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SA161 Short-Term Forecast of the Japanese Economy (2015/1-3—2017/1-3)

A Consumption-Led Economic Recovery Expected in Fiscal 2015 - Driven by Cheaper Oil Prices and Higher Wages, though Overseas Trends Present Risks

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- Nominal growth projected to be highest in quarter of a century
- Better terms of trade conditions will benefit both households and businesses
- Now is the time to put painful reforms into steady implementation

Real GDP growth in October–December 2014 was lower than expected. Although external demand (net exports) made a positive contribution, domestic demand—particularly personal consumption and capital investment—remained weak. This will most likely mean negative growth of close to 1% in real terms for fiscal 2014.

There are clear signs, though, that the prolonged downturn following the consumption tax hike has bottomed out. Our latest forecast for the Japanese economy is for consumption to put the economy back on a growth track, and we project 1.5% real growth in fiscal 2015.

The driving force behind this recovery is cheaper crude oil prices, which have fallen by more than 50% over the past six months. Plunging prices in the face of slow but rising global demand suggest there is excess supply capacity. Adjustments are likely to take some time, so oil prices are not likely to jump back up quickly.

Terms of trade gains accruing from lower prices of oil and other fossil fuels, including liquefied natural gas, are likely to reach ¥8 trillion yen—equivalent to the amount generated by the 3-point hike in the consumption tax. While the benefits of the yen's depreciation are felt primarily by export-oriented companies, lower oil prices will have a broad, positive impact on households, small and medium-sized enterprises, and even the nonmanufacturing sector.

Let us look at trends in the household sector. The slump caused by the consumption tax increase was much severer than expected. This was no doubt a factor not only of the reaction to last-minute buying before the hike but also of a rise in consumer prices that exceeded the growth in wages (resulting in a reduction in real income). An additional factor that dampened spending was the lowering of pension benefits in October 2013 and again in April 2014 to adjust for past payments that had been "too generous."

The situation in fiscal 2015 will change completely. Inflation will be near zero percent, as the impact of the tax increase will have played itself out and also as a result of lower crude oil prices. Nominal wages should grow, as a shortage of workers prompts a rise in scheduled cash earnings exceeding last year's levels, and real wages are expected to increase for the first time in five years. This should fuel a resurgence of consumer spending.

Improvement in income will impact positively on housing investment, buttressed by continuing low interest rates. Although the housing sector has been slow to rebound after the spree in last-minute, pre-tax-hike purchases, there are signs that orders are picking up. We look for a return to growth, albeit small, during fiscal 2015.

Looking at the corporate sector, businesses have seen a return to profitability with the drop in the break-even point. Cash flow is also expanding as a result, and the nonmanufacturing sector is likely to step up capital investment with the return of domestic demand, especially in the face of a shortage in capacity.

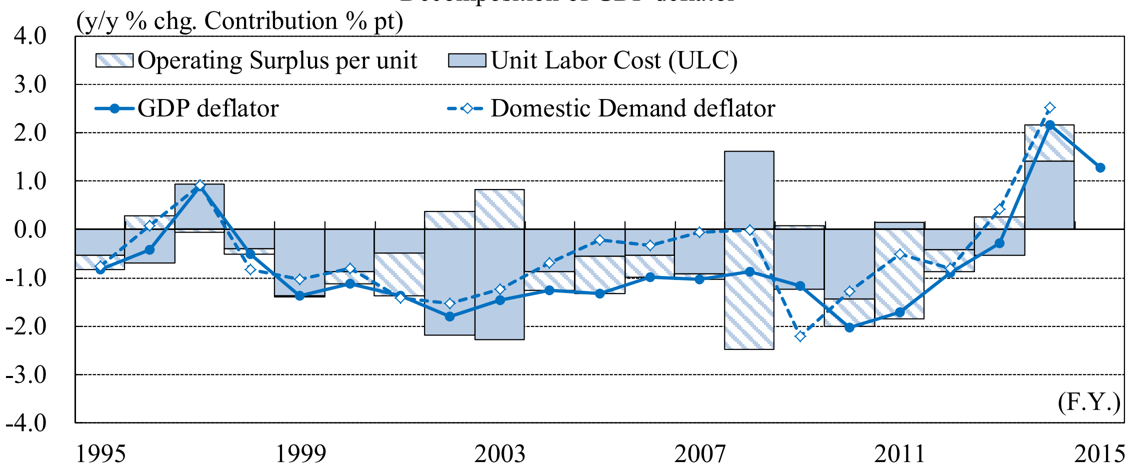
Manufacturers face a similar situation, though prospects are not as robust. Production bases are not likely to return to Japan, with the exception of such industries as electronic parts and devices. Many companies are no doubt haunted by their experience following the Lehman crisis, when they struggled with an ultra-strong yen after they had moved production back to Japan during a weak-yen phase in 2005–07.

