

Monthly Report of Prospects for Japan's Economy

August 2015

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

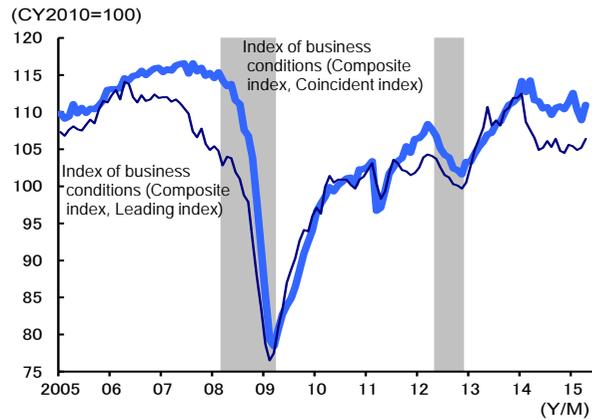
<http://www.jri.co.jp/english/periodical/>

This report is the revised English version of the July 2015 issue of the original Japanese version.

The general situation of Japan's economy – Economic activity is continuing a moderate recovery

Figure 1-1 Economic Activity

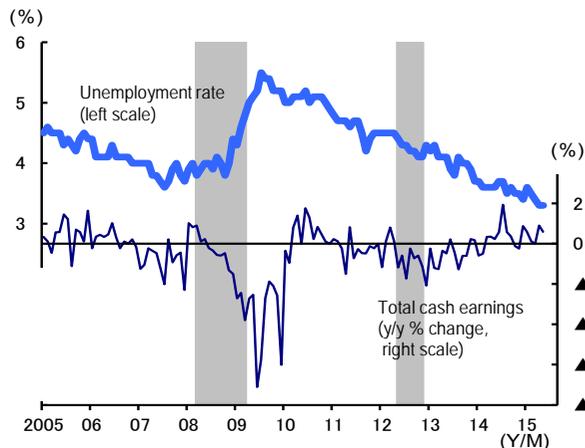
The coincident index of business conditions rose in April, due to the considerable year-on-year increase in commercial sales value.



Source: The Cabinet Office.

Figure 1-4 Employment and Income

The unemployment rate stayed at a low level, which shows continued favourable employment conditions.

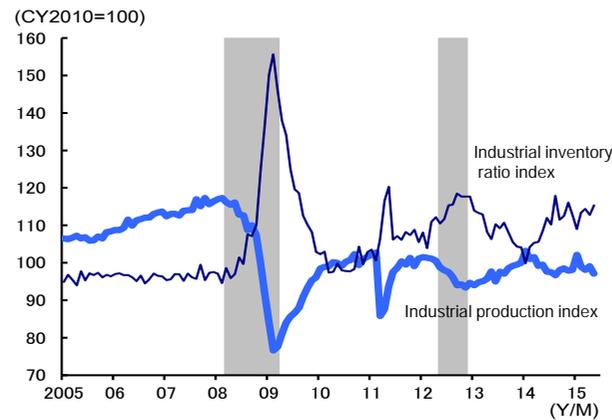


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

* The shaded area indicates the phase of recession.

Figure 1-2 The Corporate Sector

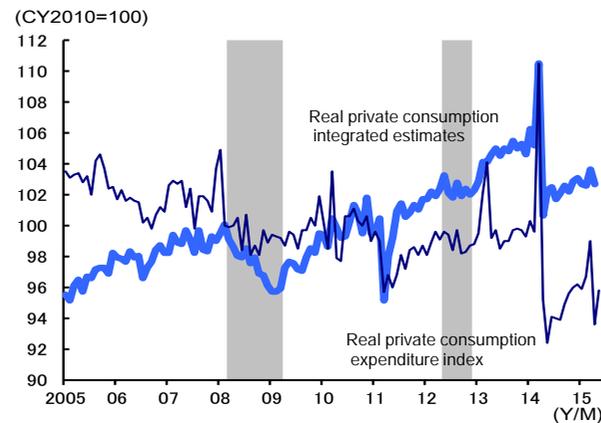
Production continued to seesaw. The inventory ratio rose again to stay at a high level.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-5 Private Consumption Expenditure

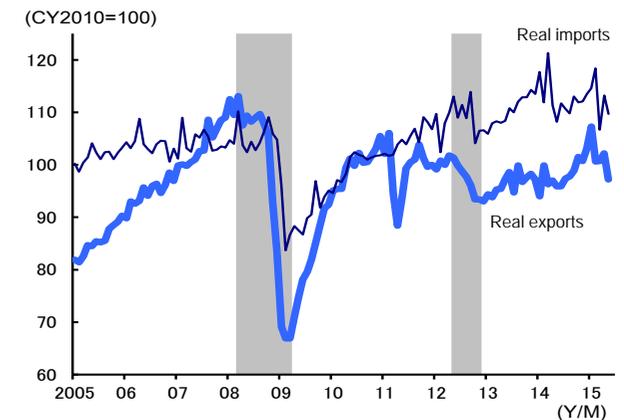
Real private consumption expenditure rose year-on-year for the first time in 14 months, as the effect of the consumption tax rise seems to be nearing its end.



Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office, The Ministry of Internal Affairs and Communications.

