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SA162 Short-Term Forecast of the Japanese Economy (2015/4-6—2017/1-3)

No Change in 1.5% Growth Projection for Fiscal 2015

- Japanese economy on recovery track, but not ready to shift into higher gear

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Abstract

Japan's real GDP grew by 0.6% in January–March 2015 over the previous quarter (annual rate of 2.4%), registering the second straight quarter of growth. Looking at domestic demand, inventory investment contributed significantly to pushing up the rate of growth, buttressed by strong consumption. Both capital and residential investment increased for the first time in a year. Public demand, on the other hand, made a slightly negative contribution—the first decline in a year—due to lower public investment. As for external demand, there was a steady increase in exports of both goods and services.

In the future, gains from trade should arise due to falling crude oil prices, leading to higher real disposable income and a boost in personal consumption. We foresee a moderate recovery in capital and housing investment, but the Japanese economy is not likely to shift into higher gear for some time. Our projections for economic growth are 1.5% in fiscal 2015 and 1.3% in fiscal 2016.

Trends in the global economy and Japan's external and domestic demand are described below.

Global Economy and External Demand

We have downwardly revised our forecast for growth in the United States during 2015 from 3.2% to 2.3%, but we expect 2.8% growth in 2016. Real GDP grew by only an annualized rate of 0.2% in January–March 2015 from the previous quarter owing to such factors as a severe winter that pushed down consumption and delayed housing construction. An additional factor was the port strike on the West Coast, which not only dampened exports and imports but also had a negative impact on production due to distribution backups. Problems have been pointed out with the methods used in the United States to make seasonal adjustment calculations. For the economy to regain momentum in April–June, there will need to be continued improvements in employment and income, leading to expanded personal consumption.

<Table 1: The Outlook for Foreign Economies>

	World		United States		Euro Area		China		NIEs		ASEAN	
	SA161R	SA162	SA161R	SA162	SA161R	SA162	SA161R	SA162	SA161R	SA162	SA161R	SA162
2013	3.8		2.2		▲0.4		7.7		3.0		5.0	
2014	3.9		2.4		0.9		7.4		3.3		4.4	
2015	4.0	3.7	3.2	2.3	1.1	1.4	6.8	6.8	3.3	3.1	5.3	4.9
2016	4.0	4.0	2.9	2.8	1.4	1.6	6.7	6.7	3.6	3.6	5.4	5.3

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

Our forecast for Europe is 1.4% real GDP growth in 2015 and 1.6% in 2016. The eurozone posted 0.4% quarterly growth in January–March 2015, up slightly from 0.3% in the previous quarter. Spain registered robust growth of 0.9%, up from 0.7%, and such countries as France and Italy that posted zero growth the previous quarter expanded by 0.6% and 0.3%, respectively. Germany decelerated from 0.7% to 0.3%, but its domestic private demand, especially consumption, remains strong, so there is little reason for concern. Lower oil prices in Europe have expanded real disposable household income, fueling personal consumption.

We have a guarded outlook for China, expecting 6.8% growth in 2015 and 6.7% in 2016. In response to the cooling of domestic demand, the People’s Bank of China (PBOC) slashed its reserve requirement ratio for all banks from 19.5% to 18.5% on April 20. The cut was twice as large as the reduction from 20.0% to 19.5% made just two months earlier in February, and it enables banks to pump an additional 1.2 trillion yuan (¥24 trillion) in loans into the economy. The PBOC also lowered interest rates on May 11 (while simultaneously allowing banks to raise their deposit rates), following an interest-rate cut on March 1. There are market expectations of further monetary easing, but as China’s problems are structural in nature—such as excess debt—the effects of such measures are likely to be limited.

Considering the above, exports in Japan are forecast to grow by 6.1% in real terms in fiscal 2015 and by 4.2% in fiscal 2016. While these figures are fairly robust, there will still not be accelerated growth. At the same time, there appears to be no major shift in Japanese companies’ export strategies toward foreign markets—meeting local demand through local production and securing profits while leaving sales prices unchanged.

Domestic Demand

As for government fixed capital formation, the impact of the ¥5.5 trillion fiscal 2013 supplementary budget and the decision to move up public works spending in fiscal 2014 will wear off during fiscal 2015, but local governments have been increasing their budgets in response to the increase in tax revenues.

