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SA156 Short-Term Forecast of the Japanese Economy (2013/10-12—2016/1-3)

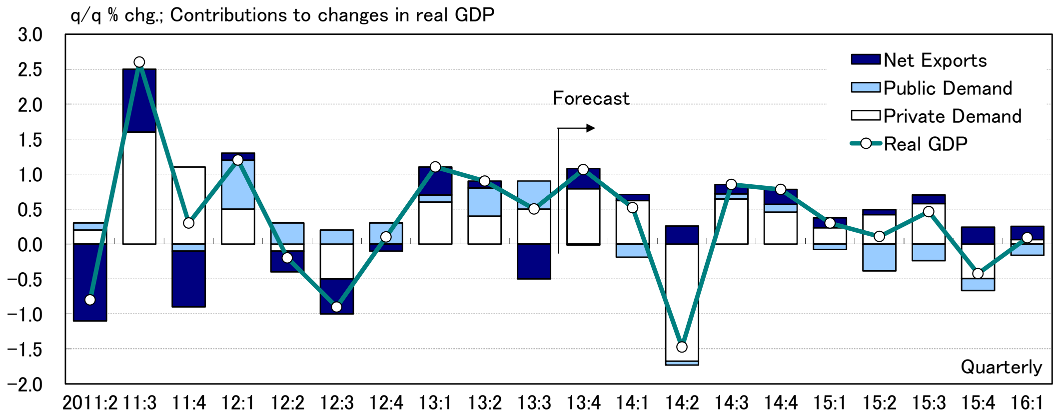
Real growth Lifted to 0.6% in FY 2014 by Fiscal Stimulus - Accelerated growth in the second half of FY 2013 driven by last-minute spending prior to tax hike

Nobuyasu Atago
Chief Forecaster, Japan Center for Economic Research

- Additional supplementary budget for FY 2013 cancels out rebound from FY 2012 supplementary budget
- Consumption and housing likely to fall in FY 2014 due to tax hike – economy will be shored up by net exports and private non-residential investment
- Phillips curve analysis indicates an inflation rate of 0.7% for FY 2015, lower than the BOJ's target

Gross domestic product grew by an annualized rate of 1.9% during the July–September period. This represented a slowdown from the high growth achieved in the previous two quarters. Public-sector demand has been up since the supplementary budget was implemented for FY 2012 (April 2012 – March 2013). Private residential investment has also increased, prompted by the consumption tax hike to be introduced in April next year. However, growth in consumption has slowed, and exports were down for the first time in three quarters, holding back the economy overall. Starting from the October–December period, however, we are likely to see a surge in last-minute demand before the higher consumption tax rate comes into force. This should help to bolster consumer spending. As a result, we are forecasting that real growth for FY 2013 will be high, up by 2.6% over the previous year. In FY 2014, the rebound from last-minute demand and decreased purchasing power after the tax hike will result in an economic slowdown, but the additional supplementary budget for FY 2013 should make it possible to achieve growth of 0.6%, equivalent to the potential growth rate (Fig. 1).

Fig.1 Forecast of Real GDP Growth and Its Breakdown



Source: Cabinet Office, "National Accounts"

The details of our forecast are as follows.
First public-sector demand, where the boost provided by the FY 2012 supplementary budget is weakening: Real growth for FY 2013 was pushed up by the supplementary budget implemented in FY 2012. We previously expected the fiscal drag from this to pull real growth down by 0.3 percentage points. However, now it seems likely that this will be canceled out by the fiscal stimulus package worth 5 trillion yen that was agreed in early October, together with the official decision to increase the consumption tax rate from 5% to 8% next April. As a result, the net contribution of public demand to real growth in FY 2014 will probably be neutral.

Consumer spending is likely to increase substantially as last-minute demand makes itself felt through the second half of FY 2013 prior to the tax hike in April. The rebound from this last-minute demand and the fall in real purchasing power will mean that consumer spending will drop dramatically in the April–June period next year. Based on the experience of 1997, the last time the consumption tax went up, we anticipate that consumption will start to recover from the July–September period. Despite this, however, the downfall anticipated for April–June will result in a small decrease over the fiscal year as a whole.

