

Monthly Report of Prospects for Japan's Economy

September 2015

Macro Economic Research Centre
Economics Department



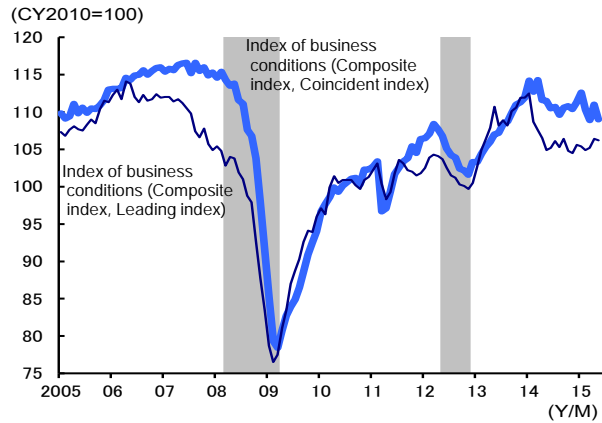
The Japan Research Institute, Limited
<http://www.jri.co.jp/english/periodical/>

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

The general situation of Japan's economy – Continued moderate recovery, only patchy momentum

Figure 1-1 Economic Activity

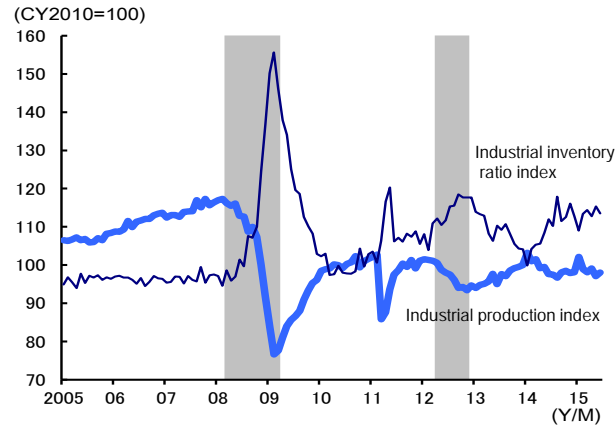
The leading index of business conditions fell in May for the first time in 3 months, due to the rise in the inventory ratios, and others.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

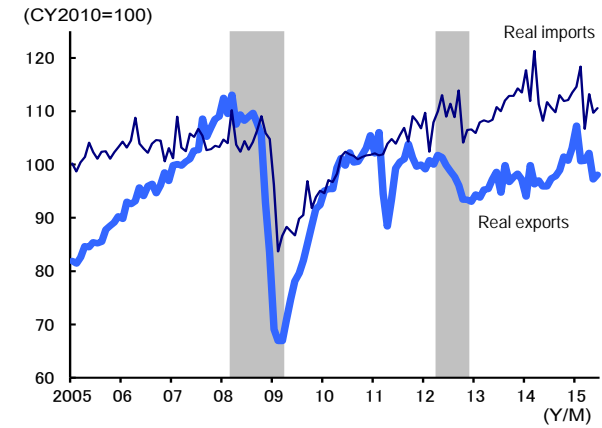
Although industrial production increased for the first time in 2 months, pressure for inventory adjustment persists.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

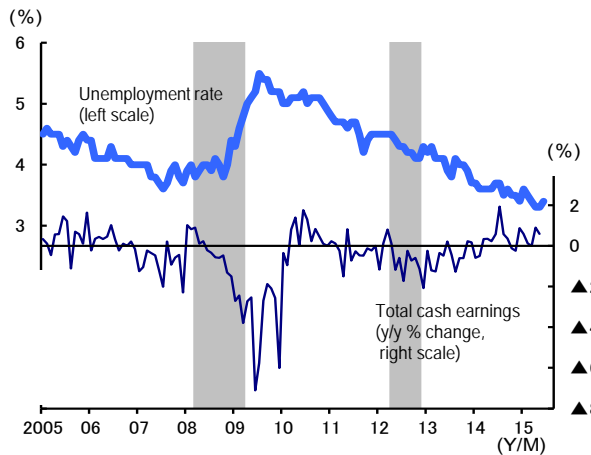
Exports have been on a declining trend since the start of the year. Imports continued to seesaw.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

