

Monthly Report of Prospects for Japan's Economy

July 2018

Macro Economic Research Center
Economics Department



The Japan Research Institute, Limited

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

This report is the revised English version of the June 2018 issue of the original Japanese version.

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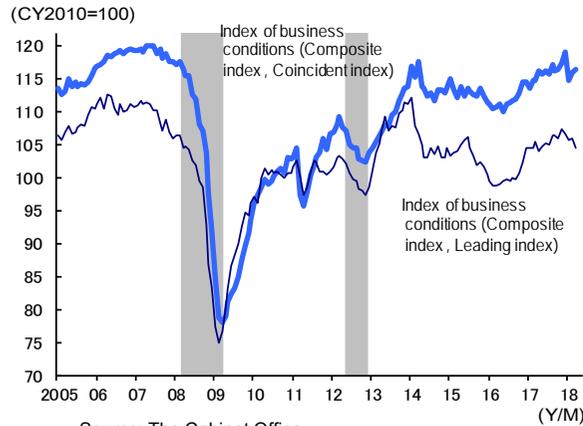
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The General Situation of Japan's Economy – Economic Recovery Trend Will Likely Continue

Figure 1-1 Economic Activity

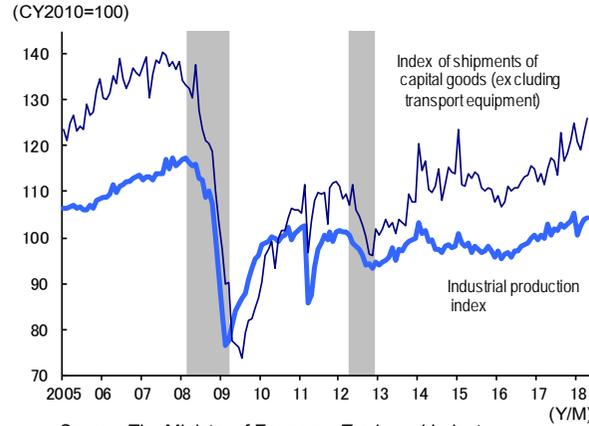
The coincident index rose for 2 months running, reflecting a pickup in production and shipments.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

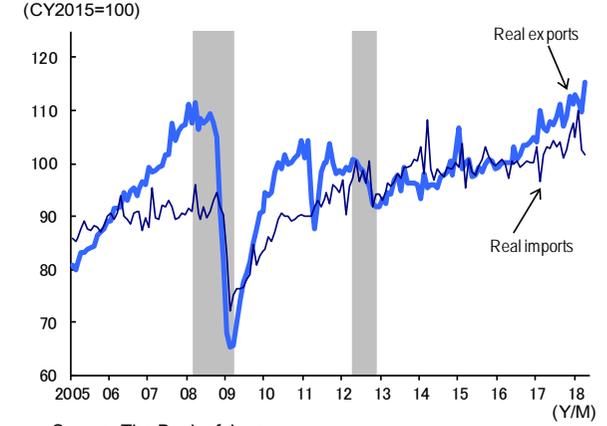
Industrial production remained at a standstill due mainly to inventory adjustment in electronic parts and devices.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

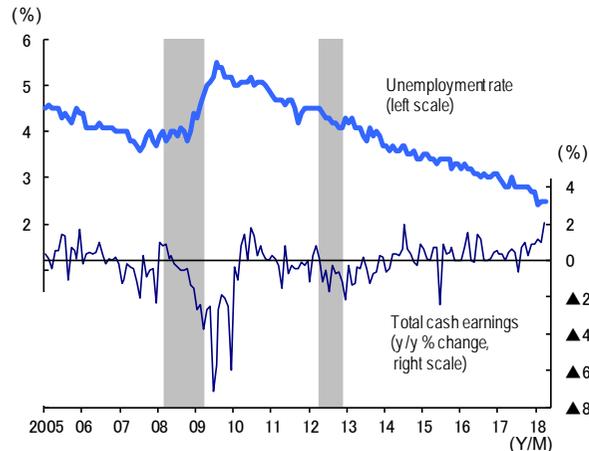
Real exports to China, the US and Europe continued to increase. The rising pace of real imports took a breather.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

The unemployment rate stayed at a low level. The pace of year-on-year rise in total cash earnings accelerated.

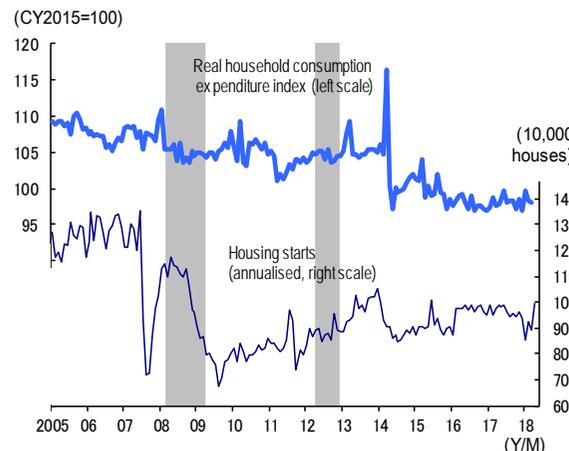


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labor and Welfare.

* The shaded area indicates the recession phase.

Figure 1-5 The Household Sector

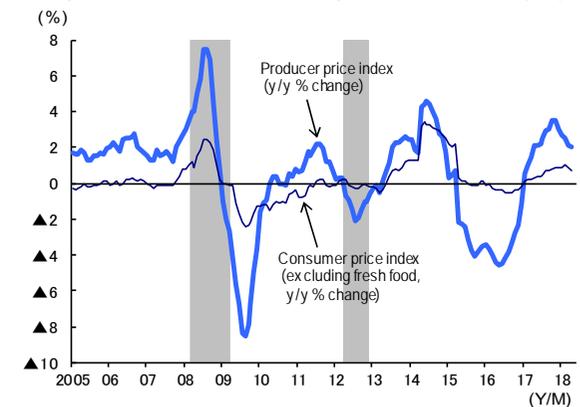
Real household consumption expenditure seesawed. Housing starts, mainly those for build-for-sale houses, climbed.



