

Monthly Report of Prospects for Japan's Economy

October 2015

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

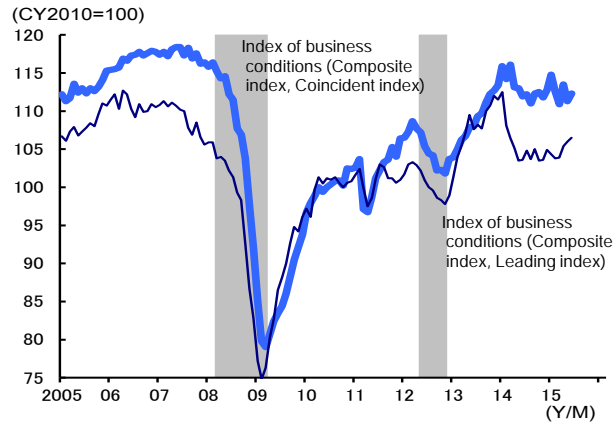
<http://www.jri.co.jp/english/periodical/>

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

The general situation of Japan's economy – stagnant private consumption and exports

Figure 1-1 Economic Activity

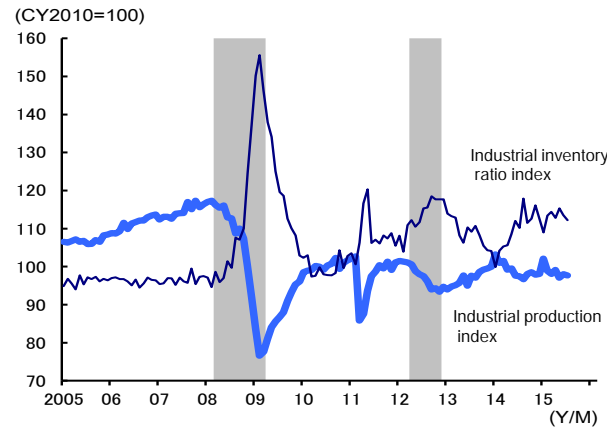
The leading index of business conditions continued to rise, due to the increase in floor areas in housing starts, and so on.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

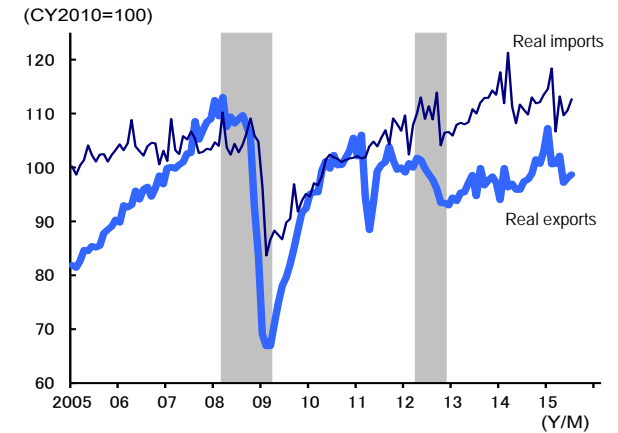
Industrial production has weakened. Pressure for inventory adjustment persists.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

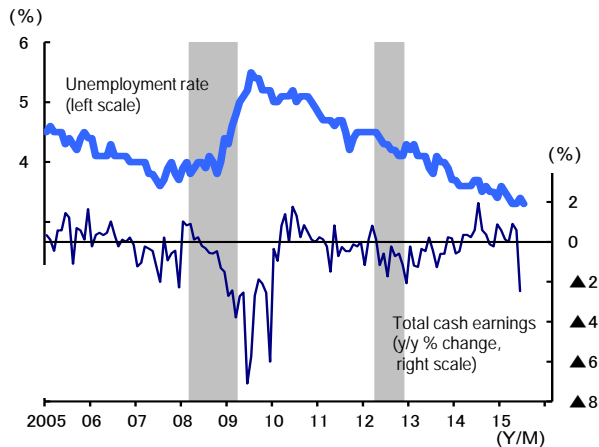
Exports have been on a declining trend since the start of the year. Imports continued to seesaw.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

The considerable year-on-year decline in total cash earnings in June was mainly due to the shift in the time for summer bonus payments to July.

