

Monthly Report of Prospects for Japan's Economy

December 2015

Macro Economic Research Centre
Economics Department



The Japan Research Institute, Limited

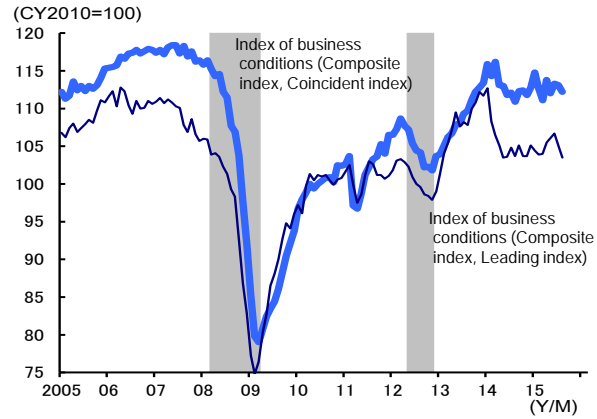
<http://www.jri.co.jp/english/periodical/>

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

The general situation of Japan's economy – Production has stagnated and private consumption has flattened

Figure 1-1 Economic Activity

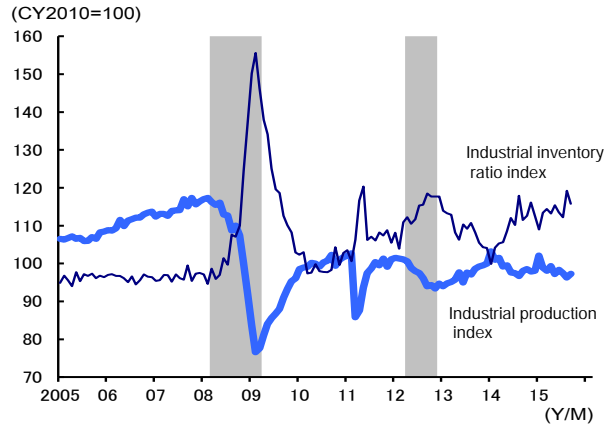
The leading index of business conditions fell for 2 months in a row, reflecting the decline in the price of stocks and commodities.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

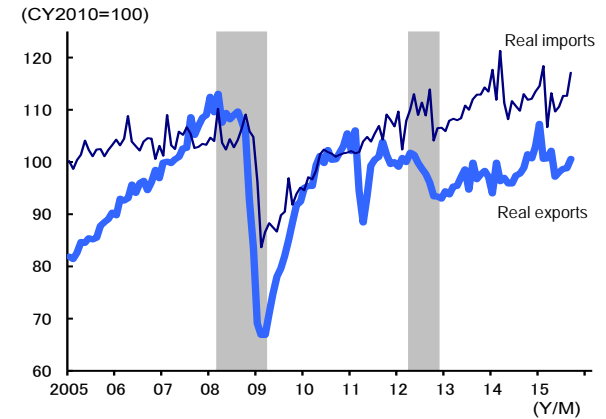
Industrial production picked up only slightly from the previous month. The inventory ratio continued to be at a high level.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

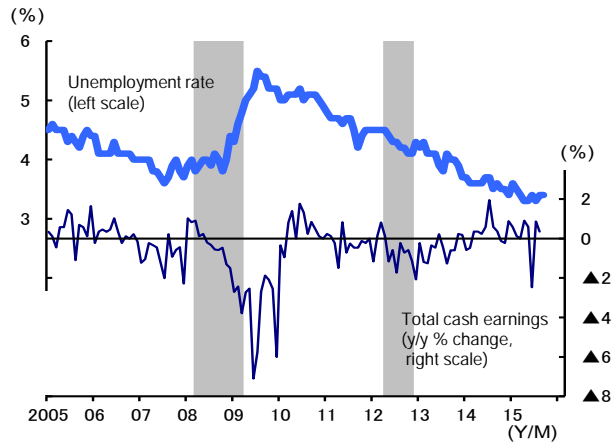
Exports have recovered modestly. Imports increased for 5 months running.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

The unemployment rate stayed at a low level. Total cash earnings continued to increase year-on-year.

