit the 2 years and 7 months high of USD/JPY 99. The range of one-day fluctuation was 8 yen, which surpassed the record at the collapse of Lehman Brothers and reached at 5th largest fluctuation. The disturbance of financial markets caused by the Brexit was significant. The appreciation of JPY exerted downward pressure on the Nikkei stock average, which sharply fell on June 24, closing at 14,952 yen down from 16,238 yen in the previous day. 10 year JGB yields also fell to the historical low of -0.24% on June 29.

Looking back the history, the ripple effects of the Lehman Crisis caused the prolonged yen's appreciation and the plunge in stock prices not confined to the beginning of the crisis (Chart 3). Since the Brexit was not fully factored into the market prices in advance, the initial reactions of foreign exchange and stock markets were larger than that at Lehman Shock. Nevertheless the risk of severe recession is estimated to remain low, since there is no rising credit impairment over the financial institutions in advanced countries. The risk of further steep yen's appreciation and tumbling stock prices is considered to be limited.

(2) Monetary policy

In a joint statement by the Minister of Finance and the governor of the Bank of Japan and at the Emergency Meeting with the government, BoJ expressed its intention to take actions if

necessary in order to sustain the stability of financial markets. At the time of Lehman Crisis, BoJ initially took the measures to supply the liquidity into the market, then, lowered its policy rate approximately one and half month later based on the judgment that the risk of economic downturn was intensifying (Table 1). If the turmoil in financial markets is protracted, BoJ will discuss the possible monetary easing including expansion of risk assets -ETF or J-REIT-purchase program on the next monetary policy meeting to be held on July 28-29.

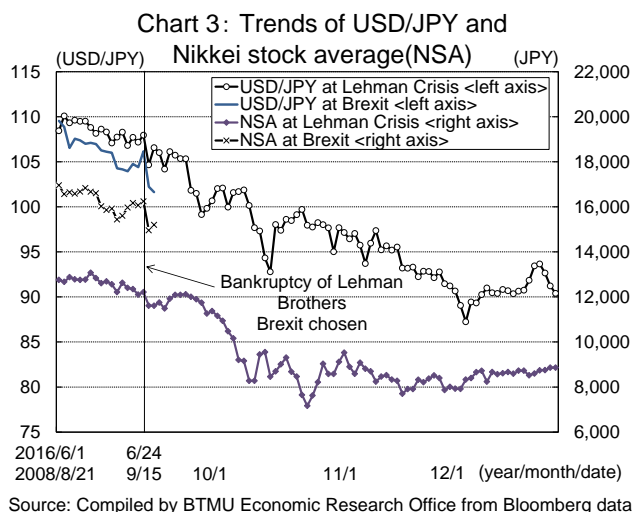


Table 1: BoJ's monetary measures taken after the bankruptcy of Lehman Brothers (September 15, 2008)

Policy meeting		Monetary measures
Sep.16-17	Regular	◇ Operational changes to the securities lending facility
Sep. 18	Extraordinary	◇ Implemented dollar supply operations
Sep. 29	Extraordinary	◇ Expanded dollar supply operations
Oct.14	Extraordinary	◇ Expanded dollar supply operations ◇ Operational changes to the securities lending facility
Oct.31	Regular	◇ Lowered call rate target (0.5%→0.3%) ◇ Basic loan rate (0.75%→0.5%) ◇ Introduced complementary deposit facility (interests : 0.1%)
Nov.20-21	Regular	N/A
Dec.2	Extraordinary	◇ Decided to implement special operation for the support of corporate finance
DEC.18-19	Regular	◇ Lowered call rate target (0.3%→0.1%) ◇ Basic loan rate (0.5%→0.3%) ◇ Increase in purchase of long-term JGB (14.4 trillion yen annually →16.8 trillion yen annually)

Source: Compiled by BTMU Economic Research Office from Bloomberg data

MAIN ECONOMIC AND FINANCIAL INDICATORS (JAPAN)

