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SA159 Short-Term Forecast of the Japanese Economy (2014/7-9—2016/1-3)

Japan's Economy to Return to Growth from July–September - But instability in emerging economies could pose risks

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- Domestic consumption rebounds, and exports finally recover
- Deflation risks fade as wages rise
- Structural reforms should proceed in a timely manner to reduce future uncertainties

Real GDP fell by 6.8% in April–June 2014, the biggest quarterly drop since the March 2011 Great East Japan Earthquake. Private domestic demand was down across the board, the only exception being inventory investment. External demand pushed up GDP, but only because imports fell. On the surface, this gives the impression that the consumption tax hike in April had a devastating impact on the Japanese economy. Below is our forecast of what is in store for the summer and subsequent months.

In short, there is no need to be overly pessimistic, as the economy should rebound strongly in July–September. For one thing, the impact of the downturn following last-minute, pre-consumption-tax-hike spending will have worn itself out by then. And for another, the impact of the fiscal 2013 supplementary budget will contribute to positive growth.

But the real test will be whether the upward momentum can be sustained thereafter. We have lowered our fiscal 2014 forecast from 0.8% real growth (as of June) to 0.5%, but we anticipate 1.3% growth in fiscal 2015. The key to powering such an upswing will be (1) exports, (2) consumption, and (3) capital investments. These have all been rather weak of late, which prompted us to revise our forecast, but they will continue to be the key engines of growth for the Japanese economy.

Exports, the first engine, should rise gradually owing to higher demand in foreign markets, as signs of a recovery are steadily appearing around the world, primarily in industrialized countries. There was robust and well-balanced real GDP growth in the US economy in April−June, led by accelerated personal consumption and capital investment, as well as a rebound in housing sales and exports.

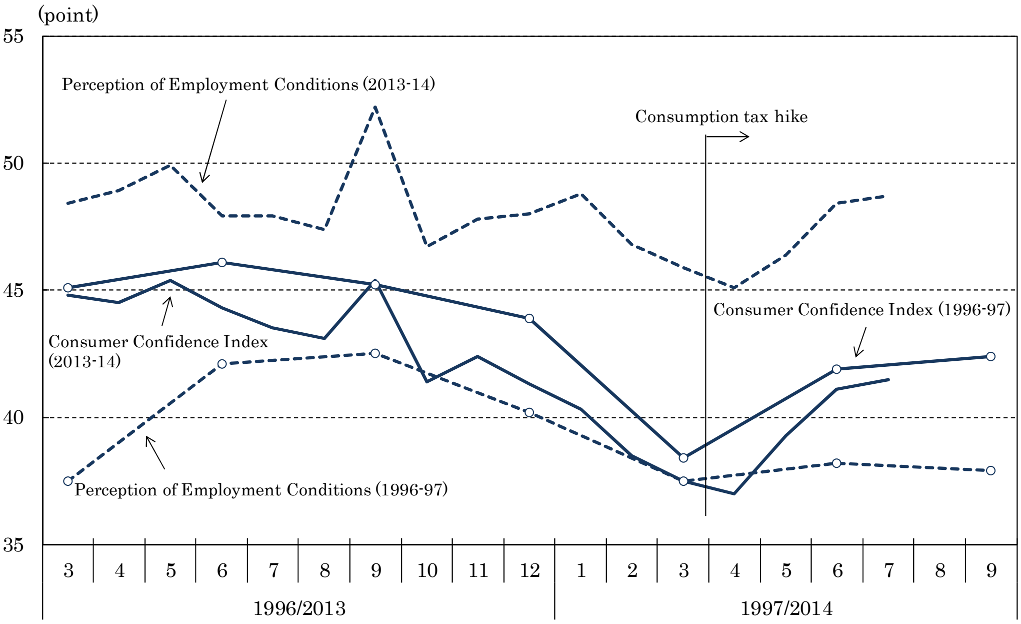
Geopolitical risks and the aftereffects of the financial crisis could cause a downswing in the euro zone, but the general recovery trend should continue. While China has many latent, structural issues that will need to be addressed over the long run, the adoption of timely economic stimulus measures is averting a slowdown for now. Other emerging economies, meanwhile, have divergent issues, but they are gradually growing more stable, for the most part, as volatility in the international financial market recedes.