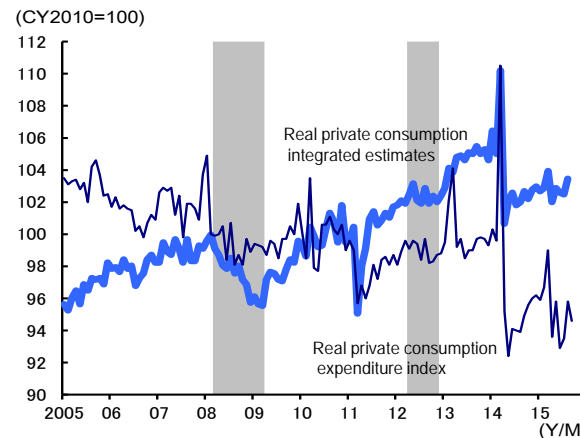


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labour and Welfare.

* The shaded area indicates the phase of recession.

Figure 1-5 Private Consumption Expenditure

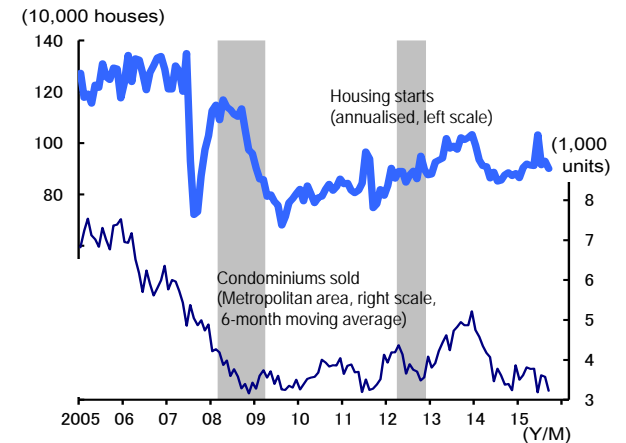
Real private consumption expenditure has lacked momentum, having declined again from the previous month.



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 stayed at the level of 900,000 houses. 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 still at a standstill, albeit with signs of the pickup in sentiment

◆ Real GDP declined in Q3, a fall for 2 quarters in a row

Japan's economic activity has been at a standstill. Real GDP in the July-September period decreased by 0.8 per cent on an annualised quarter-on-quarter change basis (national accounts, the first preliminary estimates), the second consecutive quarterly decline. While private consumption expenditure bolstered the total, the progress in inventory adjustment and the continued decline in business fixed investment, which was affected by a further cautious attitude of enterprises, pushed down the total real GDP growth rate.

◆ Although signs of the pickup in sentiment have been seen, real exports have weakened and industrial production has stagnated

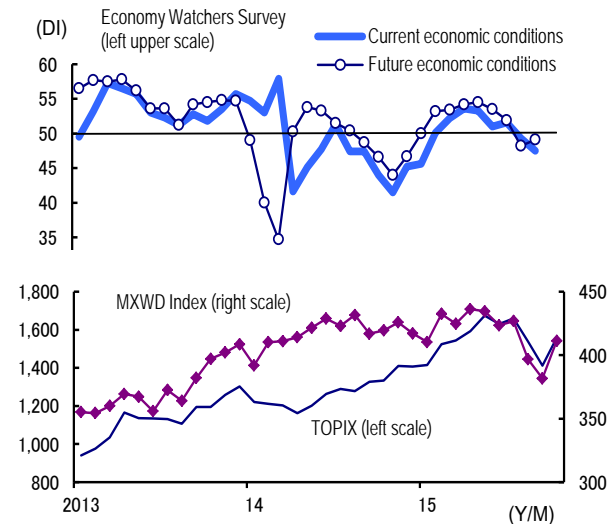
The diffusion index (DI) in future economic conditions in the Economy Watchers Survey rose slightly in September amid stabilising global stock markets. Thus, the worsening of sentiment seems to have been checked. However, monthly statistics on

exports and production continued to show a weaker tone. Japan's real exports have weakened in a wide range of items, especially in capital goods including general machinery. Although industrial production increased in September, the inventory ratio has stayed at a higher level in such industries as general machinery, which has still weighed heavily on production activity.