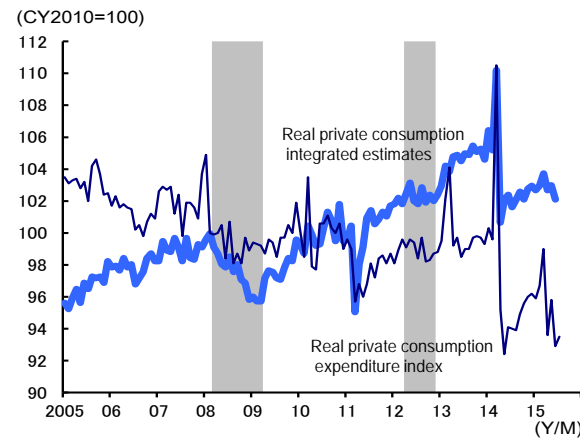


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

* The shaded area indicates the phase of recession.

Figure 1-5 Private Consumption Expenditure

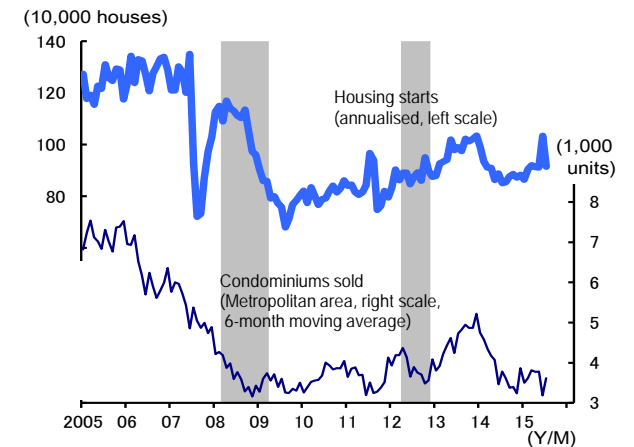
Real private consumption expenditure has weakened, partly because a succession of food price rises have weighed on it.



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

Housing starts had a reactionary fall from the surge in the previous month. Condominium sales continued to seesaw.



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

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Economic activity in Q2 was at a temporary standstill, due to sluggish private consumption and exports

◆ Economic activity halted in Q2 due to stagnant private consumption expenditure and exports

Japan's real GDP in the April-June period decreased by 1.2 per cent on an annualised quarter-on-quarter change basis (national accounts, the second preliminary estimates), the first negative figure in 3 quarters. The economic activity seems to have been at a temporary standstill. Sluggish private consumption expenditure and a fall in exports, affected by a slowdown in the Chinese economy, contributed negatively to the total change rate.

◆ Private consumption expenditure is still weak, with real wages declining year-on-year

In the household sector, wages in real terms have softened, as the rate of increase in nominal wages has fallen short of that in consumer prices. While consumer

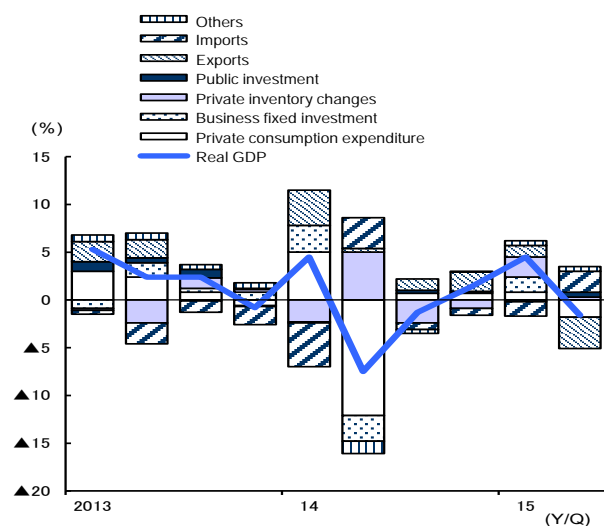
sentiment has been firm, the orientation to economisation in consumers has also been persistent. As a result, the pace of recovery in private consumption expenditure continues to be very slow.