Expectations of higher export growth have thus far—through the first half of 2014—been betrayed. Factors include a lowering of domestic production capacity resulting from the localization of the automobile supply chain overseas and a decline in the competitiveness of electrical appliances. Adding to these structural factors has been the recent weakness of foreign demand; as demand in other markets picks up, exports, too, should finally begin to grow.

Domestic demand should also continue to increase slowly. As the impact of the fiscal 2013 supplementary budget begins to wear out toward the end of 2014, ending its role as the prime driver of growth, private-sector demand should cover the slack. Personal consumption, in other words, will emerge as the second engine of growth. The shock of the consumption tax hike should eventually dissipate as employment increases and wages rise.

Figure 1 compares trends in the consumer confidence index following the 1997 and 2014 consumption tax hikes. The index overall declined in both cases as the date of the higher tax approached before subsequently returning to pre-hike levels, but confidence regarding employment remained much higher this time than in 1997. Because people are less worried about their jobs today, consumer confidence is likely to remain high, bolstering consumption.

Figure 1: Consumer Confidence Index



Note: 1996-97 data are quarterly.
Source: Cabinet Office "Consumer Confidence Survey"

The third engine of growth, namely, capital investment, has leveled off of late, but given the healthy earnings of many companies and their need to expand production capacity, it should remain strong going forward. Another piece of good news is that business confidence has not taken much of a slide since the consumption tax hike.

Housing investment during the current fiscal year will inevitably remain significantly lower in reaction to the spike in pre-hike demand. But it should contribute positively to GDP next fiscal year with the anticipated boom in sales prior to the next scheduled hike in the consumption tax in October 2015.

The consumer price index (excluding fresh food) is forecast to rise 1.0% in fiscal 2014 and 0.9% in fiscal 2015, not accounting for the impact of the tax hike. Upward pressure on prices from a weaker yen has largely dissipated, and the negative gap between supply and demand has recently been expanding again, but the CPI should continue rising as companies pass the cost of higher wages on to product prices.

The GDP deflator for April–June, too, was positive for the first time since July–September 2009, confirming that prices are indeed rising, even without the tax hike. The Bank of Japan’s 2% inflation target may still be hard to reach, but the risk of sliding back into deflation has clearly waned.

Risks going forward include heightened geopolitical tensions and the potential for turmoil in the international financial market over the FRB’s exit from unconventional monetary policy. Should there again be massive withdrawals of funds from emerging markets, as we saw in the middle of last year, many foreign economies could lose steam, which would impact Japan’s exports, the first engine of growth.

Another concern is a slump in consumption, the second engine, for the drop in spending in April–June may be a reflection not just of last-minute demand prior to the tax hike, but of a decline in real income.

We nonetheless believe that the government should go ahead with the second scheduled hike in the consumption tax in October 2015 in order to eradicate future concerns about Japan’s economic policy. There is no question that another hike would impact negatively on household spending, but there is no choice but to raise the tax in the light of Japan’s precarious fiscal situation. Even if a hike were to be postponed, this would only heighten uncertainty about Japan’s fiscal viability and may even further dampen consumption.

Prime Minister Shinzo Abe’s June announcement of lower corporate taxes under the Basic Policies for Economic and Fiscal Management and Reform and of structural reforms in his New Growth Strategy must be quickly followed up with effective and specific implementation measures and timetables. The prompt and steady implementation of these reforms will be a golden opportunity to heighten the confidence of companies, households, and investors in the sustained, longer-term growth of the Japanese economy.