◆ Monthly household consumption has been flat on the whole

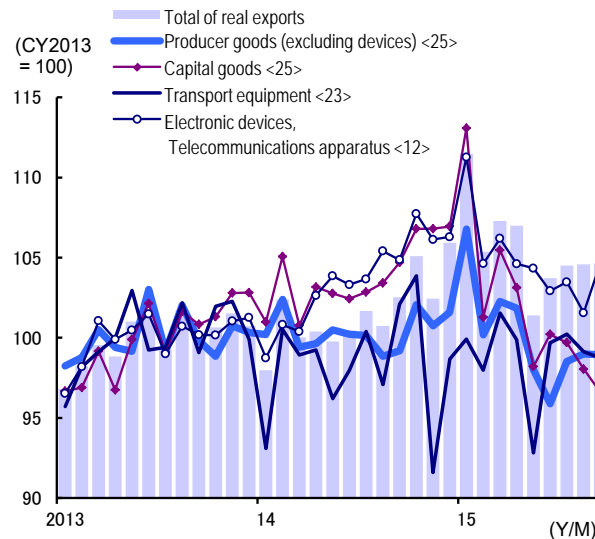
In the household sector, real household consumption expenditure seems to have been flat on the whole, as it decreased again in September. Viewed by type of retailer, in department stores, the purchasing of such items as jewellery and cosmetics by foreign tourists ("inbound demand") has contributed largely to the rate of increase in the total sales proceeds. In supermarkets, food, of which prices have risen due to the weaker yen, contributed mainly. In both type of retailers, the rate of increase in sales proceeds of items other than the above has been limited.

Figure 2-1 Stock Prices and Economy Watchers Survey



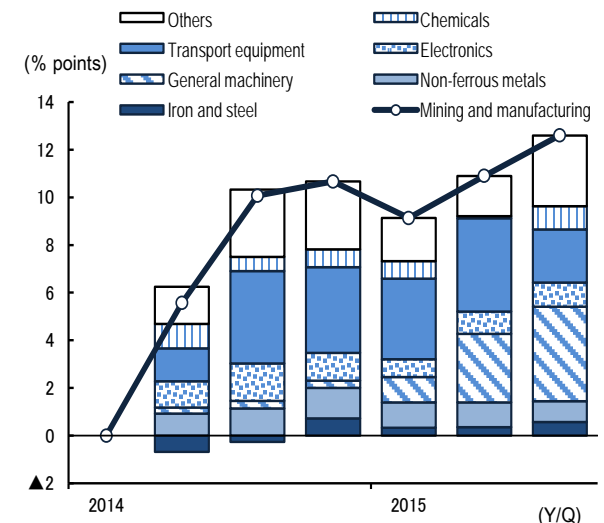
Source: The Japan Research Institute, Ltd. based on the data of The Cabinet Office, Bloomberg L.P.
 Note: MXWD Index is the worldwide stock price index, covering both advanced and emerging countries.

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 Change in Inventory Ratio in Mining and Manufacturing from Q1 2014 by Product



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

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

◆ Imports which had decreased are showing signs of bottoming out

Japan's real imports, which had decreased, are showing signs of bottoming out. Viewed by item, real imports other than mineral fuels have been still seesawing amid stagnant domestic demand. However, 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, real imports will also likely pick up further.

