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SA163 Short-Term Forecast of the Japanese Economy (2015/7-9—2017/1-3)

Fiscal 2015 Growth Projection Revised Downward to 1.1%

- Economy Contracts in April–June amid Mounting Slowdown Risks

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Real GDP contracted in April–June 2015 for the first time in three quarters. Exports—viewed as a key engine for growth—declined sharply, while personal consumption and capital spending remained sluggish. Signs of a recovery have retreated, and the outlook appears murky in view of the recent stock and exchange market routs sparked by slowdown fears in China.

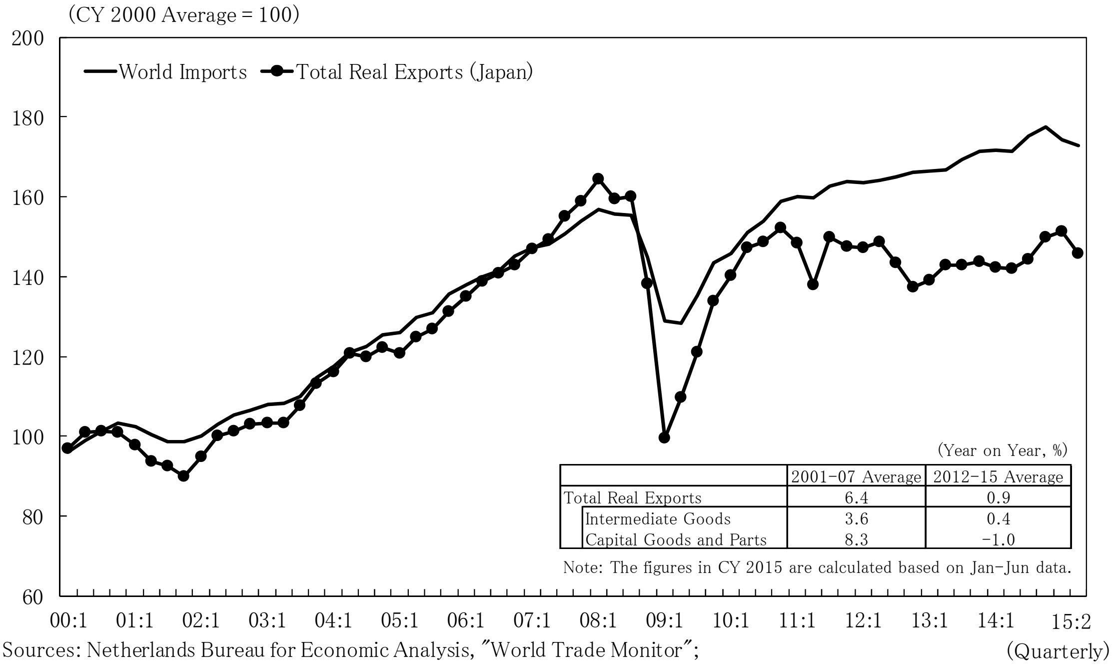
The lull is not likely to slip into a recession, however. Rising real income will push up personal consumption, and strong corporate earnings will bolster investment into plants and equipment. We continue to anticipate a surge in exports, moreover, as foreign markets expand. Cheaper oil prices have curtailed the cumulative outflow of income (trading losses) by ¥8 trillion since October–December 2014. There are plenty of positive factors on the horizon for the Japanese economy.

That said, the benefits have been slow to trickle down to the household sector. The recovery remains weak, and slowdown risks are mounting. We are thus projecting 1.1% growth in real terms for fiscal 2015 and 1.6% the following year (see table). Without the carry-over effect from the strong growth in the final quarter of fiscal 2014, the figure for the current fiscal year would be much lower, dipping below the economy's potential growth rate (which we estimate to be 0.6%).

The stagnant recovery is a product not just of cyclical factors but also of structural changes in the economy. Exports have not been growing since the Lehman crisis, even as total global imports have recovered (see figure). Global imports are growing at a slower rate than the economy as a whole (an income elasticity of demand of less than 1) and have been contracting since the beginning of 2015. The relative weakness of Japan's exports, though, is also due to the sophistication of the global supply chain, with the overseas plants of Japanese businesses procuring more of their supplies locally. This has meant lower exports of intermediate goods from Japan.

