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SA160R Short-Term Forecast of the Japanese Economy (2014/10-12—2017/1-3)

Real GDP Growth Revised Down to Negative Territory for Fiscal 2014 - A crash to be averted; gradual recovery expected

Atsushi TAKEUCHI
Chief Forecaster, Japan Center for Economic Research

- Improvement of income environment will boost personal consumption
- Favorable corporate earnings environment will support capital investment
- Several downward risks posed to European and Chinese economies.

Abstract

July–September 2014 saw real GDP growth fall for the second consecutive quarter. According to the Cabinet Office's second estimates, it contracted 1.9%, following the historic dip seen in the April–June period. By sector, early budget allotments for public work projects sent public-sector demand higher compared to the previous period. The reduction in inventories, however, pushed down the GDP growth. Additionally, Consumption of durable goods continued to decline as recovery from the plunge following last-minute demand prior to the consumption tax hike remained sluggish.

Looking at figures for the July–September period, we have revised our forecast for real GDP growth for fiscal 2014 down to –0.5%. Continued improvement in employment, however, is expected to boost real income, bolstering consumer spending. Lower oil prices will help materialize this scenario. Gradual improvement in domestic and overseas demand will buoy exports and capital investments. While over the full fiscal year the economy is expected to contract by 0.5%, there are signs that Japanese economy is on its way back to recovery.

Domestic and overseas demand for fiscal 2015 and 2016 will continue to expand, with real GDP growing 1.3% and 1.0%, respectively. The downturn in public demand as a reaction to increased spending seen to date will weigh down GDP growth. And, excluding the base effect, the speed of economic growth will stay close to 0.5%, corresponding to an estimate of potential growth of Japan.

Table1: Summary of Quarterly Forecast of the Japanese economy (SA160R)

(Year-on-year change, %)

(Fiscal Year)	2013	2014		2015		2016	
		SA159R	SA160R	SA159R	SA160R	SA159R	SA160R
Real GDE	2.1	0.4	▲0.5	1.3	1.3		1.0
Domestic Demand (Contribution)	2.6	▲0.3	▲1.3	1.0	1.1		0.9
Private Consumption	2.5	▲2.0	▲2.8	1.4	1.3		1.3
Private Residential Investment	9.3	▲10.2	▲11.2	5.6	1.2		▲2.0
Private Non-Residential Investment	4.0	3.1	0.4	3.8	2.8		3.5
Public Investment	10.3	0.4	1.0	▲9.6	▲3.8	n.a.	▲6.4
Foreign Demand (Contribution)	▲0.5	0.7	0.7	0.2	0.3		0.1
Exports of Goods & Services	4.7	6.8	6.6	5.3	5.2		4.4
Imports of Goods & Services	6.7	2.6	2.4	4.5	4.2		4.1
GDE at Current Prices	1.8	2.2	1.2	1.7	1.3		1.1
GDP Deflator	▲0.3	1.8	1.8	0.5	▲0.1		0.1
Consumer Price Index excl. Fresh Food	0.8	1.0	1.0	0.9	0.9		1.1

Note: Consumer Price Index excludes the effects of the consumption tax hikes
Sources: Cabinet Office,"Quarterly Estimates of GDP"; Ministry of Internal Affiars and Communications, "Consumer Price Index"

Below we provide our outlook for the monetary environment, global and domestic economies, and potential risks going forward.

1. Recent changes in the monetary environment: weaker yen, bullish stocks, and lower oil prices

   Globally, markets have shown increased volatility, with falling stock prices, a stronger dollar, and higher bond prices on lower yields. These have been triggered by developments since late September including speculation that the US Federal Reserve Board would postpone plans to raise interest rates, geopolitical risks such as the worsening Ebola outbreak, and the IMF's lowered outlook for the global economy. The FRB's October 29 announcement that it was ending its third round of quantitative easing on schedule and the Bank of Japan's unveiling two days later of further easing measures (QQE), however, worked to significantly lift markets and drive down the yen.