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

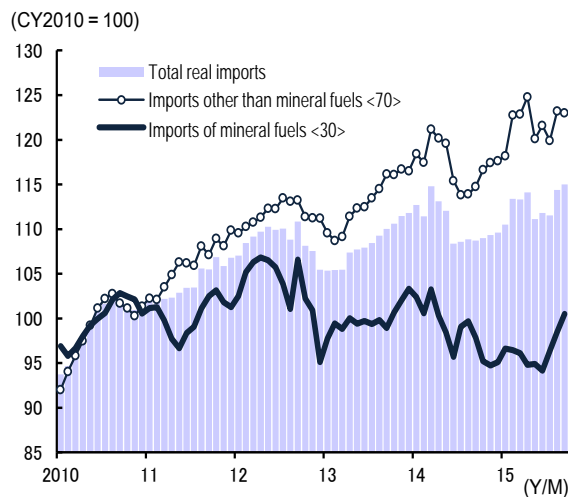
Japan's real exports, especially those of goods, have weakened. This sluggish trend seems to be against the background of the following: 1) the decrease in the share of Japan's exports in the total world trade market, which has been caused by the decline in export competitiveness of Japanese enterprises 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.

Examining the recent tendency by product, the decline in exports of general machinery has been visible. This is because demand for machinery for shale oil and gas-related investment has decreased in the US, and demand for machine tools to produce various parts for smartphones has slowed down in Asia. The decrease in real exports of general machinery has led to the increase in its inventory.

Looking ahead, in addition to solid exports of services including buoyant "inbound" demand for services for increasing tourists to Japan, the depreciation of the yen will bolster Japan's exports of goods to some degree for a while. However, the deceleration in the economies in emerging countries such as China will likely continue to be a weighing down factor. Thus, it is unlikely that Japan's real exports will regain momentum strong enough to boost the economy for the time being.

Figure 3-1 Japan's Real Imports
<seasonally adjusted,
3-month moving average>



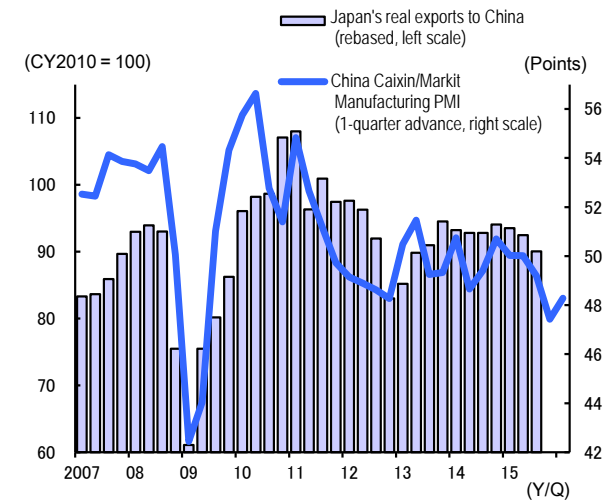
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance, The Bank of Japan.
Note: Figures in the angle brackets show the shares in FY2014.

Figure 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 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/Markit Manufacturing PMI.

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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

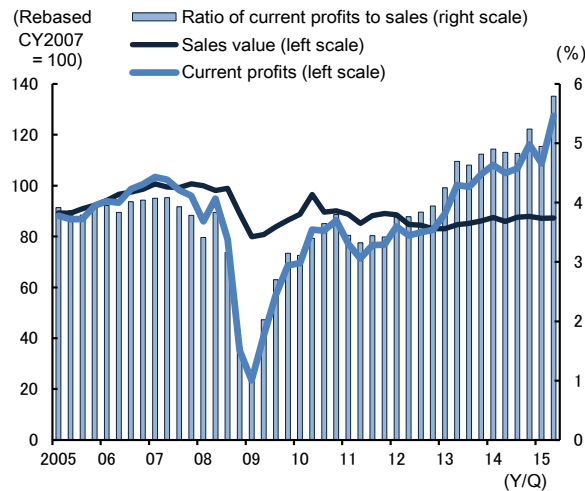
Based on the Financial Statements Statistics of Corporations by Industry, business fixed investment in all enterprises (excluding financial institutions and software

investment) declined in the April-June period from the previous quarter for the first time in 4 quarters. Thus, it is highly 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.

