

Monthly Report of Prospects for Japan's Economy

August 2018

Macro Economic Research Center
Economics Department



The Japan Research Institute, Limited

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

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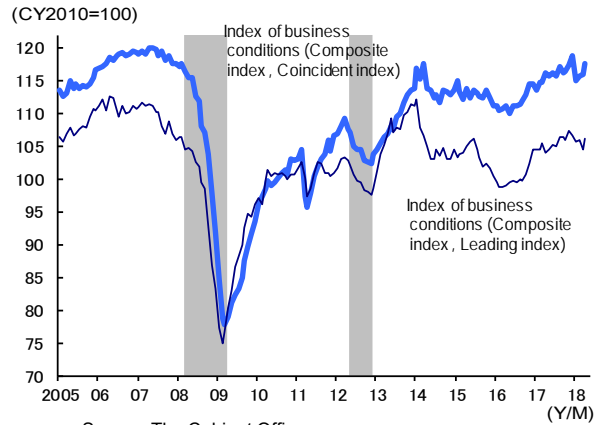
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The General Situation of Japan's Economy – Economic Recovery Trend Will Likely Continue

Figure 1-1 Economic Activity

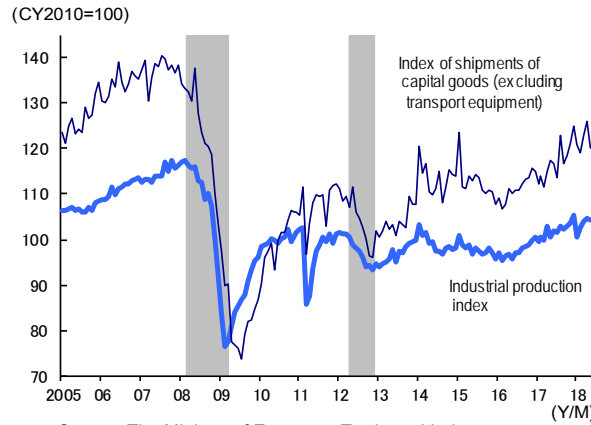
The coincident index rose for 3 months running, reflecting a pickup in shipments of durable goods and capital goods.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

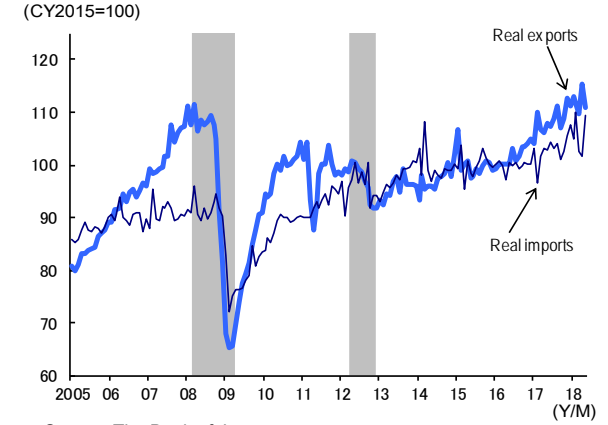
Industrial production remained at a standstill due to the decrease in the production of transport equipment and so on.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

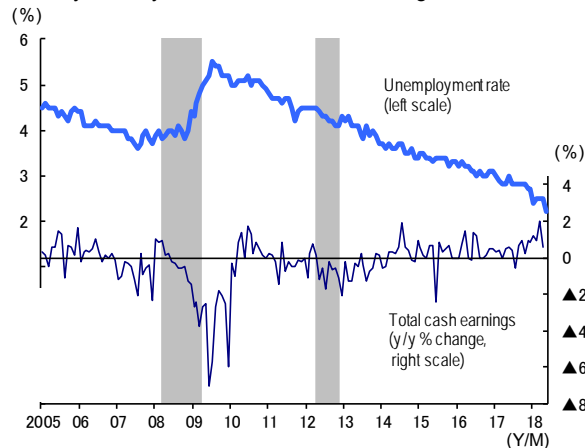
With respect to real exports, those of capital goods and chemical products increased. The pace of the rise in real imports was relatively high.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

The unemployment rate was the lowest level in about 26 years since the "bubble" period. The higher pace of year-on-year rise in total cash earnings continued.

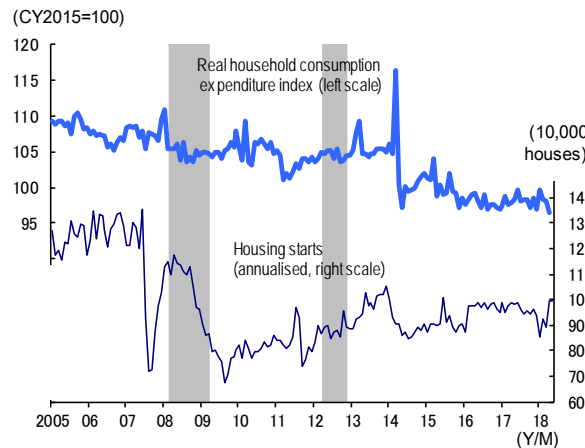


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labor and Welfare.

* The shaded area indicates the recession phase.