A second factor behind Japan's weak exports is the slowdown in fixed asset investment in leading industrial countries, as well as in China, where the impact of the 4 trillion yuan stimulus package implemented in the wake of the global financial crisis has now worn thin. Excessive public spending invites an accumulation of debt, which takes time

<Figure: World Imports and Real Exports in Japan>



Sources: Netherlands Bureau for Economic Analysis, "World Trade Monitor";
Bank of Japan, "Real Exports and Real Imports," "Corporate Goods Price Index";
Ministry of Finance, "Trade Statistics."

to repay. This has dampened Japan's exports of capital goods. A third factor is that many manufacturers have been disinclined to shift production back to Japan or to lower export prices despite the yen's depreciation. This is because such decisions during the previous weak-yen phase resulted in heavy losses when the currency swung back up.

Looking overseas, the US economy returned to growth in April–June, while the eurozone expanded for the ninth consecutive quarter. China's real estate market shows signs of stabilizing, and Beijing has enough policy space to maneuver should a need arise. Prospects for Japanese exports are thus quite favorable, although the rate of growth may be stunted due to the structural factors outlined above.

Clues to the sluggishness in personal consumption can be found by analyzing employment and income trends. Compared to past recoveries, jobs are increasing at a much faster rate. But most of them are in the service sector, where, more often than not, women are hired for part-time work. This accounts for the lack of growth in fixed wages. Without a raise in the basic salary, people's anxieties about the future will linger, and spending is unlikely to grow.

The creeping rise in consumer prices is also discouraging household spending. Higher food prices have hit the pocketbooks of the elderly, in particular, given the gradual lowering of benefits for pensioners.

But there is also some good news. Reports indicate that summer bonuses were quite robust, and pension benefits were adjusted upward in June. Consumer prices have begun to fall, meaning that real income is rising. What is needed to rekindle personal spending is a “qualitative” improvement in employment, such as encouraging part-time workers to work under full-time formats through reforms to the system of tax breaks and benefits.

In other household-related areas, home purchases are rebounding. Housing starts in June reached an annualized rate of 1 million for the first time in 18 months. But the stronger demand may be a reflection of all-out policy measures, such as the expanded tax breaks for housing loans. People may be making home-buying decisions ahead of the scheduled consumption tax hike in fiscal 2017, and there could be another plunge in sales following the increase.

The slackening of capital spending is most likely a reaction to the sharp rise during the previous quarter and should be short-lived. This is corroborated by the BOJ’s Tankan survey of business sentiment and other reports, which reveal that many companies have bullish spending plans rarely seen in recent years. Earnings are up in the corporate sector, and cash flow is abundant. With more stringent corporate governance rules encouraging companies to make effective use of cash and cash equivalents, the pieces are in place for plant and equipment investment to bolster economic growth.

The government has said it sees no need for a supplementary budget despite the contraction in April–June. We endorse this view. Given the prevailing labor shortage, public works spending is unlikely to have the multiplier effect of generating new jobs and expanding private-sector demand. More than that, any new fiscal stimulus would only add to the dangerously bloated public debt and put the goal of fiscal consolidation further out of reach.

The CPI (excluding fresh food) is likely to decline in the July–September quarter, given the plummeting prices of energy products, but it should thereafter return to moderate growth as a reflection of improvements in the supply-demand gap. We project a rise of 0.2% in fiscal 2015 and 0.9% in fiscal 2016.

The BOJ’s target of 2.0% in fiscal 2016 will be hard to reach. But lower prices accruing from more favorable terms of trade is good for the economy and should, in the long run, add to inflationary pressures. They should therefore not be tampered with. And while market indices derived from inflation-indexed bonds are moving down, they are doing so simply in tandem with cheaper oil prices, so there is no need to overreact.

Besides the slowdown in China, external risks include an anticipated interest rate hike by the Fed as early as September, which could touch off a currency crisis in emerging economies. There could also be some negative fallout should TPP negotiations drag on aimlessly. We must also be on guard against security-related threats from the Islamic State and North Korea. These risks appear to be growing.

The April–June contraction again highlighted the need to boost the potential growth rate. The government's long-term economic strategy, which seeks to boost productivity, is headed in the right direction.

But it is crucial for such efforts to be implemented in the right way. A competitive market environment is the best guarantor of efficiency in the distribution of resources and of higher productivity. This requires further deregulation and as little fiddling and intervention by the government as possible. Instead of doling out subsidies, the administration should direct its energies to promptly lowering the corporate tax rate.

