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SA157 Short-Term Forecast of the Japanese Economy (2014/1-3—2016/1-3)

Stable Economic Climate Despite Tax Hike
- Recovery in household spending expected in July-September 2014
- Maintain decisive policies for growth

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- Declining competitiveness of electronics industry slowing recovery of external demand
- The US economy will regain strength once cold weather passes
- Consumer prices likely to be sluggish in fiscal 2014

Gross domestic product growth, which was expected to accelerate, instead remained flat during the October–December period of fiscal 2013. While the predicted increase in domestic demand has materialized, external demand (net exports) has been driven down considerably as exports have remained flat and imports have swelled. Below we explain our forecast of whether the Japanese economy can maintain growth after the April consumption tax hike.

The current economic trend is toward stronger domestic demand. Increased consumption of such products as cars is being seen prior to the higher consumption tax rate coming into force, with growth likely peaking in the January–March period on last-minute demand for nondurable consumer goods. Housing investments are now seeing a decline as we approach the hike in the tax rate, but they have been up substantially for fiscal 2013 as a whole. Moreover, the recovery in investments in property, plant, and equipment is gaining traction in an improved earnings environment.

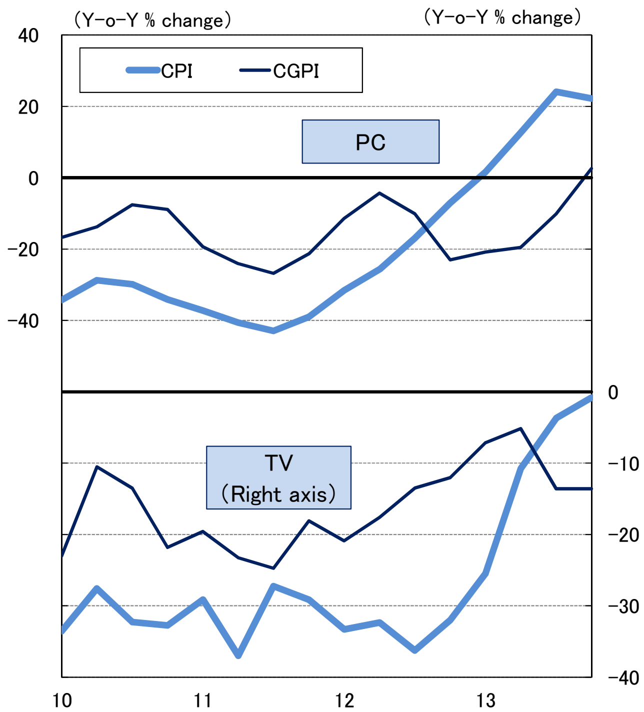
One area of concern is external demand. Exports remain sluggish despite a weaker yen, while imports have spiked, driven by such factors as last-minute demand ahead of the consumption tax hike and special demand for personal computers due to Microsoft ending support for Windows XP. As a result of this downswing in overseas demand we have adjusted our real growth forecast for fiscal 2013 down slightly to 2.3%.

A key point for fiscal 2014 will be the longevity of this downswing. We predict a positive trend of steady growth in exports and slowdown in imports as last-minute demand subsides. This will result in an increase in overseas demand and continued, steady economic recovery. Real growth for fiscal 2014 is forecast to be on par with the potential growth rate of 0.6 %.

Changes in trade structures—along with declining Japanese competitiveness, particularly of the electronics industry in markets for information and communication devices—lie behind the stagnant growth in exports. The superiority once enjoyed by domestic manufacturers has waned as manufacturers in emerging economies have come to the forefront in markets for products like PCs and televisions. Imports are accounting for a larger portion of domestic supplies as manufacturing continues to move overseas, and compared to when the yen was weak, the likely result of more imports will be a sluggish recovery in overseas demand.

Changes in the structure of the electronics industry are also affecting commodity prices. The graph below looks at desktop computers and televisions to compare the rate of increase for the consumer price index and the corporate goods price index. The CPI includes import goods, while the CGPI is limited to domestically produced goods.