Figure 1-5 The Household Sector

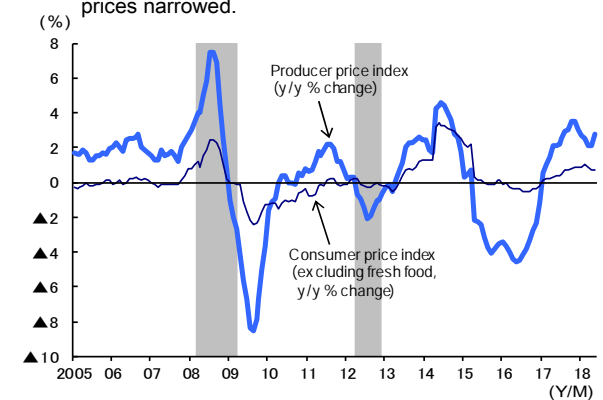
Real household consumption expenditure seesawed. Housing starts, mainly those for build-for-sale houses, climbed.



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 in producer prices widened due to the rise of the crude oil price and the weaker yen, while those in core consumer prices narrowed.



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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While Industrial Production Remained at a Standstill, Signs of Recovery Were Seen in the Household Sector

◆ Industrial Production Stayed in a Holding Pattern

The Industrial Production Index for May declined for the first time in four months, down 0.2 percent from the previous month. While industrial production for electronic parts and devices turned to an upward trend again after falling sharply during the last month, industrial production saw significant drops in transportation machinery. According to the Indices of Industrial Production Forecast, industrial production is anticipated to decrease 0.1 percent month over month in June and increase 0.8 percent month over month in July, virtually continuing in a holding pattern.

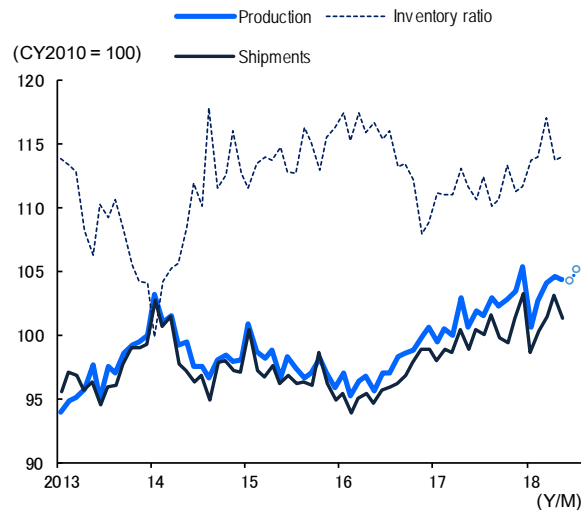
At the same time, exports saw moderate increases. On the back of an expansion of demand for infrastructure investment, exports of capital goods to China remained brisk. However, exports saw decreases in electronic parts and devices to Asian countries and transportation machinery to the United States.

◆ Improvement in the Household Sector Observed

The Synthetic Consumption Index rose 1.0% from the previous month in April. Improvement in purchasing power was seen in the household sector thanks to the recovery in the weather and the slowdown of the rising trend in fresh food prices. Positive signs have emerged in the household sector, including an increase in expenditure for services based on consumer preferences on the back of improvement in the employment and income environment.

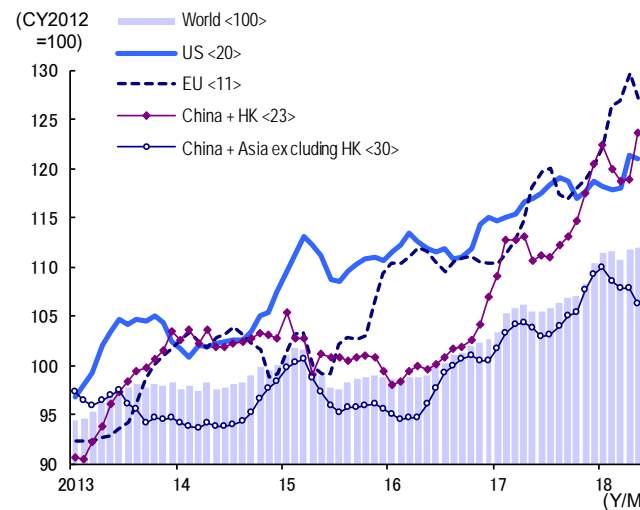
Looking at the employment situation, the number of employees has been on a rising trend, and the unemployment rate in May was 2.2%, marking its lowest level in 25 years and 7 months since the bubble period. The active opening rate also remained high at 1.6 times. Amid the severe labor shortages, progress was seen in the shift from a non-labor to a labor force mainly among women, against the backdrop of the increased willingness of companies to hire new employees.

Figure 2-1 Indices of Industrial Production
<seasonally adjusted>



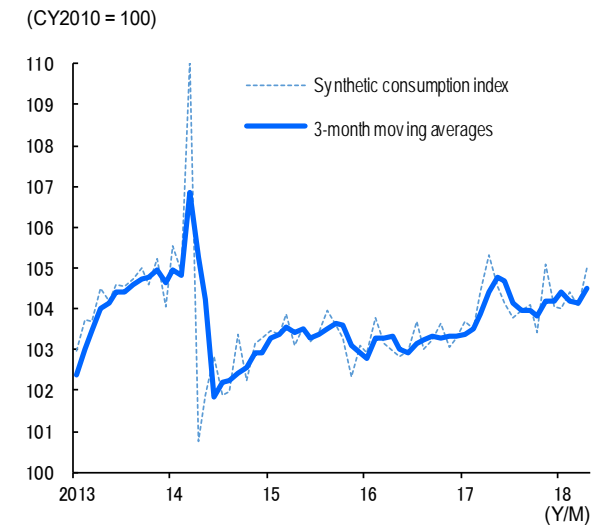
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Economy, Trade and Industry.
Note: The latest two figures in production are based on the production forecast index.