Figure 1-3 Overseas Demand

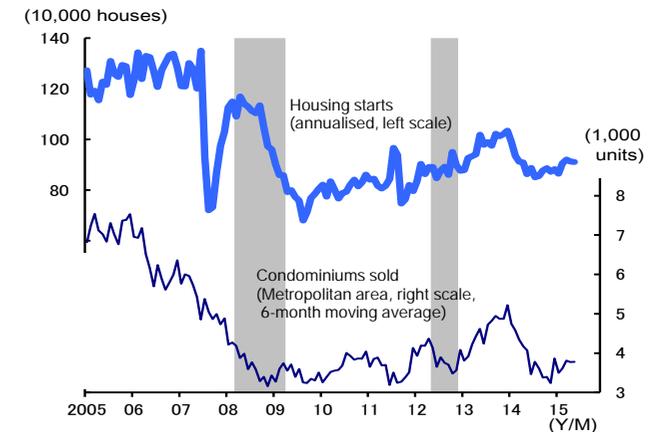
Exports, mainly those to China and the EU, were sluggish. Imports continued to seesaw.



Source: The Bank of Japan.

Figure 1-6 Housing Investment

Both housing starts and condominium sales are on a recovery trend, yet they lack momentum.



Source: The Ministry of Land, Infrastructure and Transport, Real Estate Economic Institute Co., Ltd.

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Economic activity continues to recover moderately, although inventory pile-up weighs on it

◆ Continued moderate economic recovery, yet inventory pile-up weighs

Japan's economic activity is continuing a moderate recovery. Especially, corporate profits continue to be buoyant. For example, current profits in enterprises have recovered to the level not seen since 2007, the period prior to the Lehman shock. In addition, positive behaviours of enterprises seem to have started to materialise. This seems to be shown in the fact that business fixed investment is currently on the rise, benefitting from favourable environments such as low interest rates.

Reflecting good corporate profits and the improvement in income and employment environments, private consumption expenditure has been recovering moderately from the fall after the rise in the consumption tax rate last April. This trend is shown in the fact that real household consumption expenditure increased year-on-year in May for

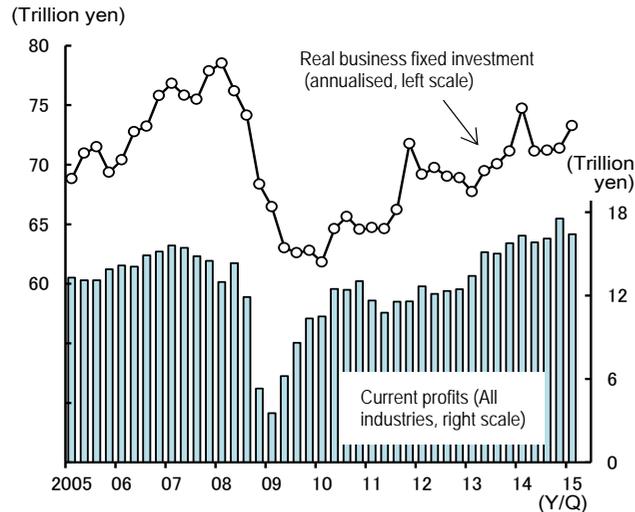
the first time in 14 months.

However, as an unfavourable factor, inventory pile-up is continuing, against the background of a sluggish consumption expenditure in a certain part of products such as automobiles and smart phones. Accordingly, it is highly likely that inventory adjustment will weigh on and cloud production activity in enterprises for the time being.

◆ Real exports lack momentum

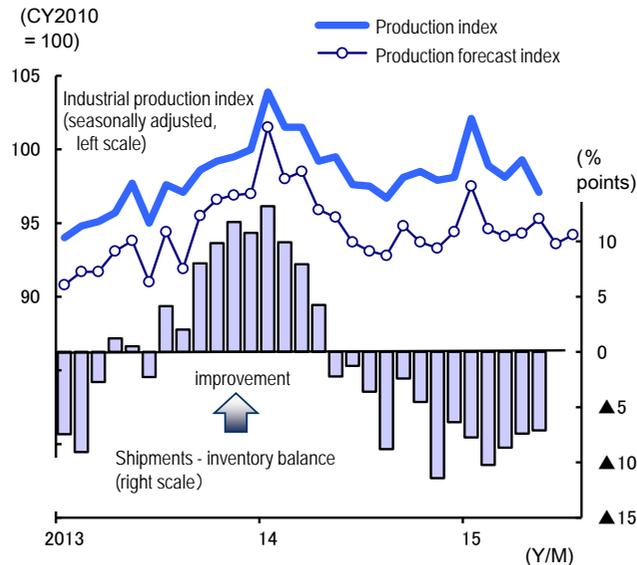
As for overseas demand, real exports lack momentum. Real exports in May decreased from the previous month. This decline was affected by stagnant exports of automobiles to China and the EU, as well as by global decline in demand for smart phones.

Figure 2-1 Current Profits and Real Business fixed Investment <seasonally adjusted>



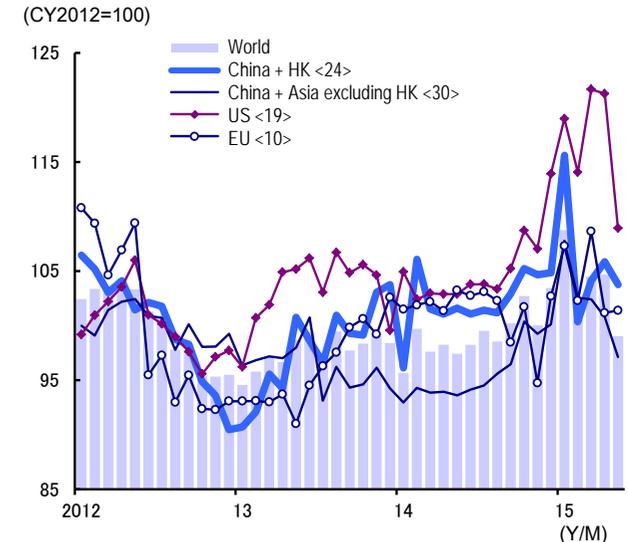
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Cabinet Office.
Note: Excluding financial institutions.

