

Monthly Report of Prospects for Japan's Economy

November 2015

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

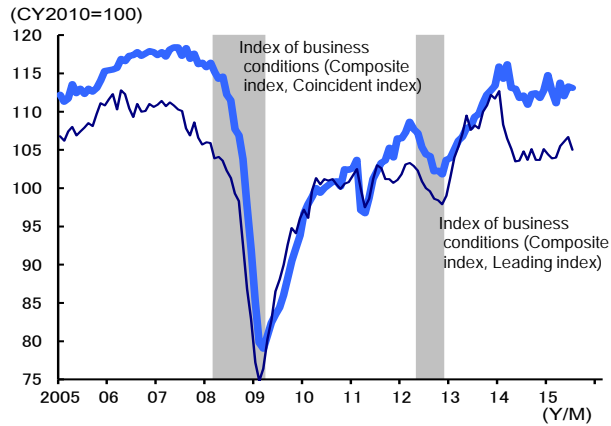
<http://www.jri.co.jp/english/periodical/>

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

The general situation of Japan's economy – exports and production have weakened, with slow consumption recovery

Figure 1-1 Economic Activity

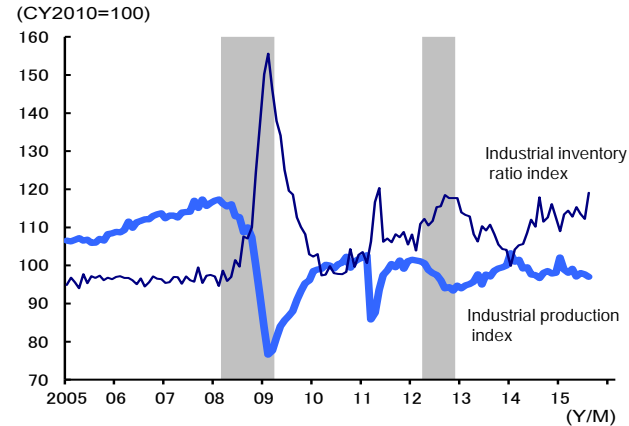
The leading index of business conditions fell for the first time in 5 months, due to the reactionary fall in the floor area of housing starts, and so on.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

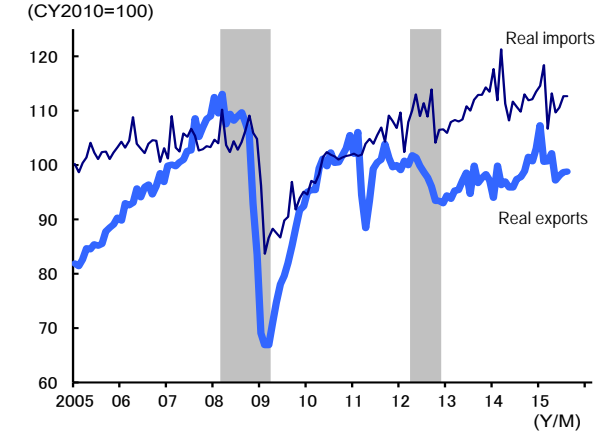
Industrial production continued to be weak. The inventory ratio rose further in a wide range of industries.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

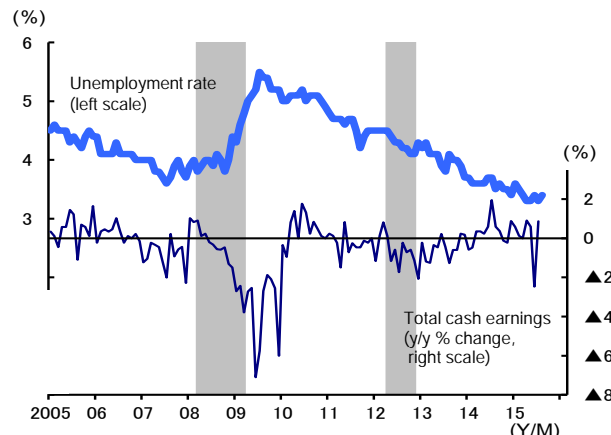
Exports have been on a weak trend since the start of the year. Imports continued to seesaw.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

The unemployment rate stayed at a low level. Total cash earnings increased year-on-year again.