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 Synthetic Consumption Index
<seasonally adjusted>



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

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BoJ's Tankan Survey - Business Sentiment Deteriorated Due to Rising Prices of Raw Materials

◆ Deterioration Was Demonstrated in Business Sentiment

In the Tankan June 2018 Survey, the diffusion index (DI) for business conditions on the whole of large manufacturing fell by 3 percentage points from the previous survey, continuing to deteriorate for the second consecutive quarter. Overall business sentiment has sounded a cautious note both in basic materials and processing industries against the backdrop of the slowdown in buoyant exports and the rise in the prices of raw materials, among other factors.

In terms of future outlook, while business conditions will be underpinned by resilient corporate earnings, there is a possibility that business confidence will continue to deteriorate due to growing concerns over the export environment reflecting intensifying trade conflicts triggered by the United States.

Meanwhile, the DI for large non-manufacturers overall increased by 1 percentage

point, showing improvement for the first time in two quarters. In addition to the DIs for construction-related industries, which continued to stay high, DIs rose in logistics-related industries, where the passing of prime costs on to sales prices has been successful, as well as personal services, accommodation and food and beverages services, where inbound demand has been resilient.

◆ Business Fixed Investment Has Been Robust

The upward revision of the capital investment Plan for FY2018 turned out to be slightly more than in normal years. The appetite for business fixed investment improved mainly in the areas of maintenance, renewal, rationalization and labor-saving on the back of strong corporate earnings despite concerns over the outlook of the overseas economy. A positive attitude toward capital investment was apparent among small and medium-sized manufacturers in particular.

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

<diffusion index of "favourable" minus "unfavourable," and percentage point contribution to total DI points>

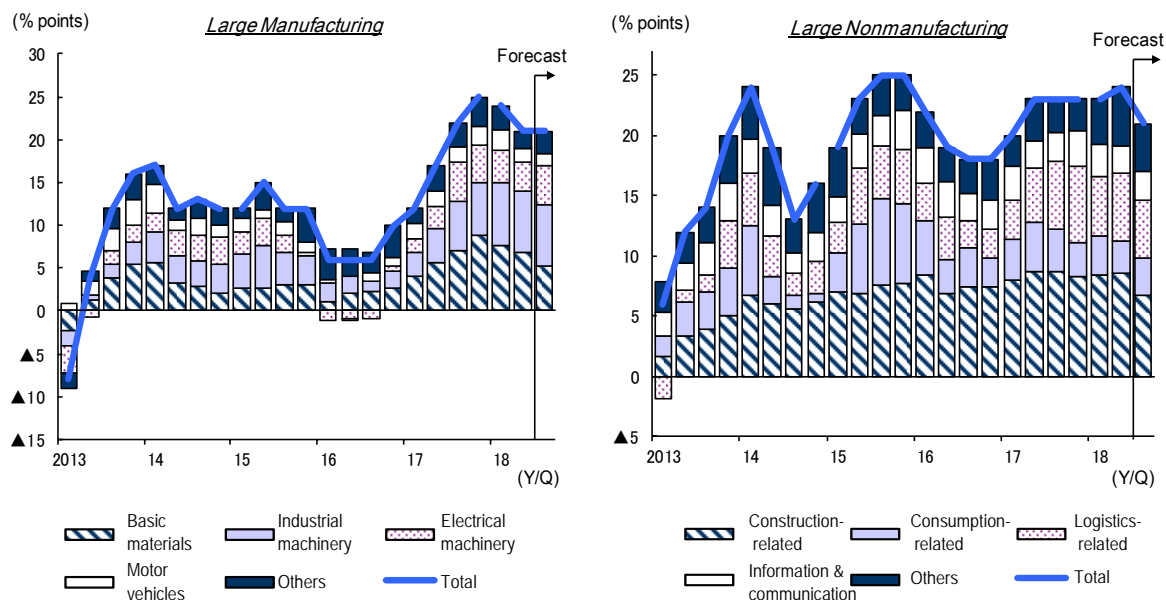
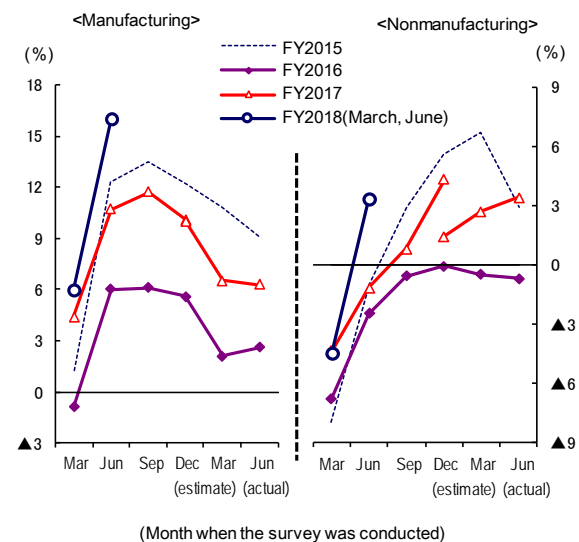


Figure 3-2 Change over Time in Planned Business Fixed Investment for Each Fiscal Year <year-on-year, %>



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

Source: The Japan Research Institute, Ltd. based on data of The Bank of Japan, "The Tankan June 2018 Survey".