Residential investment: This is an area where last-minute demand is already having a clear effect. There are already signs that a rebound may have begun. Since October, the number of new orders placed with major building contractors has in fact started to fall. But because of the time lag that occurs between placing an order and starting construction work, as well as the fact that last-minute demand is likely to continue through the October–December period for rental and built-for-sale housing which have short construction periods, we expect new building construction to peak in the October–December period. The rebound and decline in purchasing power likely emerge from January–March 2014 will mean a drop in housing investment. We expect this to pull down real growth for FY 2014 by 0.3 percentage points.

We expect private non-residential investment to increase. Company profits continue on an upward curve, and there has been a dramatic improvement in the corporate earnings environment. Also, many companies have restricted spending on facilities and equipment in recent years, with the result that there is no longer a surplus. In large non-manufacturing enterprises, there is a growing feeling that facilities and equipment are insufficient. Taking this improving environment for non-residential investment into account, we expect a 4% growth in FY 2014.

Real exports were down by 1.1% in July–September, the first decrease in three quarters. They are likely to recover by the October–December period thanks to an improved economic climate internationally and a slight depreciation in the value of the yen against other currencies. The US economy bottomed out in the October–December period last year, and has been recovering steadily ever since. However, this trend is likely to slow down in the same period this year. High interest rates for housing loans are continuing to impede the recovery of the housing market; in addition, the federal government shutdown has also likely affected economic performance adversely. However, the employment situation is showing clear signs of improvement, and new car sales are holding steady at an annual rate of more than 15 million units, suggesting that the US economy remains on a sound footing. Real growth for 2014 is likely to recover to somewhere in the region of 2.5%.

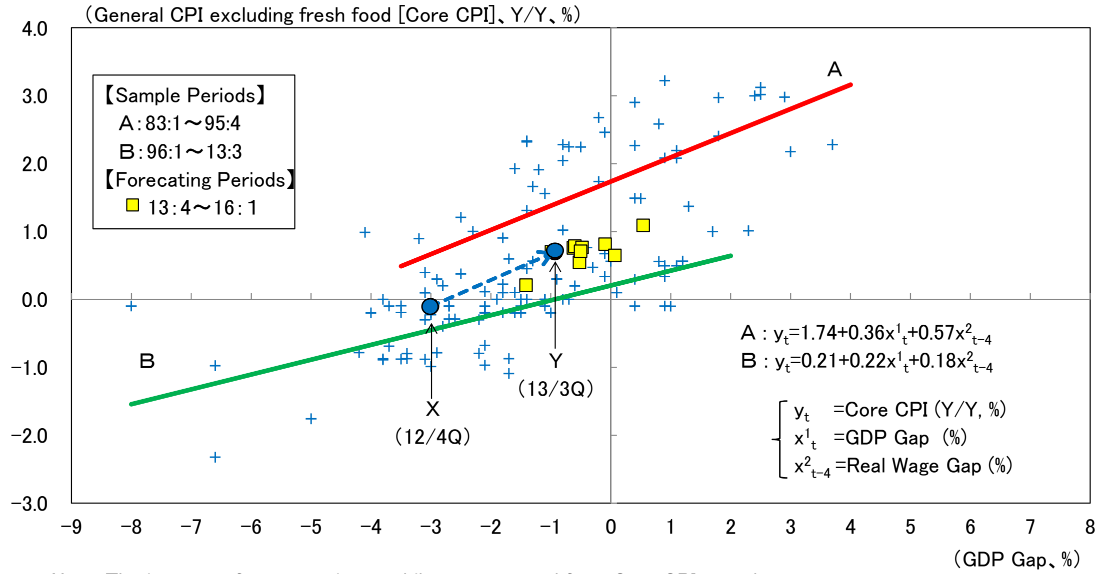
The Eurozone also seems to have emerged from recession at last. Real growth has now increased for two successive quarters, and we expect the economy to continue along the path to recovery. However, the pace of recovery is likely to remain sluggish. Problems with non-performing loans, especially in the South European countries, are weakening the impact of monetary easing, companies are putting a clamp on wages and hiring in an attempt to rebuild competitiveness, and governments are sticking with austerity policies. This "Japanization" is likely to lead to disinflation in Southern Europe and will limit the pace of economic recovery in the long term. In China, annual real growth for 2013 should achieve the government target of 7.5%, but from 2014, we expect a soft landing scenario toward the potential growth rate somewhere between 7% and 7.5%.