Fig. Change in Prices



(Note) CPI (TV) has been adjusted to reflect quality improvements made in February 2012.
(Source) Bank of Japan, Ministry of Internal Affairs and Communications

In both product categories, the CPI was initially lower but has surpassed the CGPI through a rapid increase or by ending its slide, suggesting that the increase in import goods has lifted the CPI while the yen is weak.

Exports will continue to grow at a steady pace as more overseas economies, being led by the United States, recover and the yen remains weaker.

The forecast for overseas economies is as follows.

The US economy is sound despite some slowing due to the cold weather. The annualized rate for new car sales has remained at 15 million, with the manufacturing industry receiving over 50 points on the Institute for Supply Management's index. Employment also continues to improve, meaning the country will be gearing up for expected real growth of 2.5%–3% once the cold weather passes.

The euro zone is also steadily recovering. Though problems from bad debt have made banks reluctant to lend money and a reduction in wages in southern Europe is weighing down a recovery, the soundness of the German economy will help bolster the region.

China will likely remain in its monetary tightening situation as it takes measures to bring shadow banking under control. Although market conditions will remain fragile, flexible fiscal policy will help limit any negative effects, with the economic growth rate expected to slow down to 7%, the country's potential growth rate estimated by JCER.

Looking at domestic demand, a rebound in last-minute consumer demand and a decrease in real purchasing power from the tax hike will undoubtedly result in decreased consumption. However, the drop in consumption for fiscal 2014 can be minimized and a quick recovery can be expected by the July–September period if high consumer confidence resulting from the strong stock market is maintained. As we saw with the previous tax hike in April 1997, a tax-induced drop in consumption was only seen in the April–June period. Recovery of high-value housing investments, on the other hand, is expected to take time, with concerns about an additional tax increase in October 2015 causing a large-scale decrease in investments for fiscal 2014.

While there is concern that real growth in public-sector demand for fiscal 2014 will take a hit as the demand for fiscal 2013 was lifted by the fiscal 2012 supplementary budget subsides, this should be boosted by the supplementary budget for fiscal 2013. We expect investment in property, plant, and equipment to continue its upward curve, helped by factors including monetary easing and an improved corporate earnings environment.

The CPI (excluding fresh food) was up 0.8% year on year for fiscal 2013, but even minus the effect from the tax hike, this growth rate should stall at 0.7% in fiscal 2014. An examination of the supply-demand gap (which affects prices), wages, exchange rates, energy prices, and other factors shows that none are strong enough to contribute a boost to prices in fiscal 2014. It should be kept in mind, though, that the previously mentioned core changes to the electronics industry may lead to an upswing in prices.

As potential risk factors, we can point to negative effects on emerging markets due to contraction caused by the third stage of US quantitative easing (QE3), the fragility of the Chinese financial markets, and the failure of the third arrow of Prime Minister Shinzo Abe's "Abenomics" growth strategy to meet expectations.

Overseas investors encouraged by the prime minister's policies have been making large-scale purchases of Japanese stocks, with higher stock prices bolstering consumption by creating wealth and driving up consumer confidence. The situation is the same as that seen in fiscal 2003, when sustained quantitative easing was increased after Fukui Toshihiko was appointed as governor of the Bank of Japan. Even though the yen was strong, stock prices were driven up by the anticipated easing of government regulations.

Even with a temporary downswing caused by the tax hike, stock prices will continue their steady rise as long as decisive policies for growth are maintained. What is needed is a positive view toward accelerated growth over the mid- and long term.