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Exports Will Likely Follow a Mild Rising Path

◆ Exports of Goods Moderately Increased

Japan's exports of goods and services both continue the increasing trend. Looking at exports of services, consumption by overseas tourists visiting Japan remained unchanged, reflecting the poor weather and appreciation of the yen. Also, the rising pace of the receipt of royalties for intellectual property rights took a breather. 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.

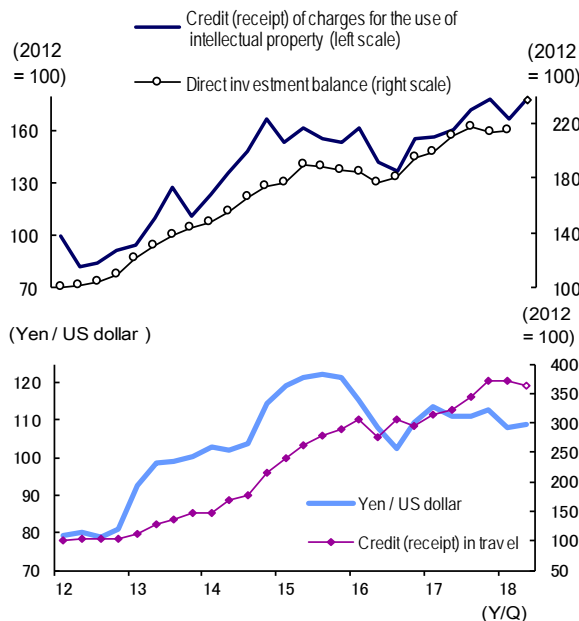
In terms of exports of goods, while the increasing trend for electronic parts and devices has slowed down due partly to sluggish sales of new smartphones and the expansion of in-house production in emerging Asian countries, exports of capital goods have grown. Against the backdrop of the expansion of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

◆ U.S. Protectionist Trade Policies Remain a Concern

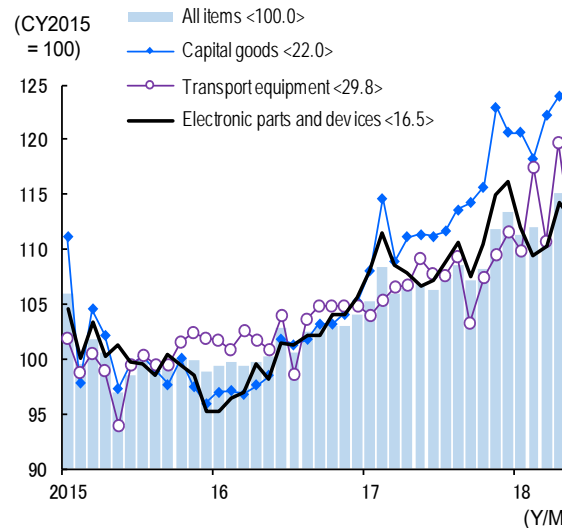
Nevertheless, the Trump administration's inclination towards protectionism and the intensification of trade friction triggered therefrom have remained as risks. The Trump administration has been considering raising tariffs on automobiles and automotive parts from 2.5% currently to 25%. Although the feasibility 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 4-1 Balance of Payments by Item
<seasonally adjusted>



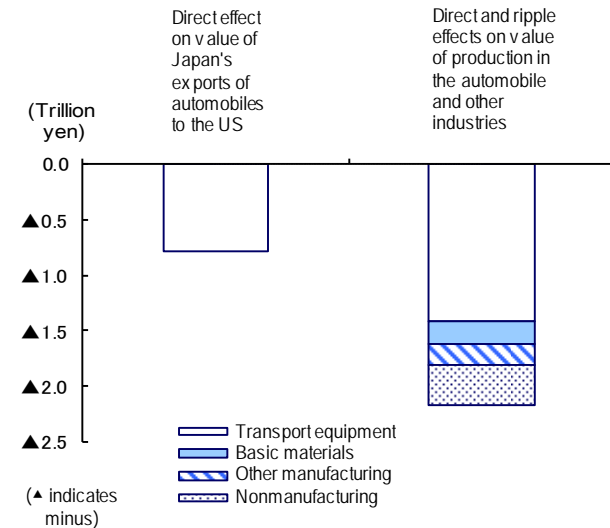
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Finance, The Bank of Japan.
Note: The latest figures of credit (receipt) are for April 2018.

Figure 4-2 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 4-3 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. Looking at operating income of TSE listed companies, profits surged significantly for FY2017, and continued profit increases are anticipated for many companies in FY2018.

While corporate earnings may be pushed down due to an increase in personnel expenses against the backdrop of severe labor shortages, reinforcement of the financial position, such as reduction of variable expenses, has resulted in a significant decline in the break-even point ratio, thus realizing a structure where an increase in sales can directly lead to expansion of profits.

Ordinary income is also likely to remain at a high level. In addition to strong operating income, since the current foreign exchange rate has moved towards depreciation of the yen compared to the anticipated exchange rate, foreign exchange

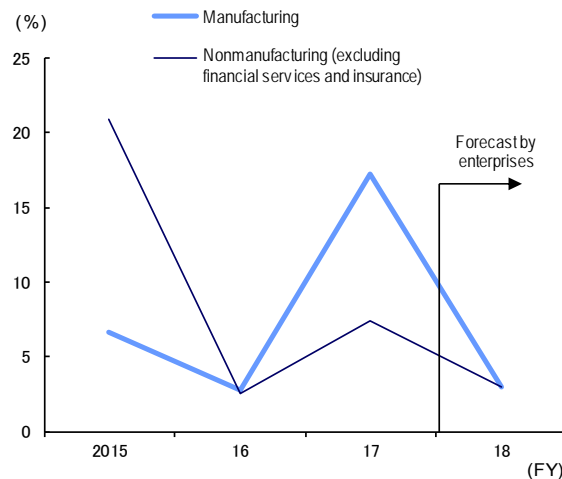
gains will likely impact corporate earnings positively in the future.

