

Monthly Report of Prospects for Japan's Economy

September 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 August 2018 issue of the original Japanese version.

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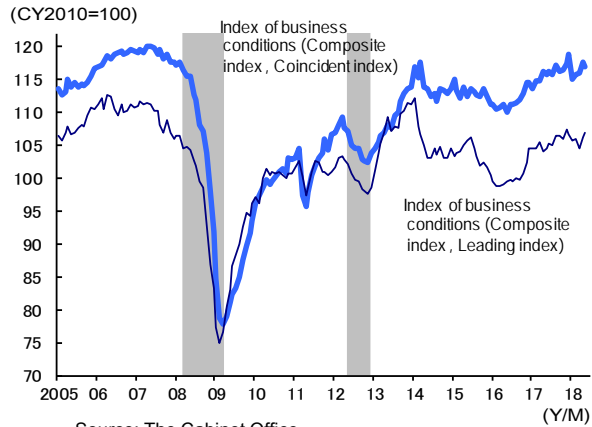
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The General Situation of Japan's Economy – Economic Recovery Trend Will Likely Continue

Figure 1-1 Economic Activity

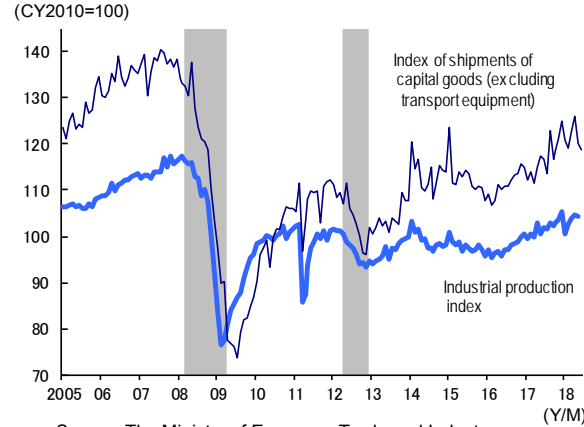
The CI coincident index fell for the first time in 4 months, reflecting a decrease in shipments of durable goods and investment goods.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

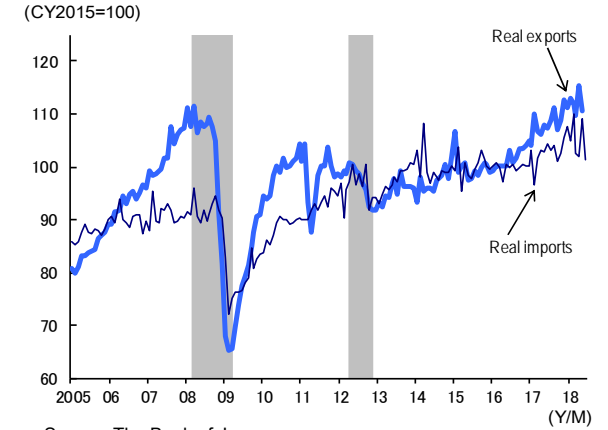
Industrial production remained at a standstill due to the slowdown in the pace of increase in exports, negative effects of the earthquake, and so on.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

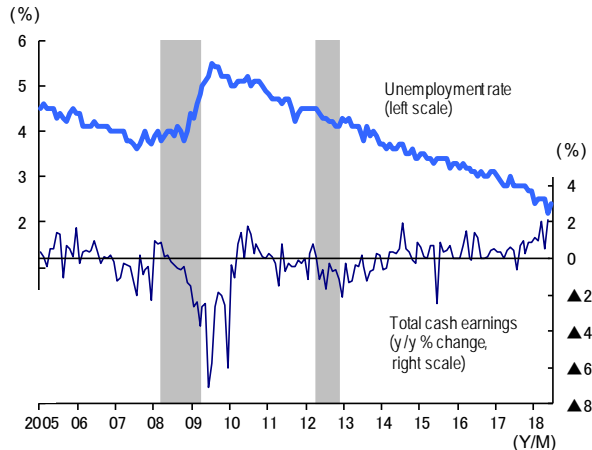
The pace of the rise in real exports slowed. Real imports, especially those of mineral fuels, fell.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

The unemployment rate was around the lowest level in 25 years. The pace of year-on-year increase in pay for scheduled hours worked accelerated.