<Table 2: The Outlook for Japan's Economy>

(Fiscal Year)	(Year-on-year change, %)					
	2013	2014	2015		2016	
			SA161R	SA162	SA161R	SA162
Real GDE	2.1	▲1.0	1.5	1.5	1.3	1.3
Domestic Demand (Contribution)	2.6	▲1.6	1.1	1.4	1.4	1.5
Private Consumption	2.5	▲3.1	1.8	1.7	1.8	1.8
Private Residential Investment	9.3	▲11.6	0.4	2.3	3.0	3.3
Private Non-Residential Investment	4.0	▲0.5	2.4	2.4	3.5	3.6
Public Investment	10.3	2.0	▲4.2	▲3.5	▲5.6	▲4.5
Foreign Demand (Contribution)	▲0.5	0.6	0.3	0.1	▲0.1	▲0.1
Exports of Goods & Services	4.4	8.0	5.9	6.1	4.3	4.2
Imports of Goods & Services	6.7	3.7	4.7	6.1	5.4	5.6
GDE at Current Prices	1.8	1.4	2.7	2.3	1.5	1.6
GDP Deflator	▲0.3	2.5	1.2	0.8	0.2	0.3
Consumer Price Index excl. Fresh Food	0.8	0.8	0.3	0.3	1.2	1.1

Note: Consumer Price Index excludes the effects of the consumption tax hikes

Sources: Cabinet Office, "Quarterly Estimates of GDP";

Ministry of Internal Affairs and Communications, "Consumer Price Index"

The conditions are now in place for an expansion in capital investment. The corporate earnings environment remains very strong, and cash flow is expanding moderately, notably in the manufacturing sector. Businesses have extremely easy access to financing, and in the face of aging facilities, the BOJ's Tankan shows a growing net insufficiency in the diffusion index for production and sales equipment, especially in the non-manufacturing sector. Yet capital investment has remained rather sluggish. We expect private, non-residential investment to grow by 2.4% in fiscal 2015 and by 3.6% in fiscal 2016.

There are growing expectations that manufacturers will move their offshore production facilities back to Japan given the continued weakness of the yen, but such a "reshoring" trend will be limited. Many manufacturers relocated to Japan prior to the Lehman crisis when the yen depreciated, only to see the move backfire once the yen began its steep, post-crisis rise. For many Japanese businesses, the chief motive for moving offshore is to enable a flexible response to fluctuating local demand, not necessarily to reduce labor costs.

With a tighter job market improving the income situation, personal consumption is forecast to expand by 1.7% in fiscal 2015 and by 1.8% in fiscal 2016. There should be further increases in the basic salary this year, potentially leading to the first upturn in real wages in five years.

Real private residential investments are expected to increase by 2.3% in fiscal 2015 and 3.3% in fiscal 2016. Supporting factors include not only a brighter job and income

picture but also such policy measures as a bigger discount on interest rates (from -0.3% to -0.6%) for the Japan Housing Finance Agency's Flat 35S mortgage loans and a ¥115 billion supplementary budget in fiscal 2014.

Consumer Prices

The core CPI (excluding the impact of the consumption tax hike) in fiscal 2015 is expected to rise by 0.3% over the preceding year. Crude oil prices have been creeping upward, and the surcharge on electricity bills for the promotion of renewable energy is being raised in May from ¥0.75 per 1kWh to ¥1.58. This should mean that the anticipated decline in the CPI will be limited to the roughly three-month period between July and September. The CPI should begin rising from the second half of the fiscal year, as the impact of the drop in oil prices will have played itself out and as the supply-demand gap narrows. In fiscal 2016, it is projected to rise by 1.1%, which is still quite shy of the BOJ's 2% inflation target. Achieving this target would require a GDP gap of around 6%, based on a Phillips curve using data from the late 1990s. This, unfortunately, is not a realistic goal for the time being.

Risks

The immediate risks emanating from abroad include (1) higher-than-expected hikes in oil prices, (2) a drawn-out slowdown in the United States, choking off global economic growth, (3) a hard landing in the Chinese real-estate market, (4) a deepening crisis in Greece, causing turmoil in the financial market, (5) TPP negotiations that wander adrift, and (6) a geopolitical crisis in Syria, Yemen, or Ukraine.

Of these risks, the second involving the US economy bears close watching, as this is linked to the FRB's monetary policy and could have serious repercussions on the global financial market.

Short-term domestic risks include (7) a slow recovery in personal consumption owing to lower-than-anticipated wage hikes and (8) the prime minister's statement on the 70th anniversary of the end of World War II triggering an angry reaction from China and South Korea, adversely affecting trade, tourism, and other aspects of Japan's relationship with these countries.

A longer-term risk that cannot be ignored is that associated with (9) the loss of confidence in Japan's economic policy, touching off a simultaneous "Japan-selling" of stocks, government bonds, and currency. Roadmaps to fiscal consolidation are often sketchy and based on wishful thinking, being premised on highly optimistic growth rates and prolonged low interest rates. Another danger is that of (10) Japan's gradual devitalization, unless the growth strategy is boldly implemented to advance further reforms in the job market and to address the country's serious demographic challenges.