Figure 2-2 Industrial Production Index and Shipments - Inventory Balance



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Economy, Trade and Industry.
Note: Shipments - inventory balance = $y/y \text{ \% change in shipments} - y/y \text{ \% change in inventory}$

Figure 2-3 Real Exports <seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan.
Note: Figures in the angle brackets show the shares in FY2014.

BoJ's Tankan Survey - Business conditions keep a high level, with fixed investment staying firm

◆ Business conditions DI for large manufacturers improved, while DIs for small and medium-sized manufacturers worsened

In the Tankan June 2015 Survey, the diffusion index (DI) for business conditions on the whole of large manufacturing was plus 15 percentage points, a 3 percentage point improvement from the previous result. Viewed by industry, the DI for industrial machinery and electrical machinery advanced, reflecting the pickup in business fixed investment and the rising trend in stock prices. On the other hand, the DI for motor vehicles worsened, due to sluggish domestic sales and stagnant exports.

The DI for the whole of large nonmanufacturing was plus 23 percentage points, a 4 percentage point improvement. Especially, the DIs for private consumption-related industries such as retailing, accommodations, and eating and drinking services increased significantly. It seems that the consumption expenditure of foreign visitors to Japan ("inbound demand") contributed largely.

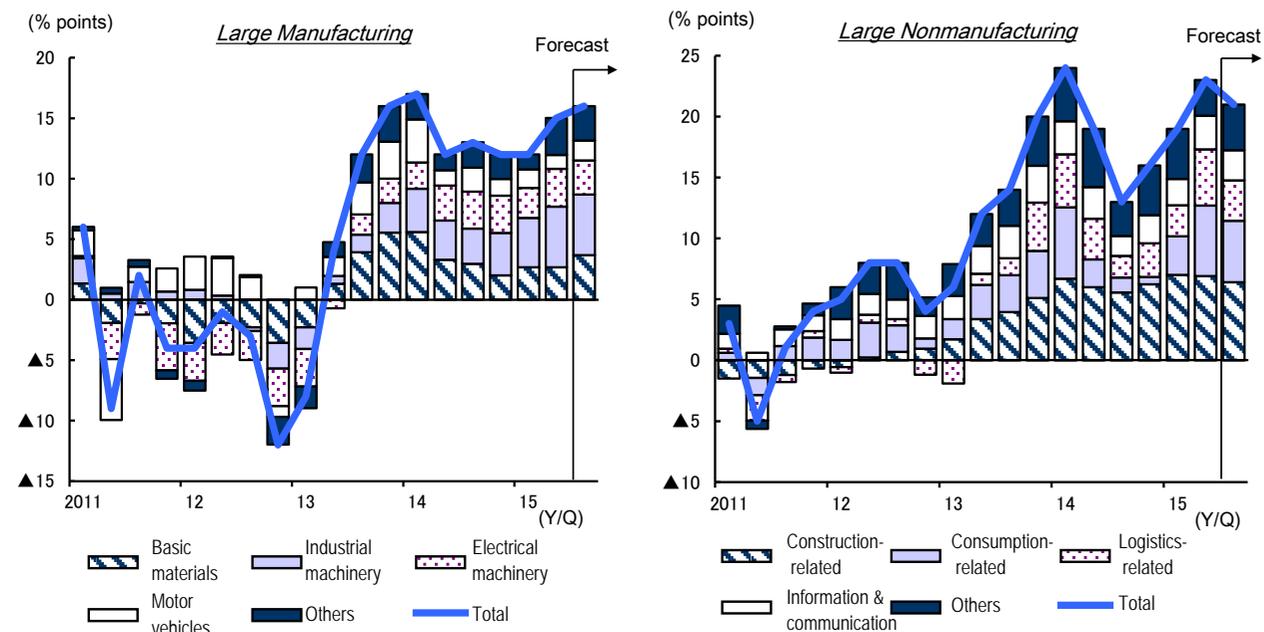
Meanwhile, with respect to small and medium-sized industries (SMEs), the DIs for small manufacturers worsened. With their exports and production being still very slow to increase, benefits from the weaker yen, which large manufacturers have enjoyed, have yet to spread to SMEs.

◆ Planned business fixed investment for FY2015 was firm, mainly in large enterprises

In the Tankan June 2015 Survey, planned business fixed investment for FY2015 was revised upwards considerably from that in the previous survey both in large manufacturing and large nonmanufacturing. The trend suggested that the rate of annual increase in FY2015 could be more than that in FY2014. However, planned business fixed investment for FY2015 in small enterprises remained almost the same as that of last fiscal year, which implied that business fixed investment would remain at a similar level to that in FY2014.

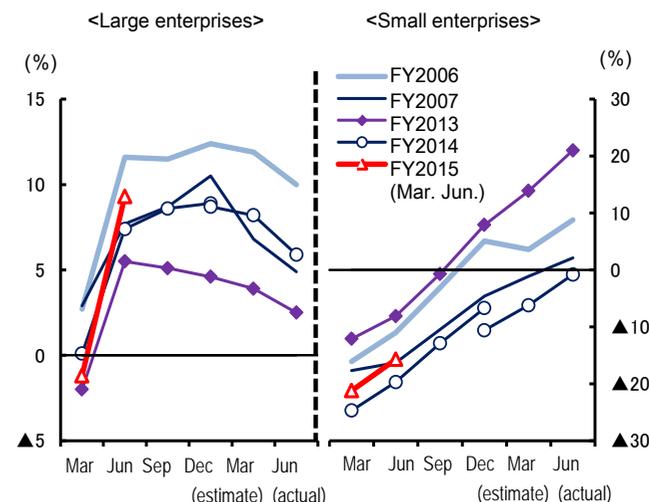
Figure 3-1 Contributions to Business Conditions Diffusion Index by Industry

<diffusion index of "favourable" minus "unfavourable", and percentage point contribution to the total DI points>



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "The Tankan June 2015 Survey".