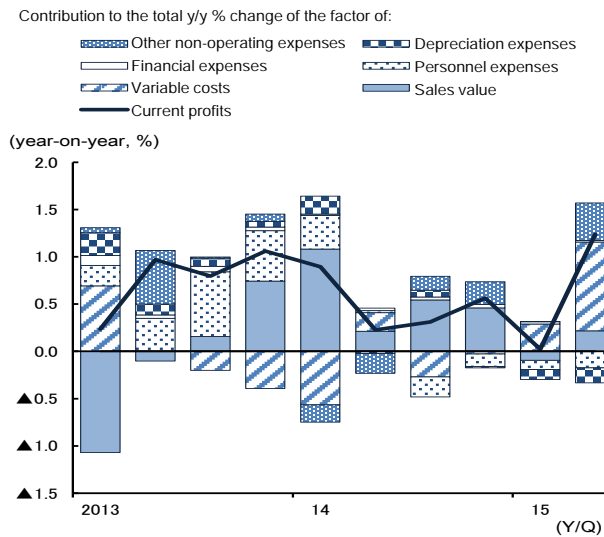
Judging from both favourable and unfavourable factors, business fixed investment will likely pick up, against the background of buoyant corporate profits and increased demand for investment for rationalisation, saving, and research and development. Yet, the pace of the pickup could be much more moderate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

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



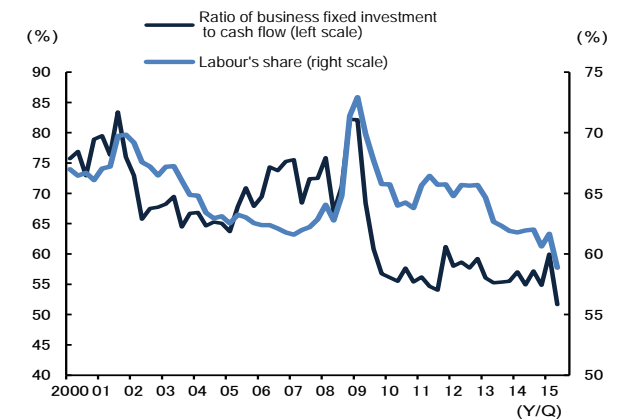
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.
Note: All industries excluding financial institutions.

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 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 this late August to September could have weighed through worsening consumer sentiment.

However, since early autumn, automobile sales have shown signs of bottoming out. Also, in spite of the fact that the core CPI fell slightly year-on-year for 2 months running, a certain degree of core CPI inflation is still forecast by consumers.

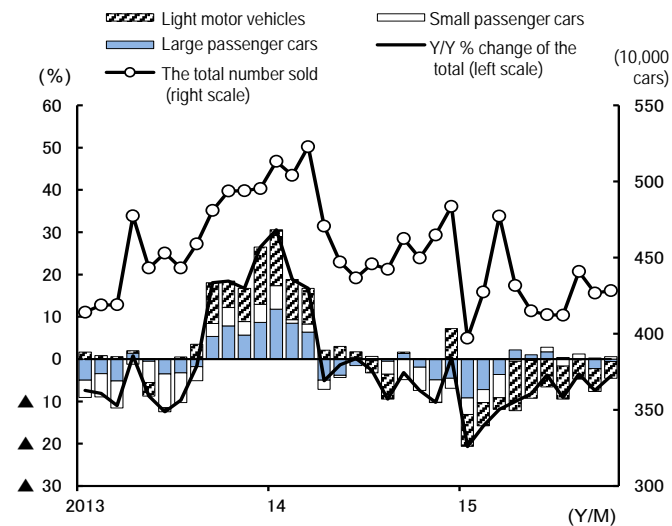
◆ An improvement in income and employment environments is expected to bolster a moderate recovery in private consumption expenditure

Income, which is a source of private consumption expenditure, is continuing its rising trend. Corporate profits continue to improve, supported by favourable factors such as reduced costs due to cheaper crude oil. Compensation for employees including winter bonuses is highly likely to maintain its increasing trend

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.