1. Main Economic Indicators

As of July. 20, 2016

	Fiscal	Fiscal	2015		2016	2016				
	2014	2015	3Q	4Q	1Q	FEB	MAR	APR	MAY	JUN
Real GDP Growth Rate <% changes from previous period at SA annual rate>	-0.9	0.8	1.7 (1.8)	-1.8 (0.7)	1.9 (0.1)	***	***	***	***	***
Index of All Industries Activity	-1.1	0.8	0.0 (1.2)	-0.2 (0.6)	0.0 (0.3)	-0.9 (1.6)	0.2 (0.1)	1.3 (0.1)		
Industrial Production Index	-0.5	-1.0	-1.0 (-0.9)	0.1 (-0.8)	-1.0 (-1.6)	-5.2 (-1.2)	3.8 (0.2)	0.5 (-3.3)	-2.6 (-0.4)	
Production										
Shipments	-1.2	-1.2	-0.7 (-0.8)	0.4 (-0.8)	-2.0 (-2.4)	-4.1 (-1.6)	1.8 (-0.7)	1.6 (-3.4)	-2.6 (-1.0)	
Inventory	6.1	1.8	-0.5 (2.0)	-0.5 (0.0)	2.4 (1.8)	-0.2 (-0.9)	2.9 (1.8)	-1.7 (0.1)	0.4 (0.8)	
Inventory/Shipments Ratio (2010=100)	112.0	115.0	114.7 [113.2]	114.9 [113.8]	116.3 [113.0]	114.5 [113.5]	118.3 [114.0]	115.7 [113.7]	117.8 [114.8]	112.8
Domestic Corporate Goods Price Index	2.7	-3.2	-1.1 (-3.7)	-1.4 (-3.7)	-1.4 (-3.4)	-0.3 (-3.4)	-0.1 (-3.8)	-0.4 (-4.2)	0.1 (-4.3)	-0.1 (-4.2)
Consumer Price Index(SA, total, excl.fresh foods)	2.8	0.0	0.0 (-0.1)	0.0 (0.0)	-0.8 (-0.1)	-0.1 (0.0)	-0.1 (-0.3)	-0.1 (-0.3)	0.0 (-0.4)	
Index of Capacity Utilization (2010=100)	100.6	98.0	97.6 [99.1]	97.9 [100.7]	97.3 [101.4]	94.5 [100.5]	97.5 [99.9]	96.5 [99.3]	94.2 [96.8]	98.0
Machinery Orders(Private Demand, Excl.Electric Power and Ship building)	0.8	4.1	-6.5 (-0.9)	2.6 (2.1)	6.7 (3.4)	-9.2 (-0.7)	5.5 (3.2)	-11.0 (-8.2)	-1.4 (-11.7)	
Manufacturing	7.0	6.2	-9.6 (-1.1)	-3.0 (-3.1)	13.7 (4.3)	-30.6 (-12.3)	19.7 (2.7)	-13.3 (-14.8)	-6.4 (-21.5)	
Non-manufacturing Excl.Electric Power & Ship building	-3.3	2.5	-4.9 (-0.8)	5.6 (6.3)	3.5 (2.6)	10.2 (8.7)	-6.9 (2.7)	-3.9 (-3.0)	-0.3 (-2.5)	
Shipments of Capital Goods (Excl.Transport Equipment)	4.4	-2.3	-1.8 (-1.3)	-1.7 (-4.2)	-2.4 (-5.5)	-8.1 (-1.5)	2.6 (-4.8)	5.2 (-3.7)	-1.4 (-1.1)	
Construction Orders	8.2	-0.9								
Private	4.8	7.9								
Public	22.9	-15.6								
Public Works Contracts	-0.3	-3.8								
Housing Starts 10,000 units at Annual Rate, SA	88.0 (-10.8)	92.1 (4.6)	91.7 (6.2)	86.8 (-0.7)	94.7 (5.5)	97.4 (7.8)	99.3 (8.4)	99.5 (9.0)	101.7 (9.8)	
Total floor										
Sales at Retailers	-1.2	0.8								
Real Consumption Expenditures of Households over 2 persons (SA)	-5.1	-1.2	0.5 (0.7)	-2.1 (-3.3)	0.5 (-2.6)	1.7 (1.2)	0.5 (-5.3)	0.2 (-0.4)	-1.5 (-1.1)	
Propensity to Consume (SA, %)	74.2	73.6	73.4 [74.6]	73.1 [74.4]	72.8 [74.3]	74.6 [72.9]	71.5 [75.4]	74.2 [73.6]	75.2 [74.8]	74.3
Overtime Hours Worked (All Industries, 5 employees or more)	2.0	-1.3	0.1 (-0.9)	-0.2 (-0.9)	-1.2 (-2.1)	-1.0 (-1.9)	-0.2 (-1.8)	0.7 (-0.9)	-0.9 (-1.8)	
Total Cash Earnings (Regular Employees Only; All Industries, 5 employees or more)	0.5	0.2								
Employment Index(Regular Employees Only;All Industries, 5 employees or more) (Change over the M/Q/Y)	77	98	95	104	98	94	102	94	90	
Ratio of Job Offers to Applicants (SA, Times)	1.11	1.23	1.22 [1.10]	1.26 [1.12]	1.29 [1.15]	1.28 [1.15]	1.30 [1.16]	1.34 [1.17]	1.36 [1.18]	1.19
Unemployment Rate (SA, %)	3.5	3.3	3.4	3.3	3.2	3.3	3.2	3.2	3.2	
Economy Watcher Survey (Judgment of the present condition D.I.%)	46.6	48.8	49.5 [48.7]	47.7 [43.6]	45.6 [49.3]	44.6 [50.1]	45.4 [52.2]	43.5 [53.6]	43.0 [53.3]	41.2 [51.0]
Bankruptcies (Number of cases)	9,543 (-9.4)	8,684 (-9.0)	2,092 (-14.1)	2,152 (-3.1)	2,144 (-5.6)	723 (4.4)	746 (-13.1)	695 (-7.0)	671 (-7.3)	763 (-7.4)