Figure 3-2 Change over Time in Planned Business Fixed Investment for Each Fiscal Year <year-on-year, %>



(Month when the survey was conducted)

Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, "The Tankan Surveys".

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Monthly trade surplus is unlikely to continue, amid the slow pace of increase in exports

◆ **Decrease in imports contributed largely to reducing trade deficits**

With respect to Japan's trade balance, the decrease in the total value of imports, reflecting cheaper crude oil and stagnant total import quantity (real imports), has contributed largely to narrowing trade deficits. Viewed by product, real imports of mineral fuels, which have a one third share in the total, has been sluggish, against the background of the increase in the inventory of fuels stemming from stagnant production activity after the rise in the consumption tax rate. However, it is unlikely that the imports of mineral fuels will decrease further. As domestic demand recovers more noticeably, real imports will likely pick up again.

◆ **Pace of picking up in exports has been slow. Trade balance is expected to continue a trend of small deficits**

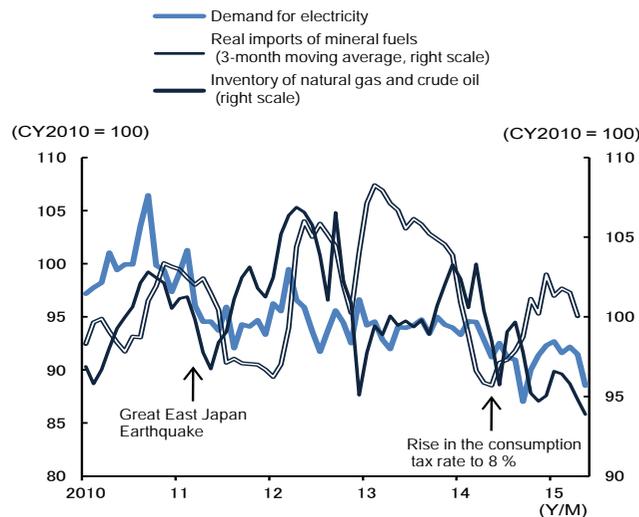
The latest figure of real exports showed a decline, with a wide range of export products excluding "others" decreasing. Especially, exports of capital goods

(excluding transport equipment), which have a share of about one quarter in the total real exports, weakened in the first quarter. This was against the background of the deceleration in business fixed investment in the US and China.

Looking ahead, the depreciation of the yen will bolster exports for the time being. On the other hand, the pickup in global economic activity will lack momentum, because a deceleration in the economies in emerging countries such as China will likely be a weighing down factor on the global economy. Accordingly, the pace of increase in Japan's exports is predicted to remain moderate, corresponding to the pace of pickup in overseas demand.

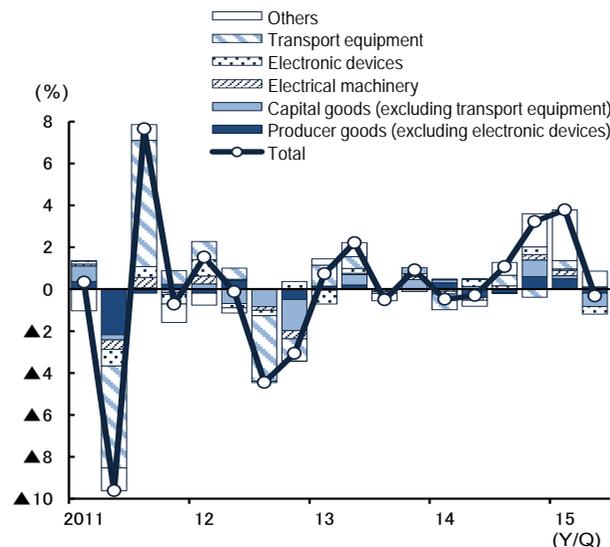
Taking the above factors and trends into consideration, it is expected that the monthly trade balance will continue the trend of small deficits, on the assumption that price factors such as the exchange rate of the yen and the price of crude oil stabilise at the present level.

Figure 4-1 Demand for Electricity, Real Imports of Mineral Fuels, and Gas and Oil Inventory <seasonally adjusted>



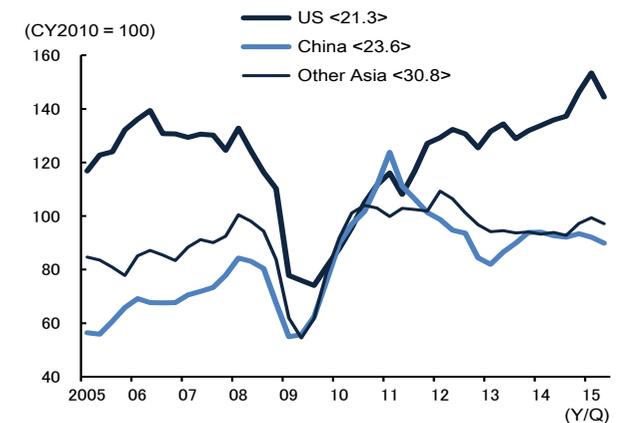
Source: : The Japan Research Institute, Ltd. based on the data of The Federation of Electric Power Companies of Japan, The Ministry of Economy, Trade and Industry, The Ministry of Finance, The Bank of Japan.

Figure 4-2 Contributions to the Quarter-on-quarter Change Rate in Japan's Real Exports by Goods



Source: : The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan.