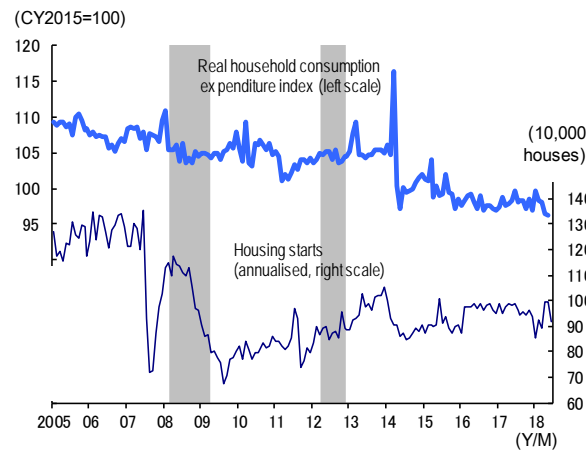


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labor and Welfare.

* The shaded area indicates the recession phase.

Figure 1-5 The Household Sector

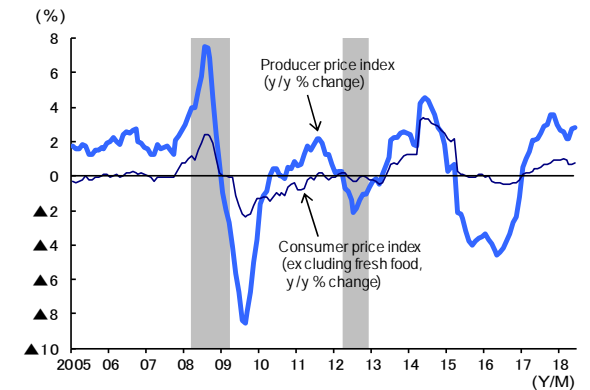
Real household consumption expenditure weakened. Housing starts seasawed.



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, while the pace of those in core consumer prices slowed.



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, the Household Sector Continued to Improve

◆ Japan's Economic Activity Returned to Growth

Japan's real GDP in the April-June period 2018 increased by 1.9 percent on an annualized quarter-on-quarter change basis (national accounts, the first preliminary estimates), a positive figure for the first time in 2 quarters.

Viewed by demand item, private consumption expenditure grew at a higher pace. Business fixed investment also firmed. Thus, economic activity returned to growth, driven by domestic demand.

◆ Industrial Production Stayed in a Holding Pattern

The Industrial Production Index for June fell significantly below forecasts, down 1.8 percent from the previous month. Industrial production saw drops in a wide range of fields due to the slowdown in buoyant exports and the effects of the Northern Osaka Prefecture Earthquake.

Looking at the Indices of Industrial Production Forecast, the holding pattern is likely

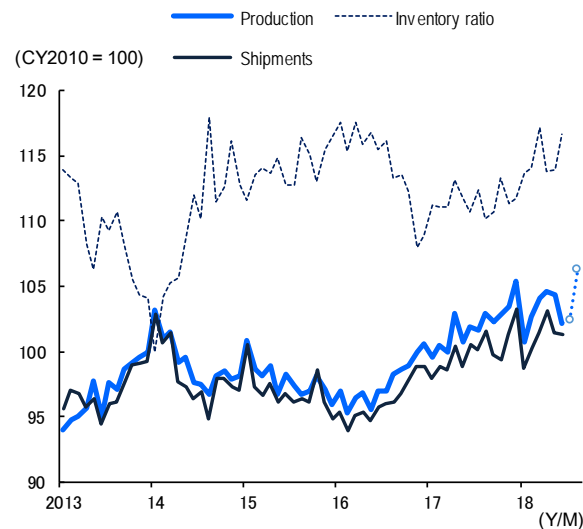
to continue for the time being.

◆ The Household Sector Continued to Improve

The employment situation remained brisk. The active opening rate increased 0.02 points from the previous month in June at 1.62 times. Although the unemployment rate rose by 0.2 points month over month to 2.4% due mainly to an increase in voluntary resignations, it still continues at its lowest level in almost 25 years. Real compensation for employees continued to increase on the back of a rise in total cash earnings and consumer price stability in addition to the robust employment climate.