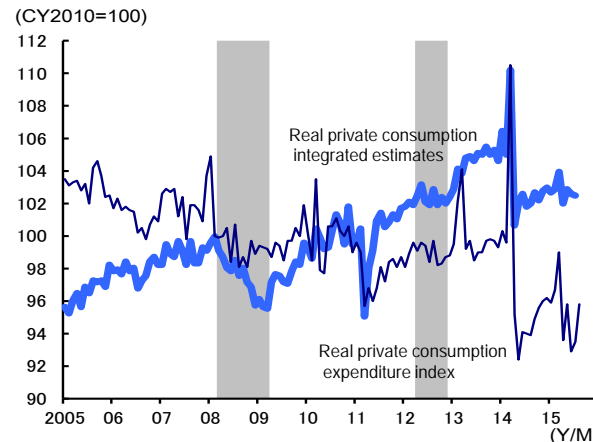


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

* The shaded area indicates the phase of recession.

Figure 1-5 Private Consumption Expenditure

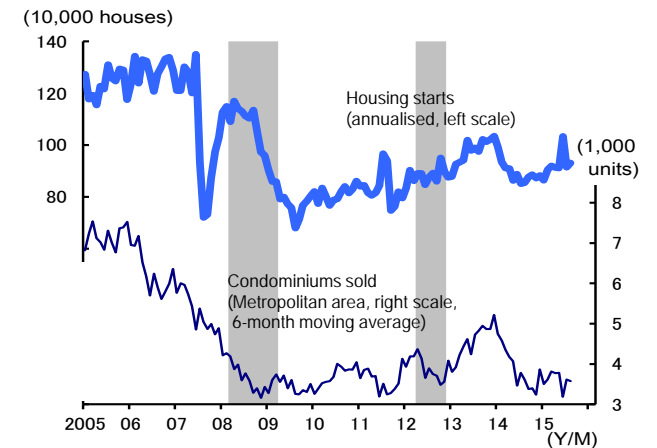
Real private consumption expenditure picked up in a limited range of items such as articles of value, including housing-related.



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 seems to be on a moderate recovery trend. 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 has been at a standstill, affected by a slowdown in the Chinese economy

◆ Business sentiment has worsened, affected by a deceleration in the Chinese economy

Japan's economic activity has been at a standstill. The situation is shown, for example, in the fact that the diffusion index for economic conditions in the Economy Watchers Survey fell below 50 points, the diverging point between better and worse, in August for the first time in 7 months. The deterioration seems to have been affected by a slowdown in the Chinese economy and anxiety over its future prospects, which had led to the fall in stock prices worldwide.

◆ Real exports and industrial production have weakened

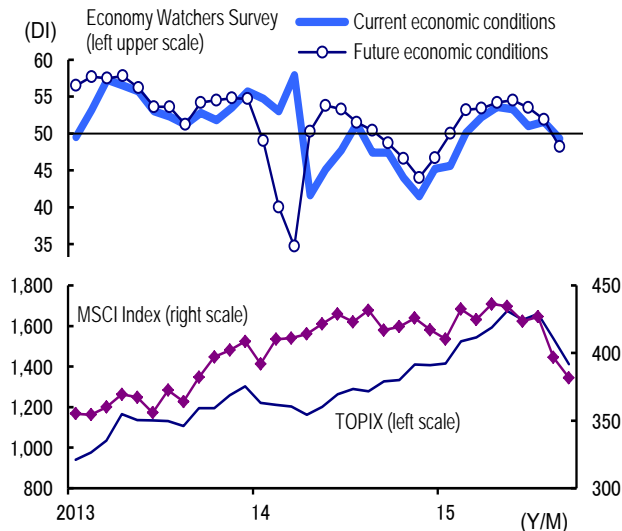
The negative impact of the deceleration in the Chinese economy has been felt in Japan's economic activities such as exports, production and machinery orders received. Real exports continue to lack momentum, reflecting a slowdown in demand for automobiles and infrastructure investment-related goods in emerging economies

as well as demand for smartphones worldwide. Under these circumstances, industrial production continues to be weak, with the inventory ratio staying at a higher level in a wide range of industries led by general and industrial machinery. Also, machinery orders, which is a leading indicator for business fixed investment, have declined to fall short of the forecast considerably for the July-September period.

◆ The pace of pickup in private consumption remains very slow

In the household sector, the pace of recovery in private consumption expenditure continues to be very slow. One of the illustrations is that new automobile sales are staying at a very low level, negatively affected by the rise in the tax on light vehicles. On the bright side, real wages increased year-on-year in July for the first time in 27 months (since April 2013), against the background of continued tight supply-demand conditions for labour, that is, a shortage of workers.