◆ The delay in inventory adjustment has curbed production. Exports have lacked momentum

With respect to the corporate sector, the inventory ratio stays at a high level in industries such as transport equipment, where automobile sales have been stagnant, and material-related including petroleum and coal products as well as non-ferrous metals. With the delay in inventory adjustment weighing heavily on production activity, industrial production continues to weaken.

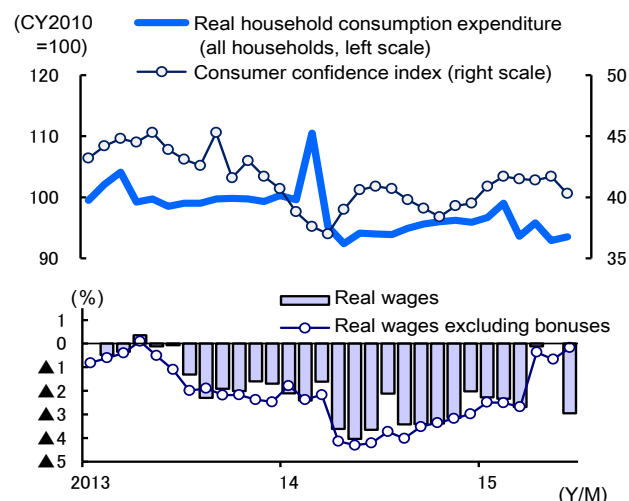
As for overseas demand, real exports lack momentum. Reflecting the decelerating trend in China, real exports continue to soften especially in those to Asian countries.

Figure 2-1 Real GDP Change Rate by Demand Item
<the first preliminary estimates, on an annualised q/q change basis, seasonally adjusted>



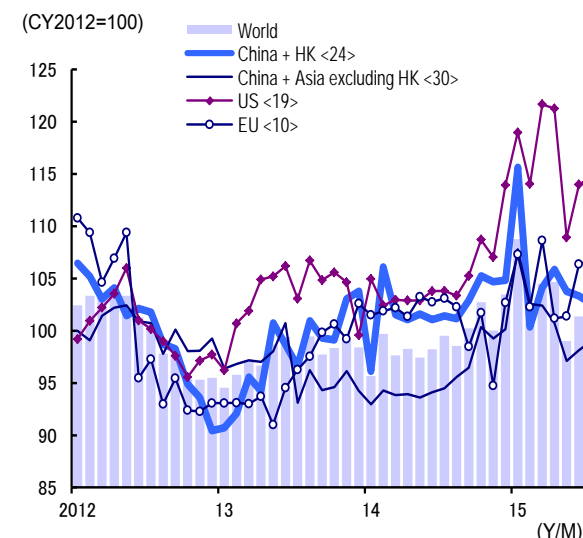
Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office.

Figure 2-2 Real Household Consumption Expenditure and Real Wages
<year-on-year % change>



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 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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Japan's exports have weakened, with a slowdown in China's economy being a worrisome risk

◆ Imports which had decreased have signs of bottoming out

The decrease in the total value of imports, which had contributed largely to narrowing trade deficits, has shown signs of bottoming out. Viewed by product, real imports of mineral fuels, which have a one third share in the total, have been picking up, as the inventory adjustment in mineral fuels is nearing its end. As domestic demand recovers more noticeably, real imports will also likely pick up again.

◆ It is expected that exports will recover modestly, under the circumstances that a slowdown in China's economy will continue to be a weighing down factor