Source: The Japan Research Institute, Ltd. based on data of The Cabinet Office, The Ministry of Land, Infrastructure and Transport.

Figure 1-6 Prices

The extent of year-on-year increases both in producer prices and in core consumer prices narrowed, due to a pause in the rise of crude oil prices and the stronger yen.



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

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Production Activities in the Corporate Sector Remained at a Standstill

◆ Economic Recovery Trend Will Likely Continue

Japan's real GDP in the January-March period declined by 0.6 percent on an annualized quarter-on-quarter change basis (national accounts, the second preliminary estimates), falling for the first time in 9 quarters.

On the domestic demand front, consumer spending slowed down due mainly to a rise in fresh food prices and sluggish sales of seasonal clothing reflecting the effects of the cold weather. Looking at overseas demand, in addition to the decline in services exports including inbound demand and the receipt of royalties for intellectual property rights, exports of goods also plunged, mainly in electronic parts to Asia.

However, the negative growth is likely to be a temporary condition as exports and other indicators have picked up since April.

◆ Industrial Production Remained at a Standstill

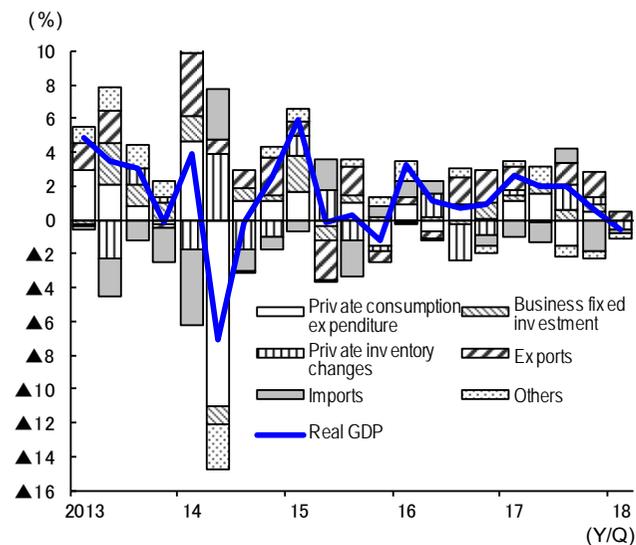
The Industrial Production Index for April increased only slightly by 0.5 percent from the previous month, which was below the initial forecast. While industrial production

saw increases in transportation machinery and machinery for general, production and business use, industrial production declined for electronic parts and devices due to ongoing inventory adjustment. According to the Indices of Industrial Production Forecast, industrial production is expected to rise 0.3 percent month over month in May and decline 0.8 percent month over month in June, continuing on the holding pattern that started from the beginning of this year.

◆ The Household Sector Has Picked Up

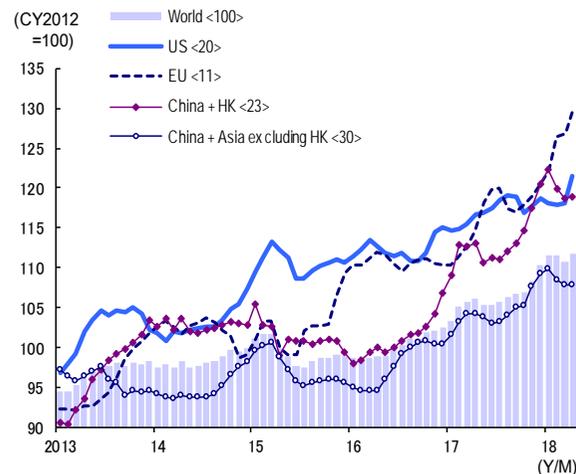
In the Economic Watchers Survey for April, the Household Activity DI remained below the 50 level, which distinguishes good and poor conditions. Having said that, some signs of recovery in consumer spending were evident, as the DI increased by 1.2 points month over month for food and beverages and slightly increased by 0.3 points month over month for services against the backdrop of a better climate and resilient income conditions.

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



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

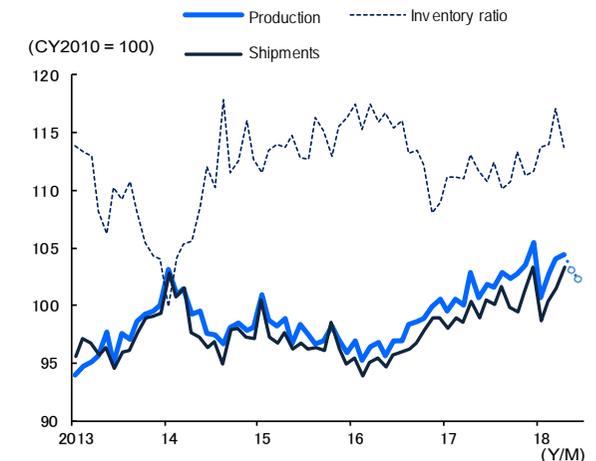
Figure 2-2 Real Exports by Destination
<seasonally adjusted, 3-month moving averages>



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

Note: Figures in the angled brackets show the shares in total nominal exports in FY2017.

Figure 2-3 Indices of Industrial Production
<seasonally adjusted>



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

Note: The latest two figures in production are based on the production forecast index.