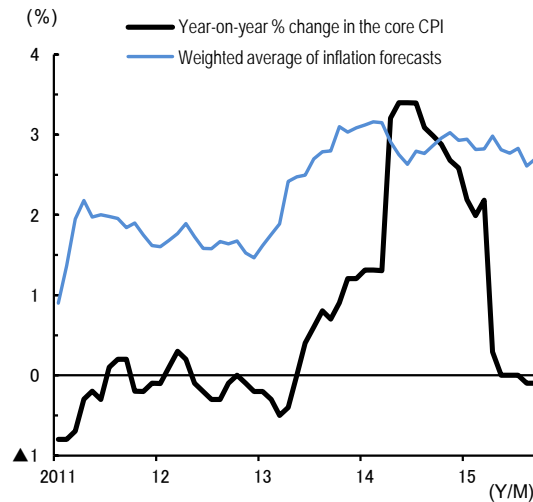
For the time being, compensation for employees in real terms is predicted to be bolstered by a deceleration in the consumer price rise due to the significant fall in the crude oil price. These improvements in income and employment environments are expected to support a moderate recovery in private consumption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

Figure 5-1 Automobile Sales by Type
<seasonally adjusted>



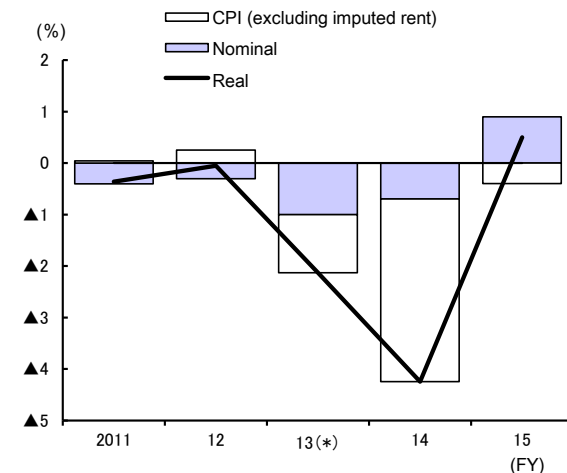
Source: The Japan Research Institute, Ltd. based on the data of Japan Automobile Dealers Association, Japan Light Motor Vehicle and Motorcycle Association.

Figure 5-2 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 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 core consumer price index (CPI), which excludes fresh food, decreased by 0.1 per cent year-on-year in September, the second successive fall. The recent trend in the core CPI 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 keep on falling, 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. Basic 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

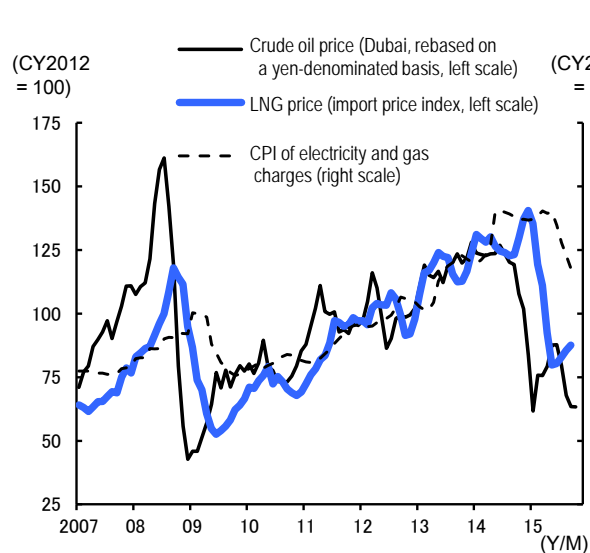
to a long-lasting year-on-year decrease. As employment and wages continue to improve, a moderate pickup in domestic demand will likely push up consumer prices. Therefore, with the downward effect of the crude oil price on consumer prices nearing its end, it is predicted that the pace of the core CPI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