◆ Business Fixed Investment Is on a Moderate Rising Trend

Reflecting abundant cash flow, capital investment has remained on an upward trend mainly in the fields of rationalization and labor saving against the backdrop of labor shortages.

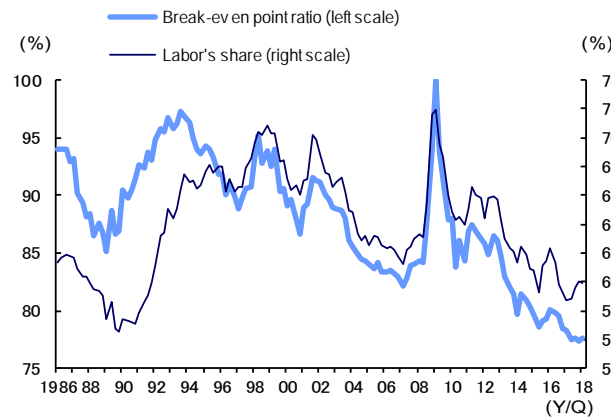
However, since it is hard to foresee Japan's growth outlook due to its declining population, the momentum of capital investment has been rather sluggish compared to the pace of improvement in corporate earnings. Furthermore, there is a risk that the appetite for capital investment may wane if concerns over the outlook for corporate earnings increase due to intensification of trade friction between the United States and China, and subsequent acceleration of the appreciation of the yen.

Figure 5-1 Operating Profits of Companies which Are Listed in the Tokyo Stock Exchange <year-on-year % change>



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

Figure 5-2 Break-even Point Ratio



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

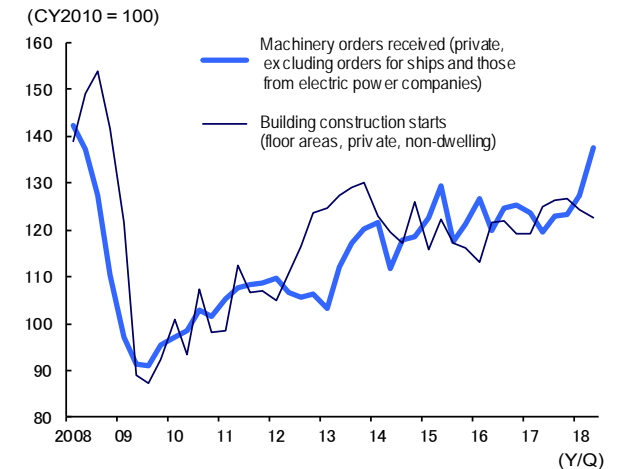
Note: The break-even point ratio =
break-even point sales value / sales value

Break-even point sales value =
fixed costs / (1 - (variable costs / sales value))

Fixed costs = personnel expenses + depreciation expenses
+ interest payment

Variable costs = cost of goods sold + selling and administration
expenses - personnel expenses - depreciation expenses

Figure 5-3 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 for April and that in building starts is April-May 2018.

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Income Is Likely to Recover Steadily

◆ 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. As the pace of increase in the number of regular employees has also accelerated of late, the employment situation has been improving in terms of both the number and quality of jobs.

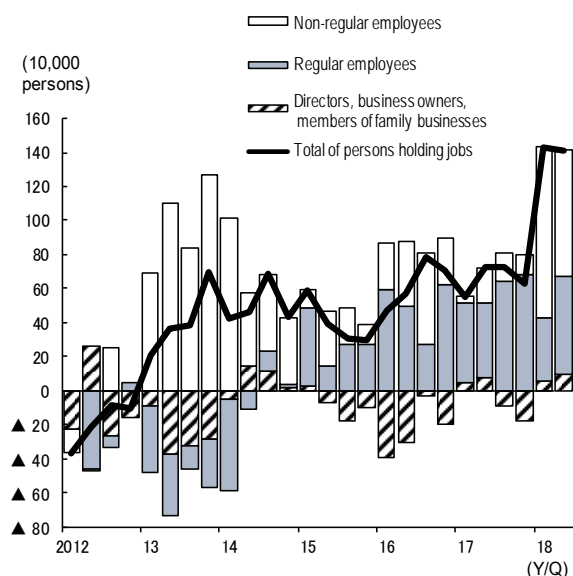
Nominal wage growth has also accelerated recently, attributable to a rapid increase in scheduled salaries for full-time workers as well as a rise in special salaries on the back of strong corporate earnings.

◆ Real Income Is Likely to Increase Firmly

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.