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

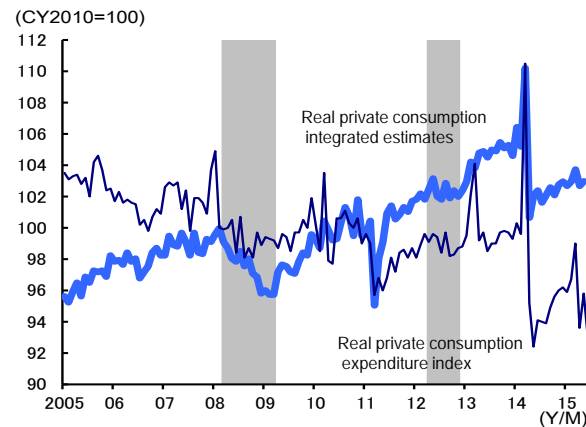


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

* The shaded area indicates the phase of recession.

Figure 1-5 Private Consumption Expenditure

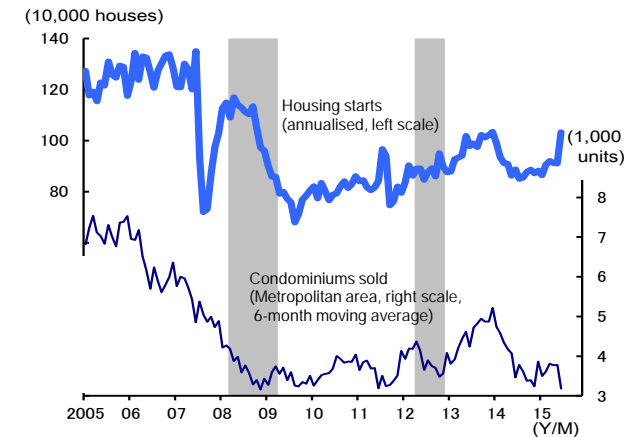
Real private consumption expenditure weakened due to the negative effects of bad weather, and others.



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

Figure 1-6 Housing Investment

While housing starts recovered considerably, condominium sales softened.



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

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Continued moderate recovery trend, although real GDP in Q2 was at a temporary standstill

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

Japan's economic activity is basically continuing a moderate recovery on the whole. Corporate profits continue to be buoyant. Also, income and employment environments continue to improve. Enterprises seem to have started to invest in plant and equipment, which had been postponed.

As for Q2, Japan's economic activity seems to have been at a temporary standstill. Japan's real GDP in the April-June period decreased by 1.6 per cent on an annualised quarter-on-quarter change basis (national accounts, the first preliminary estimates), the first negative figure in 3 quarters. The pace of recovery in private consumption expenditure was still slow. Also, real exports declined reflecting the deceleration in overseas economies such as China. Persistent pressure for inventory adjustment could be a weighing factor on economic activity for the time being.

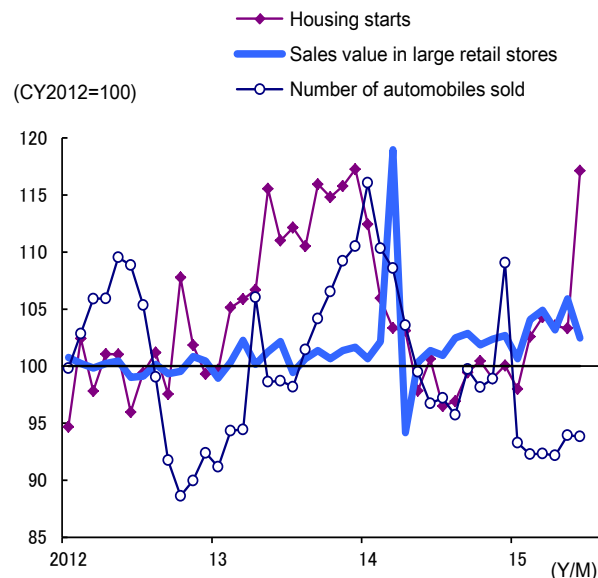
However, there is no change in the basic view that "Japan's economy has been on a moderate recovery path from the reactionary fall after the consumption tax rise in April 2014". Therefore, after a standstill in Q2, the economic activity will likely return to the trend recovery path again.