Figure 4-3 Real Exports of Capital Goods excluding Transport Equipment <seasonally adjusted>



Source: : The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan.

Note: The figures in the angle brackets show the share of each destination in Japan's total nominal exports of capital goods in FY2014.

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Business fixed investment will likely pick up, reflecting firm corporate profits

◆ Corporate profits continue to be firm

Concerning the corporate sector, based on the Financial Statements Statistics of Corporations by Industry, current profits in enterprises in the January-March quarter continued to be around their highest level thus far on an aggregate basis, while sales proceeds were still stagnant during that period.

This trend of the improvement in the ratio of current profits to sales seems to be against the background of a materialisation of the effect of restructuring, a further increase owing to the weaker yen in receipts of dividend and interest from overseas assets, and a cost reduction effect thanks to the fall in the crude oil price. Among these elements, the third appears to have been the biggest contributor to recent firmness in profits, which was seen as a contribution of the fall in variable costs.

◆ Solid business fixed investment could be expected

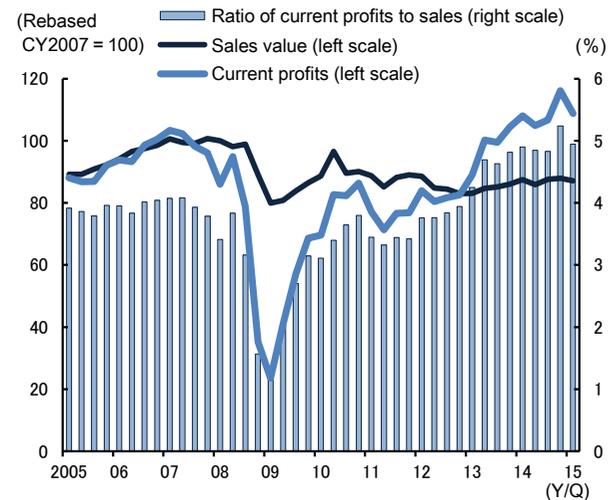
Machinery orders, which are a leading indicator for business fixed investment, have

been on a rising trend. Also, the Financial Statements Statistics of Corporations by Industry show that the ratio of business fixed investment to cash flow has bottomed out and has signs of picking up. Judging from these statistics, it is unlikely that business fixed investment will falter, although machinery orders are forecast to decline in the April-June quarter.

It is predicted that business fixed investment will be solid, mainly in investment for maintenance and replacement as well as rationalisation and saving, amid the situation where the fall in labour's share has been checked, and the virtuous cycle that firm corporate profits spread to wage rises seems to have started.

Further, in order for the ratio of business fixed investment to cash flow to keep its rising trend, and for business fixed investment to grow in earnest, it is imperative for growth expectations of Japan's domestic economy to rise.

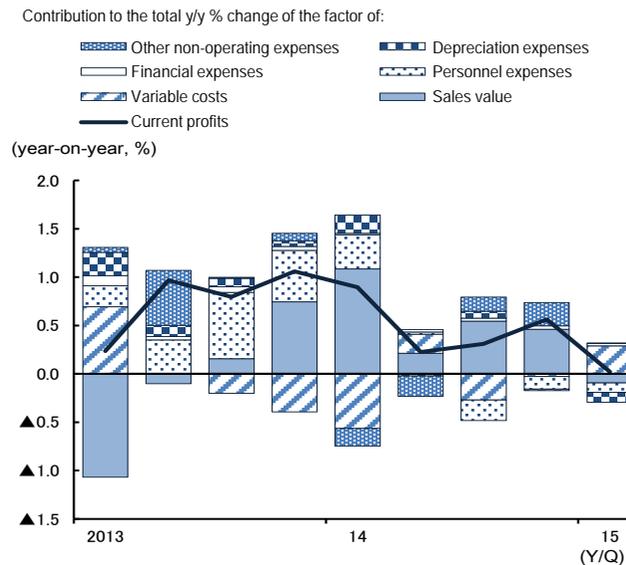
Figure 5-1 Sales Value and Ratio of Current Profits to Sales <seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Note: All industries excluding financial institutions.

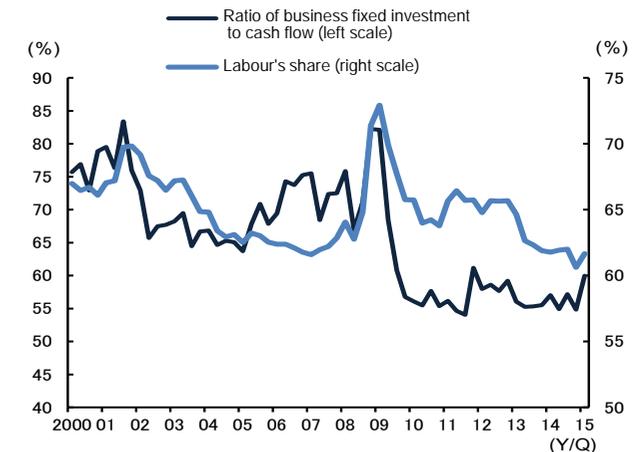
Figure 5-2 Contributions of Factors to the Year-on-year Change Rate in Current Profits



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Note: All industries excluding financial institutions.

Figure 5-3 Labour's Share and Ratio of Business Fixed investment to Cash Flow



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.

Note 1: All industries excluding financial institutions.