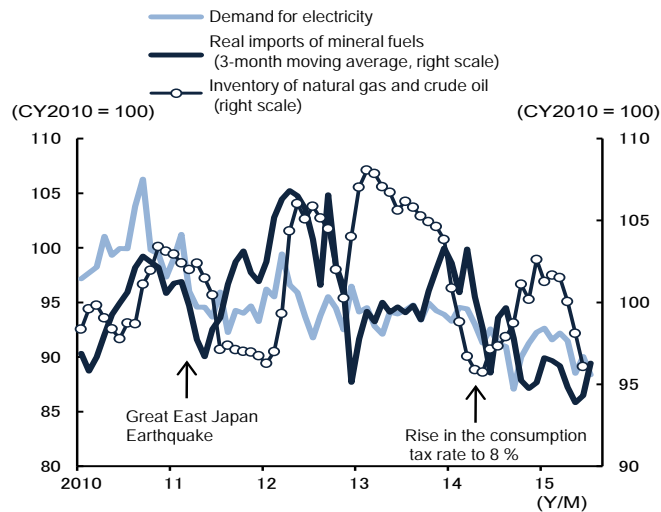
Japan's real exports have weakened. This sluggish trend seems to be against the background of the following: 1) the decline in export competitiveness of Japanese enterprises, 2) the decrease in the share of Japan's exports in the total world trade market, which has been caused by the changed attitude of Japanese enterprises that they have prioritised profitability rather than quantity, and 3) a slowdown in the growth

rate in world trade per se.

Especially, the latest anxiety is that the slowdown in the Chinese economy will push down world trade further. Looking at the degree of the negative impact of the decrease in China's final demand by country or area, the direct negative effect on Japan's value added exports to China seems to be limited. This is because Japan's value added exports to China represent only 2 per cent in Japan's nominal GDP. On the other hand, the ratio of value added exports of East Asia (excluding Japan) to China in their total nominal GDP is over 5 per cent. Therefore, it is necessary to watch the negative impact on the economies of East Asia more carefully.

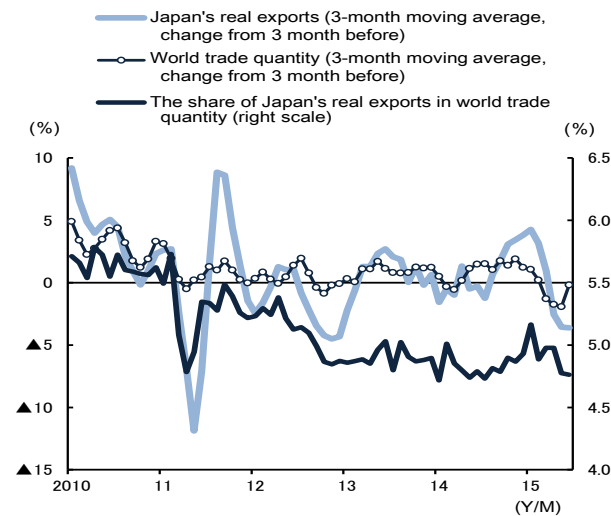
Looking ahead, the depreciation of the yen will bolster Japan's exports for the time being. However, the deceleration in the economies in emerging countries such as China will likely continue to be a weighing down factor on the global economy. Accordingly, the pace of increase in Japan's exports is predicted to remain modest, corresponding to the pace of pickup in overseas demand on the whole.

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



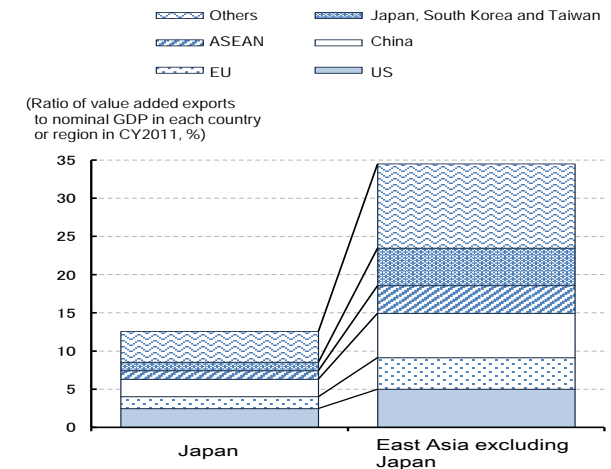
Source : The Japan Research Institute, Ltd. based on the data of The Federation of Electric Power Companies of Japan, The Ministry of Economy, Trade and Industry, The Ministry of Finance, The Bank of Japan.

Figure 3-2 World Trade Quantity and Japan's Real Exports <seasonally adjusted>



Source : The Japan Research Institute, Ltd. based on the data of CPB Netherlands Bureau for Economic Policy Analysis, "World Trade Monitor".