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Exports Will Likely Follow a Mild Rising Path

◆ Exports of Goods Moderately Increased

Looking at overseas demand, while consumption by overseas tourists visiting Japan remained unchanged, reflecting the poor weather and appreciation of the yen, exports of services including the receipt of royalties for intellectual property rights declined. However, consumption by overseas tourists is anticipated to increase again unless the yen further appreciates, and the receipt of royalties for intellectual property rights will pick up as the aggressive attitude towards foreign direct investment is maintained.

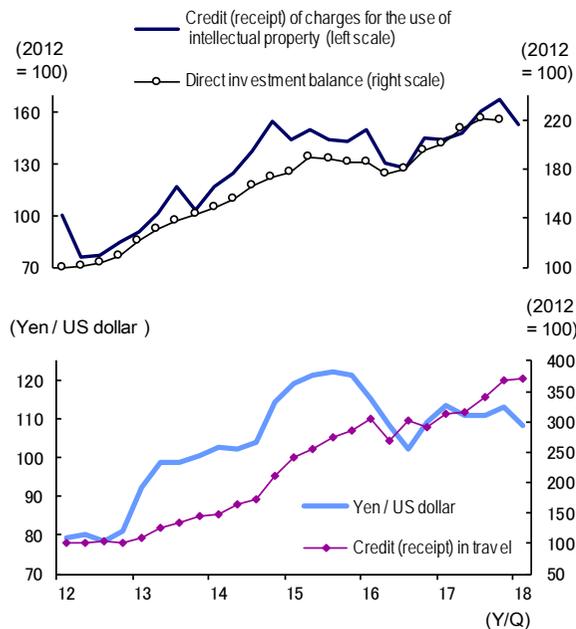
In terms of exports of goods, while the increasing trend for electronic parts and devices has slowed down due partly to sluggish sales of new smartphones and the expansion of in-house production in emerging Asian countries, exports of capital goods and transportation machinery have grown. Against the backdrop of the global expansion of capital investment and the sophistication of production equipment

mainly in emerging Asian nations, the growth trend in exports of capital goods will likely continue, particularly for machine tools and semiconductor manufacturing equipment.

◆ U.S. Protectionist Trade Policies Remain a Concern

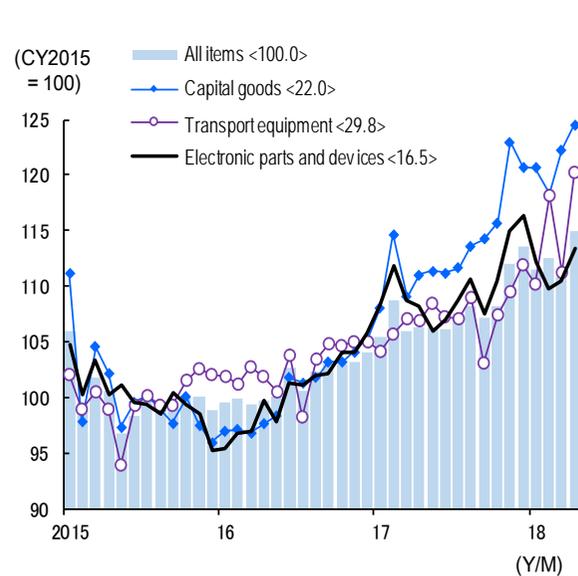
Nevertheless, the Trump administration's inclination towards protectionism and the intensification of trade friction triggered therefrom have remained as risks. The Trump administration has been considering raising tariffs on automobiles and automotive parts from 2.5% currently to 25%. Although the feasibility of this move is unclear, if enacted, the direct impact could be downward pressure on Japan's exports amounting to approximately 800 billion yen. As the automobile industry covers a broad range of fields, there is a risk that this will result in downward pressure on production exceeding 2 trillion yen, including ripple effects on related industries such as parts, materials, commerce and transportation.

Figure 3-1 Balance of Payments by Item
<seasonally adjusted>



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

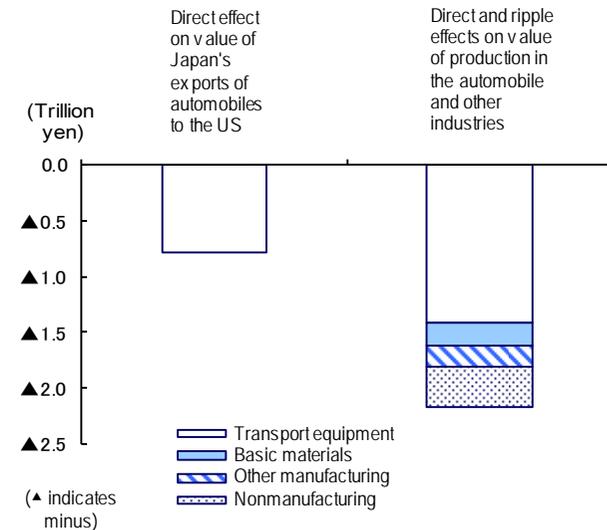
Figure 3-2 Real Exports by Item
<seasonally adjusted>



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

Note: Figures in the angled brackets show the shares in total nominal exports in FY2017.

Figure 3-3 Effects of the Rise in Tariffs on Imported Automobiles Imposed by the U.S. Government <Estimate>



Source: The Japan Research Institute, Ltd. based on data of Autodata, BLS, BEA, The Ministry of Finance, The Ministry of Economy, Trade and Industry.

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With Profits Continuing to Improve, Business Fixed Investment Is on a Rising Trend

◆ Corporate Profits Continue to Be Firm

Corporate earnings have remained strong. According to the Financial Statements Statistics of Corporations by Industry, Quarterly, the January-March period saw both increased sales value and current profits for the first time in three quarters (all industries excluding financial services and insurance; ratio to the previous quarter; seasonally adjusted).