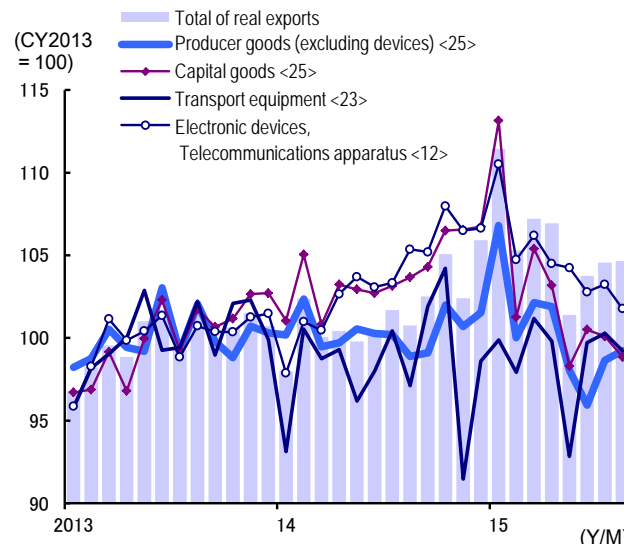
Figure 2-1 Stock Prices and Economy Watchers Survey



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

Note: MSCI Index is the worldwide stock price index, covering both advanced and emerging countries.

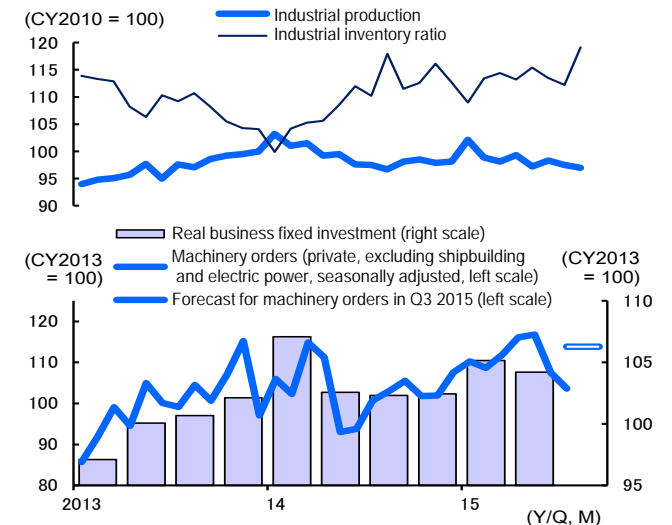
Figure 2-2 Real Exports by Goods <seasonally adjusted>



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.

Figure 2-3 Industrial Production and Machinery Orders <seasonally adjusted>



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

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BoJ's Tankan Survey - Business conditions worsened in large manufacturers, affected by China

◆ Business conditions DI for large manufacturers worsened, having been affected by anxiety over the slowdown in the Chinese economy

In the Tankan September 2015 Survey, the diffusion index (DI) for business conditions on the whole of large manufacturing was plus 12 percentage points, a 3 percentage point deterioration from the previous result. This seems to be against the background of anxiety about the slowdown in the Chinese economy and heightened uncertainties in the financial markets influenced by the anxiety. Viewed by industry, the DI for industrial machinery and electrical machinery worsened noticeably, reflecting the delay in inventory adjustment.

However, the DI for the whole of large nonmanufacturing was plus 25 percentage points, a 2 percentage point improvement. Especially, the DIs for private consumption-related industries such as retailing and services for individuals continued to increase. It seems that the consumption expenditure of foreign visitors to Japan ("inbound demand") contributed largely. Looking further, though, uncertainties remain as has

been shown in the considerably worsening forecast DI. One of the uncertainties is that "inbound demand," which had been driven mainly by Chinese tourists thus far, could decrease hereafter.