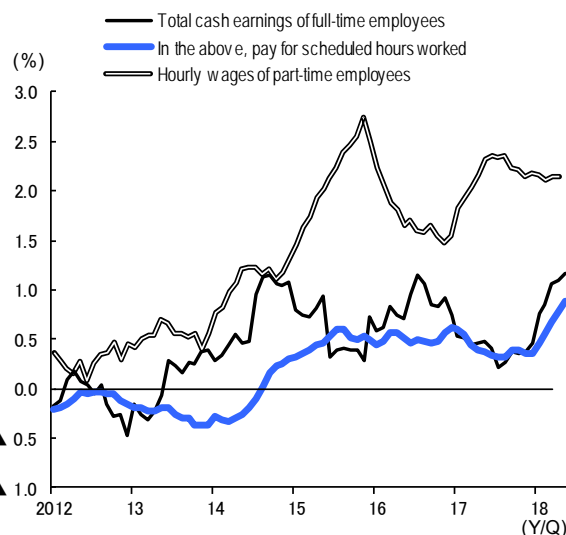
Figure 6-1 Number of Persons Holding Jobs <difference from a year earlier>



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

Note: 1. Regular employees are persons employed for an indefinite period.
2. The figures in Q2 2018 are for April-May 2018.

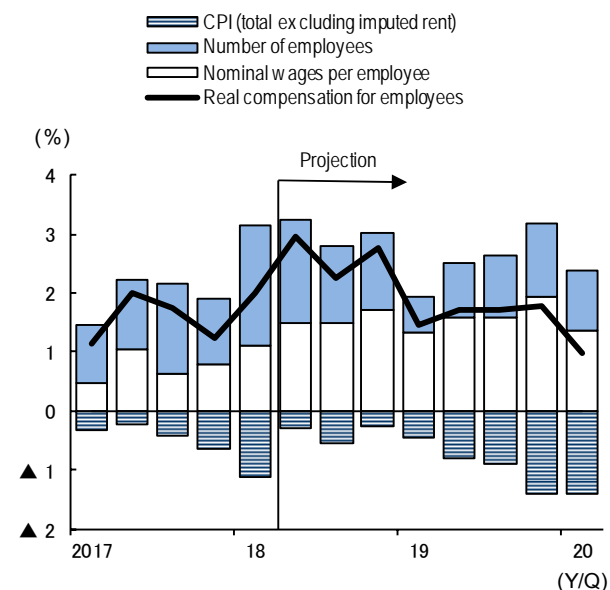
Figure 6-2 Year-on-year Change Rates of Wages by Type of Employees <6-month moving averages>



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 6-3 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

Consumer spending has picked up since April. The Consumer Activity Index for non-durables turned positive in April after plunging during the January-March period due to a hike in vegetable prices as well as delayed purchasing as a result of the heavy snowfall and cold weather. Consumption of services also remained firm. Despite fluctuations due to weather-related factors, among other reasons, it is judged that the rebound in consumer spending has continued.

In terms of outlook, consumer spending will likely remain on a moderate recovery path, as employment and income conditions are expected to continue to improve.

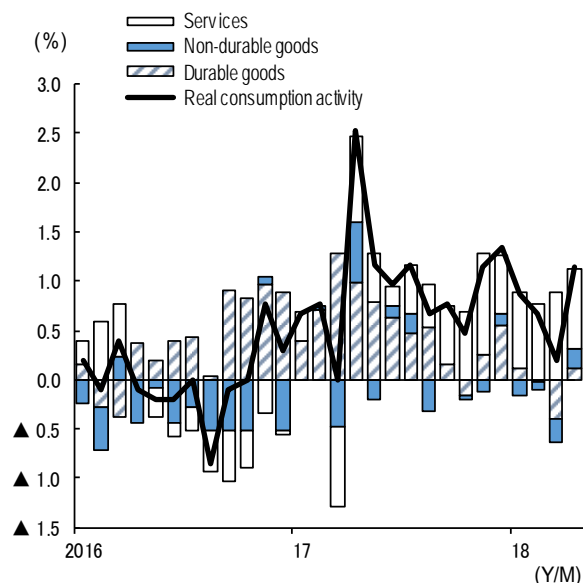
◆ Housing Investment Will Likely Remain Weak

The number of housing starts in May increased year on year for the second consecutive month thanks to the concentration of new construction projects for

condominiums in Osaka.

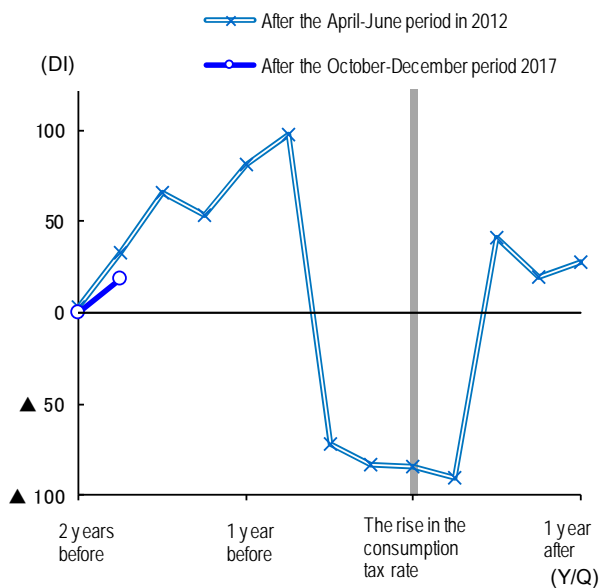
As for the future outlook, investment in owner-occupied housing is expected to pick up on the back of the rush in demand prior to the rise in the consumption tax scheduled for October 2019, in addition to the improvement in the employment and income environment. Meanwhile, the overall trend for housing 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.