External demand remains strong but is unlikely to accelerate. Even if cheaper oil prices generate growth in the United States and Europe, many Asian countries are likely to give priority to slashing fuel subsidies, so the benefits of lower prices will not trickle down to consumers in full. Also casting a shadow is a slowdown of the Chinese economy. Exports are unlikely to grow significantly. A recovery in domestic demand, moreover, should result in higher imports, so the contribution of external demand (net exports) to real growth will likely decline from fiscal 2014.

Public-sector spending is not likely to have much impact in fiscal 2015. The government drafted a supplementary fiscal 2014 budget as part of an emergency economic stimulus package announced late last year, but such spending may not be necessary, since the economy is already poised for a recovery. Grants for local gift certificates, which is part of the package, will be particularly ineffective, because the amount disbursed will go almost entirely into savings and do little to push up the growth rate.

The nominal growth rate in fiscal 2015 is forecast to reach 2.8%, the highest since fiscal 1991—nearly a quarter century ago. The GDP deflator is expected to grow by 1.3%, indicating the first positive price change in 17 years—even without the 1.4% (based on a simple calculation) increase resulting from the consumption tax hike in fiscal 2014 (Figure).

<Decomposition of GDP deflator>



Notes: ULC = nominal compensation of employees / real GDP, Operating Surplus per unit = (nominal GDP - nominal compensation of employees) / real GDP. The figure in FY2014 (prospect) is calcurated from Apr.- Dec. actual value and that in FY15 is forecast by JCER.
Source: Cabinet Office, "Quarterly Estimates of GDP"

The GDP deflator indicates general price trends and, like GDP, reflects the relationship of subtracting imports from the sum of domestic demand and exports. In fiscal 2014, strong domestic demand contributed to pushing up the overall growth rate. The deflator should be further buoyed by lower fuel imports in fiscal 2015.

Seen from the viewpoint of income distribution, the domestic unit labor cost (average cost of labor per unit of production) and unit operating surplus are both positive, so households and companies are sharing the rise in the value added per unit of output. This situation is expected to continue in fiscal 2015.

On the other hand, there is a strong likelihood that the rise in consumer prices (excluding fresh food) will be negative between April and September due to plummeting energy costs. This will not indicate a return to deflation, however, as improvements in the supply and demand gap will push up consumer prices in the second half of the fiscal year.

A number of risks exist, though, particularly in economic trends abroad. The US Federal Reserve Board will begin raising interest rates around the middle of the year; in the past, such developments were often accompanied by currency crises in emerging markets. Deflation has become entrenched in Europe, which must also address the threat of sovereign default in Greece. Another concern is the future of China's housing market, and there is a need for growing vigilance against terrorism and other geopolitical risks. With many central banks easing credit, charges of a "currency war" are being heard, and there is a danger of heightening trade protectionism.

The Japanese economy should achieve a growth rate higher than its actual potential in fiscal 2015. This will be an opportunity that should not be missed to implement painful reforms that are essential for Japan's future growth. The government must squarely confront reality and adopt concrete measures aimed at fiscal consolidation. The current administration should focus its growth strategy on areas that have not been fully addressed to date, such as labor market reform, and steadily implement those measures that have been adopted.