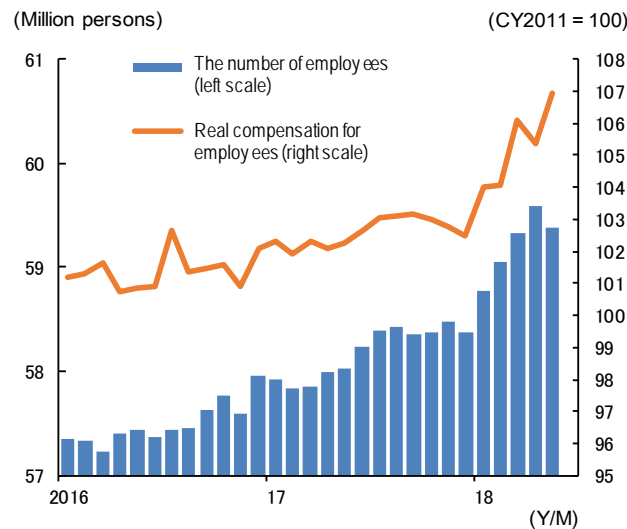
Consumer spending remained firm overall, reflecting the improvement in the income environment. The Synthetic Consumption Index declined 0.4 percent from the previous month in May due to a decrease in consumption expenditure for food services and summer clothing against the backdrop of unseasonable weather. In contrast, sales of summer clothing by department stores recovered in June thanks to favorable weather conditions.

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



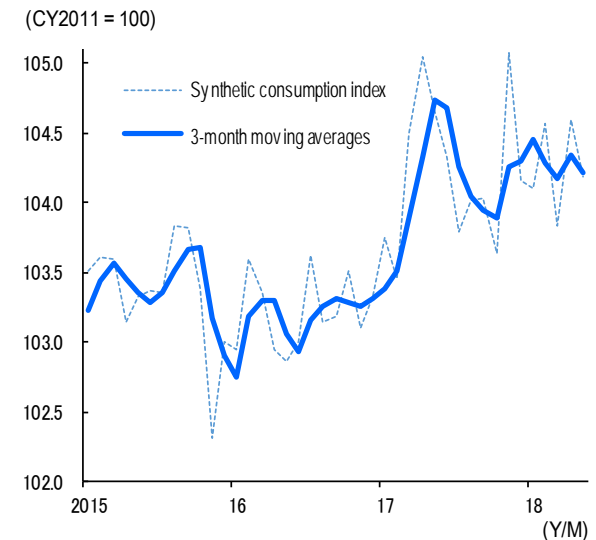
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Economy, Trade and Industry.
Note: The latest two figures in production are based on the production forecast index.

Figure 2-2 Compensation for Employees and the Number of Employees <seasonally adjusted>



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

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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Exports Will Likely Follow a Mild Rising Path

◆ Buoyant Exports Have Slowed

World trade volume has remained at a standstill since the beginning of this year against the backdrop of a lull in demand for smartphones among other factors, following a rapid increase in volume at the end of the previous year in response to growing IT demand.

Amid these circumstances, Japan's buoyant exports have also slowed down, mainly in electronic parts and devices.

◆ Exports Will Likely Continue on a Moderate Increasing Trend

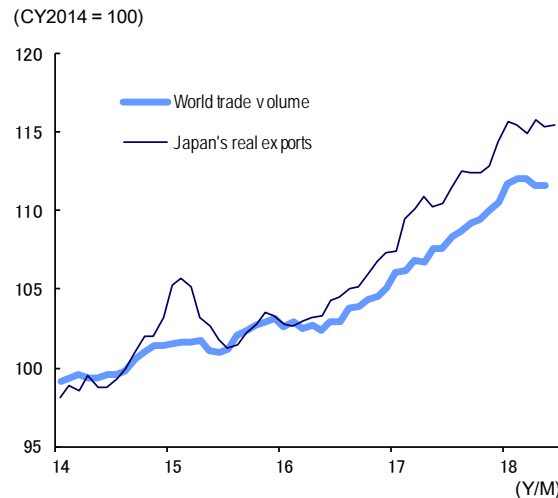
In terms of the future outlook, exports are anticipated to increase moderately mainly for transport equipment and capital goods. As for transport equipment exports, resource-supplying countries such as the Middle East are expected to serve as a driving force. The downturn in sales will likely come to a halt as the local economy picks up on the back of a rise in the prices of natural resources such as crude oil.