Looking at monthly statistics, automobile sales continued to be sluggish in June, due to the tax increase for light vehicles, and so on. Therefore, in the inventory ratio, that in the transport equipment industry has been at a high level. Including automobiles, it is highly likely that inventory adjustment will weigh on production activity in enterprises for the time being.

◆ Real exports lack momentum

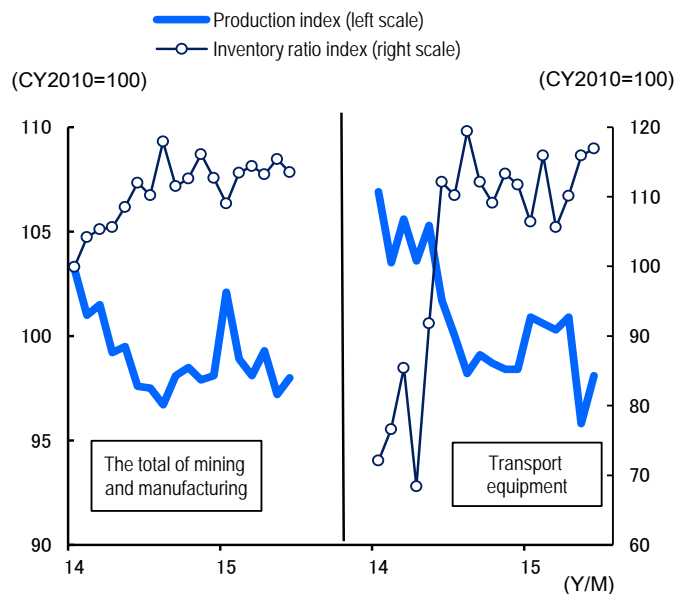
As for overseas demand, real exports lack momentum. Reflecting the decelerating trend in China, real exports as a whole are likely to have declined again.

Figure 2-1 Household-related Statistics
<rebased, seasonally adjusted>



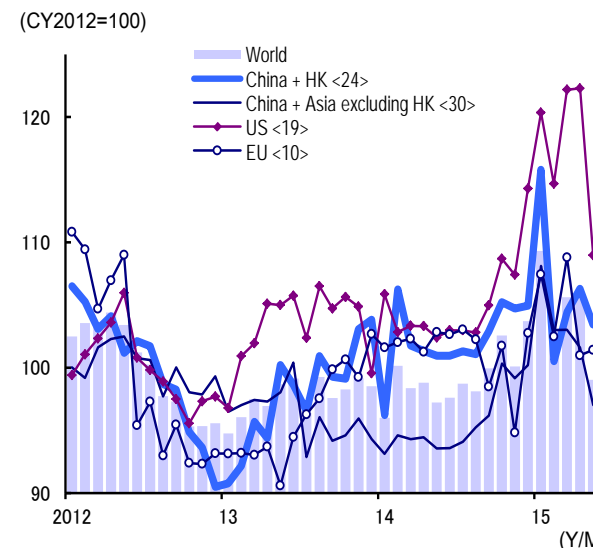
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Land, Infrastructure and Transport, The Ministry of Economy, Trade and Industry, Japan Automobile Dealers Association, Japan Light Motor Vehicle and Motorcycle Association.

Figure 2-2 Production Index and Inventory Ratio Index



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Economy, Trade and Industry.

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.

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Monthly trade surplus is unlikely to continue, as the recovery in exports lacks momentum

◆ 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, have 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, the rise in the inventory of fuels has recently been checked. 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