Note 2: Labour's share = personnel expenses / value added

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Private consumption expenditure will be affected positively by wage rises and cheaper oil

◆ The latest downswing in private consumption expenditure was due to bad weather and the light vehicle tax rise, as the reactionary fall after the consumption tax rise is coming to an end

With respect to the household sector, a certain degree of improvement has been seen in consumer sentiment, as the negative effect of the reactionary fall after the consumption tax rise last April is coming to an end. Yet, the pace of recovery in household consumption expenditure has remained slow, due to sluggish results caused by bad weather in such services as eating out, negative effects of the tax increase for light vehicles, and so on.

◆ A pickup in income and an improvement in employment environments are likely to bolster the recovery in private consumption expenditure

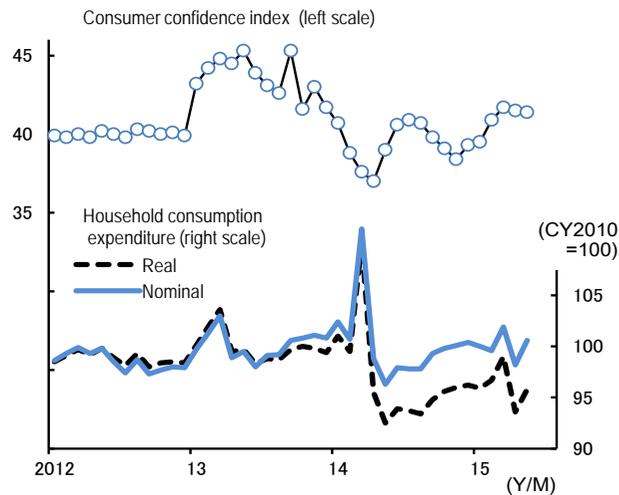
Income, which is a source of private consumption expenditure, is continuing its rising trend. Amid continued improvement in corporate profits, the rate of wage rise

after the wage negotiations this spring increased, albeit slightly. In addition, summer bonuses increased. As employment environments also continue to improve, nominal compensation for employees is likely to increase further. Compensation for employees in real terms is predicted to be bolstered by a deceleration in the consumer price rise. These improvements in income and employment environments will be likely to support a moderate recovery in private consumption expenditure.

◆ The rise in stock prices will also have a positive effect

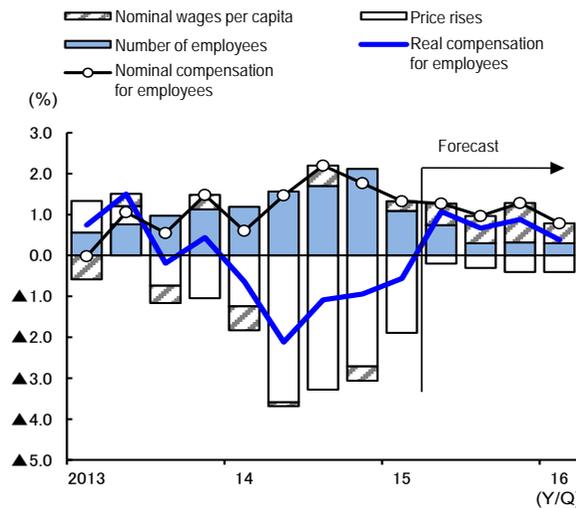
In addition, the wealth effect from the stock price rise will be expected on private consumption expenditure. Stock prices have been on a rising trend, against the background of the continued increase in corporate profits. Assuming that the Nikkei 225 stock price average stays at the 20,500 yen level during the rest of the year, it is projected that the appraisal profits in stock prices in the household sector as a whole will likely be over 50 trillion yen in 2015.

Figure 6-1 Consumer Sentiment and Household Consumption Expenditure <seasonally adjusted>



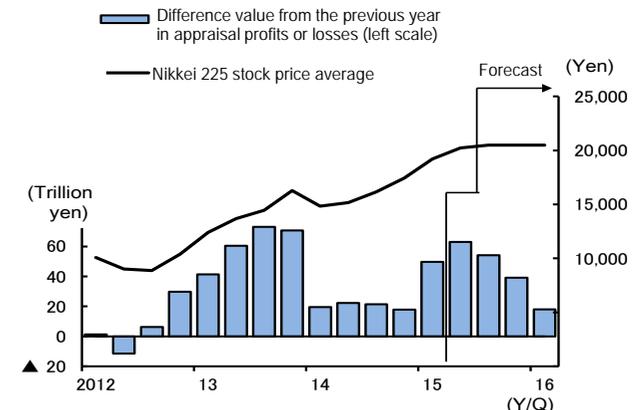
Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office, The Ministry of Internal Affairs and Communications.

Figure 6-2 Contributions to the Year-on-year Change Rate in Real Compensation for Employees



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labour and Welfare, The Ministry of Internal Affairs and Communications.

Figure 6-3 Stock Price Average and Appraisal Profits in Stock Prices in the Household Sector <defined as the difference value from the previous year>



Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, Nikkei NEEDS.

Note: Assuming that the Nikkei 225 stock price average stays at the 20,500 yen level during the rest of the year,

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The pace of rise in core CPI is likely to gain momentum again

◆ The rate of rise in the core CPI has decelerated considerably

The recent significant deceleration in the rate of year-on-year increase in the core consumer price index (CPI), which excludes fresh food, has been caused mainly by the downswing in energy prices stemming from the considerable fall in crude oil price. Although the fall in crude oil price has been checked recently, the price of liquefied natural gas (LNG), which is used in order to set the electricity and gas charges, has fallen significantly with a time lag between the considerable fall in the crude oil price.* Accordingly, it is predicted that a sluggish pace of increase in consumer prices will continue for the time being.

* The price of LNG destined for Japan is mostly linked to the crude oil price in the contract.