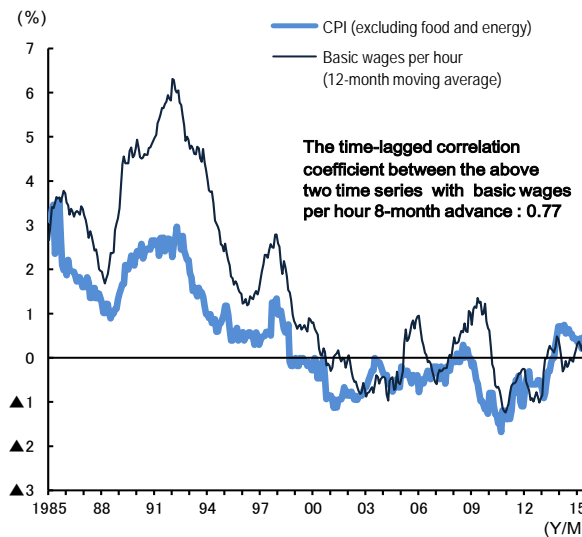
However, it is likely that achieving the goal will take time, taking the situation into account where a rise in inflation expectations in households and enterprises and an upward shift of the Phillips curve have been limited thus far.

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



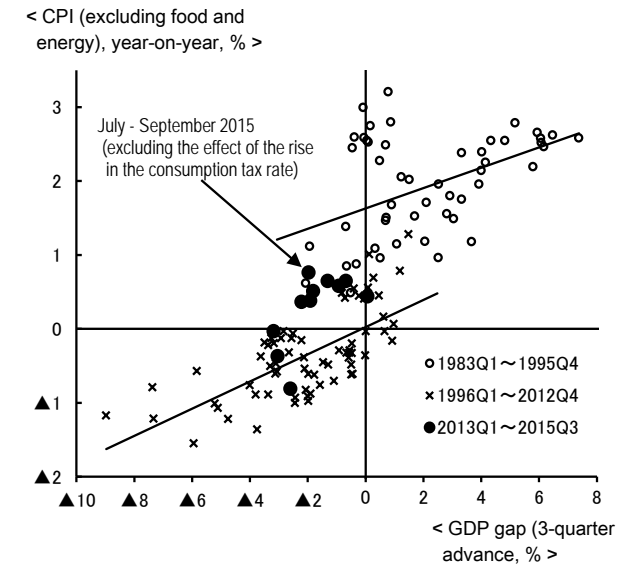
Source: The Japan Research Institute, Ltd. based on the data of The Bank of Japan, Nikkei, The Ministry of Internal Affairs and Communications.

Figure 6-2 Time-lagged Correlation between Year-on-year Change in CPI and Basic 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; 0.8% in FY2015 and 1.2% in FY2016

◆ Although the economic activity is likely to be at a standstill for the time being, Japan's economy is projected to return to its recovery trajectory at a moderate pace through the "autonomous economic expansion mechanism"

(1) Japan's real GDP in the July-September period decreased by 0.8 per cent on an annualised quarter-on-quarter change basis (national accounts, the first preliminary estimates), the second consecutive quarterly decline. While private consumption expenditure bolstered the total, the progress in inventory adjustment and the continued decline in business fixed investment, which was affected by a further cautious attitude of enterprises, pushed down the total real GDP growth rate. Japan's economic activity appears to have been at a standstill.

(2) It is likely that the business activity will lack momentum for the time being, due to the following factors. These are: 1) downward pressure on Japan's exports of goods will increase against the background of deceleration in overseas economies in countries such as China, and 2) production adjustment in order to proceed with inventory adjustment will continue to weigh on economic activity.

On the other hand, the "autonomous economic expansion mechanism" has not faltered and is expected to 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 moderately, thanks to increased corporate profits and the tendency of a shortage of workers, and so on.

(3) Under these circumstances, it is expected that Japan's economy will return to its recovery trajectory from early CY2016 onwards albeit at a moderate pace, as inventory adjustment nears its end.

Looking ahead further, in FY2016 to March 2017, the "autonomous expansion mechanism" will likely continue to work. However, the following factors are predicted to weigh on economic activity: 1) the slowdown in growth in overseas economies in countries such as China, 2) a very slow pace in the increase in real wages due to rising consumer prices, and so on. On the other hand, 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.

(4) Thus, due to the recovery mainly led by private demand, real GDP is projected to grow by 0.8 per cent in FY2015 and 1.2 per cent in FY2016.