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 Actual	FY2015 Forecast	FY2016 Forecast
Real GDE (Chained 2005 Yen) *	-1.9	-0.3	0.3	1.1	-0.4	0.5	0.4	0.3	0.5	0.4	0.3	0.3	2.1	-0.9	1.1	1.6
Real GDE (Chained 2005 Yen) **	-0.4	-1.4	-1.0	-0.8	0.7	1.5	1.6	0.7	1.6	1.6	1.5	1.5				
Private Consumption *	-5.0	0.3	0.3	0.3	-0.8	0.5	0.4	0.4	0.4	0.3	0.4	1.0	2.5	-3.1	0.4	1.7
Private Residential Investment *	-10.9	-6.3	-0.6	1.7	1.9	0.7	0.9	0.5	1.2	1.4	1.3	-1.3	9.3	-11.7	2.3	3.6
Private Non-Residential Investment *	-4.6	-0.0	0.2	2.8	-0.1	0.9	0.8	0.8	0.9	0.9	1.0	1.2	4.0	0.5	3.4	3.6
Public Investment *	0.2	1.7	0.3	-1.2	2.6	-3.0	-3.5	-3.9	1.5	1.8	1.7	1.6	10.3	2.0	-2.7	-1.5
Domestic Demand ***	-2.8	-0.4	0.0	1.2	-0.1	0.2	0.3	0.2	0.5	0.4	0.5	0.5	2.6	-1.5	1.0	1.5
Foreign Demand ***	0.9	0.1	0.3	-0.1	-0.3	0.3	0.1	0.1	0.0	0.0	-0.2	-0.2	-0.5	0.6	0.1	0.1
Exports of Goods & Services *	0.6	1.8	2.8	1.6	-4.4	2.2	1.1	0.9	1.0	1.1	1.0	0.9	4.4	7.9	0.9	4.4
Imports of Goods & Services *	-3.9	0.9	0.9	1.8	-2.6	0.7	0.6	0.5	1.1	1.2	2.4	2.3	6.7	3.6	0.3	4.6
GDE at Current Prices *	0.2	-0.7	0.8	2.2	0.0	0.3	0.6	0.3	0.7	0.7	0.4	-0.3	1.8	1.6	2.5	1.9
Indices of Industrial Production *	-3.0	-1.4	0.8	1.5	-1.4	0.4	0.7	0.5	0.3	0.6	1.2	1.9	3.2	-0.4	0.5	2.6
Unemployment Rate (%)	3.6	3.6	3.5	3.5	3.3	3.3	3.3	3.3	3.3	3.2	3.2	3.2	3.9	3.5	3.3	3.2
Compensation of Employees **	1.5	2.2	1.8	1.4	0.8	3.0	3.0	2.0	1.8	1.3	1.2	1.3	1.0	1.7	2.2	1.4
10-Year Government Bond Yield (%)	0.598	0.528	0.443	0.339	0.401	0.418	0.436	0.453	0.470	0.490	0.509	0.529	0.691	0.478	0.427	0.500
Nikkei Stock Average (Yen)	14,655	15,553	16,660	18,226	20,058	20,646	20,728	20,945	21,163	21,311	21,431	21,505	14,407	16,253	20,594	21,352
Yen to US Dollar Exchange Rate	102.1	103.9	114.3	119.1	121.4	122.6	123.6	123.8	124.5	124.7	125.4	125.5	100.1	109.7	122.9	125.0
WTI Crude Oil Price (Dollar / Barrel)	103.0	97.3	73.2	48.6	58.0	49.2	51.9	54.5	56.4	57.5	57.6	57.7	99.1	80.8	53.4	57.3
Corporate Goods Price Index **	4.3	4.0	2.4	0.4	-2.2	-2.6	-1.2	0.8	0.6	0.7	0.8	0.7	1.9	2.8	-1.3	0.7
Consumer Price Index, All Items Less Fresh Food **	3.3	3.2	2.7	2.1	0.1	-0.1	0.3	0.6	0.6	0.9	1.0	1.0	0.8	2.8	0.2	0.9
Current Balance of Payments / Nominal GDP (%)	0.7	0.4	2.2	3.1	3.4	3.2	3.4	3.8	3.4	3.0	2.9	2.8	0.3	1.6	3.5	3.0
Real U.S. GDP (2009 Dollars) ** (Seasonally Adjusted Annual Rate)	4.6	4.3	2.1	0.6	2.3	2.9	2.9	2.8	2.8	2.8	2.8	2.8	1.5	2.4	2.3	2.8
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)
Real China GDP (1990 Prices) **	7.5	7.3	7.3	7.0	7.0	6.6	6.8	6.9	6.8	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.