An increasing trend is likely to continue for exports of capital goods against the

backdrop of a recovery in global capital investment demand. Among emerging countries in Asia as principal export destinations, sophistication of manufacturing equipment and expansion of investment demand related to infrastructure will likely continue. Looking at the manufacturing PMI of each country and region, the index is expected to remain at a high level except in the case of South Korea, exceeding the 50-point mark that indicates a general trend of economic expansion.

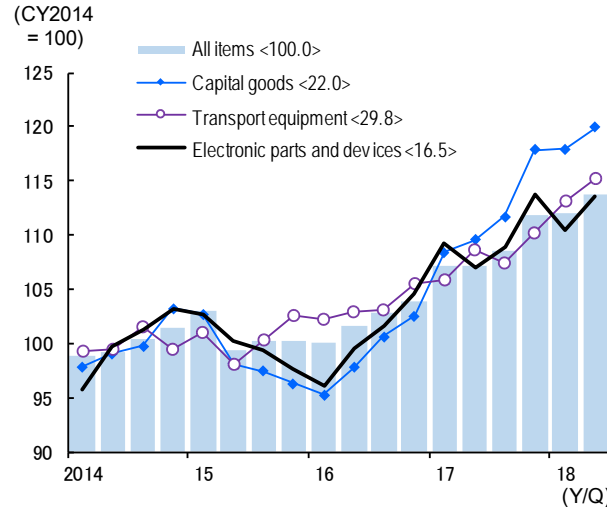
Nevertheless, the Trump administration's inclination towards protectionism and the intensification of trade friction triggered therefrom have remained as risks. If the Trump administration decides to raise tariffs on automobiles and automotive parts, downward pressure on Japan's exports will follow. Furthermore, should retaliatory measures between the U.S. and China and between the U.S. and Europe escalate in the form of imposing further tariffs, the concern is that trading activities will stagnate on a global scale.

Figure 3-1 World Trade Volume and Japan's Exports
<seasonally adjusted,
3-month moving averages>



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

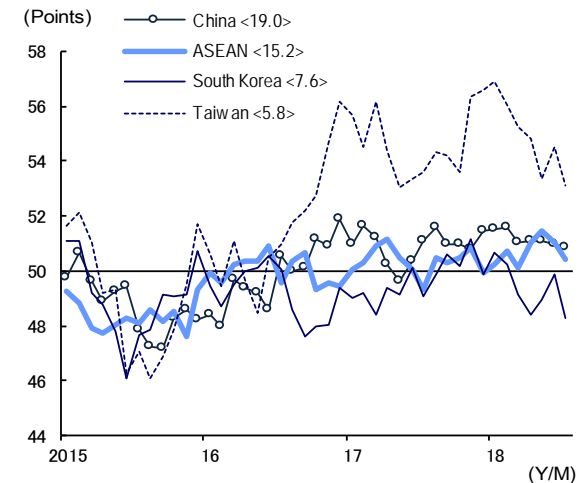
Figure 3-2 Real Exports by Item
<seasonally adjusted>



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 Manufacturing PMIs in Major Export Destinations



Source: The Japan Research Institute, Ltd. based on data of Nikkei, Caixin, IHS Markit.

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

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

◆ Corporate Profits Continue to Be Firm

Corporate earnings have remained strong. 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.

Further, solid non-operating profits have supported buoyant total profits. As corporate earnings continue to be solid worldwide, the amount of receipt of dividends and interest from overseas subsidiaries has maintained its high level. In addition, 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

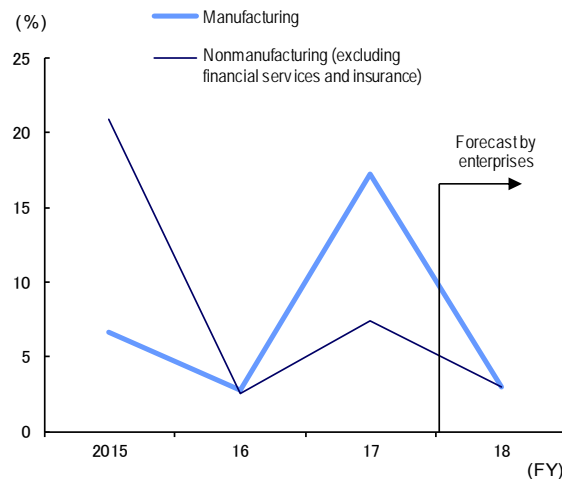
corporate earnings positively in the future.

◆ 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.