Figure 7-1 BoJ's Consumption Activity Index
<year-on-year % change>



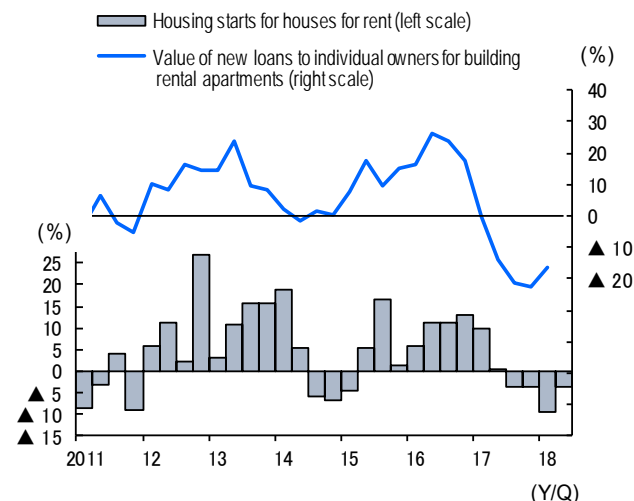
Source: The Japan Research Institute, Ltd. based on data of The Bank of Japan.

Figure 7-2 Index of Housing Business Sentiment for Custom-built Detached Houses



Source: The Japan Research Institute, Ltd. based on data of Japan Federation of Housing Organization.

Figure 7-3 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.

Note: The figure of housing starts in Q2 2018 is for April-May 2018.

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Topics: Exports of Semiconductors Are Facing a Headwind Due to In-house Production in China

◆ The Momentum of Japan's Electronic Device Exports Has Slowed

The momentum of Japan's exports of electronic parts and devices has been sluggish compared to the pace of expansion of semiconductor demand around the world. This is attributable primarily to 1) the decreasing share of Japanese manufacturers in the memory market that has been driving the expansion of global demand, and 2) diminished demand related to smartphones that utilize Japanese products.

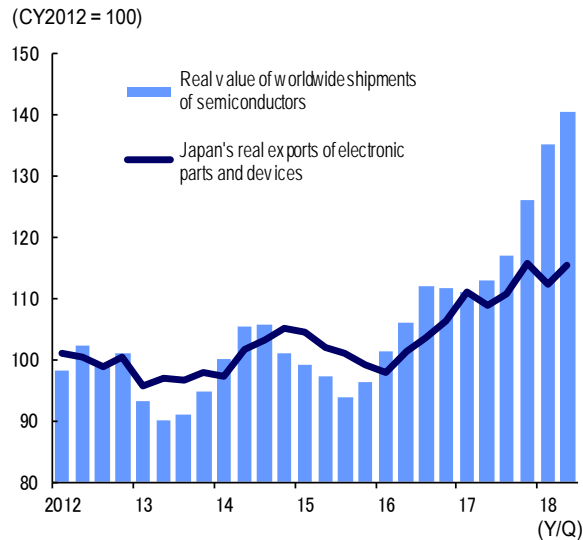
◆ China's In-house Production Is Likely to Weigh on Japan's Exports

As for the future outlook, the upward trend of Japan's exports of electronic parts and devices will likely continue given the fact that the global semiconductor market is expected to grow solidly due to expansion of the scope of semiconductor demand in line with technological innovation such as IoT-related demand and automotive

demand in addition to the growth in memory demand.

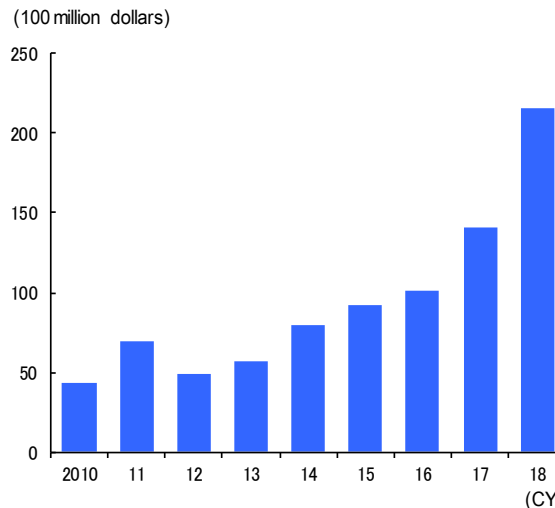
However, it is difficult to expect that Japan's exports will increase at a pace exceeding the expansion of global demand, owing to the progress in in-house semiconductor production in China, which has driven semiconductor demand around the world. The Chinese government has set a policy to promote the in-house production of semiconductors under its industrial policy termed "Made in China 2025." In fact, China's imports of semiconductor manufacturing equipment have increased substantially, indicating a significant improvement in supply capacity. As a result, the volume of semiconductor production has been far above the import of semiconductors in China during the past few years. Therefore, there is a fear that Japan's exports of electronic parts and devices will be exposed to an increasingly strong headwind from a medium to long-term perspective.