◆ The pace of rise in core CPI is likely to gain momentum again

On the other hand, the core CPI excluding energy prices has maintained a certain degree of year-on-year increase. Wages per hour, which are highly correlated to the CPI excluding food and energy, are on the rise. Taking the time-lagged correlation

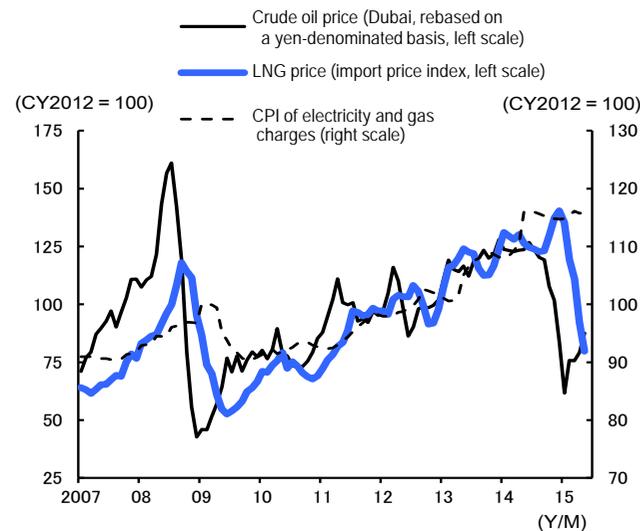
between the two into account, it is highly unlikely that the CPI will be back to the year-on-year decreasing trend. As employment and wages continue to improve, it is predicted that a moderate pickup in domestic demand will push up consumer prices. Therefore, with the downward effect of the crude oil price on consumer prices nearing its end, it is likely that the pace of the core CPI rise will accelerate again.

◆ It will take time to achieve the goal set by the BoJ

In order to achieve the goal set by the BoJ of the "continuously stable core CPI inflation rate at a pace of 2 per cent year-on-year", it is vital for the Phillips curve, which shows the relation between the GDP gap and the change in consumer prices, to be shifting upwards through a rise in inflation expectations, in addition to the boosting effect due to the improvement in supply-demand conditions.

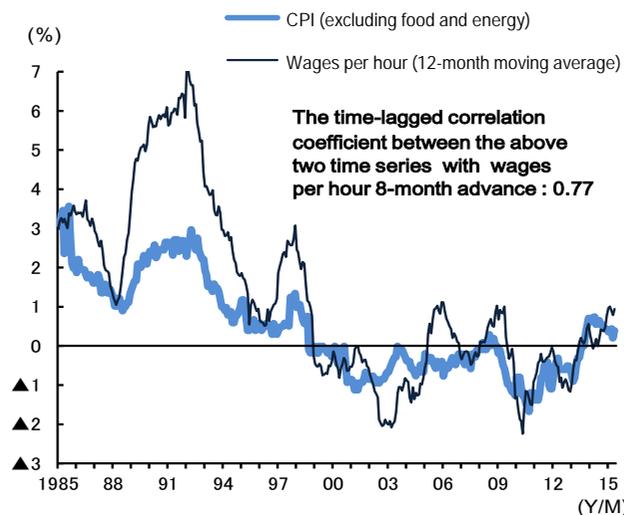
However, it is likely that achieving the goal will take time, taking the situation into account where a rise in inflation expectations in households and enterprises and an upward shift of the Phillips curve have been limited thus far.

Figure 7-1 Price of Crude Oil and Liquefied Natural Gas (LNG) and Electricity and Gas Charges



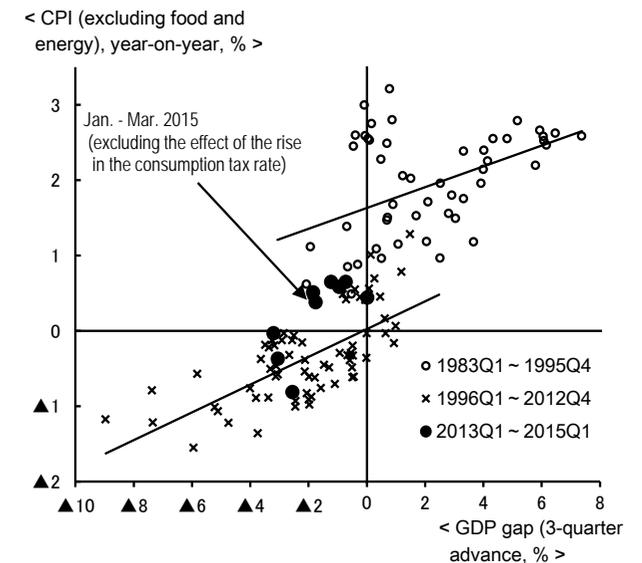
Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, Nikkei, The Ministry of Internal Affairs and Communications.

Figure 7-2 Time-lagged Correlation between Year-on-year Change in CPI and Wages per Hour



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

Figure 7-3 Phillips Curve



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Internal Affairs and Communications, The Cabinet Office, and others.

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Prospects for Japan's economy - Projected real GDP change; 1.5% in FY2015 and 1.3% in FY2016

◆ Although inventory pile-up weighs for the time being, the autonomous expansion mechanism is likely to strengthen gradually. Accordingly, economic activity is predicted to become firmer

(1) It is predicted that downward pressure for inventory adjustment will likely weigh down economic activity. On the other hand, it is expected that the "autonomous economic expansion mechanism" will work increasingly more strongly. This favourable trend is against the background that 1) the conditions for business fixed investment continue to be favourable, including continued buoyant corporate profits and low interest rates, and 2) the income and employment environments for households continue to improve, thanks to increased corporate profits and the tendency of a shortage of workers.

However, the pace of economic recovery will remain moderate on the whole, because exports of goods will not be able to be counted on so much, and public investment will likely be levelling off. As a result, it is projected that real GDP will grow by 1.5 per cent in FY2015, with economic activity in the second half getting firmer as inventory adjustment nears its end.