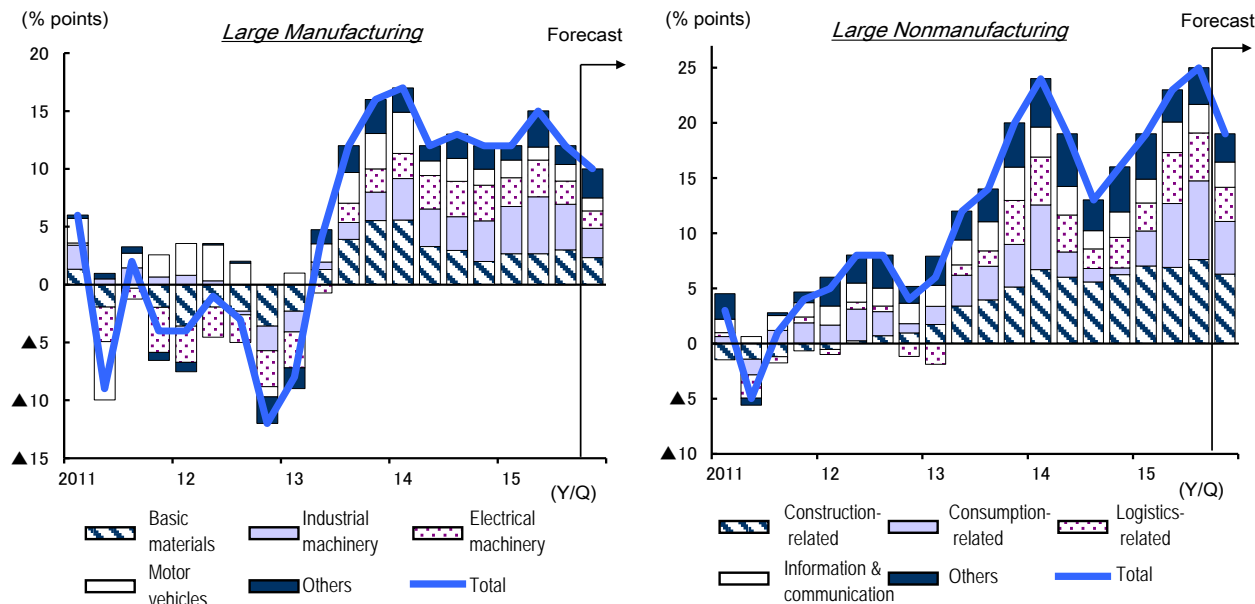
Meanwhile, the DI for overseas supply and demand conditions for products in large manufacturing continued to worsen. Although the forecast DI showed an improvement, actual results thus far have tended to be revised downwards. Therefore, overseas supply and demand conditions could deteriorate further.

◆ Planned business fixed investment for FY2015 continued to be firm

In the same Survey, planned business fixed investment for FY2015 continued to be firm. The planned rate of annual increase in FY2015 was unchanged in large manufacturing, and was revised upwards in large nonmanufacturing. The rate in small enterprises was also revised upwards. However, judging from the decline in machinery orders, business fixed investment will likely lack momentum for the time being. Yet, its faltering could be avoided, as suggested by high planned rates.

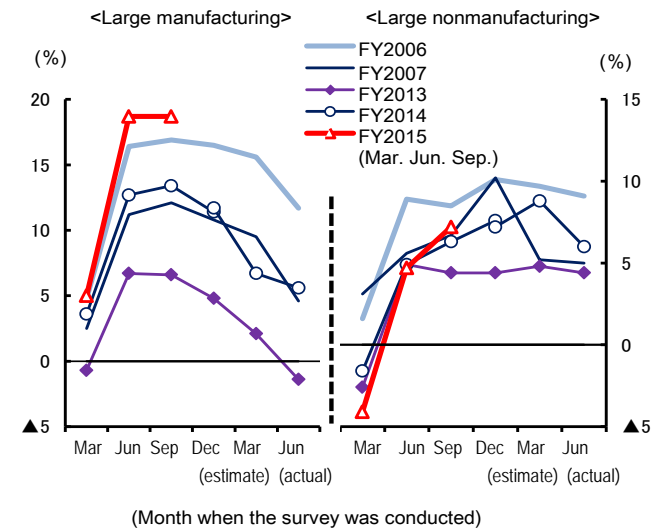
Figure 3-1 Contributions to Business Conditions Diffusion Index by Industry

<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 September 2015 Survey".

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



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

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Japan's exports have weakened, due to a slowdown in the Chinese economy and other factors

◆ Imports which had decreased are showing 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. If domestic demand recovers more noticeably, real imports will also likely pick up again.

◆ Real exports will likely continue to lack momentum, against the background of a slowdown in the Chinese economy and other factors

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

slowdown in the growth rate in world trade per se.

As the latest anxiety, a slowdown in the Chinese economy has been pushing down Japan's exports further, through stagnating world trade. Especially, it is necessary to watch the negative impact on the economies of East Asia more carefully. This is because, while Japan's value added exports to China as the final consumption destination is about 2 per cent in Japan's nominal GDP, the equivalent ratio of East Asia (excluding Japan) is over 5 per cent.