(The original Japanese article was posted in the February 27, 2015 issue of the Nikkei)

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	-0.6	0.6	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.4	2.1	-0.9	1.5	1.3
Real GDE (Chained 2005 Yen) **	-0.4	-1.4	-0.5	-1.3	0.9	1.9	1.7	1.5	1.5	1.3	1.2	1.3				
Private Consumption *	-5.1	0.3	0.3	0.5	0.5	0.5	0.4	0.4	0.4	0.3	0.4	1.1	2.5	-3.1	1.8	1.7
Private Residential Investment *	-10.3	-7.0	-1.2	0.4	1.4	1.6	0.8	0.2	0.4	1.1	2.0	-0.7	9.3	-12.0	0.8	3.0
Private Non-Residential Investment *	-5.0	-0.1	0.1	0.7	0.6	1.0	0.8	0.9	0.6	0.9	1.1	1.3	4.0	0.1	2.5	3.5
Public Investment *	1.0	2.1	0.6	-1.1	-1.5	-1.5	-2.0	-2.5	-1.2	-0.8	-0.5	-0.8	10.3	2.6	-4.2	-5.5
Domestic Demand ***	-2.7	-0.6	0.3	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.4	0.5	2.6	-1.6	1.3	1.4
Foreign Demand ***	1.1	0.1	0.2	0.0	0.0	-0.0	0.0	0.0	0.0	-0.0	-0.2	-0.2	-0.5	0.7	0.2	-0.1
Exports of Goods & Services *	-0.3	1.5	2.7	0.7	0.9	1.0	1.2	1.1	1.0	0.9	1.2	1.1	4.7	7.1	4.9	4.3
Imports of Goods & Services *	-5.3	1.0	1.3	0.8	0.9	1.1	1.2	1.1	1.1	1.0	2.5	2.2	6.7	3.0	4.2	5.4
GDE at Current Prices *	0.2	-0.9	1.1	1.8	1.0	-0.2	0.3	0.2	0.7	0.4	0.3	0.3	1.8	1.7	2.8	1.6
Indices of Industrial Production *	-3.8	-1.9	1.7	1.5	0.6	0.4	0.5	0.5	0.3	0.4	1.2	1.9	3.2	-0.7	2.8	2.4
Unemployment Rate (%)	3.6	3.6	3.5	3.5	3.4	3.4	3.4	3.4	3.4	3.4	3.3	3.3	3.9	3.5	3.4	3.4
Compensation of Employees **	1.7	2.4	2.2	2.3	2.1	1.4	1.0	1.0	1.3	1.3	1.1	1.0	1.0	2.1	1.4	1.2
10-Year Government Bond Yield (%)	0.598	0.528	0.443	0.249	0.283	0.317	0.351	0.386	0.404	0.422	0.440	0.459	0.691	0.454	0.334	0.431
Nikkei Stock Average (Yen)	14,655	15,553	16,660	17,224	17,747	18,139	18,558	18,949	19,275	19,624	19,948	20,254	14,407	16,023	18,348	19,775
Yen to US Dollar Exchange Rate	102.1	103.9	114.3	117.9	118.8	119.7	120.7	121.6	122.6	123.1	124.1	124.5	100.1	109.6	120.2	123.6
WTI Crude Oil Price (Dollar / Barrel)	103.0	97.3	73.2	48.1	50.5	55.4	59.7	61.6	62.1	62.4	62.5	62.6	99.1	80.4	56.8	62.4
Corporate Goods Price Index **	4.3	4.0	2.4	1.2	-2.3	-2.5	-0.8	0.5	1.3	1.1	0.8	0.6	1.9	3.0	-1.3	0.9
Consumer Price Index, All Items Less Fresh Food **	3.3	3.2	2.7	2.6	-0.0	-0.2	0.4	0.7	0.9	1.2	1.2	1.1	0.8	2.9	0.2	1.1
Current Balance of Payments / Nominal GDP (%)	0.6	0.5	2.3	3.9	4.3	3.6	3.7	3.6	3.5	3.3	3.4	3.0	0.2	1.8	3.9	3.3
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	4.6	5.0	2.6	3.2	3.0	2.9	2.9	2.9	2.9	2.9	2.9	2.8	2.2	2.4	3.3	2.9
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real China GDP (1990 Prices) **	7.5	7.3	7.3	7.2	6.9	6.6	6.7	6.7	6.7	6.7	6.7	6.6	7.7	7.4	6.8	6.7
													(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.