During the projected period, it is probable that economic stimulus measures through a supplementary budget will be compiled and implemented in order to avoid the faltering of economic activity. In this case, real GDP growth rates would be revised upwards.

◆ 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 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 early CY2016, when the effect of the fall in crude oil price on the year-on-year change rate in prices nears its end.

Figure 8 Projections for GDP Growth and Main Indicators of Japan (as of November 25, 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)	
Real GDP	4.6	▲ 0.7	▲ 0.8	0.8	1.4	0.3	1.8	1.8	3.0	▲ 0.9	0.8	1.2
Private Consumption Expenditure	1.7	▲ 2.3	2.1	0.9	2.1	▲ 0.3	0.8	1.4	5.9	▲ 3.1	0.6	1.2
Housing Investment	8.1	10.1	8.0	2.0	3.0	2.8	2.8	4.2	5.5	▲ 11.6	3.8	3.4
Business Fixed Investment	10.1	▲ 4.8	▲ 5.0	1.1	1.9	2.8	3.3	3.5	5.8	0.5	▲ 0.2	2.4
Private Inventories (percentage points contribution)	(1.8)	(0.9)	(▲ 1.9)	(0.0)	(0.0)	(0.0)	(0.6)	(0.4)	(▲ 0.8)	(0.5)	(0.0)	(0.0)
Government Consumption Expenditure	1.1	2.6	1.2	0.4	0.4	0.5	0.6	0.6	0.6	0.4	1.4	0.6
Public Investment	▲ 5.2	8.6	▲ 1.3	▲ 2.0	▲ 0.8	3.0	9.8	5.0	2.3	2.0	0.9	3.1
Net Exports (percentage points contribution)	(▲ 0.2)	(▲ 0.8)	(0.6)	(▲ 0.2)	(▲ 0.3)	(▲ 0.4)	(▲ 0.7)	(▲ 0.7)	(▲ 1.2)	(0.6)	(▲ 0.0)	(▲ 0.4)
Exports of Goods and Services	8.0	▲ 16.1	10.9	3.2	2.7	3.0	3.2	3.4	3.5	7.9	1.3	3.6
Imports of Goods and Services	7.8	▲ 10.8	7.1	4.3	4.6	5.0	6.7	6.9	9.5	3.6	1.3	5.8

	(% 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	1.0	1.0	0.9	0.3	0.4	1.1	1.2	1.9	▲ 0.9	0.8	1.2
Nominal GDP	2.6	2.5	3.1	3.2	1.4	1.3	2.0	1.7	2.4	1.6	2.5	1.8
GDP deflator	3.5	1.5	2.0	2.2	1.1	0.8	0.9	0.5	0.5	2.5	1.7	0.7
Consumer Price Index (excluding fresh food)	2.1	0.1	▲ 0.1	0.1	0.6	0.7	1.1	1.3	1.4	2.8	0.2	1.1
(excluding fresh food and consumption tax)	0.1	0.0	▲ 0.1	0.1	0.6	0.7	1.1	1.3	1.4	0.8	0.1	1.1
Industrial Production Index	▲ 2.1	▲ 0.4	▲ 0.4	1.2	0.4	2.1	3.7	1.6	1.3	▲ 0.5	0.2	2.2
Unemployment Rate (%)	3.5	3.3	3.4	3.2	3.2	3.2	3.2	3.1	3.1	3.5	3.3	3.2
Current Account Balances (trillion JY)	4.42	3.76	4.05	2.46	4.34	2.14	3.34	1.75	3.90	7.93	14.61	11.12
Share of Nominal GDP (%)	3.6	3.0	3.3	1.9	3.5	1.7	2.7	1.3	3.0	1.6	2.9	2.2
Exchange Rates (JY/US\$)	119	121	122	122	124	123	123	124	123	110	122	123
Import Price of Crude Oil (US\$/barrel)	56	60	58	49	53	58	60	63	66	91	55	62

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%, 2.5%, 2.7%; the euro area, 0.9%, 1.5%, 1.6%; China, 7.3%, 6.9%, 6.8%.