   The Nikkei dipped close to 14,500 in mid-October, but following the BOJ announcement on October 31 stock prices quickly rebounded, with the Nikkei recovering to the 17,500 mark. The yen, which had been weakening against the dollar since mid-August, fell to a seven-year low following the BOJ announcement of further QQE measures, settling around 116. Slowdowns in China and other developing nations have reduced demand for West Texas Intermediate crude oil. Oil-producing nations have failed to adjust production, resulting in a dramatic drop in crude prices.

For our 160th short-term economic forecast, we have adjusted our outlook toward higher stock prices, weaker yen, and lower crude oil prices. The BOJ is not expected to adjust interest rates, meaning current currency and stock market trends will remain steady.

2. Global Economy

Table2: Outlook of Global Economy

(%)

	World		United States		Euro Area		China		NIEs		ASEAN	
	SA159R	SA160R	SA159R	SA160R	SA159R	SA160R	SA159R	SA160R	SA159R	SA160R	SA159R	SA160R
2013	3.7		2.2		▲0.5		7.7		2.9		5.2	
2014	3.8	3.8	2.1	2.2	0.9	0.8	7.3	7.3	3.4	3.3	4.7	4.4
2015	4.2	4.1	3.0	3.1	1.2	1.0	7.0	7.0	3.6	3.5	5.8	5.4
2016	n.a.	4.1	n.a.	3.0	n.a.	1.3	n.a.	6.8	n.a.	3.7	n.a.	5.2

Note: World economic growth rate is an average weighted by exports from Japan. Estimates are calender year base.

The United States

Growth in real terms in 2014 remains strong. The 3.5% annualized GDP growth seen in the July–September period follows a 4.6% figure logged in April–June. Looking at specific categories, consumer spending, home sales, capital investment, and exports continue to show robust growth. Specifically, exports have shown significant growth despite concerns of a stronger dollar. Since 2011, US exports have continued their upward trend in real terms even as the effective exchange rate for the dollar has edged upward, indicating improved competitiveness for US exports. In addition, consumer confidence continues to recover as employment improves. We expect real annual growth under these conditions to be 2.2% for 2014, 3.1% for 2015 and 3.0% for 2016.

Europe

In the euro zone, growth in real terms for the July–September period lagged, advancing to 0.2% from the 0.1% seen in the April–June period. By country, Spain continued to show positive growth, dropping a tenth of a percentage point to 0.5% from the previous period. Germany and France, which both shrank by 0.1% in the previous period, barely avoided logging back-to-back quarters of negative growth, posting 0.1% and 0.3%, respectively. Italy was not so lucky, inching upward from –0.2% to –0.1%, a second straight quarter of negative growth. The Eurozone Purchasing Manager's Index pointed to downward trends in manufacturing and the service industry. Under these conditions, we expect GDP growth in real terms for 2014 to be 0.8%. This will increase slightly to 1.0% in 2015 and then 1.3% in 2016. Relevant factors in this outlook are the ongoing risk from such long-term European issues as massive private-sector debt, the growing burden of nonperforming loans, and stalled employment. Steps taken by the European Central Bank to introduce monetary easing will likely have only limited effect.

China

China remains on course for potential growth in the range of 7%. Investment and consumption in real terms showed signs of stalling during the July–September period. In hints of a slowdown, the economy posted its lowest numbers in five and a half years, dropping to an annualized 7.3% from 7.5% in the previous period. China's central bank is considering propping up the economy through adoption of a targeted program of easing measures. Looking at these conditions, we predict growth will follow a downward trend, moving from 7.3% in 2014 to 7.0% in 2015 and then 6.8% in 2016.

One issue facing the Chinese economy is its ability to ease the nation's housing market back into positive growth. Average new home prices for September in 69 of 70 major cities fell compared to the previous month, the first negative year-on-year figures in two years. The central bank moved in late September to allow buyers to apply favorable housing loan measures toward a second home after paying off their first residence. The effects of this move, however, have yet to be determined. Shrinkage of China's real estate market and related sectors, which account for a quarter of the economy, would lead to a collapse in the country's so-called shadow banking system, potentially destabilizing the entire economy.