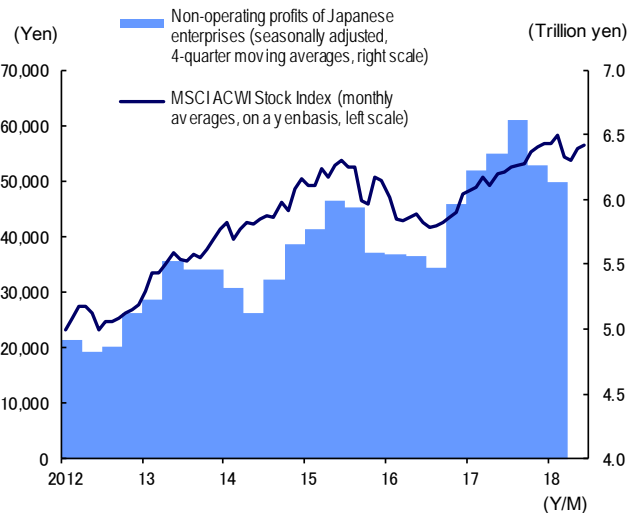
However, since it is hard to foresee Japan's growth outlook due to its declining population, the momentum of capital investment has been rather sluggish compared to the pace of improvement in corporate earnings. Furthermore, there is a risk that the appetite for capital investment may wane if concerns 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 4-1 Operating Profits of Companies which Are Listed in the Tokyo Stock Exchange <year-on-year % change>



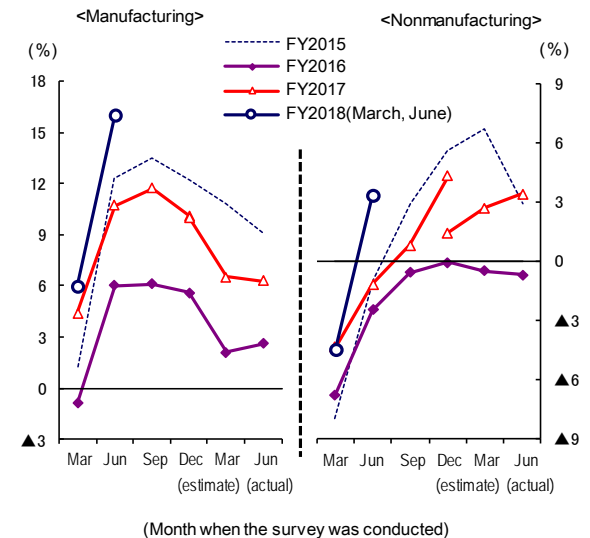
Source: The Japan Research Institute, Ltd. based on the data of SPEEDA.

Figure 4-2 Global Stock Price Index and Non-operating Profits of Japanese Enterprises



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

Figure 4-3 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."

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.

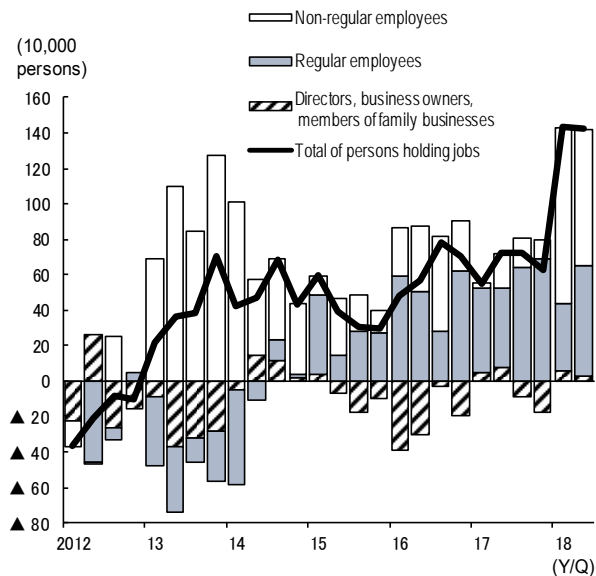
Nominal wage growth has also accelerated recently, attributable to a rapid increase in scheduled salaries for full-time workers as well as a rise in special salaries on the back of strong corporate earnings.

◆ 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, the situation of which is the severest since year 1991, 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 at a higher pace.

