May 2014

SA158 Short-Term Forecast of the Japanese Economy (2014/4-6—2016/1-3)

Sustained Expansion Will Resume in July–September as Effects from Tax Hike Subside

- Upswing in capital investment brings high January–March growth in real GDP

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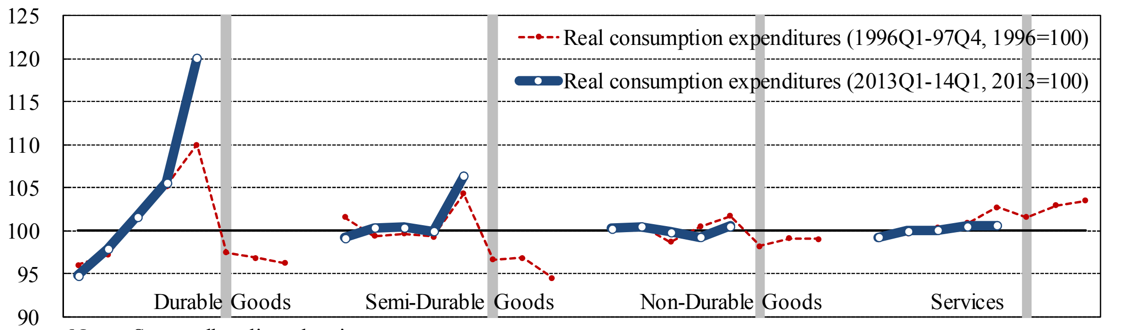
- Last-minute demand prior to tax hike exceeds that seen in 1997
- Recovery from downturn from tax hike will start in July–September 2014
- Geopolitical unrest and US disinflation concerns could be risk factors to drive up yen

Real GDP growth was strong during January–March 2014, reaching 1.5% from the previous quarter, or an annualized rate of 5.9%. This strong growth was due to last-minute demand prior to the April consumption tax hike combined with an upswing in capital investments and revisions of balance-of-payment statistics, which produced larger net exports than initially projected. The environment will likely remain positive, and in light of revised trade figures, we have adjusted growth projections up to 0.7% for fiscal 2014. Below we check the current economic state and explain our forecast for the economy.

Looking back at last-minute consumer spending in January–March 2014, prior to the April consumption tax hike, shows that purchases of goods, specifically durable items, increased more than what was seen in the same period prior to the previous consumption tax increase in 1997 (Fig. 1). Spending on services, however, grew less than it did in the first quarter of 1997.

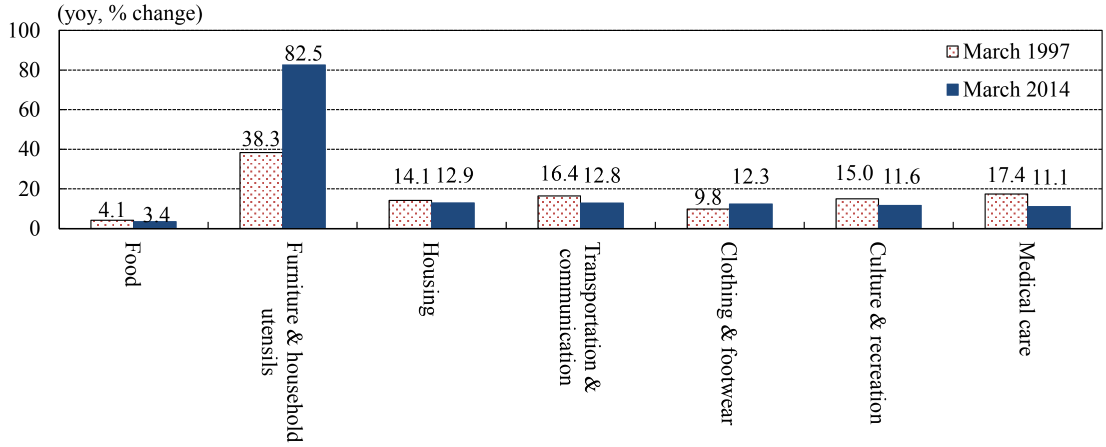
Figure 1 Households consumption before and after consumption tax hike (comparison of 1997 and 2014)



Notes: Seasonally adjusted series.
Shadow period shows when consumption tax rate was raised.
Source: Cabinet Office, "Quarterly Estimates of GDP"

A survey of household expenditure shows last-minute demand was up nearly across the board. Outlays on furniture and household utensils were particularly high, rising 82.5% year on year to eclipse the 38.3% jump seen in March 1997 (Fig. 2). Household spending was boosted most by purchases of durable household goods, such as refrigerators and air conditioners. Demand for many other items was also well above that seen in 1997, with particularly strong growth for underclothing, prescription glasses, train passes, PCs, and gasoline.