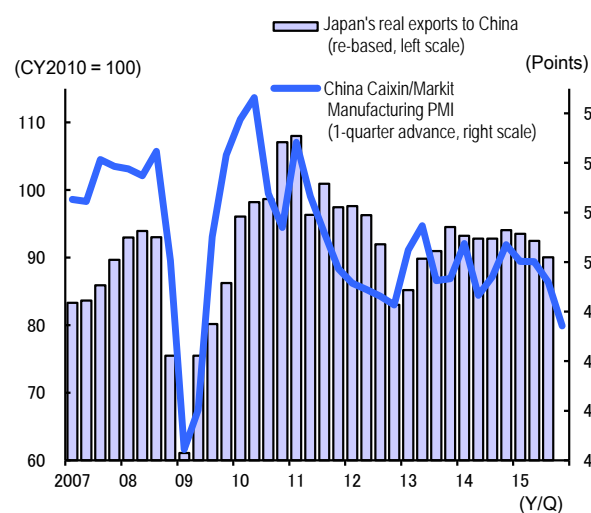
Looking ahead, the depreciation of the yen will bolster Japan's exports for the time being. However, the deceleration in the economies in emerging countries such as China will likely continue to be a weighing down factor. Therefore, it is unlikely that Japan's real exports will regain momentum strong enough to boost the economy for the time being.

Figure 4-1 World Trade Quantity and Japan's Real Exports <seasonally adjusted>



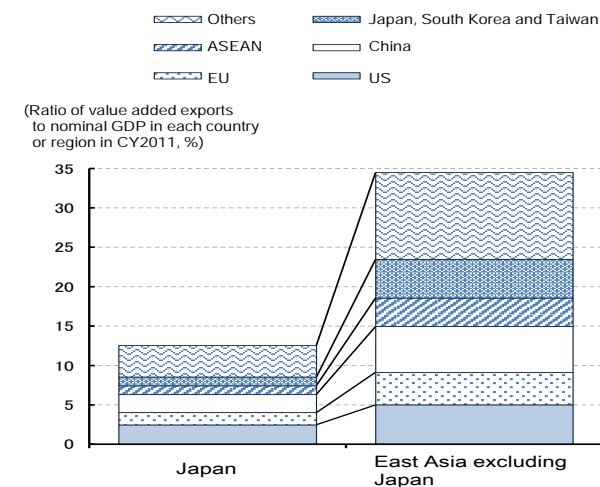
Source: : The Japan Research Institute, Ltd. based on the data of CPB Netherlands Bureau for Economic Policy Analysis, "World Trade Monitor".

Figure 4-2 China's Manufacturing PMI and Japan's Real Exports to China <seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, China Caixin/Market Manufacturing PMI.

Figure 4-3 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 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 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. These were seen as a contribution of the rise in "other non-operating gains" and the fall in "variable costs", respectively. The latter appears to have been the biggest contributor to recent firmness in profits.

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

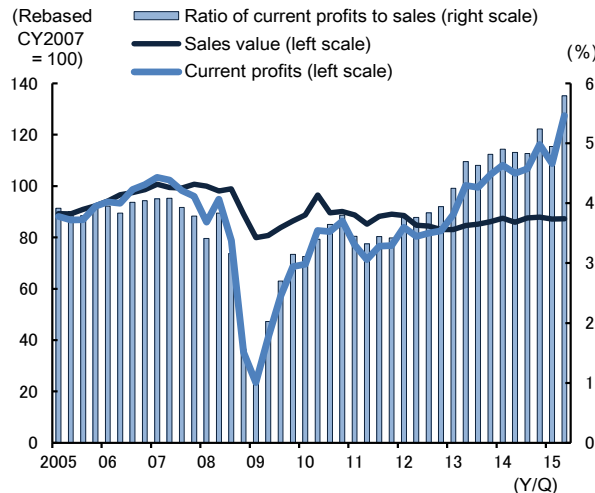
Based on the Financial Statements Statistics of Corporations by Industry, business fixed investment in all enterprises (excluding financial institutions and software

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.