While an increase in labor cost due to the worsening labor shortage caused downward pressure on profits, increased net sales contributed positively to the improvement in corporate earnings amid solid demand both at home and abroad.

Reflecting favorable conditions for corporate earnings with a significant decline in the breakeven point ratio, corporate earnings are expected to continue to improve in the future. Since the current foreign exchange level has not deviated far from the presumed exchange rate, there are only small concerns over a possible downturn in

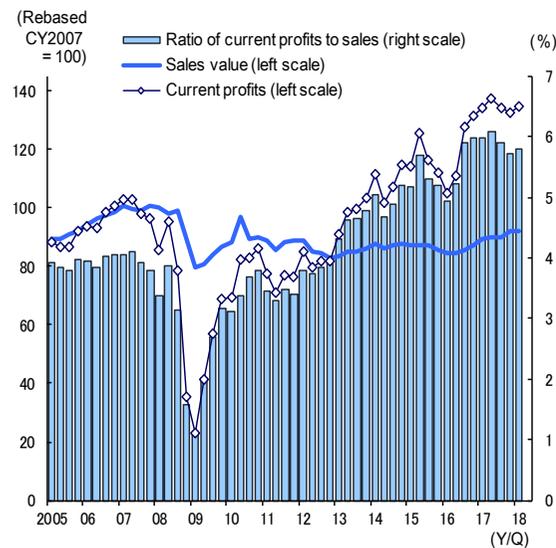
corporate earnings.

◆ Business Fixed Investment Is on a Moderate Rising Trend

Reflecting abundant cash flow, capital investment has remained on a moderate upward trend mainly in the fields of rationalization and labor-saving against a backdrop of labor shortages. Orders for machinery in the January-March period increased for the third consecutive quarter, and are expected to continue to increase in the April-June period.

However, capital investment momentum has been weak in proportion to the improvement in corporate earnings amid the sluggish outlook for growth in Japan that comes with a diminishing population. Furthermore, there is a risk that the appetite for capital investment may wane if concerns over the outlook of corporate earnings increase due to the intensification of trade friction between the U.S. and China and subsequent acceleration of the appreciation of the yen.

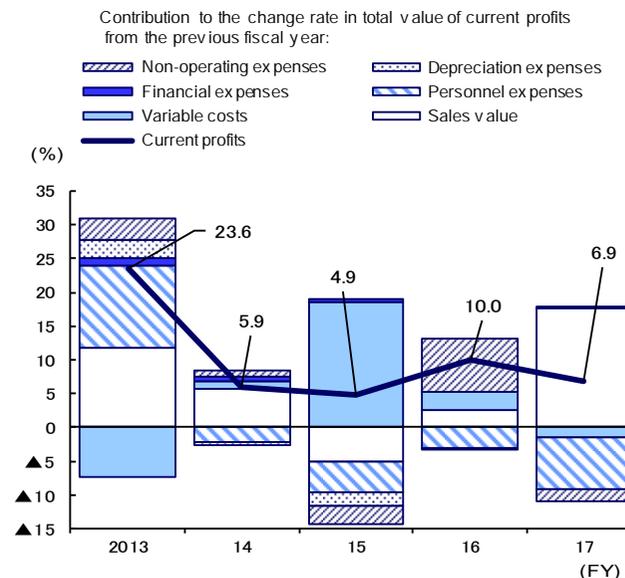
Figure 4-1 Sales Value and Ratio of Current Profits to Sales <seasonally adjusted>



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

Note: All industries except for financial institutions.

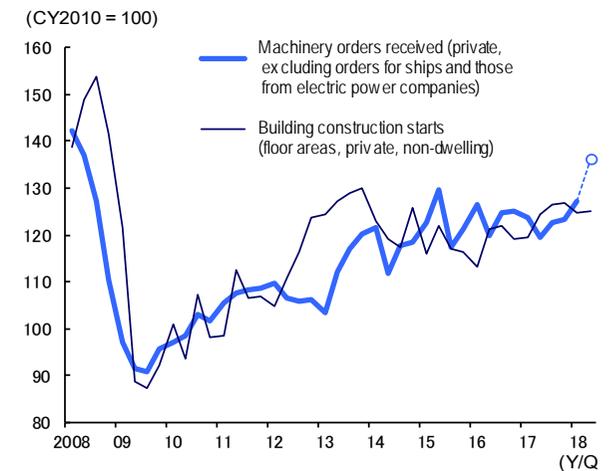
Figure 4-2 Contributions of Factors to the Change Rate in Total Value of Current Profits



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

Note: All industries except for financial institutions.

Figure 4-3 Leading Indicators for Business Fixed Investment <seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on data of The Cabinet Office, The Ministry of Land, Infrastructure and Transport.

Note: The latest figure in machinery orders is based on the forecast by the Cabinet Office.

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Income Is Likely to Recover Moderately

◆ Employment and Income Conditions Continue to Improve

The employment situation continued to improve. Since the beginning of 2018, the pace of increase in the number of workers has accelerated, reflecting the rapid expansion of non-regular employment of mainly younger workers aged 24 years and younger and elderly workers aged between 65 and 69 years. The expansion of employment was particularly apparent in the services industry, including accommodations and catering services.