Figure 3-3 Trade Value Added by the Final Consumption Market



Source : The Japan Research Institute, Ltd. based on the data of OECD-WTO, "Trade Value Added".

Note: East Asia here is for Japan, South Korea, Taiwan, and ASEAN. China includes HK.

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Business fixed investment will likely pick up, albeit moderately, 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 April-June quarter continued to be at 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.

◆ The pace of increase in business fixed investment could be more moderate, compared with buoyant corporate profits

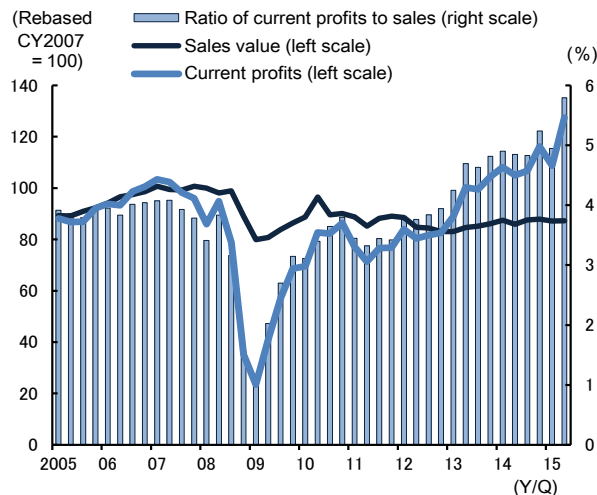
Machinery orders, which are a leading indicator for business fixed investment, have been on a rising trend. However, based on the Financial Statements Statistics of

Corporations by Industry, business fixed investment in all enterprises (excluding financial institutions and software investment) declined in the April-June period from the previous quarter for the first time in 4 quarters. Thus, it is probable that enterprises have postponed a certain part of their investment, due to sluggish exports and prolonged inventory adjustment. Cautious attitudes of enterprises to business fixed investment could be seen in the declining trend in labour's share and in the ratio of business fixed investment to cash flow.

In addition, uncertainties have heightened in equities and other markets, reflecting anxiety about the slowdown in the Chinese economy. There is a risk that these uncertainties could curb business fixed investment.

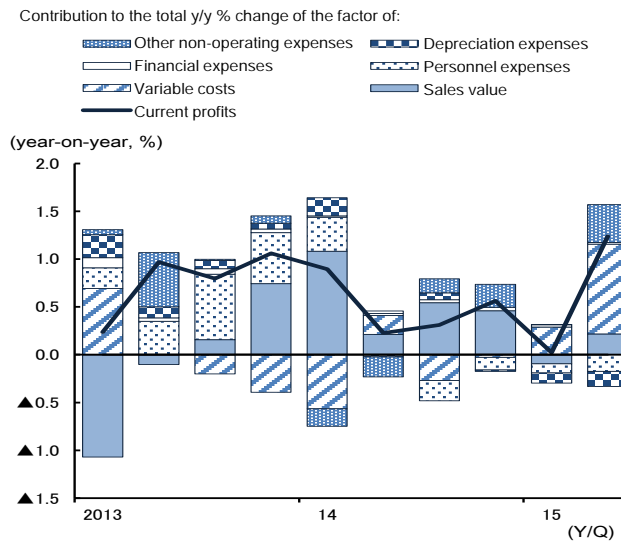
Judging from both favourable and unfavourable factors, business fixed investment will likely pick up, against the background of buoyant corporate profits and increased demand for investment for rationalisation, saving, and research and development. Yet, the pace of the pickup could be more moderate than anticipated.

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



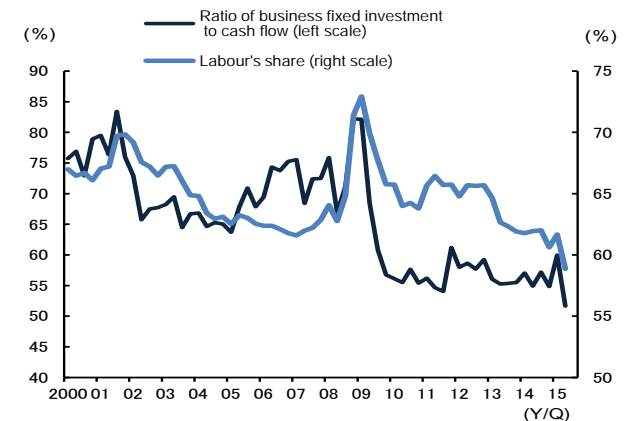
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.
Note: All industries excluding financial institutions.