Figure 8-1 Value of Worldwide Shipments of Semiconductors and Japan's Real Exports of Electronic Devices



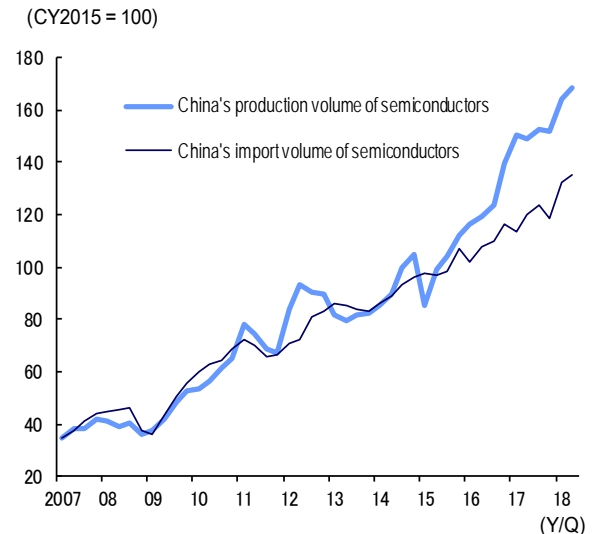
Source: The Japan Research Institute, Ltd. based on data of World Semiconductor Trade Statistics (WSTS), The Ministry of Finance of Japan, The Bank of Japan.

Figure 8-2 China's Value of Imports of Semiconductor Manufacturing Equipment



Source: The Japan Research Institute, Ltd. based on data of General Administration of Customs of China.

Figure 8-3 China's Production and Imports of Semiconductors <seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on data of National Bureau of Statistics of China, General Administration of Customs of China.

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Prospects for Japan's Economy - Projected Real GDP Change; 1.3% 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) 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.

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 business logistics facilities, and 2) willingness for business fixed investment 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.

(2) 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, as shown in the fact that the pace of the increase in cash earnings for scheduled time has accelerated, as the attitude of enterprises to wage rises seems to have become positive gradually. In addition, the pace of the rise in fresh food prices has taken a breather recently.

(3) 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 1.3 percent in FY2018.

(4) 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), and 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. 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

(5) 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, a fall in prices of households durable goods, and so on.

Looking ahead, it is predicted that the year-on-year increase rate in the core CPI will stay flat, 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 is likely to slow down.

Figure 10 Projections for GDP Growth and Main Indicators of Japan (as of July 5, 2018)

	(seasonally adjusted, annualised % changes from the previous quarter)											(% changes from the previous fiscal year)				
	CY2017		1~3	CY2018			CY2019				1~3	CY2020	FY2016	FY2017	FY2018	FY2019
	7~9	10~12		4~6	7~9	10~12	1~3	4~6	7~9	10~12						
	(Actual)		(Actual)	(Projection)			(Projection)				(Projection)	(Actual)	(Actual)	(Projection)	(Projection)	
Real GDP	2.0	1.0	▲ 0.6	1.7	1.9	1.6	1.6	1.4	2.3	▲ 3.6	1.3	1.2	1.6	1.3	1.0	
Private Consumption Expenditure	▲ 2.7	1.3	▲ 0.3	1.9	1.6	1.5	1.5	1.8	5.2	▲ 9.1	1.3	0.3	0.9	1.0	0.8	
Housing Investment	▲ 6.3	▲ 10.3	▲ 7.2	▲ 6.6	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	3.9	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	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.5	0.7	0.6	0.7	
Public Investment	▲ 10.1	▲ 1.7	▲ 0.5	2.9	5.1	▲ 6.4	▲ 1.4	0.0	1.0	0.5	0.3	0.9	1.4	▲ 0.1	▲ 0.4	
Net Exports (percentage points contribution)	(2.2)	(▲ 0.4)	(0.2)	(0.2)	(0.1)	(0.1)	(▲ 0.0)	(▲ 0.1)	(▲ 0.7)	(1.1)	(0.0)	(0.8)	(0.4)	(0.2)	(▲ 0.0)	
Exports of Goods and Services	8.2	9.2	2.6	3.1	3.1	3.3	3.3	3.2	3.0	2.8	2.8	3.6	6.2	4.0	3.1	
Imports of Goods and Services	▲ 5.2	12.9	1.2	2.2	2.8	3.1	3.6	3.9	6.8	▲ 3.3	2.9	▲ 0.8	4.0	3.1	3.2	
(Ref.) Domestic Private Demand (percentage points contribution)	(0.4)	(1.4)	(▲ 0.9)	(1.3)	(1.5)	(1.8)	(1.6)	(1.4)	(2.8)	(▲ 4.7)	(1.2)	(0.3)	(1.0)	(1.0)	(0.9)	
(Ref.) Public Demand (percentage points contribution)	(▲ 0.5)	(▲ 0.0)	(0.0)	(0.3)	(0.4)	(▲ 0.2)	(0.1)	(0.1)	(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)			
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Nominal GDP	2.1	2.0	1.6	0.9	0.8	1.3	2.4	2.5	2.8	1.8	1.8	1.0	1.7	1.3	2.2
GDP deflator	0.1	0.1	0.5	▲ 0.3	▲ 0.2	0.1	0.7	0.9	1.0	1.4	1.4	▲ 0.2	0.1	0.1	1.2
Consumer Price Index (excluding fresh food)	0.6	0.9	0.8	0.8	1.1	1.0	1.1	1.0	1.0	1.9	2.0	▲ 0.2	0.7	1.0	1.5
(excluding fresh food, consumption tax)	0.6	0.9	0.8	0.8	1.1	1.0	1.1	1.0	1.0	1.0	1.0	▲ 0.2	0.7	1.0	1.0
Unemployment Rate (%)	2.8	2.7	2.5	2.4	2.4	2.4	2.4	2.3	2.3	2.3	2.3	3.0	2.7	2.4	2.3
Exchange Rates (JY/US\$)	111	113	108	109	110	110	111	111	110	110	109	108	111	110	110
Import Price of Crude Oil (US\$/barrel)	50	58	67	71	73	70	68	68	68	68	68	47	57	71	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.