(Notes)

Unless otherwise indicated, tabulated figures and those in parentheses show % changes from previous quarter/month as applicable.

The figures in () indicate % changes from previous year.

[] show the comparable figure of the previous year.

2. Balance of Payments

As of July, 20, 2016

	Fiscal	Fiscal	2015		2016	2016				
	2014	2015	3Q	4Q	1Q	FEB	MAR	APR	MAY	JUN
Customs Clearance (Exports in Yen Terms)	5.4	-0.7	(3.7)	(-4.6)	(-7.9)	(-4.0)	(-6.8)	(-10.1)	(-11.3)	
Value	3.9	2.1	(6.8)	(-0.6)	(-4.7)	(-4.2)	(-5.8)	(-5.7)	(-9.1)	
Volumes	1.3	-2.7	(-2.9)	(-4.1)	(-3.2)	(0.2)	(-1.0)	(-4.6)	(-2.4)	
Imports (In Yen terms)	-1.0	-10.3	(-5.9)	(-13.9)	(-15.7)	(-14.2)	(-14.9)	(-23.3)	(-13.8)	
Value	1.2	-8.5	(-4.1)	(-11.8)	(-14.9)	(-12.0)	(-19.0)	(-17.0)	(-16.8)	
Volumes	-2.1	-1.8	(-1.9)	(-2.5)	(-0.8)	(-2.4)	(-2.5)	(-7.5)	(3.6)	
Current Account (100 mil. yen)	87,245	180,028	48,709	34,479	59,636	23,874	29,862	18,785	18,091	
Goods (100 mil. yen)	-65,890	5,419	-3,488	954	8,534	4,023	8,828	6,971	399	
Services (100 mil. yen)	-27,252	-11,451	-2,238	-5,212	2,414	1,653	2,623	-4,012	1,174	
Financial Account (100 mil. yen)	137,595	238,095	54,646	49,065	90,136	30,107	52,380	14,793	40,994	
Gold & Foreign Exchange Reserves (\$1mil.)	1,245,316	1,262,099	1,248,936	1,233,214	1,262,099	1,254,149	1,262,099	1,262,509	1,253,967	1,265,402
Exchange Rate (¥/\$)	109.92	120.13	122.23	121.48	115.45	115.02	113.07	109.88	109.15	105.49