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

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.

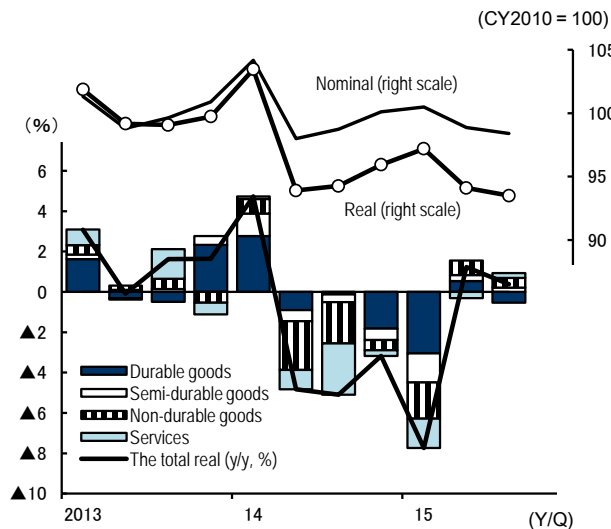
◆ A pickup in income and an improvement in employment environments are likely to bolster the recovery in private consumption expenditure

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.

Meanwhile, although the amount of pension payments had continued to decline on a nominal basis, the national pension payment in FY2015 increased by 0.9 % over the previous fiscal year. This is also an encouraging factor.

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.

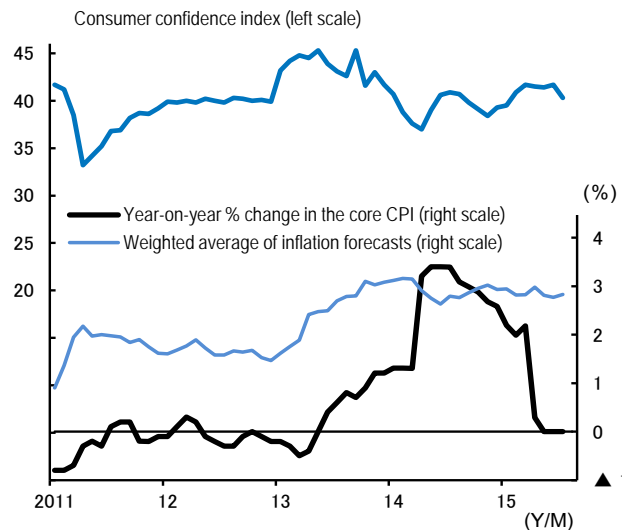
Figure 5-1 Consumption Expenditure per Household <rebased>



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

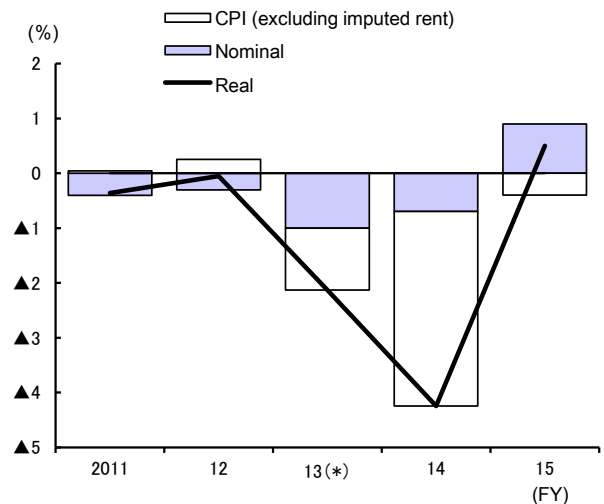
Note: Households with 2 or more family members.