Table. The Outlook for Japan's Economy

Forecast

	FY2013				FY2014				FY2015				FY2012	FY2013	FY2014	FY2015
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	Actual	Forecast	Forecast	Forecast
Real GDE (Chained 2005 Yen) *	1.0	0.3	0.3	1.1	-1.2	0.4	0.6	0.5	0.0	0.6	-0.7	0.4	0.6	2.3	0.6	1.1
Real GDE (Chained 2005 Yen) **	1.2	2.3	2.7	2.7	0.4	0.6	0.9	0.3	1.6	1.8	0.5	0.4				
Private Consumption *	0.6	0.2	0.5	1.9	-2.8	0.4	0.3	0.3	0.4	0.9	-1.4	0.5	1.5	2.4	-0.5	1.0
Private Residential Investment *	0.9	3.3	4.2	-1.3	-9.0	-5.7	1.6	4.0	4.0	-1.0	-3.6	-2.8	5.3	8.3	-9.7	3.0
Private Non-Residential Investment *	1.1	0.2	1.3	2.4	-0.2	1.0	0.9	0.9	1.0	1.6	0.0	0.8	0.7	0.8	3.8	3.8
Public Investment *	6.9	7.2	2.3	-1.1	0.5	0.3	0.1	-0.1	-8.5	-1.5	-1.2	1.0	1.3	15.8	2.8	-9.8
Domestic Demand ***	0.8	0.8	0.8	1.3	-1.7	0.3	0.4	0.4	0.1	0.7	-1.0	0.2	1.4	2.5	0.3	0.8
Foreign Demand ***	0.1	-0.5	-0.5	-0.2	0.4	0.2	0.2	0.1	-0.1	-0.0	0.3	0.2	-0.8	-0.3	0.2	0.3
Exports of Goods & Services *	2.9	-0.7	0.4	0.9	1.5	1.5	1.6	1.5	1.2	1.2	1.4	1.5	-1.2	3.4	4.7	5.6
Imports of Goods & Services *	1.8	2.4	3.5	2.2	-1.3	0.7	0.4	1.0	1.7	1.5	-0.1	0.5	3.7	5.8	3.6	4.1
GDE at Current Prices *	1.0	0.2	0.4	0.4	0.3	0.5	0.9	0.7	-0.1	0.5	-0.1	0.6	-0.2	1.7	1.9	1.6
Indices of Industrial Production *	1.5	1.7	1.8	3.8	-2.4	0.9	0.8	0.7	0.5	0.6	-0.6	0.1	-2.9	3.3	3.0	1.9
Unemployment Rate (%)	4.0	4.0	3.9	3.8	3.7	3.7	3.7	3.7	3.7	3.6	3.6	3.6	4.3	3.9	3.7	3.6
Compensation of Employees **	1.2	0.6	1.8	1.7	1.6	1.0	0.3	0.3	0.5	0.6	0.6	0.5	0.1	1.3	0.8	0.5
10-Year Government Bond Yield (%)	0.731	0.768	0.636	0.625	0.659	0.694	0.728	0.762	0.803	0.844	0.884	0.889	0.781	0.690	0.711	0.855
Nikkei Stock Average (Yen)	13,629	14,128	14,951	14,834	15,021	15,848	16,108	15,968	16,380	17,033	17,057	17,008	9,612	14,386	15,736	16,870
Yen to US Dollar Exchange Rate	98.8	98.9	100.3	102.6	103.1	103.5	104.7	105.2	105.6	106.8	107.2	107.9	82.9	100.1	104.1	106.9
WTI Crude Oil Price (Dollar / Barrel)	94.2	105.8	97.6	97.0	96.4	94.1	91.8	89.9	90.2	90.7	91.2	91.7	92.0	98.7	93.0	90.9
Corporate Goods Price Index **	0.7	2.2	2.5	2.8	5.3	4.5	4.3	3.5	0.4	0.4	2.1	2.3	-1.1	2.1	4.4	1.3
Consumer Price Index, All Items Less Fresh Food **	0.0	0.7	1.1	1.5	2.8	2.7	2.7	2.8	1.1	0.9	2.0	1.9	-0.2	0.8	2.8	1.5
Current Balance of Payments / Nominal GDP (%)	1.9	0.5	-0.3	-0.2	0.1	0.0	0.1	0.6	0.2	0.0	0.1	0.8	0.9	0.4	0.4	0.5
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	2.5	4.1	3.2	1.9	2.4	2.7	2.9	2.7	2.8	2.8	2.8	2.7	2.8	1.9	2.7	2.8
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real China GDP (1990 Prices) **	7.5	7.8	7.7	7.5	7.5	7.0	7.0	7.2	7.1	7.0	6.9	7.0	7.7	7.7	7.3	7.0
													(C.Y.)	(C.Y.)	(C.Y.)	(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.