Table. The Outlook for Japan's Economy

	Forecast												FY2013 Actual	FY2014 Actual	FY2015 Forecast	FY2016 Forecast
	FY2014				FY2015				FY2016							
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th				
Real GDE (Chained 2005 Yen) *	-1.8	-0.5	0.3	0.6	0.4	0.4	0.4	0.4	0.3	0.3	0.2	0.3	2.1	-1.0	1.5	1.3
Real GDE (Chained 2005 Yen) **	-0.4	-1.4	-0.9	-1.4	0.8	1.7	1.8	1.7	1.6	1.5	1.3	1.2				
Private Consumption *	-5.1	0.3	0.4	0.4	0.5	0.5	0.4	0.4	0.4	0.4	0.5	1.1	2.5	-3.1	1.7	1.8
Private Residential Investment *	-10.8	-6.4	-0.6	1.8	1.4	1.2	1.0	0.5	0.6	1.1	1.8	-0.9	9.3	-11.6	2.3	3.3
Private Non-Residential Investment *	-5.2	-0.1	-0.0	0.4	1.0	0.6	1.0	0.7	1.0	0.7	1.1	1.3	4.0	-0.5	2.4	3.6
Public Investment *	0.7	1.6	0.1	-1.4	-1.2	-1.2	-1.2	-1.2	-1.1	-1.1	-1.1	-1.1	10.3	2.0	-3.5	-4.5
Domestic Demand ***	-2.8	-0.6	0.0	0.8	0.5	0.4	0.4	0.4	0.3	0.3	0.4	0.5	2.6	-1.6	1.4	1.5
Foreign Demand ***	1.1	0.1	0.3	-0.2	-0.1	0.0	-0.0	0.0	0.0	-0.0	-0.2	-0.2	-0.5	0.6	0.1	-0.1
Exports of Goods & Services *	-0.0	1.6	3.2	2.4	0.7	1.0	1.0	1.0	1.1	1.0	1.1	1.0	4.4	8.0	6.1	4.2
Imports of Goods & Services *	-5.2	1.1	1.4	2.9	1.2	1.1	1.1	1.1	1.3	1.2	2.4	2.2	6.7	3.7	6.1	5.6
GDE at Current Prices *	-0.0	-0.6	0.7	1.9	0.7	-0.3	0.2	0.4	0.6	0.6	0.2	0.3	1.8	1.4	2.3	1.6
Indices of Industrial Production *	-3.0	-1.4	0.8	1.5	0.3	0.6	0.6	0.6	0.2	0.5	1.2	2.0	3.2	-0.4	2.4	2.7
Unemployment Rate (%)	3.6	3.6	3.5	3.5	3.5	3.5	3.4	3.4	3.4	3.4	3.3	3.3	3.9	3.5	3.4	3.4
Compensation of Employees **	1.5	2.2	1.8	1.3	2.4	2.3	2.5	1.7	1.2	1.3	1.2	1.3	1.0	1.7	2.2	1.2
10-Year Government Bond Yield (%)	0.598	0.528	0.443	0.339	0.382	0.377	0.396	0.415	0.431	0.448	0.465	0.481	0.691	0.478	0.392	0.456
Nikkei Stock Average (Yen)	14,655	15,553	16,660	18,226	19,694	19,505	19,863	20,258	20,587	20,975	20,916	21,241	14,407	16,253	19,830	20,930
Yen to US Dollar Exchange Rate	102.1	103.9	114.3	119.1	119.7	120.8	121.8	122.8	123.8	124.9	125.6	125.1	100.1	109.7	121.3	124.8
WTI Crude Oil Price (Dollar / Barrel)	103.0	97.3	73.2	48.6	58.8	61.5	65.0	66.5	67.1	67.4	67.5	67.6	99.1	80.8	62.9	67.4
Corporate Goods Price Index **	4.3	4.0	2.4	0.4	-3.1	-3.0	-1.3	0.8	1.5	1.2	0.8	0.7	1.9	2.8	-1.7	1.0
Consumer Price Index, All Items Less Fresh Food **	3.3	3.2	2.7	2.1	0.1	-0.2	0.3	0.9	1.2	1.1	1.0	0.9	0.8	2.8	0.3	1.1
Current Balance of Payments / Nominal GDP (%)	0.7	0.4	2.2	3.0	3.1	2.1	2.0	2.2	2.1	1.8	1.6	1.5	0.3	1.6	2.4	1.8
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	4.6	5.0	2.2	0.2	2.4	2.7	2.8	2.8	2.8	2.8	2.8	2.8	2.2	2.4	2.3	2.8
Real China GDP (1990 Prices) **	7.5	7.3	7.3	7.0	6.6	6.7	6.9	7.0	6.9	6.6	6.5	6.5	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.