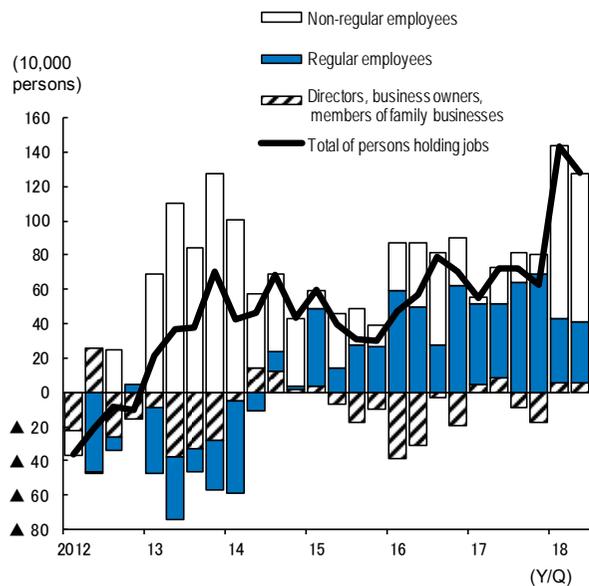
Nominal wage growth has also accelerated recently, attributable to a rapid increase in scheduled salaries for full-time workers as well as a rise in special salaries on the back of strong corporate earnings.

◆ Real Income Has Been Steadily Increasing

As for the future outlook, both the employment situation and nominal wages are expected to continue to improve on the back of the economic recovery. As companies are increasingly suffering from labor shortages, labor demand and supply conditions are likely to remain tight. Since the rate of wage increases as a result of this year's spring labor offensive has been high in recent years, nominal wages will also likely continue to grow.

Furthermore, since the upward pressure on prices that pushed down real income for the January-March 2018 period has peaked out, we predict that real employee compensation will continue to grow by around 2 percent or more year on year for the time being.

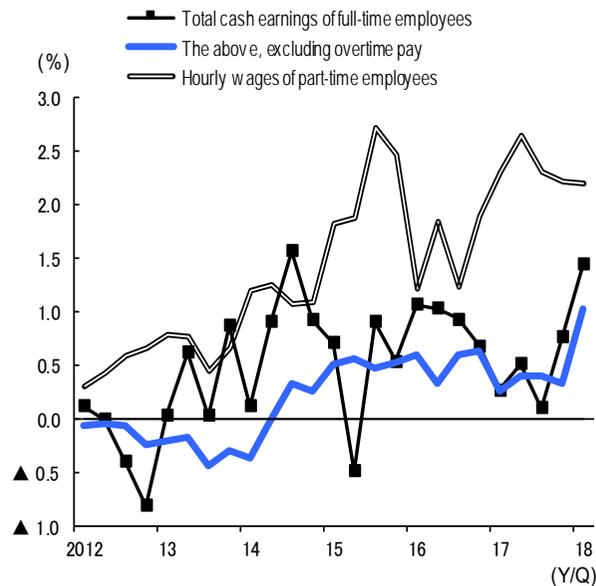
Figure 5-1 Number of Persons Holding Jobs <difference from a year earlier>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Health, Labor and Welfare.

Note: Regular employees are persons employed for an indefinite period.

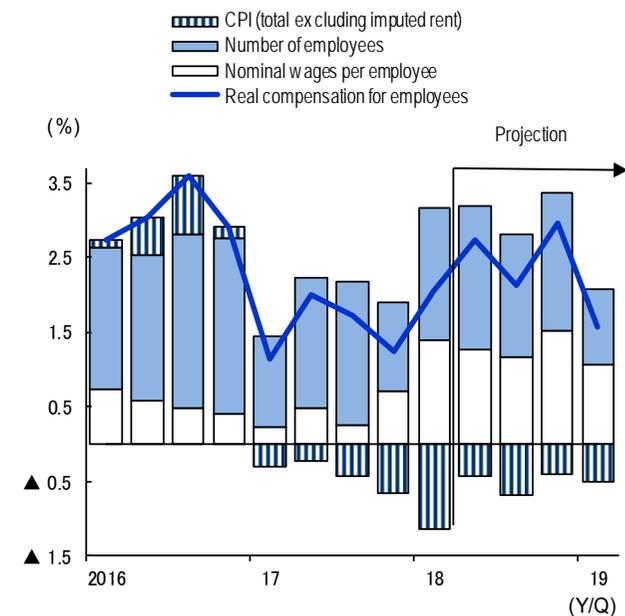
Figure 5-2 Year-on-year Change Rates of Wages by Type of Employees



Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Health, Labor and Welfare.

Note: Full-time employees are persons who are regular employees, but are not part-time employees.

Figure 5-3 Earnings for Employees <year-on-year % change>



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

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Signs of a Moderate Recovery Have Been Seen in Private Consumption Expenditure

◆ Signs of a Gradual Recovery Have been Seen in Private Consumption

Final household spending for the January-March period declined mainly in the consumption of goods due to a decrease in purchasing power reflecting a rise in fresh food prices as well as delayed purchasing as a result of the effects of the cold weather and heavy snowfall.

However, consumer spending picked up since April on the back of better weather and the levelling-off of fresh food prices. Looking at retail sales, sales of apparel and accessories, which had plunged during the January-March period, once again increased. In addition, consumer sentiment, which had weakened, improved in April.

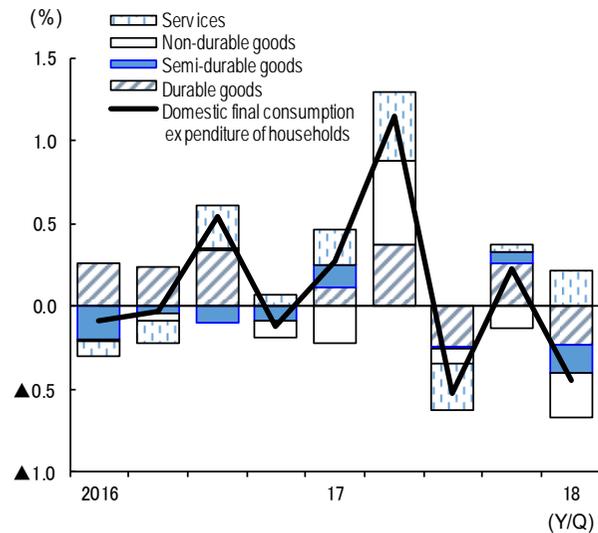
In terms of outlook, consumer spending will remain on a moderate recovery path thanks to improved employment and income conditions

◆ Housing Investment Will Likely Remain Weak

The number of housing starts rapidly increased in April mainly for subdivision housing, recovering to nearly one million on an annualized basis. However, the sustainability of this trend in the future is limited because the increase may have been a reaction to the move to refrain from commencing with new construction as a result of heavy snowfall at the beginning of this year.

