What lies ahead regarding a reduction to the consumption tax? (1)

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Impact on Japan's sovereign ratings

- If consumption tax were cut, downward pressure would likely be exerted on Japan's sovereign ratings
- Whether it would actually lead to downgrade depends on scale and period of tax cut; S&P (*) would likely emphasize balance with fundamentals
- Full-fledged debate expected from autumn until year-end; our main scenario is that a downgrade would be avoided

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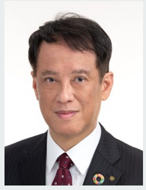

(*) indicates unregistered credit rating agencies. Please see the disclaimer at the end of the document.

What lies ahead regarding a reduction to the consumption tax? (1): Impact on Japan's sovereign ratings

If the consumption tax were cut, downward pressure would very likely be exerted on Japan's sovereign ratings. However, the scale and period of the tax cut would be key factors in determining whether it actually led to a downgrade. And, it should be noted that when S&P (*) makes its determination, it will likely place importance on the balance with fundamentals such as the domestic economy and savings, as well, rather than focusing solely on the fiscal deficit. A full-scale debate will likely take place from autumn until the end of the year. For the time being, we anticipate that the scale and period of a tax cut would not result in a downgrade.

Calls for cut to consumption tax mounting ahead of Upper House election

In the lead up to the election in the House of Councillors (Upper House) in July, increasing action is taking place among opposition parties to include a cut to the consumption tax as part of their campaign pledges. With income growth failing to keep pace with rising prices, public expectations for a tax cut are higher than ever.

Currently lacking sources of funding, top officials of the Liberal Democratic Party (LDP) have not changed their cautious stance towards cutting the consumption tax. However, Komeito, the LDP's coalition partner, is indicating a more positive stance towards cutting the tax.

Furthermore, the ruling coalition does not currently have a majority in the House of Representatives (Lower House), so the cooperation of opposition parties will be indispensable in order to pass the FY25 supplementary budget and FY26 initial budget. It is very likely that some form of consumption tax cut will be implemented due to the LDP accepting some of the demands from opposition parties.

Impact of cut to consumption tax on Japan's sovereign ratings by Moody's (*)

On 2 May, Moody's (*) maintained its rating for Japan at A1/Stable. While the rating agency factored in the impact from Trump tariffs to some extent, it did not touch on a cut to the consumption tax in particular.

Key points regarding the agency's valuation of Japan's fiscal and political situation were as follows:

- Very high government debt is a challenge, but the current situation is backed by private sector savings.
- Fiscal position has improved in recent years, especially relative to other G7 economies.
- The ongoing normalization of the BOJ's monetary policy stance is not regarded as a particular issue.
- Unstable political situation suggests challenges to the implementation of difficult reforms to address pressing economic and fiscal risks.
- Factors that could lead to a downgrade include a significant deterioration in debt burden due to an increase in prospects of a material and sustained widening in fiscal deficits.

Therefore, the agency could lower its ratings for Japan depending on the period and scale of the consumption tax cut

Impact of cut to consumption tax on Japan's sovereign ratings by S&P (*)

On 28 March, S&P (*) also maintained its rating for Japan at A+/Stable.

Key points of the valuation were as follows:

- Very fragile fiscal condition is a negative factor for ratings.
- Fiscal deficit remains above pre-pandemic levels due to structural increase in spending.
- Ratings are supported by strong external positions, rich and diversified economy, and high domestic spending.
- The effectiveness of the political system and governance is also a positive factor.
  The public has accepted past consumption tax hikes (in 2014 and 2019).
- The growth rate of per-capita real GDP is expected to be on par with that of other high-income economies over the next three to five years.
  Ratings could be lowered if the growth rate declines significantly and continuously.
- Changes in the BOJ's monetary policy do not have a major impact on ratings.

S&P (*) tends to emphasize fundamentals over fiscal deficit and debt burden when assessing ratings of local governments.

Fiscal deterioration itself due to a cut to the consumption tax would be a negative factor for ratings. However, S&P (*) would likely make its determination based on the scale and period of the tax cut, as well as domestic savings and economic growth.

Summary

Some form of cut to the consumption tax will likely be made, and that will likely put downward pressure on Japan's sovereign ratings. However, whether this will actually lead to a downgrade depends on the period and scale of the tax cut. And, it should be noted that S&P (*) places importance on the fundamentals of the economy and savings. We also take note of the differences in the stances taken by the two agencies when making their rating valuations.

Adjustments and coordination between the ruling and opposition parties will likely take place in earnest while the budget is being worked out in autumn or at the end of the year. There may also be major changes to the political framework with the ruling and opposition parties after the Upper House election. For now, our main scenario is that the ruling party will pass a budget after deliberations with the Constitutional Democratic Party, which has the most moderate stance with regard to cutting the consumption tax. We will cover more details in future reports.