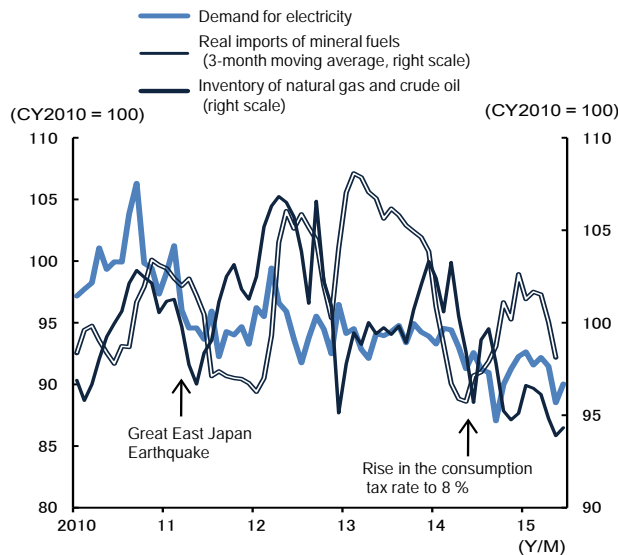
The latest figure of real exports showed a decline, with a wide range of export products, excluding "others," decreasing. Especially, exports of capital goods

(excluding transport equipment), which have a share of about one quarter in the total real exports, weakened in the second 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.

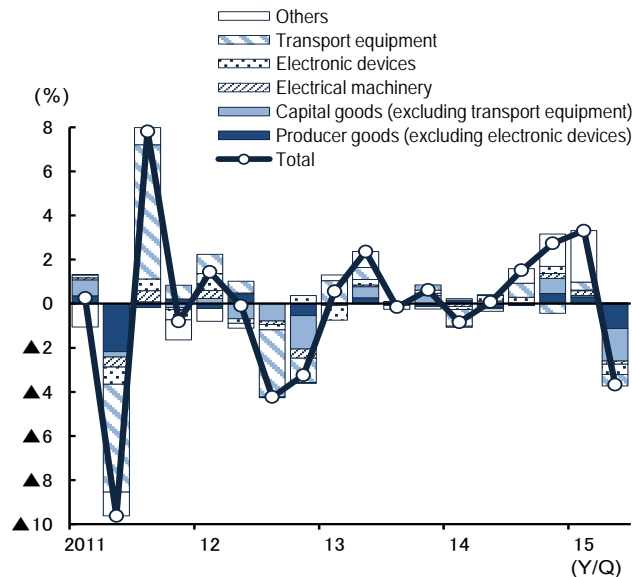
Taking the above factors and trends into consideration, it is expected that the monthly trade balance will continue the trend of small deficits, on the assumption that price factors such as the exchange rate of the yen and the price of crude oil stabilise at the present level.

Figure 3-1 Demand for Electricity, Real Imports of Mineral Fuels, and Gas and Oil Inventory <seasonally adjusted>



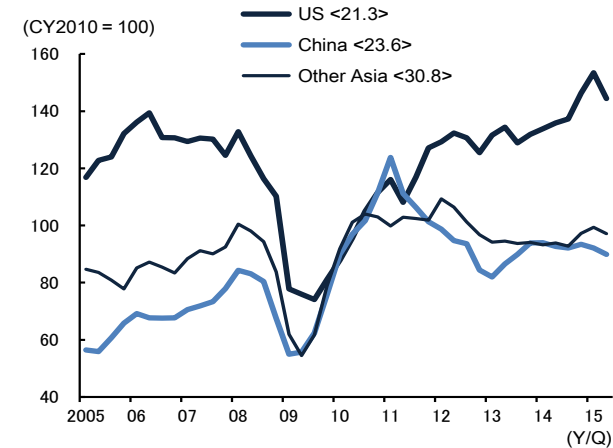
Source: : The Japan Research Institute, Ltd. based on the data of The Federation of Electric Power Companies of Japan, The Ministry of Economy, Trade and Industry, The Ministry of Finance, The Bank of Japan.

Figure 3-2 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 3-3 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 profits stemming from overseas operations and 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

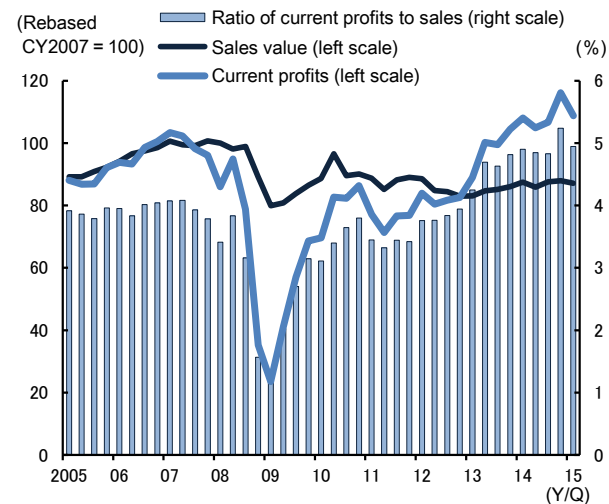
Machinery orders, which are a leading indicator for business fixed investment, have

been on a rising trend. They are currently staying at a considerably higher level than the April-June forecast had predicted. 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 very likely that business fixed investment will be firmer.