(The original Japanese article was posted in the August 22, 2014 issue of the Nikkei)

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 Actual	FY2014 Forecast	FY2015 Forecast
Real GDE (Chained 2005 Yen) *	0.9	0.4	-0.0	1.5	-1.7	1.0	0.4	0.3	0.2	0.7	-0.3	0.1	0.7	2.3	0.5	1.3
Real GDE (Chained 2005 Yen) **	1.2	2.3	2.5	3.0	-0.1	0.7	1.2	0.0	2.0	1.6	0.9	0.7				
Private Consumption *	0.7	0.2	0.4	2.0	-5.0	1.7	0.8	0.3	0.4	1.1	-1.6	0.3	1.5	2.5	-1.7	1.5
Private Residential Investment *	2.1	4.7	2.4	2.0	-10.3	-5.1	-0.2	1.6	5.6	3.7	-3.5	-3.2	5.4	9.5	-10.1	5.6
Private Non-Residential Investment *	1.4	0.6	1.4	7.7	-2.5	1.0	0.8	0.9	0.9	1.6	-0.3	0.9	0.7	2.7	5.3	3.5
Public Investment *	5.8	7.1	1.4	-2.5	-0.5	2.7	-1.9	-2.5	-6.0	-1.0	-1.0	-1.7	1.3	15.1	0.4	-9.6
Domestic Demand ***	0.8	0.8	0.5	1.7	-2.8	1.0	0.5	0.3	0.3	0.8	-0.9	0.1	1.4	2.7	-0.1	1.1
Foreign Demand ***	0.1	-0.4	-0.6	-0.2	1.1	0.1	-0.1	0.1	-0.1	-0.1	0.6	0.1	-0.8	-0.5	0.6	0.2
Exports of Goods & Services *	3.0	-0.7	0.3	6.5	-0.4	2.1	1.1	1.3	1.2	1.1	1.5	1.4	-1.3	4.8	6.9	5.3
Imports of Goods & Services *	2.3	1.8	3.7	6.4	-5.6	1.8	1.8	1.0	2.0	1.8	-2.1	1.2	3.6	7.0	3.6	4.8
GDE at Current Prices *	0.3	0.3	0.3	1.6	-0.1	0.9	0.4	0.2	0.3	0.6	0.7	0.1	-0.2	1.9	2.2	1.7
Indices of Industrial Production *	1.6	1.8	1.8	2.9	-3.8	1.1	0.4	0.8	1.0	1.6	-1.0	0.1	-2.9	3.2	0.8	2.8
Unemployment Rate (%)	4.0	4.0	3.9	3.6	3.6	3.5	3.5	3.5	3.4	3.4	3.4	3.4	4.3	3.9	3.5	3.4
Compensation of Employees **	1.2	0.6	1.6	0.5	1.3	1.0	0.5	0.9	0.6	0.9	0.7	0.4	0.1	1.0	0.9	0.7
10-Year Government Bond Yield (%)	0.731	0.768	0.636	0.625	0.598	0.528	0.565	0.601	0.638	0.674	0.717	0.760	0.781	0.691	0.573	0.697
Nikkei Stock Average (Yen)	13,629	14,128	14,951	14,959	14,655	15,227	15,692	15,996	16,388	16,466	16,777	17,049	9,612	14,407	15,393	16,670
Yen to US Dollar Exchange Rate	98.8	98.9	100.3	102.7	102.1	102.1	103.0	103.9	104.9	105.2	106.1	106.4	82.9	100.1	102.8	105.6
WTI Crude Oil Price (Dollar / Barrel)	94.2	105.8	97.6	98.6	103.0	100.0	98.4	96.7	96.3	95.7	96.0	96.5	92.0	99.1	99.5	96.1
Corporate Goods Price Index **	0.7	2.2	2.5	1.9	4.4	3.8	3.8	3.8	0.8	0.8	2.5	2.3	-1.1	1.9	4.0	1.6
Consumer Price Index, All Items Less Fresh Food **	0.0	0.7	1.1	1.3	3.3	3.1	2.9	2.9	0.9	0.8	1.8	1.9	-0.2	0.8	3.0	1.3
Current Balance of Payments / Nominal GDP (%)	1.5	0.5	0.0	-1.1	0.5	0.2	0.5	0.0	-0.1	-0.1	0.8	0.4	0.9	0.2	0.2	0.2
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	1.8	4.5	3.5	-2.1	4.0	2.8	3.0	3.0	2.8	2.8	2.7	2.6	2.3	2.2	2.0	2.9
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real China GDP (1990 Prices) **	7.5	7.8	7.7	7.4	7.5	7.2	7.2	7.4	7.0	6.9	6.9	6.9	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.