3. Financial Market Indicators

	Fiscal	Fiscal	2015		2016	2016					
	2014	2015	3Q	4Q	1Q	FEB	MAR	APR	MAY	JUN	
Uncollateralized Overnight Call Rates	0.068	0.063	0.074 [0.067]	0.076 [0.064]	0.035 [0.073]	0.033 [0.076]	-0.003 [0.070]	-0.037 [0.061]	-0.059 [0.069]	-0.055 [0.072]	
Euro Yen TIBOR (3 Months)	0.194	0.157	0.169 [0.210]	0.169 [0.184]	0.122 [0.171]	0.098 [0.171]	0.098 [0.170]	0.060 [0.170]	0.060 [0.169]	0.059 [0.169]	
Newly Issued Japanese Government Bonds Yields (10 Years)	0.400	-0.050	0.350 [0.525]	0.270 [0.330]	-0.050 [0.400]	-0.065 [0.330]	-0.050 [0.400]	-0.085 [0.340]	-0.120 [0.390]	-0.230 [0.455]	
Average Contracted Interest Rates on Loans and Discounts(City Banks) (% changes from previous period)	1.006	0.924	0.969 (-0.018)	0.956 (-0.013)	0.924 (-0.032)	0.943 (-0.011)	0.924 (-0.019)	0.914 (-0.010)	0.904 (-0.010)		
The Nikkei Stock Average (TSE 225 Issues)	19,207	16,759	17,388 [16,174]	19,034 [17,451]	16,759 [19,207]	16,027 [18,798]	16,759 [19,207]	16,666 [19,520]	17,235 [20,563]	15,576 [20,236]	
M2(Average)	(3.3)	(3.6)	(4.0)	(3.4)	(3.2)	(3.2)	(3.2)	(3.4)	(3.4)	(3.4)	
Broadly-defined Liquidity(Average)	(3.3)	(4.0)	(4.4)	(3.8)	(3.5)	(3.5)	(3.2)	(2.7)	(2.3)	(1.9)	
Principal Figures of Financial Institutions											
Loans and Discount (Average)	Banks & Shinkin	Banks & Shinkin	(2.3)	(2.4)	(2.6)	(2.3)	(2.2)	(2.2)	(2.0)	(2.2)	(2.2)
		Banks	(2.5)	(2.5)	(2.7)	(2.3)	(2.2)	(2.2)	(2.0)	(2.2)	(2.0)
		City Banks etc.	(1.4)	(1.2)	(1.6)	(1.0)	(0.9)	(1.0)	(0.7)	(1.0)	(0.9)
		Regional Banks	(3.8)	(3.7)	(3.9)	(3.7)	(3.4)	(3.5)	(3.2)	(3.4)	(3.4)
		Regional Banks II	(2.9)	(3.2)	(3.4)	(3.2)	(3.2)	(3.2)	(3.3)	(3.4)	(3.2)
	Shinkin	(1.4)	(2.2)	(2.1)	(2.3)	(2.3)	(2.3)	(2.3)	(2.2)	(2.3)	
Deposits and CDs (Average)	Total(3 Business Condition)	Total(3 Business Condition)	(3.3)	(3.7)	(4.3)	(3.2)	(3.0)	(3.1)	(3.0)	(3.2)	(3.3)
		City Banks	(3.4)	(4.5)	(5.4)	(3.6)	(3.6)	(4.0)	(3.8)	(4.6)	(4.7)
		Regional Banks	(3.3)	(3.0)	(3.3)	(3.0)	(2.4)	(2.3)	(2.1)	(1.8)	(1.7)
		Regional Banks II	(3.1)	(2.5)	(2.7)	(2.3)	(2.1)	(2.1)	(1.9)	(2.0)	(1.8)

(Notes)

Newly Issued Japanese Government Bonds Yields and Interest rates are averages. The Nikkei Stock Average is as of month-end. Unless otherwise indicated, tabulated figures and those in parentheses show % changes from previous quarter/month as applicable. The figures in () indicate % changes from previous year. [] show the comparable figure of the previous year.

(Sources)

Cabinet Office, National Accounts, Machinery Orders; METI, Indices of Tertiary Industry Activity, Industrial Production, Current Survey of Commerce; MOF, Trade Statistics, Balance of Payments; MPMHAPT, Consumer Price Index, Family Income and Expenditure Survey, Labour Force Survey; MHLW, Monthly Labour Survey; Ministry of Land, Infrastructure, and Transport, Economic Construction Statistics; BOJ, Corporate Price Index, Financial and Economic Statistics Monthly, etc.

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