By type, 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.

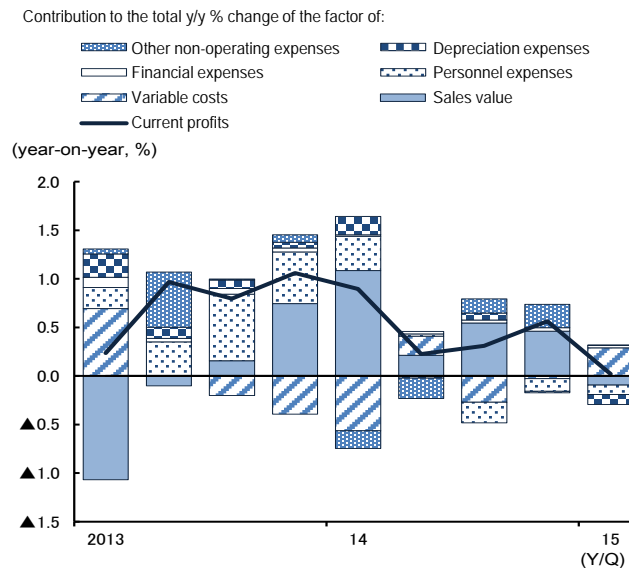
Figure 4-1 Sales Value and Ratio of Current Profits to Sales <seasonally adjusted>



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

Note: All industries excluding financial institutions.

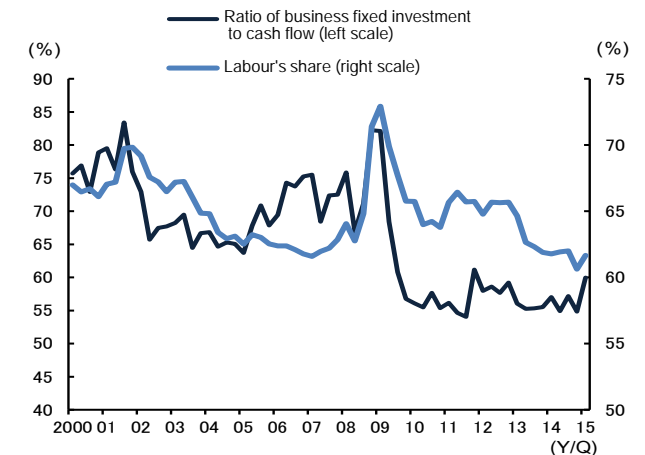
Figure 4-2 Contributions of Factors to the Year-on-year Change Rate in Current Profits



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

Note: All industries excluding financial institutions.

Figure 4-3 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

Although the negative effect of the reactionary fall after the consumption tax rise last April is coming to an end, the pace of recovery in household consumption expenditure has remained slow. This has been 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.

On the other hand, in spite of the fact that the year-on-year change rate in the core CPI has been almost zero recently, a certain degree of core CPI inflation is still forecast by consumers. Also, consumer sentiment is still at a firm level, which seems to imply people still have a good future outlook.