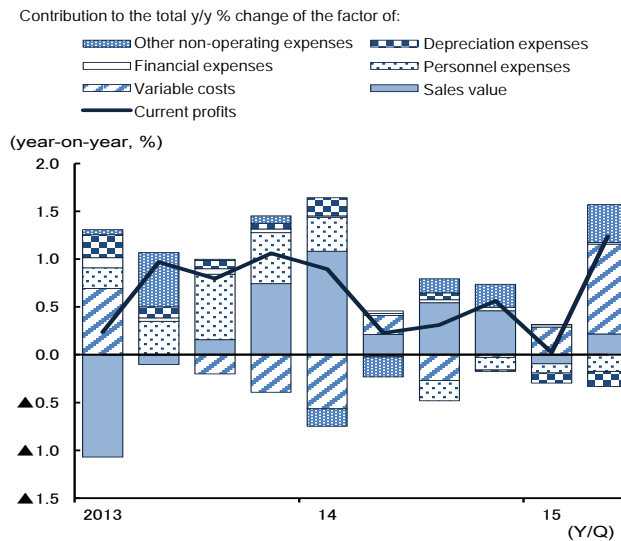
Judging from both favourable and unfavourable factors, business fixed investment will likely pick up, against the background of buoyant corporate profits and increased demand for investment for rationalisation, saving, and research and development. Yet, the pace of the pickup could be more moderate than anticipated, due to the increasingly cautious attitudes of enterprises as well as rising future uncertainties.

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



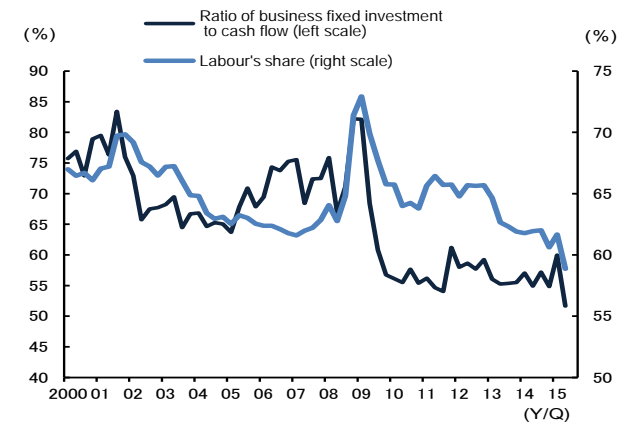
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.
Note: All industries excluding financial institutions.

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

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

◆ The pace of recovery in private consumption expenditure has remained slow, affected by 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 private consumption expenditure has still been slow since this April as well. This is 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. Also, the fall in stock prices after late this August could be a weighing factor through worsening consumer sentiment.

However, since early autumn, automobile sales have shown signs of bottoming out. Also, 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, which seems to imply people still have a good future outlook.

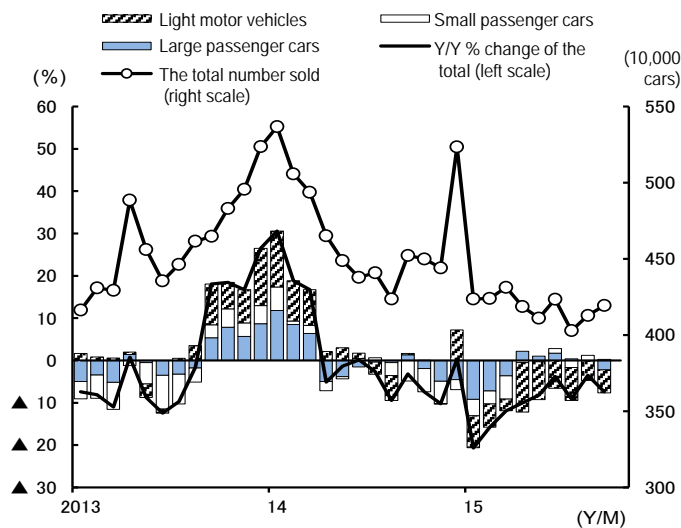
◆ An improvement in income and employment environments is expected to bolster a moderate recovery in private consumption expenditure

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.

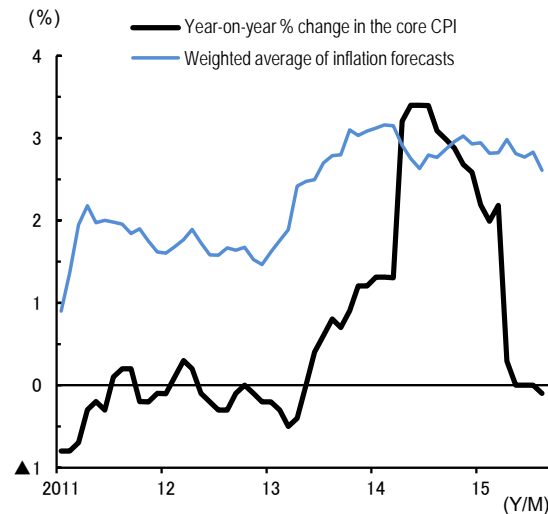
For the time being, compensation for employees in real terms is predicted to be bolstered by a deceleration in the consumer price rise due to the significant fall in the crude oil price. These improvements in income and employment environments are expected to support a moderate recovery in private consumption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