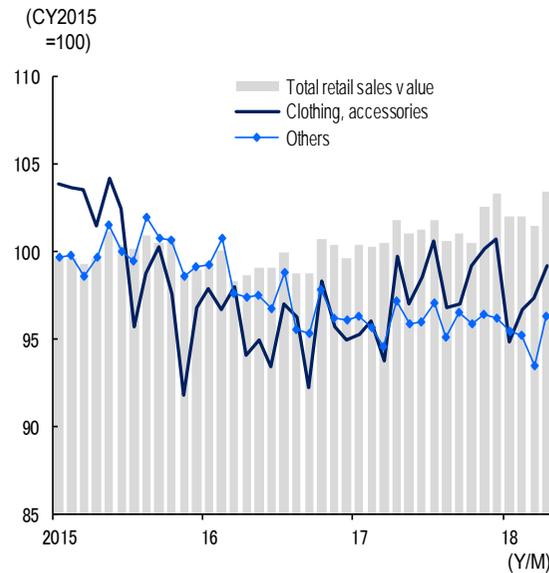
As for the future outlook, the trend for new housing starts will remain weak given the fact that the number of new construction projects for subdivision housing, which had temporarily increased, is expected to decrease, and the rental market is likely to continue to stagnate. New construction for rental housing in particular will continue to decline on a year-on-year basis against the backdrop of subleasing contract issues and concerns over excessive supply, as seen in the rise in vacancy rates. In fact, new apartment loans for individuals continued to fall in year-on-year terms.

Figure 6-1 Domestic Final Consumption Expenditure of Households by Item <quarter-on-quarter % change>



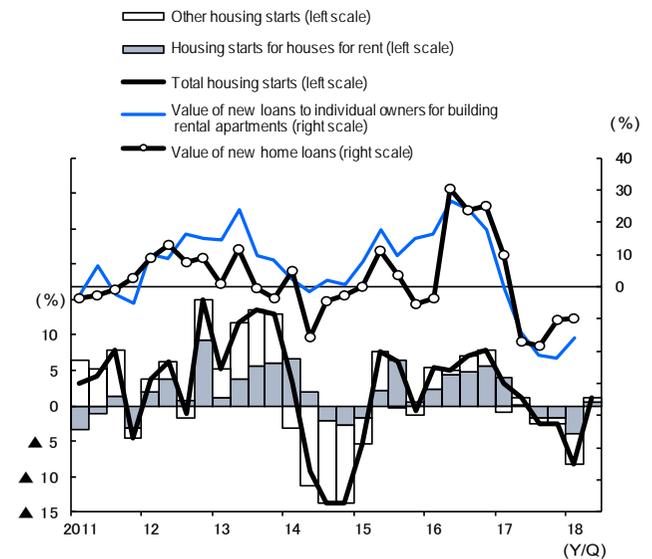
Source: The Japan Research Institute, Ltd. based on data of The Cabinet Office.

Figure 6-2 Retail Sales Value by Item <seasonally adjusted>



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

Figure 6-3 Value of New Loans for the Building of Rental Apartments <year-on-year % change>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Land, Infrastructure and Transport, The Bank of Japan.

Topics: Work Style Reform Could Trigger a Downturn in Consumption by the Younger Generation

◆ Active Debate on Work Style Reform

The following two points related to work style reform were featured as major themes at this year's spring offensive.

The first point is the reduction of working hours. While the ratio of those who work long hours has shown a downward tendency, more than 10% of full-time workers have still been forced to work long hours. Since health problems due to working long hours has emerged as a social issue, there has been active debate towards the reduction of overtime working hours.

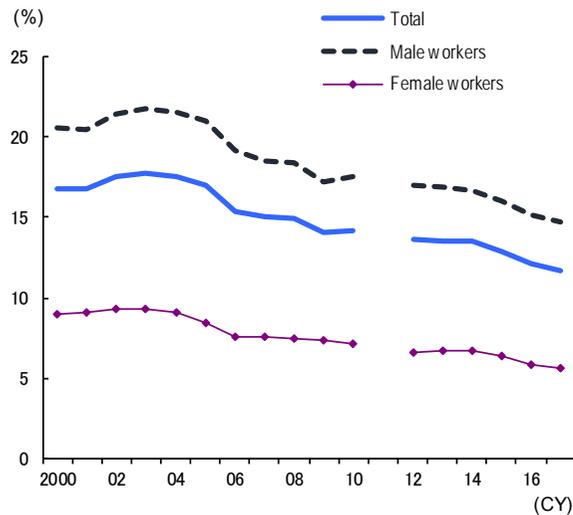
The second point is improvement in the treatment of elderly workers. In many companies, salaries tend to drop significantly in line with reemployment if a worker wishes to continue to work for the same company after retirement. As the utilization of elderly workers has become an imminent issue against the backdrop of a severe labor shortage, the intention has been to boost elderly workers' desire to work by revising the wage structure and labor conditions.