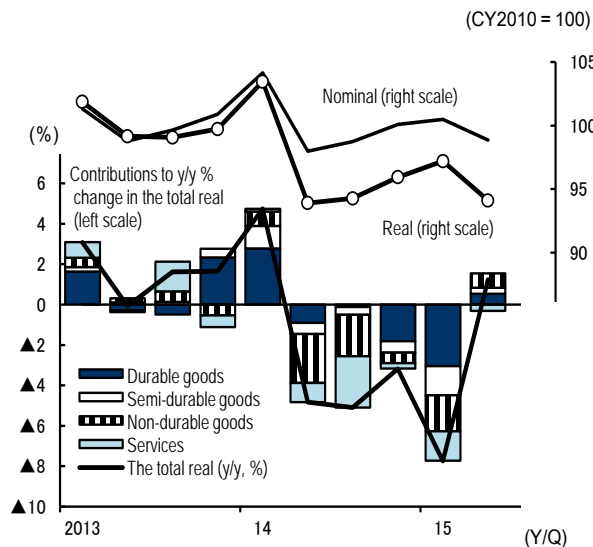
◆ A pickup in income and an improvement in employment environments are likely to bolster the recovery in private consumption expenditure

Income, which is a source of private consumption expenditure, is continuing its rising trend. Corporate profits continue to improve, partly because a certain number of enterprises have managed to pass on the increased costs of the weaker yen to downstream industries and consumers. Personnel expenses (wages) have also increased, corresponding to the pace of increase in sales proceeds. Employment also is expected to improve, amid a persistent sense of labour shortage.

For the time being, compensation for employees in real terms is predicted to be bolstered by a deceleration in the consumer price rise due to the significant fall in the crude oil price. These improvements in income and employment environments will be likely to support a moderate recovery in private consumption expenditure.

In addition, the wealth effect from the stock price rise is expected on private consumption expenditure.

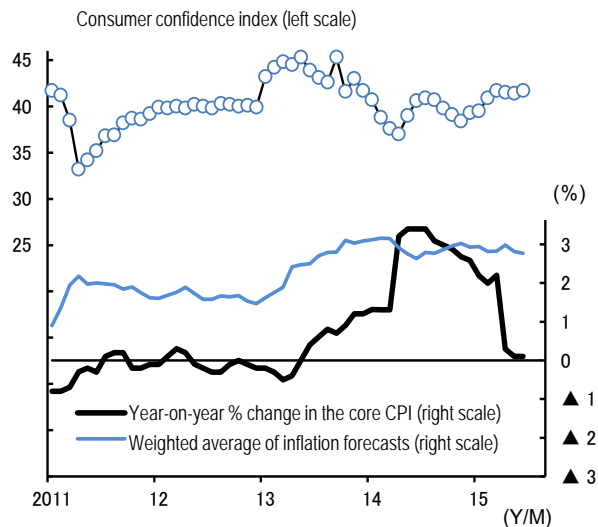
Figure 5-1 Consumption Expenditure per Household <rebased>



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

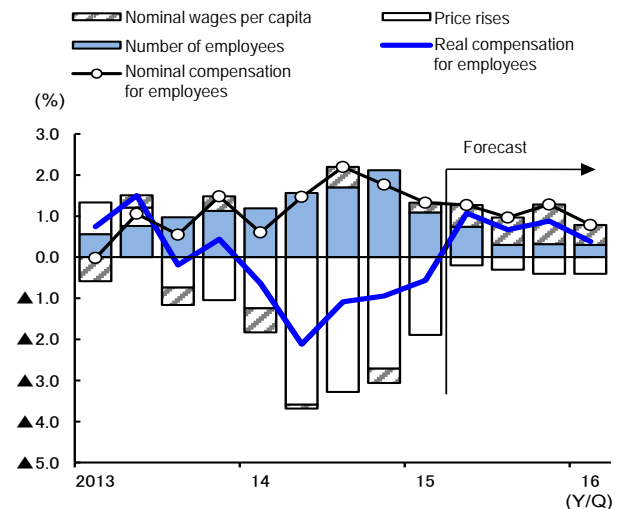
Note: Households with 2 or more family members.

Figure 5-2 Consumer Confidence and Inflation Forecasts



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

Figure 5-3 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.