Figure 6-1 Automobile Sales by Type
<seasonally adjusted>



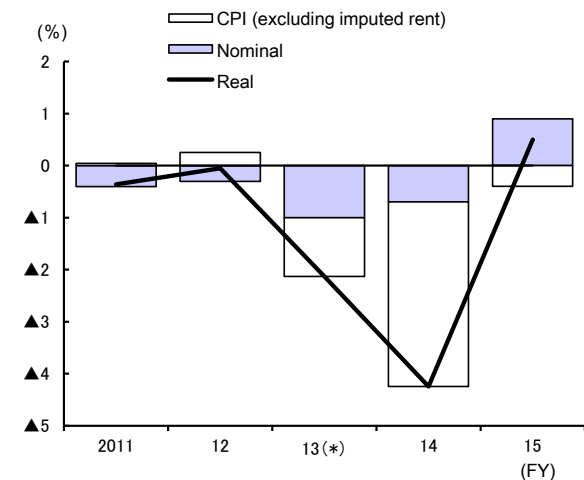
Source: The Japan Research Institute, Ltd. based on the data of Japan Automobile Dealers Association, Japan Light Motor Vehicle and Motorcycle Association.

Figure 6-2 Core Consumer Price Index 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 6-3 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 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-

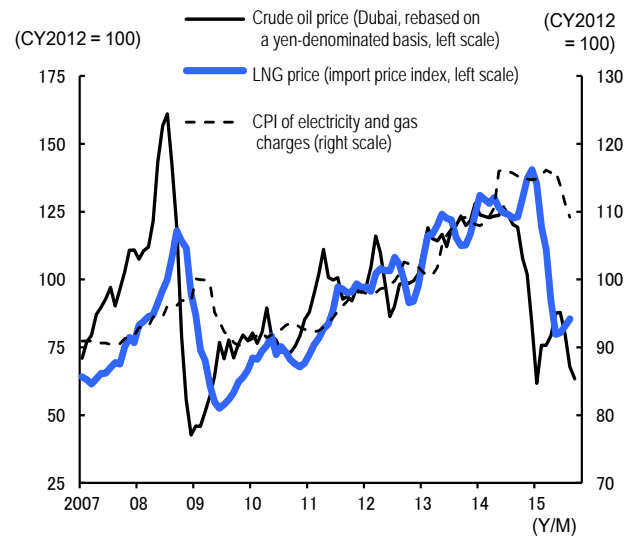
on-year decreasing trend. As employment and wages continue to improve, it is predicted that a moderate pickup in domestic demand will push up consumer prices. Therefore, with the downward effect of the crude oil price on consumer prices nearing its end, it is likely that the pace of the core CPI rise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

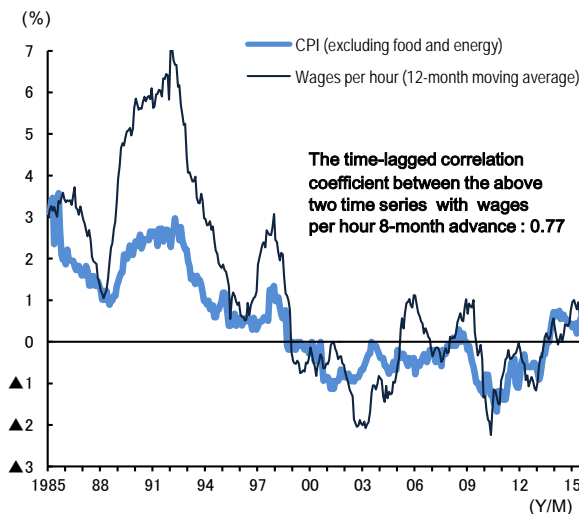
However, it is likely that achieving the goal will take time, taking the situation into account where a rise in inflation expectations in households and enterprises and an upward shift of the Phillips curve have been limited thus far.

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.