(2) Looking ahead further, although the "autonomous economic expansion mechanism" will continue to work, factors such as 1) stagnant real income through re-acceleration in consumer price rises mainly due to the depreciation of the yen, and 2) a slowdown in overseas economies such as China, will weigh down economic activity in FY2016.

However, towards the fourth quarter to March 2017, it is projected that rushed demand in private consumption expenditure and others will boost economic activity before the rescheduled rise in the consumption tax rate (from 8 to 10 per cent) in April 2017. Accordingly, it is projected that real GDP will grow by 1.3 per cent in FY2016 as a whole.

◆ The boosting effect of the weaker yen on consumer prices will likely materialise gradually

(3) The pace of increase in consumer prices is predicted to continue to be slow for the time being, affected by the considerable fall in the oil price. However, from the second half of FY2015 onwards, the pace of increase in the core CPI will likely accelerate again, as upward pressure on consumer prices from the depreciation of the yen materialises, albeit with a lag.

Figure 9 Projections for GDP Growth and Main Indicators of Japan (as of July 3, 2015)

	(seasonally adjusted, annualised % changes from the previous quarter)									(% changes from the previous fiscal year)		
	CY2015				CY2016				CY2017	FY2014	FY2015	FY2016
	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3	(Actual)	(Projection)	(Projection)
	(Actual)	(Projection)			(Projection)			(Projection)		(Actual)	(Projection)	(Projection)
Real GDP	3.9	0.8	1.4	1.7	2.0	0.4	1.1	1.1	2.2	▲ 0.9	1.5	1.3
Private Consumption Expenditure	1.5	1.0	1.2	1.2	2.2	▲ 0.4	0.8	1.3	5.9	▲ 3.1	1.3	1.2
Housing Investment	7.0	3.7	3.5	3.3	3.0	2.8	2.8	4.2	5.5	▲ 11.7	1.5	3.3
Business Fixed Investment	11.0	0.0	0.9	3.9	3.6	3.4	3.2	3.0	3.2	0.4	3.0	3.2
Private Inventories (percentage points contribution)	(2.2)	(▲ 1.2)	(▲ 0.5)	(0.0)	(0.0)	(0.0)	(0.5)	(0.2)	(▲ 0.8)	(0.5)	(▲ 0.3)	(0.0)
Government Consumption Expenditure	0.3	0.4	0.4	0.4	0.4	0.5	0.6	0.6	0.6	0.4	0.5	0.5
Public Investment	▲ 5.9	2.7	1.3	▲ 0.8	0.0	0.0	▲ 0.5	▲ 1.0	▲ 1.2	2.0	0.0	▲ 0.4
Net Exports (percentage points contribution)	(▲ 0.7)	(0.1)	(0.1)	(▲ 0.2)	(▲ 0.3)	(▲ 0.3)	(▲ 0.9)	(▲ 0.9)	(▲ 1.6)	(0.6)	(0.1)	(▲ 0.6)
Exports of Goods and Services	9.9	3.9	4.8	5.1	4.3	3.3	2.8	2.8	2.8	8.0	6.6	3.6
Imports of Goods and Services	12.2	2.4	4.2	5.6	5.3	5.2	6.0	6.0	8.9	3.7	5.7	5.7

	(% changes from the same quarter of the previous year)									(% changes from the previous fiscal year)		
	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3	FY2014	FY2015	FY2016
Real GDP	▲ 0.9	1.0	1.9	1.7	1.6	1.4	1.3	1.1	1.3	▲ 0.9	1.5	1.3
Nominal GDP	2.5	2.5	3.6	3.1	1.6	1.7	1.8	1.7	1.8	1.6	2.7	1.8
GDP deflator	3.4	1.5	1.7	1.4	0.1	0.3	0.5	0.6	0.6	2.5	1.1	0.5
Consumer Price Index (excluding fresh food)	2.1	0.1	0.3	0.6	1.0	1.3	1.2	1.3	1.4	2.8	0.5	1.3
(excluding fresh food and consumption tax)	0.1	0.0	0.3	0.6	1.0	1.3	1.2	1.3	1.4	0.8	0.5	1.3
Industrial Production Index	▲ 2.1	▲ 1.1	0.8	0.9	0.1	1.8	1.8	1.6	1.3	▲ 0.5	0.2	1.6
Unemployment Rate (%)	3.5	3.3	3.3	3.3	3.3	3.3	3.2	3.2	3.2	3.5	3.3	3.2
Current Account Balances (trillion JY)	4.30	2.38	3.48	1.49	3.83	1.94	3.50	1.89	4.64	7.81	11.18	11.96
Share of Nominal GDP (%)	3.5	1.9	2.8	1.1	3.0	1.5	2.8	1.4	3.6	1.6	2.2	2.3
Exchange Rates (JY/US\$)	119	121	123	124	124	124	123	123	123	110	123	123
Import Price of Crude Oil (US\$/barrel)	56	59	66	67	69	69	70	70	71	91	65	70

Source: The Cabinet Office; The Ministry of Internal Affairs and Communications; The Ministry of Economy, Trade and Industry; The Ministry of Finance.

The projection figures are based on those of The Japan Research Institute, Ltd.

Note 1: "▲" indicates minus.

2: It is assumed that the consumption tax rate will be raised from 8% to 10% in April 2017.

3: The assumptions on the real GDP growth rate in 2014 (actual result), 2015 and 2016 in major overseas economies: the US, 2.4%, 2.3%, 2.8%; the euro area, 0.8%, 1.3%, 1.6%; China, 7.4%, 6.9%, 6.8%.