Figure 2 Real consumption growth in the month before tax hike (1997 and 2014)



Source: Ministry of Internal Affairs and Communications, "Family Income and Expenditure Survey"

Macroeconomic forces of improved earnings, pent-up demand, and growth of online shopping can be seen as factors driving demand for these items above 1997 levels. For example, online shopping may have acted to raise last-minute demand by incentivizing customers to make purchases from home and thus avoid crowded shops.

Personal spending in fiscal 2014 will decline as last-minute purchases prior to the April consumption tax hike reduce demand afterwards and real purchasing power wanes. Although spending is expected to drop significantly in April–June, it will rebound in July–September and end just 0.4% lower for the year. As incomes gradually improve, though, it will then shift upward to positive 0.9% growth in fiscal 2015. While a degree of last-minute demand is anticipated prior to the consumption tax being increased to 10% in October 2015, it is not expected to greatly affect overall growth for that year.

By type, construction starts of owned dwellings have followed a trend similar to that seen in 1997 and appears to have peaked in October–December 2013. Rentals, which were in decline from the last half of 1996 prior to the previous tax hike, have remained high for the year this time. Rental properties have been bolstered by efforts to reduce tax burdens in view of a hike in the inheritance tax planned for 2015. While last-minute demand for construction on dwellings built for sale prior to the 1997 tax hike was held in check due to stock adjustment, sales this time around have remained similar to those seen for homeownership, dropping off after the last-minute demand surge.

While construction starts of new homes began to decline in January–March 2014, real GDP figures for housing investments over this period remained 3.1% above the previous quarter. This is less than the growth seen in October–December 2013, which was up 4.3% from the previous quarter, and the market will likely continue to lose momentum in April–June. The drop in housing investment will take longer to recover compared to other types of consumption. While there will be a considerable decline in fiscal 2014, the market is expected to see positive growth from fiscal 2015.

Turning to monetary indicators, the trend toward a gradual weakening of the yen and rise in stock prices is expected to continue. Factors behind this are (1) the general soundness of the American economy, (2) the view that US interest rates will be raised in the last half of 2015 as the US Federal Reserve gradually tapers the third round of quantitative easing (QE3), (3) further continuation of quantitative and qualitative easing by the Bank of Japan, and (4) the likelihood that US-Japan interest rate gaps will widen.

Real exports remain sluggish, but are still expected to maintain a gentle upward trajectory into fiscal 2015. This outlook is based on our forecast for overseas economies given below.

Real growth in the US GDP shrank in January–March 2014, the first such decline in three years, but is expected to get back on a positive track from the April–June period. The dip was caused by such temporary factors as unusually cold winter weather and a downturn in inventory in the wake of excessive accumulation in October–December 2013. Business sentiment and the employment market continue to recover, with the economy gearing up for 2.5%–3% growth stretching into 2015.

The euro zone remains on a steady course to recovery. The European economy posted the fourth consecutive quarter of real growth, expanding in January–March 2014 by 0.2% quarterly. Economic sentiment is also gradually improving.

China will likely remain in a situation of monetary and regulatory tightening as the People's Bank of China takes measures to bring shadow banking under control. GDP growth is expected to gradually slow down to the potential growth of around 7%. Although the Chinese government set the 2014 growth target at 7.5% during the National People's Congress held in March this year, we maintain the view that this goal will be difficult to meet.

Looking at domestic public-sector demand in Japan, the main boost provided by the 2012 supplementary budget has passed and public demand has leveled off. Impact from the 5.5 trillion yen fiscal 2013 supplementary budget approved on February 6 this year will begin to be felt in April and is expected to contribute to positive growth in the first half of this fiscal year. This will result in 0.2% contribution to real GDP growth for fiscal 2014.

Capital investment will continue an upward trend. Corporate earnings, after large advances in fiscal 2013, are expected to give way to smaller gains in fiscal 2014, but will remain at a high level and demand for stocks of facilities and equipment is rising. A favorable environment for investment will remain in place thanks to monetary easing, healthy corporate cash flow, and slight shortages on the stock side for facilities and equipment.

As a result, the economy is expected to expand in real terms by 1.1% into fiscal 2015 as investment and other demand returns. Risks to the economy exist from (1) increased drag brought on by the consumption tax hike, (2) a downswing in net exports as the electronics and other industries continue to hollow out, (3) effects on markets in emerging economies from tapering of QE3 measures in the United States, (4) fragility of the Chinese financial market, (5) geopolitical instability, such as the situation in Ukraine, and (6) foreign exchange market fluctuation. In the United States, employment has been improving, but the rate of inflation, by comparison, is flat and long-term interest rates may remain lower than expected, which has the potential to increase upward pressure on the yen. Geopolitical instability could also drive up the yen and needs to be watched carefully.