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 Real Purchasing Power in Households with Pensioner Members



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, 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 the price of crude oil and liquefied natural gas (LNG). These prices are used in order to set the electricity and gas charges with a time lag of from 3 to 5 months. As the energy charges have fallen recently, it is predicted that a sluggish pace of increase in consumer prices will continue for the time being.

◆ 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

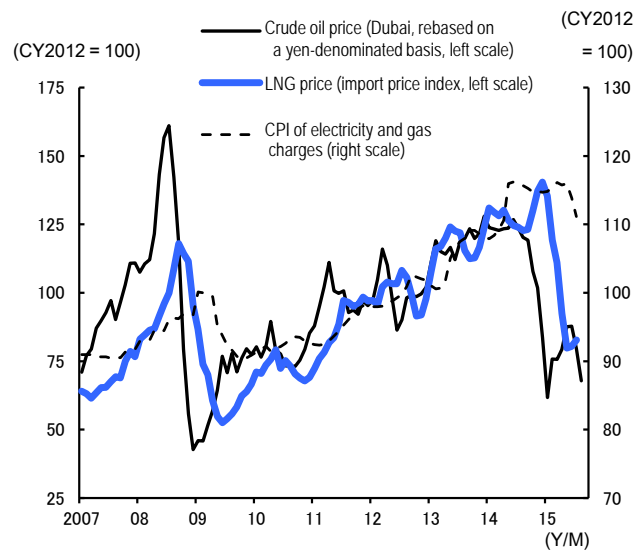
to the year-on-year decreasing trend. As employment and wages continue to improve, it is predicted that a moderate pickup in domestic demand will push up consumer prices. Therefore, with the downward effect of the crude oil price on consumer prices nearing its end, it is likely that the pace of the core 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.

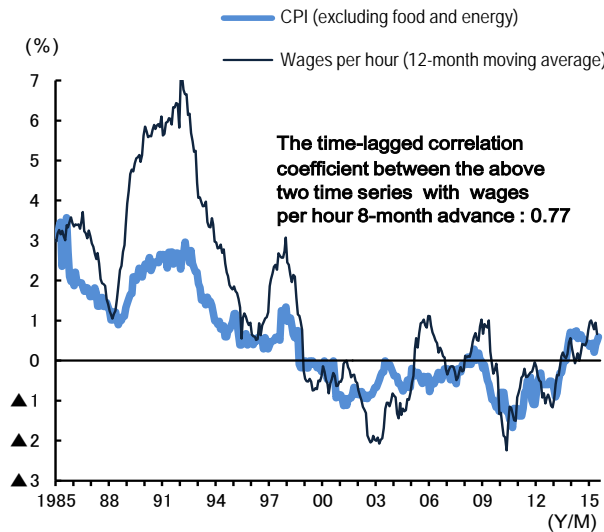
However, it is likely that achieving the goal will take time, taking the situation into account where a rise in inflation expectations in households and enterprises and an upward shift of the Phillips curve have been limited thus far.

Figure 6-1 Price of Crude Oil and Liquefied Natural Gas (LNG) and Electricity and Gas Charges



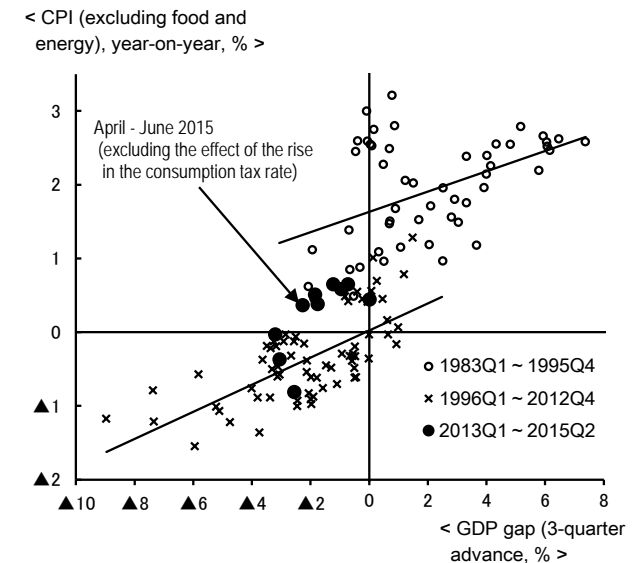
Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, Nikkei, The Ministry of Internal Affairs and Communications.