3. Japan

Exports

Exports have been bolstered by a weaker yen, an upswing in the global economy, and, in particular, recovering capital investments. Under these conditions, we expect exports to continue their gradual upward trend heading into fiscal 2015. Growth in real terms will be weak, however, resulting in such outcomes as stifled growth in the domestic production sector and lower competitiveness of Japanese companies. As a result, exports will follow a downward trend in fiscal 2014–16, posting 6.6%, 5.2%, and 4.4%, respectively.

Public Investment

Turning an eye to public investment, a labor shortage in the construction industry and other factors will mean the effects of the ¥5.5 trillion supplementary budget for fiscal 2013 and the decision by the government to move up the allotment of funds from the 2014 regular budget toward public projects will likely not be felt until fiscal 2015.

In the interim, the 2014 supplementary budget provides a one-time allotment of ¥600 billion for disaster countermeasures. The budget, however, does not include funds for economic stimulus. Therefore, our forecasts for fiscal 2015 and 2016 do not reflect the inclusion of such measures. The government plans to lower the corporate tax rate from fiscal 2015, but this is not reflected in our forecast as the new rate has yet to be decided.

Personal Consumption

Personal consumption will shrink by 2.8% in fiscal 2014 due to lingering effects of last-minute demand prior to the consumption tax hike. However, incomes will gradually improve as the employment market gains momentum, boosting personal spending. The significant rise in bonuses seen this summer is expected to continue into the winter as companies' earnings improve. Muted consumer confidence is a concern, but will likely rebound as companies finalize production adjustments.

Looking ahead to fiscal 2015 and 2016, consumer spending on a year-on-year basis will be 1.3% and 1.3%, respectively.

Housing

Confidence in the housing market shows signs of improvement, with several manufacturers posting higher order volumes compared to the previous year. Despite signs of recovery, personal residential investment in real terms is down sharply due to lingering effects of last-minute home buying prior to the consumption tax hike and concerns over rising construction costs. Interest rates will remain low, with private residential investment growing by 1.2% in fiscal 2015. Looking toward fiscal 2016, they will fall by 2.0% as the housing stock has a downward pressure from medium-term perspectives.

Capital Investment

Looking at capital investment, machinery orders for the July–September period were up and are expected to maintain their momentum beyond October–December. The September release of the BOJ's Tankan short-term economic survey pointed to a favorable corporate earnings environment, as companies, particularly in the nonmanufacturing sector, pay close attention to shortages in production and operation facilities. Growth can be expected as companies at the very least will need to renovate and repair older facilities. According to the survey, planned capital investment near base GDP in all sectors including software but excluding real estate were up 1.3% for fiscal 2014 since the June Tankan, increasing 6.1% compared to the previous year. Looking at yearly patterns, we expect capital investments in all sectors to be up 3.8% for 2014 on a year-on-year basis. Looking ahead, capital investments will post 0.4% growth in fiscal 2014, 2.8% in 2015, and 3.5% in 2016.

4. Risk

Relevant risks to the economy exist from (1) the prolonged lag in production lowering the operation rate of facilities and affecting the employment market by cooling capital investments and consumer spending, (2) the protracted recovery of developing economies producing a downswing in overseas demand, (3) the onset of deflation in the European economy resulting in long-term economic stagnation, (4) geopolitical instability from Ebola as well as the situations in the Ukraine and Israel, (5) short-term disruption of financial markets from uncertainty in the FRB’s schedule for raising interest rates, and (6) the chance that postponement of the scheduled consumption tax hike will cause investors to lose confidence in Japan’s economic policies, sparking selloffs of stocks, bonds, and yen.