◆ Negative Impact Anticipated for Consumption by the Younger Generation

While reform has positive effects on the macro economy, it could affect negatively consumption activities by the younger generation. First, the reduction in working hours will suppress income level through decreased overtime pay. As overtime pay accounts for a relatively high percentage of the total salary of full-time workers in their 20s and 30s, there will be a significant negative impact on income as a result of reducing overtime.

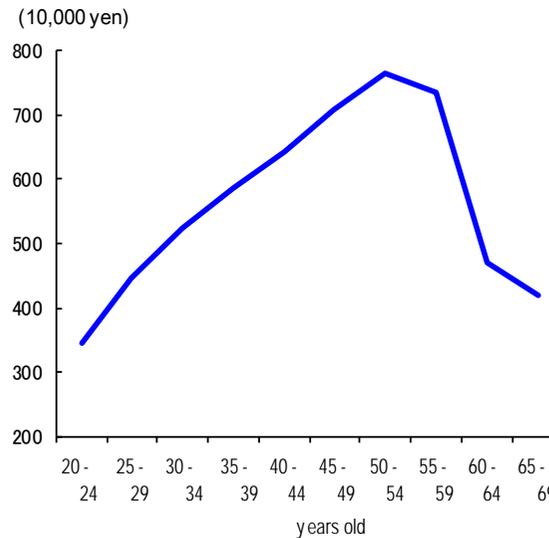
Second, since many companies have maintained their stance on reducing labor cost, increased employment of elderly workers may result in decreased wages for young and middle-career employees. In fact, the data on wage increase rates by industry and company size indicates that wage increases for the working generation have generally been suppressed among companies that significantly raised wages for elderly workers.

Figure 7-1 The Ratio of Persons who Work Long Hours among Full-time Workers



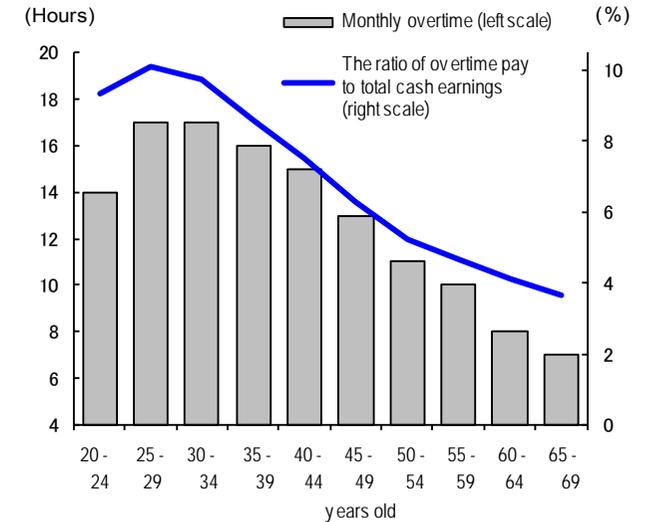
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Internal Affairs and Communications.

Figure 7-2 Annual Wages by Age Group <CY2017>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Health, Labor and Welfare.

Figure 7-3 The Ratio of Overtime Pay to Total Cash Earnings <CY2017>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Health, Labor and Welfare.

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Prospects for Japan's Economy - Projected Real GDP Change; 1.2% in FY2018 and 1.0% in FY2019

◆ Japan's Economic Activity will Likely Continue its Recovery Trend against the Background of Firm Demand at Home and Abroad

(1) Japan's real GDP in the January-March period 2018 declined by 0.6 percent on an annualized quarter-on-quarter change basis (national accounts, the second preliminary estimates), which was unchanged from the first preliminary estimates.

Viewed by demand item, business fixed investment was revised upward, while private inventory changes and private consumption expenditure were revised downward from the first preliminary estimates. The upward revision in capital spending suggests firm willingness for investment among enterprises. On the whole, there is no alteration in JRI' view that the negative figure in the January-March quarter was due to various factors which had negative effects in the same period. The factors include a rise in fresh food prices, the cold weather, a downswing demand for electronic devices in Asia, and so on.

(2) Looking ahead, it is predicted that inventory adjustment, mainly in the electronic parts and devices industry, will weigh down production activity. However, it can be judged that it is unlikely that production activity will falter. This is because a rising trend in exports will likely continue, against the backdrop of solid growth in overseas economies and a recovery in demand for business fixed investment.

With respect to domestic capital investment, positive factors will contribute to its growth. These include: 1) construction investment will stay solid, driven by redevelopment projects in metropolitan areas as well as by new building of accommodations and business logistics facilities, 2) willingness for business fixed investment in manufacturers is likely to improve, encouraged by a rise in investment for replacement of superannuated production facilities, and labor saving and rationalization investment buoyed by a shortage of workers.

(3) In the household sector, it is predicted that private consumption expenditure will return to its moderate rising trend. This is mainly because income environments continue to improve, reflecting the fact that 1) income in the middle to lower income brackets has visibly improved due the rise in the ratio of regular employees to the total, 2) the attitude of enterprises to the increase in cash earnings for scheduled time seems to have become positive gradually, and so on. In addition, the pace of the rise in fresh food prices has taken a breather recently.

(4) As a result, it is projected that real GDP in FY 2018 will grow at a pace over Japan's potential output growth rate, which is currently estimated to be about 1.0 percent, as demand at home and abroad stays solid. Specifically, it is forecast that the annual real GDP growth rate will be 1.2 percent in FY2018.

(5) With respect to economic activity in FY2019, it is predicted that the pace of real GDP growth will decelerate, since private consumption expenditure will likely be pushed down in total by lowering purchasing power due to the rise in the consumption tax rate from 8 to 10 per cent scheduled for October 2019.