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



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 is a heavy weight 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 continue to work because of the following: 1) the favourable environments for business fixed investment have been maintained, including continued buoyant corporate profits and low interest rates, 2) the income and employment environments for households continue to improve, thanks to increased corporate profits and the tendency of a shortage of workers, and so on.

Under these circumstances, it is projected that Japan's economy will regain its firmness, as inventory adjustment nears its end. However, the pace of economic recovery will remain moderate on the whole, because 1) exports will not be able to be counted on so much, due to the slowdown in growth in overseas economies in countries such as China, 2) public investment will likely be levelling off, and so on. As a result, real GDP will grow by 1.2 per cent in FY2015.

(2) Looking ahead further, the "autonomous economic expansion mechanism" will still continue to work. Nevertheless, the following factors will weigh down economic activity in FY2016: 1) stagnant real income

through re-acceleration in consumer price rises mainly due to the depreciation of the yen, 2) a downswing in private consumption expenditure due to the reactionary fall after the increase caused by leap day, and so on.

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

(3) The pace of increase in consumer prices is predicted to continue to be very 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, the depreciation of the yen, and other factors contribute to boosting the core CPI in earnest.

Figure 8 Projections for GDP Growth and Main Indicators of Japan (as of September 8, 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	▲ 1.2	1.6	1.3	2.0	0.3	1.3	1.3	2.4	▲ 0.9	1.2	1.3
Private Consumption Expenditure	1.5	▲ 2.7	2.0	1.1	2.2	▲ 0.3	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	11.0	▲ 3.6	3.8	2.8	2.8	3.0	3.3	3.3	3.3	0.5	2.2	3.1
Private Inventories (percentage points contribution)	(2.2)	(1.1)	(▲ 1.0)	(▲ 0.4)	(0.0)	(0.0)	(0.5)	(0.2)	(▲ 0.8)	(0.5)	(0.1)	(▲ 0.0)
Government Consumption Expenditure	1.1	2.0	0.2	0.4	0.4	0.5	0.6	0.6	0.6	0.4	1.0	0.4
Public Investment	▲ 5.3	8.9	▲ 4.6	▲ 0.9	▲ 0.4	0.0	▲ 1.0	▲ 1.2	▲ 1.5	2.0	0.4	▲ 0.9
Net Exports (percentage points contribution)	(▲ 0.3)	(▲ 1.1)	(0.5)	(0.1)	(▲ 0.2)	(▲ 0.3)	(▲ 0.7)	(▲ 0.7)	(▲ 1.3)	(0.6)	(▲ 0.1)	(▲ 0.4)
Exports of Goods and Services	6.7	▲ 16.6	7.8	5.1	4.3	3.0	3.0	3.1	3.1	7.9	0.8	3.8
Imports of Goods and Services	7.3	▲ 10.1	6.0	4.3	4.9	4.8	5.8	5.8	8.6	3.6	1.2	5.4

	(% 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	▲ 0.8	0.8	1.6	1.3	1.1	1.3	1.2	1.1	1.4	▲ 0.9	1.2	1.3
Nominal GDP	2.6	2.3	3.3	2.8	1.5	1.7	2.0	1.9	2.3	1.6	2.5	2.0
GDP deflator	3.5	1.5	1.7	1.5	0.5	0.4	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	▲ 0.4	0.7	1.0	0.3	1.9	2.1	1.6	1.3	▲ 0.5	0.4	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	3.77	3.32	2.01	3.47	2.16	3.43	2.07	3.70	7.93	12.56	11.36
Share of Nominal GDP (%)	3.6	3.0	2.7	1.5	2.8	1.7	2.7	1.6	2.9	1.6	2.5	2.2
Exchange Rates (JY/US\$)	119	121	122	123	124	123	123	123	123	110	123	123
Import Price of Crude Oil (US\$/barrel)	56	60	58	58	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%, 2.6%, 2.8%; the euro area, 0.8%, 1.3%, 1.6%; China, 7.4%, 6.9%, 6.8%.