Table. The Outlook for Japan's Economy

Forecast →

	FY2014 1st Qtr	2nd	3rd	4th	FY2015 1st Qtr	2nd	3rd	4th	FY2016 1st Qtr	2nd	3rd	4th	FY2013 Actual	FY2014 Forecast	FY2015 Forecast	FY2016 Forecast
Real GDE (Chained 2005 Yen) *	-1.7	-0.5	0.8	0.6	0.2	0.3	0.3	0.2	0.2	0.3	0.2	0.4	2.1	-0.5	1.3	1.0
Real GDE (Chained 2005 Yen) **	-0.3	-1.3	0.0	-0.8	1.2	1.9	1.4	0.9	1.0	1.0	1.0	1.2				
Private Consumption *	-5.1	0.4	0.7	0.5	0.2	0.2	0.3	0.1	0.3	0.3	0.5	1.3	2.5	-2.8	1.3	1.3
Private Residential Investment *	-10.0	-6.8	-0.5	1.2	2.3	1.7	-1.8	-1.0	-0.5	-0.4	0.4	-0.8	9.3	-11.2	1.2	-2.0
Private Non-Residential Investment *	-4.7	-0.4	0.6	0.8	0.8	1.0	0.8	0.5	0.7	1.0	1.2	1.3	4.0	0.4	2.8	3.5
Public Investment *	0.9	1.4	-1.4	-0.9	-1.0	-1.0	-1.4	-1.5	-1.7	-1.8	-1.8	-2.0	10.3	1.0	-3.8	-6.4
Domestic Demand ***	-2.8	-0.5	0.7	0.4	0.2	0.2	0.2	0.1	0.2	0.2	0.4	0.5	2.6	-1.3	1.1	0.9
Foreign Demand ***	1.0	0.1	0.2	0.2	-0.1	0.0	0.1	0.1	0.0	0.1	-0.1	-0.1	-0.5	0.7	0.3	0.1
Exports of Goods & Services *	-0.5	1.3	2.0	1.4	1.0	1.2	1.1	1.2	1.0	1.1	1.0	1.0	4.7	6.6	5.2	4.4
Imports of Goods & Services *	-5.4	0.7	1.2	0.3	1.5	1.2	0.9	0.8	0.9	0.5	2.1	1.6	6.7	2.4	4.2	4.1
GDE at Current Prices *	0.1	-0.9	0.9	0.7	0.1	0.3	0.3	0.2	0.2	0.4	0.1	0.5	1.8	1.2	1.3	1.1
Indices of Industrial Production *	-3.8	-1.9	1.6	1.4	0.5	0.3	0.3	0.3	0.1	0.2	1.1	1.8	3.2	-0.7	2.2	1.7
Unemployment Rate (%)	3.6	3.6	3.6	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.4	3.4	3.9	3.6	3.5	3.4
Compensation of Employees **	1.7	2.4	2.2	2.0	1.6	0.9	0.7	0.5	0.5	0.5	0.4	0.4	1.0	2.1	0.9	0.5
10-Year Government Bond Yield (%)	0.598	0.528	0.476	0.514	0.552	0.590	0.628	0.668	0.707	0.746	0.786	0.827	0.691	0.529	0.609	0.766
Nikkei Stock Average (Yen)	14,655	15,553	16,908	17,667	18,048	18,384	18,643	18,940	19,263	19,587	19,945	20,144	14,407	16,196	18,504	19,735
Yen to US Dollar Exchange Rate	102.1	103.9	115.2	118.0	118.9	119.8	120.7	121.0	121.4	121.7	122.1	122.4	100.1	109.8	120.1	121.9
WTI Crude Oil Price (Dollar / Barrel)	103.0	97.3	77.4	78.9	79.2	80.2	80.8	81.3	81.2	81.3	81.3	81.3	99.1	89.1	80.4	81.3
Corporate Goods Price Index **	4.3	4.0	3.1	2.9	0.1	-0.2	0.6	0.6	0.6	0.6	0.6	0.5	1.9	3.6	0.3	0.6
Consumer Price Index, All Items Less Fresh Food **	3.3	3.2	2.9	2.8	0.8	1.0	1.0	1.1	1.2	1.1	0.9	1.0	0.8	3.0	0.9	1.1
Current Balance of Payments / Nominal GDP (%)	0.6	0.5	1.2	1.0	0.8	0.8	1.1	0.7	0.7	0.9	0.9	0.3	0.2	0.7	0.8	0.6
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	4.6	3.9	1.9	3.2	3.1	3.0	3.0	3.0	2.9	2.9	2.9	2.9	2.2	2.2	3.1	3.0
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real China GDP (1990 Prices) **	7.5	7.3	7.2	7.4	7.1	6.8	6.8	6.8	6.8	6.7	6.7	6.6	7.7	7.3	7.0	6.8
													(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.