On exchange rates, the differing approaches to monetary policy of the Bank of Japan and the US Federal Reserve are likely to affect currency markets. While the Fed moves toward a tapering of the third stage of quantitative easing (QE3), Japan looks likely to continue with further easing in April next year, with the government's "price stability targets" still some distance away. The different levels of enthusiasm for monetary easing in the two countries will become clearer in the months to come, and as a result, the slight trend toward a weaker yen is unlikely to come to an end anytime soon.

Finally, a few words on the outlook for inflation: At present, the core Consumer Price Index (CPI, all items less fresh food products) is up by between 0.7% and 0.8% over last year. The big picture remains unchanged, with higher energy prices continuing to push up the total, but it is worth noting that the margin of the negative growth is shrinking steadily. In particular, recreational durables, such as computers and televisions, are up over last year, suggesting that prices for IT goods may be shifting away from their long-term downward trajectory.

In spite of this, the increase in the core CPI caused by the rapid correction of the value of the yen is now likely to slow; we expect the core CPI to grow by around 0.7% or more in FY 2013. In FY 2014, the consumption tax rate hike should lift this to a year-on-year increase of around 2.7%. Setting aside the influence of the tax hike, however, the increase in real terms is likely to be much smaller, in the region of 0.6%. This forecast is based on the Phillips curve analysis described below.

Fig. 2 The Hybrid Phillips Curve Analysis



Note: The impacts of consumption tax hike are removed from Core CPI growth rates .
Source: Cabinet Office, Ministry of Internal Affairs and Communications

We estimated a hybrid Phillips curve for the two periods (A) and (B), before and after 1995, the year in which the working-age population (15 to 64) began to decrease. The GDP gap and real wage gap were used as the two explanatory variables. This showed a downward shift in the slope of the Phillips curve from A to B, as well as a fall in the GDP gap coefficient (Fig. 2). The first of these factors suggests that the rate of inflation will be lower under the same positive economic conditions. The second shows that the pace of inflation in response to an expanding economy is more sluggish than before. We estimated the year-on-year increase in the core CPI by extrapolating predictions for the GDP gap and real wage gap based on the estimated results for period B. This gave forecasts of 0.6% for FY 2014 and 0.7% for FY 2015. These results suggest that as well as continued economic growth and a clear increase in real wages, a certain amount of time will be necessary, in order to achieve the Bank of Japan's 2% price stability target.