However, it is unlikely that private consumption expenditure will falter. This is because 1) the extent of the rise in the consumption tax rate in 2019 will be less than that in April 2014 (from 5 to 8 percent), 2) the degree of burden such as an increase in income tax and social insurance premiums is estimated to be less than that in 2014, and 3) a reduced tax rate is planned to be introduced. As a result, real GDP will likely grow by 1.0 percent in FY2019.

◆ The year-on-year Change Rate in the Core CPI will Likely continue to flatten

(6) The core CPI, which excludes fresh food, expanded the extent of its year-on-year increase gradually, albeit slightly, after having turned into positive territory in January 2017. Then, it flattened at just below 1 percent, reflecting a slowdown in the pace of the rise in energy prices.

Looking ahead, it is predicted that the year-on-year increase rate in the core CPI will stay flat at around 1 percent, which is below the BoJ's target of 2 percent. This is because, while upward pressure will likely strengthen due to an improvement in supply-demand conditions on an aggregate basis, the pace of the year-on-year rise in energy prices will likely slow down.

Figure 9 Projections for GDP Growth and Main Indicators of Japan (as of June 8, 2018)

	(seasonally adjusted, annualised % changes from the previous quarter)											(% changes from the previous fiscal year)			
	CY2017		CY2018				CY2019				CY2020	FY2016	FY2017	FY2018	FY2019
	7~9	10~12	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3	(Actual)	(Actual)	(Projection)	(Projection)
	(Actual)		(Actual)	(Projection)			(Projection)				(Projection)	(Actual)	(Actual)	(Projection)	(Projection)
Real GDP	2.0	1.0	▲ 0.6	1.5	1.8	1.6	1.5	1.4	2.4	▲ 3.6	1.3	1.2	1.6	1.2	1.0
Private Consumption Expenditure	▲ 2.7	1.3	▲ 0.3	1.8	1.5	1.4	1.3	1.8	5.2	▲ 9.1	1.3	0.3	0.9	0.9	0.8
Housing Investment	▲ 6.3	▲ 10.3	▲ 7.2	▲ 6.7	0.3	3.3	6.5	1.9	▲ 2.4	▲ 9.8	▲ 7.2	6.2	▲ 0.3	▲ 3.9	▲ 0.1
Business Fixed Investment	4.1	2.8	1.3	3.8	4.2	4.2	3.6	3.0	2.7	2.3	2.3	1.2	3.2	3.4	3.1
Private Inventories (percentage points contribution)	(1.4)	(0.6)	(▲ 0.7)	(▲ 0.2)	(▲ 0.1)	(0.2)	(0.0)	(▲ 0.1)	(▲ 0.5)	(0.3)	(0.3)	(▲ 0.3)	(0.1)	(0.0)	(▲ 0.0)
Government Consumption Expenditure	0.2	0.2	0.4	0.6	0.7	0.7	0.8	0.8	0.8	0.8	0.8	0.5	0.7	0.5	0.8
Public Investment	▲ 10.1	▲ 1.7	▲ 0.5	2.3	5.1	▲ 6.4	▲ 1.8	0.0	1.0	0.5	0.3	0.9	1.4	▲ 0.3	▲ 0.5
Net Exports (percentage points contribution)	(2.2)	(▲ 0.4)	(0.2)	(0.1)	(0.0)	(0.1)	(▲ 0.0)	(▲ 0.1)	(▲ 0.6)	(1.1)	(▲ 0.0)	(0.8)	(0.4)	(0.2)	(0.0)
Exports of Goods and Services	8.2	9.2	2.6	2.8	3.0	3.2	3.2	3.0	3.0	2.8	2.8	3.6	6.2	3.9	3.0
Imports of Goods and Services	▲ 5.2	12.9	1.2	2.4	2.8	2.8	3.3	3.9	6.3	▲ 3.3	2.9	▲ 0.8	4.0	3.1	3.0
(Ref.) Domestic Private Demand (percentage points contribution)	(0.4)	(1.4)	(▲ 0.9)	(1.2)	(1.4)	(1.7)	(1.5)	(1.4)	(2.8)	(▲ 4.7)	(1.2)	(0.3)	(1.0)	(0.9)	(0.9)
(Ref.) Public Demand (percentage points contribution)	(▲ 0.5)	(▲ 0.0)	(0.0)	(0.2)	(0.4)	(▲ 0.2)	(0.1)	(0.2)	(0.2)	(0.2)	(0.2)	(0.1)	(0.2)	(0.1)	(0.1)

	(% changes from the same quarter of the previous year)											(% changes from the previous fiscal year)			
	7~9	10~12	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3	FY2016	FY2017	FY2018	FY2019
Nominal GDP	2.1	2.0	1.6	0.8	0.7	1.2	2.3	2.4	2.6	1.6	1.7	1.0	1.7	1.3	2.0
GDP deflator	0.1	0.1	0.5	▲ 0.2	▲ 0.2	0.1	0.7	0.8	0.9	1.2	1.2	▲ 0.2	0.1	0.1	1.0
Consumer Price Index (excluding fresh food)	0.6	0.9	0.8	0.9	1.1	1.0	1.1	0.9	0.8	1.8	1.9	▲ 0.2	0.7	1.0	1.3
(excluding fresh food, consumption tax)	0.6	0.9	0.8	0.9	1.1	1.0	1.1	0.9	0.8	0.8	0.9	▲ 0.2	0.7	1.0	0.8
Unemployment Rate (%)	2.8	2.7	2.5	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.3	3.0	2.7	2.4	2.4
Exchange Rates (JY/US\$)	111	113	108	109	109	110	111	111	110	110	109	108	111	110	110
Import Price of Crude Oil (US\$/barrel)	50	58	67	71	70	68	68	68	68	68	68	47	57	69	68

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 : "▲" indicates minus.