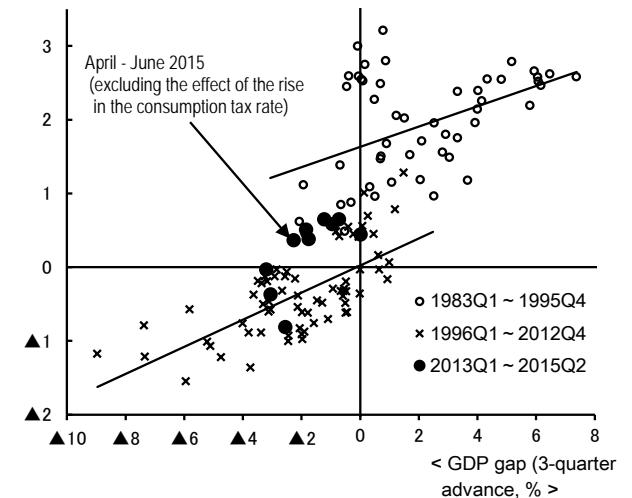
Figure 7-2 Time-lagged Correlation between Year-on-year Change in CPI and Wages per Hour



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

< 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; 0.9% in FY2015 and 1.1% in FY2016

◆ While the slowdown in overseas economies and an inventory adjustment are a heavy weight for the time being, the autonomous expansion mechanism will be able to be maintained. Accordingly, Japan's economic activity is predicted to recover moderately

(1) For the time being, the following factors will likely weigh down economic activity. These are 1) Japan's exports will be pushed down by the slowdown in the Chinese economy, 2) private consumption expenditure and business fixed investment could be negatively affected by the deterioration in sentiment caused by the fall in stock prices, and 3) downward pressure on the economy stemming from the inventory adjustment will persist.

On the other hand, it is expected that the "autonomous economic expansion mechanism" will continue to work. This can be judged from 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.

(2) Under these circumstances, it is expected that Japan's economy will regain its firmness from early CY2016 onwards, as inventory adjustment nears its end. Looking ahead further, it is predicted 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.

However, during the projected period, 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 is projected to grow by 0.9 per cent in FY2015 and 1.1 per cent in FY2016.

◆ 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 crude oil price. However, as the pickup in domestic demand contributes to boosting prices, the pace of increase in the core CPI will likely accelerate again after the second half of FY2015, when the effect of the fall in crude oil price on the year-on-year change rate in prices nears its end.

Figure 9 Projections for GDP Growth and Main Indicators of Japan (provisional as of October 2, 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	4.5	▲ 1.2	0.6	0.5	1.5	0.3	1.5	1.5	2.6	▲ 0.9	0.9	1.1
Private Consumption Expenditure	1.5	▲ 2.7	1.5	0.8	2.1	▲ 0.3	0.8	1.4	5.9	▲ 3.1	0.3	1.2
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	0.0	1.4	1.9	2.8	3.3	3.5	3.9	0.5	1.2	2.6
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)	(0.4)	(▲ 0.2)	(▲ 0.4)	(▲ 0.2)	(▲ 0.2)	(▲ 0.2)	(▲ 0.9)	(0.6)	(▲ 0.3)	(▲ 0.5)
Exports of Goods and Services	6.7	▲ 16.6	7.8	2.5	2.5	3.4	3.8	3.7	3.5	7.9	0.3	3.5
Imports of Goods and Services	7.3	▲ 10.1	7.0	3.6	4.5	4.8	5.8	5.9	8.7	3.6	1.3	5.3

	(% 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	(Actual)	(Projection)	(Projection)
Real GDP	▲ 0.8	0.8	1.3	0.9	0.5	0.7	0.9	1.1	1.5	▲ 0.9	0.9	1.1
Nominal GDP	2.6	2.3	3.2	2.5	0.8	1.0	1.4	1.5	2.3	1.6	2.2	1.6
GDP deflator	3.5	1.5	1.9	1.6	0.3	0.2	0.4	0.4	0.8	2.5	1.3	0.5
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	▲ 0.0	1.0	0.2	1.9	3.4	1.6	1.3	▲ 0.5	0.2	2.1

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	4.05	2.16	4.61	1.99	3.45	1.56	4.19	7.93	14.59	11.19
Share of Nominal GDP (%)	3.6	3.0	3.3	1.6	3.7	1.6	2.8	1.2	3.3	1.6	2.9	2.2
Exchange Rates (JY/US\$)	119	121	122	121	122	122	122	122	122	110	122	122
Import Price of Crude Oil (US\$/barrel)	56	60	58	56	63	64	66	68	70	91	59	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, 0.9%, 1.5%, 1.6%; China, 7.3%, 6.9%, 6.8%.