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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 CPI excluding food and 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

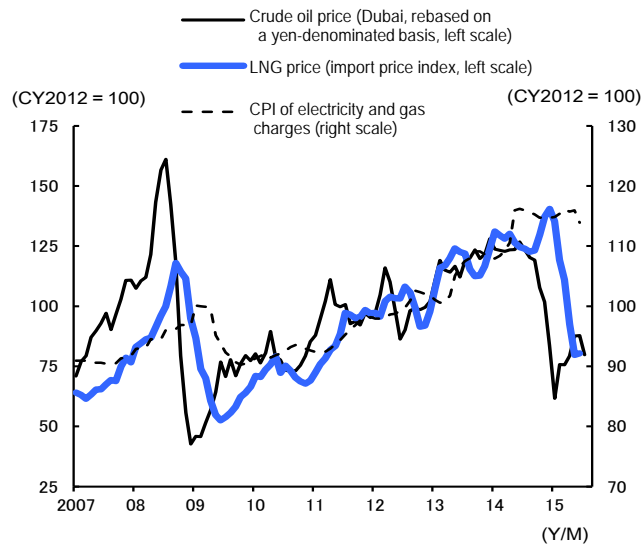
correlation between the two into account, it is highly unlikely that the CPI will be back to the year-on-year decreasing trend. As employment and wages continue to improve, it is predicted that a moderate pickup in domestic demand will push up consumer prices. Therefore, with the downward effect of the 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.

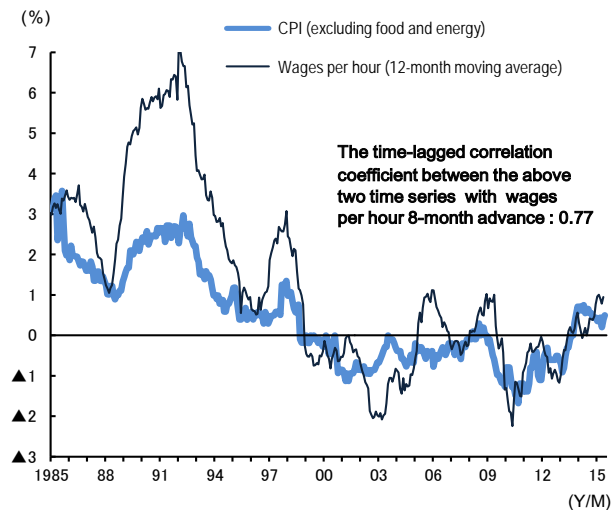
However, it is likely that achieving the goal will take time, taking the situation into account where a rise in inflation expectations in households and enterprises and an upward shift of the Phillips curve have been limited thus far.

Figure 6-1 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.

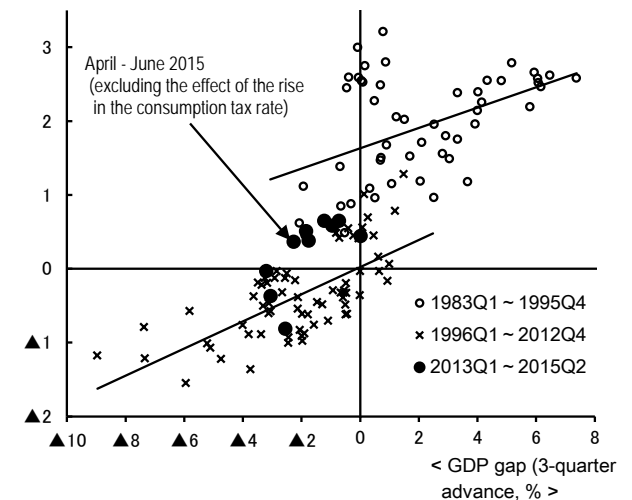
Figure 6-2 Time-lagged Correlation between Year-on-year Change in CPI and Wages per Hour



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 6-3 Phillips Curve

< CPI (excluding food and energy), year-on-year, % >



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; 1.2% 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) Japan's real GDP in the April-June period decreased by 1.6 per cent on an annualised quarter-on-quarter change basis (national accounts, the first preliminary estimates), the first negative figure in 3 quarters. Japan's economic activity seems to have been at a temporary standstill.

The pace of recovery in private consumption expenditure from the reactionary fall after the rise in the consumption tax rate in April 2014, was still slow, due to the negative effects of bad weather, the tax increase for light vehicles, and so on. Also, real exports declined reflecting the deceleration in overseas economies such as China.

(2) In this issue of The Monthly Report, the projected real GDP change rate in FY2015 was revised downwards from 1.5 to 1.2 per cent. This downward revision was made because of the fact that persistent pressure for inventory adjustment could be a weighing factor on economic activity for the time being, in addition to the negative result in the second quarter GDP figure.

