

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

FICC Research Dept.

Koji Hamada

81-3-5555-8791

kouji.hamada@daiwa.co.jp

Daiwa Securities Co. Ltd.



(*) 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.

IMPORTANT

This report is provided as a reference for making investment decisions and is not intended to be a solicitation for investment. Investment decisions should be made at your own discretion and risk. Content herein is based on information available at the time the report was prepared and may be amended or otherwise changed in the future without notice. We make no representations as to the accuracy or completeness. Daiwa Securities Co. Ltd. retains all rights related to the content of this report, which may not be redistributed or otherwise transmitted without prior consent.

Ratings

Issues are rated 1, 2, 3, 4, or 5 as follows:

- 1: Outperform TOPIX/benchmark index by more than 15% over the next 12 months.
- 2: Outperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 3: Out/underperform TOPIX/benchmark index by less than 5% over the next 12 months.
- 4: Underperform TOPIX/benchmark index by 5-15% over the next 12 months.
- 5: Underperform TOPIX/benchmark index by more than 15% over the next 12 months.

Benchmark index: TOPIX for Japan, S&P 500 for US, STOXX Europe 600 for Europe, HSI for Hong Kong, STI for Singapore, KOSPI for Korea, TWII for Taiwan, and S&P/ASX 200 for Australia.

Target Prices

Daiwa Securities Co. Ltd. sets target prices based on its analysts' earnings estimates for subject companies. Risks to target prices include, but are not limited to, unexpected significant changes in subject companies' earnings trends and the macroeconomic environment.

Disclosures related to Daiwa Securities

Please refer to https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/e_disclaimer.pdf for information on conflicts of interest for Daiwa Securities, securities held by Daiwa Securities, companies for which Daiwa Securities or foreign affiliates of Daiwa Securities Group have acted as a lead underwriter, and other disclosures concerning individual companies. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Explanatory Document of Unregistered Credit Ratings

This report may use credit ratings assigned by rating agencies that are not registered with Japan's Financial Services Agency pursuant to Article 66, Paragraph 27 of the Financial Instruments and Exchange Act. Please review the relevant disclaimer regarding credit ratings issued by such agencies at: https://drp.daiwa.co.jp/rp-daiwa/direct/reportDisclaimer/credit_ratings.pdf. If you need more information on this matter, please contact the Research Production Department of Daiwa Securities.

Notification items pursuant to Article 37 of the Financial Instruments and Exchange Law

(This Notification is only applicable to where report is distributed by Daiwa Securities Co. Ltd.)

If you decide to enter into a business arrangement with our company based on the information described in this report, we ask you to pay close attention to the following items.

- In addition to the purchase price of a financial instrument, our company will collect a trading commission* for each transaction as agreed beforehand with you. Since commissions may be included in the purchase price or may not be charged for certain transactions, we recommend that you confirm the commission for each transaction. In some cases, our company also may charge a maximum of ¥2 million per year as a standing proxy fee for our deposit of your securities, if you are a non-resident.
- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

** The ratio of margin requirements etc. to the amount of the transaction cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.

When making an actual transaction, please be sure to carefully read the materials presented to you prior to the execution of agreement, and to take responsibility for your own decisions regarding the signing of the agreement with our company.

Corporate Name: Daiwa Securities Co. Ltd.

Registered: Financial Instruments Business Operator, Chief of Kanto Local Finance Bureau (Kin-sho) No.108

Memberships: Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association, Japan Security Token Offering Association