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	Actual	Forecast	Forecast
Real GDE (Chained 2005 Yen) *	0.9	0.3	0.1	1.5	-1.0	0.4	0.4	0.3	0.2	0.8	-0.6	0.3	0.7	2.3	0.7	1.1
Real GDE (Chained 2005 Yen) **	1.3	2.4	2.5	3.0	0.8	0.9	1.2	0.0	1.3	1.8	0.8	0.8				
Private Consumption *	0.7	0.2	0.4	2.1	-2.8	0.5	0.4	0.2	0.3	1.0	-1.5	0.4	1.5	2.5	-0.4	0.9
Private Residential Investment *	0.8	3.3	4.3	3.1	-8.8	-6.3	0.4	4.7	4.2	1.1	-3.6	-3.3	5.3	9.5	-7.4	4.3
Private Non-Residential Investment *	1.0	0.7	1.4	4.9	-1.3	1.1	0.9	1.0	1.2	1.5	-0.2	0.9	0.8	1.7	4.8	4.0
Public Investment *	6.4	6.9	1.2	-2.4	4.6	-1.0	-1.5	-1.9	-4.6	0.0	0.4	-1.0	1.3	15.3	2.9	-6.9
Domestic Demand ***	0.7	0.8	0.6	1.7	-1.5	0.2	0.2	0.3	0.3	0.9	-0.9	0.2	1.4	2.8	0.3	0.9
Foreign Demand ***	0.1	-0.5	-0.6	-0.3	0.5	0.2	0.2	0.1	-0.1	-0.0	0.3	0.2	-0.8	-0.5	0.4	0.3
Exports of Goods & Services *	2.9	-0.7	0.5	6.0	2.0	1.5	1.6	1.4	1.1	1.2	1.4	1.4	-1.2	4.7	9.0	5.3
Imports of Goods & Services *	1.8	2.4	3.7	6.3	-1.2	0.7	0.4	1.0	1.7	1.5	-0.1	0.5	3.7	7.1	6.9	4.0
GDE at Current Prices *	0.9	0.2	0.2	1.2	0.5	0.3	0.5	0.4	0.4	0.9	-0.1	0.4	-0.2	1.9	2.2	1.8
Indices of Industrial Production *	1.6	1.8	1.8	2.9	-1.6	0.6	0.8	0.7	0.7	1.8	-1.3	0.3	-2.9	3.2	2.9	2.5
Unemployment Rate (%)	4.0	4.0	3.9	3.6	3.7	3.7	3.7	3.7	3.6	3.6	3.6	3.6	4.3	3.9	3.7	3.6
Compensation of Employees **	1.2	0.6	1.6	0.4	0.8	0.8	0.5	1.0	0.7	0.9	0.6	0.3	0.1	1.0	0.8	0.6
10-Year Government Bond Yield (%)	0.731	0.768	0.636	0.625	0.609	0.634	0.660	0.685	0.710	0.740	0.770	0.801	0.781	0.691	0.647	0.755
Nikkei Stock Average (Yen)	13,629	14,128	14,951	14,959	14,356	14,773	15,309	15,543	15,812	16,259	16,343	16,550	9,612	14,407	14,995	16,241
Yen to US Dollar Exchange Rate	98.8	98.9	100.3	102.7	102.2	103.2	104.7	105.1	106.1	106.5	107.4	107.8	82.9	100.1	103.8	107.0
WTI Crude Oil Price (Dollar / Barrel)	94.2	105.8	97.6	98.6	101.0	99.0	96.3	93.9	92.6	92.9	93.4	93.9	92.0	99.1	97.6	93.2
Corporate Goods Price Index **	0.7	2.2	2.5	1.9	4.5	4.0	4.0	4.0	0.8	0.7	2.4	2.2	-1.1	1.9	4.1	1.5
Consumer Price Index, All Items Less Fresh Food **	0.0	0.7	1.1	1.3	3.3	3.0	2.8	2.8	0.7	0.7	1.6	1.6	-0.2	0.8	2.9	1.1
Current Balance of Payments / Nominal GDP (%)	1.5	0.5	0.0	-1.2	-0.2	0.0	0.7	0.4	0.2	0.0	0.7	0.6	0.9	0.2	0.2	0.3
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	2.5	4.1	2.6	0.1	3.9	3.1	2.9	2.6	2.6	2.6	2.6	2.6	2.8	1.9	2.5	2.8
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real China GDP (1990 Prices) **	7.5	7.8	7.7	7.4	7.4	6.9	6.9	7.2	7.0	7.0	6.9	6.9	7.7	7.7	7.2	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.