Table. The Outlook for Japan's Economy

Forecast →

	FY2013 1st Qtr	2nd	3rd	4th	FY2014 1st Qtr	2nd	3rd	4th	FY2015 1st Qtr	2nd	3rd	4th	FY2012 Actual	FY2013 Forecast	FY2014 Forecast	FY2015 Forecast
Real GDE (Chained 2005 Yen) *	0.9	0.5	1.1	0.5	-1.5	0.8	0.8	0.3	0.1	0.5	-0.4	0.1	1.2	2.6	0.6	1.1
Real GDE (Chained 2005 Yen) **	1.1	2.7	3.6	3.0	0.6	0.9	0.7	0.4	2.0	1.7	0.4	0.2				
Private Consumption *	0.6	0.1	0.5	1.2	-3.2	1.4	0.9	0.2	0.2	0.7	-0.9	0.2	1.6	2.0	-0.5	1.3
Private Residential Investment *	0.4	2.7	7.3	-1.0	-8.3	-7.3	-4.1	1.1	5.0	2.9	-2.5	-1.7	5.3	9.7	-11.9	2.1
Private Non-Residential Investment *	1.1	0.2	2.0	1.6	0.9	0.7	0.8	0.8	0.9	0.6	0.4	0.1	-1.3	1.2	4.3	2.8
Public Investment *	4.8	6.5	0.5	-2.9	-4.3	0.5	2.0	-1.6	-7.5	-4.5	-3.0	-2.8	14.9	13.6	-3.8	-12.6
Domestic Demand ***	0.8	0.9	0.8	0.4	-1.7	0.7	0.6	0.2	0.0	0.3	-0.7	-0.1	2.0	2.5	0.0	0.5
Foreign Demand ***	0.1	-0.5	0.3	0.1	0.3	0.1	0.2	0.1	0.1	0.1	0.2	0.2	-0.8	0.2	0.6	0.6
Exports of Goods & Services *	2.9	-0.6	3.0	1.7	1.3	1.4	1.6	1.5	1.4	1.4	1.3	1.3	-1.2	4.8	6.2	5.8
Imports of Goods & Services *	1.7	2.2	1.4	1.3	-0.4	0.6	0.3	0.7	1.2	0.8	-0.0	0.3	3.9	4.2	2.7	2.7
GDE at Current Prices *	1.1	0.4	1.2	0.4	-0.3	0.8	0.9	0.1	0.3	0.6	0.5	0.0	0.3	2.4	1.8	1.8
Indices of Industrial Production *	1.5	1.7	1.6	1.8	-2.1	0.8	0.7	0.7	0.4	0.6	-0.7	0.1	-2.9	2.7	1.5	1.6
Unemployment Rate (%)	4.0	4.0	4.0	3.9	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	4.3	4.0	3.8	3.8
Compensation of Employees **	1.1	0.5	1.0	0.6	0.9	0.5	0.3	0.4	0.2	0.5	0.6	0.7	-0.3	0.8	0.5	0.5
10-Year Government Bond Yield (%)	0.731	0.768	0.628	0.688	0.747	0.777	0.807	0.837	0.867	0.898	0.929	0.960	0.781	0.704	0.792	0.913
Nikkei Stock Average (Yen)	13,629	14,128	14,440	14,635	14,483	14,773	15,182	15,314	15,419	15,690	15,478	15,648	9,612	14,208	14,938	15,559
Yen to US Dollar Exchange Rate	98.8	98.9	99.1	99.5	100.5	101.2	102.5	103.2	103.9	104.5	105.2	105.8	82.9	99.1	101.9	104.8
WTI Crude Oil Price (Dollar / Barrel)	94.2	105.8	103.5	100.2	99.3	99.7	99.0	98.7	97.7	97.7	97.7	97.8	92.0	100.9	99.2	97.7
Corporate Goods Price Index **	0.7	2.2	3.2	3.0	5.1	4.3	3.6	3.1	0.4	0.3	2.3	2.2	-1.1	2.3	4.0	1.3
Consumer Price Index, All Items Less Fresh Food **	0.0	0.7	0.9	1.2	2.9	2.5	2.6	2.6	0.6	0.7	2.1	2.1	-0.2	0.7	2.7	1.4
Current Balance of Payments / Nominal GDP (%)	1.9	0.5	0.5	0.7	1.2	0.8	1.0	1.3	1.8	1.4	1.9	2.2	0.9	1.0	1.3	1.4
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	2.5	2.8	1.6	2.6	2.7	2.7	2.9	2.8	2.8	2.8	2.8	2.7	2.8 (C.Y.)	1.6 (C.Y.)	2.5 (C.Y.)	2.8 (C.Y.)
Real China GDP (1990 Prices) **	7.5	7.8	7.6	7.5	7.4	7.0	7.0	7.3	7.2	7.2	7.2	7.2	7.7 (C.Y.)	7.6 (C.Y.)	7.3 (C.Y.)	7.2 (C.Y.)

[Notes] 1. * Changes from the previous quarter (%), ** Year-on-year percentage change (%), *** Contributions to changes in real GDE growth over the previous period (%pt)

2. Figures for the corporate goods price index, consumer price index, indices of industrial production are at 2010 year basis.

3. Figures for GDP components, compensation of employees, unemployment rate, indices of industrial production and current account are seasonally adjusted.

4. Japan's fiscal year is April 1 to March 31.

5. Figures for the 10-year government bond yield, stock prices, oil prices, exchange rate and unemployment rate are shown as period averages.