However, there is no change in the basic view that "Japan's economy has been on a moderate recovery path from the reactionary fall after the consumption tax rise in April 2014". Therefore, after a standstill in Q2, the economic activity will likely return to the trend recovery path again.

(3) 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 1.2 per cent in FY2015, with economic activity in the second half getting firmer as inventory adjustment nears its end.

(4) 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 effects of the pickup in domestic demand and the weaker yen on consumer prices will likely materialise gradually

(5) 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 the pickup in domestic demand and upward pressure on consumer prices from the depreciation of the yen materialise.

Figure 8 Projections for GDP Growth and Main Indicators of Japan (as of August 17, 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)				
Real GDP	4.5	▲ 1.6	2.1	1.4	2.0	0.3	1.2	1.2	2.4	▲ 0.9	1.2	1.3
Private Consumption Expenditure	1.4	▲ 3.0	2.1	1.1	2.2	▲ 0.4	0.8	1.3	5.9	▲ 3.1	0.4	1.3
Housing Investment	7.0	8.0	3.0	3.0	3.0	2.8	2.8	4.2	5.5	▲ 11.7	2.5	3.2
Business Fixed Investment	11.7	▲ 0.3	3.0	2.8	2.8	3.0	3.3	3.3	3.3	0.5	3.1	3.1
Private Inventories (percentage points contribution)	(2.1)	(0.3)	(▲ 0.8)	(▲ 0.3)	(0.0)	(0.0)	(0.5)	(0.2)	(▲ 0.8)	(0.5)	(0.0)	(▲ 0.0)
Government Consumption Expenditure	1.0	1.7	0.2	0.4	0.4	0.5	0.6	0.6	0.6	0.4	0.9	0.4
Public Investment	▲ 4.7	10.7	▲ 4.9	▲ 1.0	▲ 0.4	0.0	▲ 1.0	▲ 1.2	▲ 1.5	2.0	0.9	▲ 0.9
Net Exports (percentage points contribution)	(▲ 0.3)	(▲ 1.1)	(0.8)	(0.1)	(▲ 0.2)	(▲ 0.2)	(▲ 0.8)	(▲ 0.8)	(▲ 1.4)	(0.6)	(▲ 0.1)	(▲ 0.3)
Exports of Goods and Services	6.7	▲ 16.5	10.1	5.1	4.3	3.0	2.8	2.8	2.8	7.9	1.2	3.8
Imports of Goods and Services	7.4	▲ 9.8	6.7	4.4	4.9	4.8	5.7	5.8	8.6	3.6	1.5	5.4

	(% changes from the same quarter of the previous year)									(% changes from the previous fiscal year)		
Real GDP	▲ 0.8	0.7	1.6	1.3	1.1	1.4	1.2	1.1	1.3	▲ 0.9	1.2	1.3
Nominal GDP	2.6	2.2	3.4	2.9	1.6	1.7	2.0	1.8	2.2	1.6	2.5	1.9
GDP deflator	3.5	1.6	1.8	1.6	0.5	0.3	0.8	0.8	0.9	2.5	1.3	0.7
Consumer Price Index (excluding fresh food)	2.1	0.1	▲ 0.1	0.2	0.7	1.0	1.2	1.3	1.4	2.8	0.2	1.2
(excluding fresh food and consumption tax)	0.1	0.0	▲ 0.1	0.2	0.7	1.0	1.2	1.3	1.4	0.8	0.2	1.2
Industrial Production Index	▲ 2.1	▲ 0.6	1.0	1.1	0.4	2.2	1.8	1.6	1.3	▲ 0.5	0.5	1.7
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)	4.42	3.50	3.27	1.27	3.72	1.66	3.46	1.91	4.80	7.93	11.76	11.83
Share of Nominal GDP (%)	3.6	2.8	2.7	1.0	3.0	1.3	2.8	1.4	3.7	1.6	2.3	2.3
Exchange Rates (JY/US\$)	119	121	124	125	125	124	123	123	123	110	123	123
Import Price of Crude Oil (US\$/barrel)	56	60	60	57	63	64	66	68	70	91	60	67

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%.