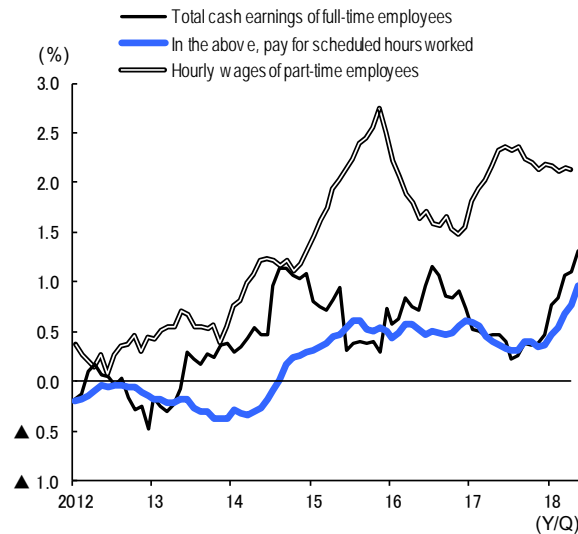
Furthermore, since the upward pressure on prices that pushed down real income for the January-March 2018 period has peaked out, we predict that real employee compensation will continue to grow by around 3 percent or more year on year through the end of the year.

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



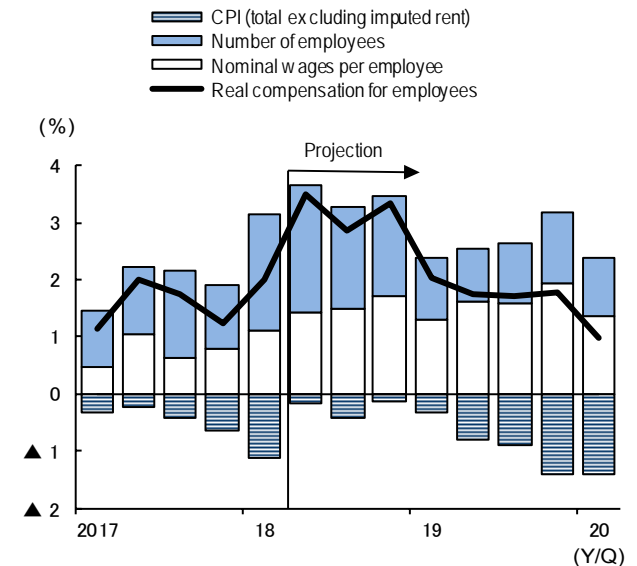
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Health, Labor and Welfare.
Note: Regular employees are persons employed for an indefinite period.

Figure 5-2 Year-on-year Change Rates of Wages by Type of Employees <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 5-3 Real Compensation for Employees <year-on-year % change>



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

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Private Consumption Expenditure Has Picked up

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

Improvement was seen in consumer spending in June. On the back of a rise in temperature due to favorable weather, sales of household appliances such as air conditioners, clothing and beverages surged. Consumption of services also remained firm as sales per customer continued to increase and the number of customers returned to growth in food services.

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 despite possible fluctuations due to weather factors.

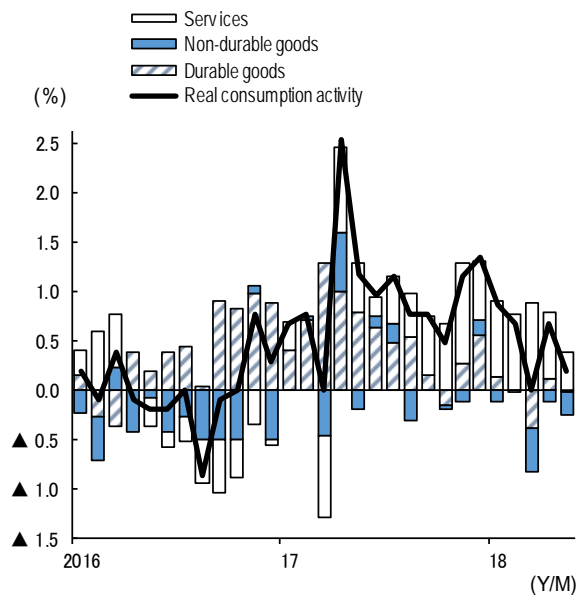
◆ Housing Investment Will Likely Remain Weak

The number of housing starts in June decreased for the first time in three months. In addition to a significant decline in the number of new construction projects for

subdivision housing, new construction of owner-occupied housing and rental houses also decreased.

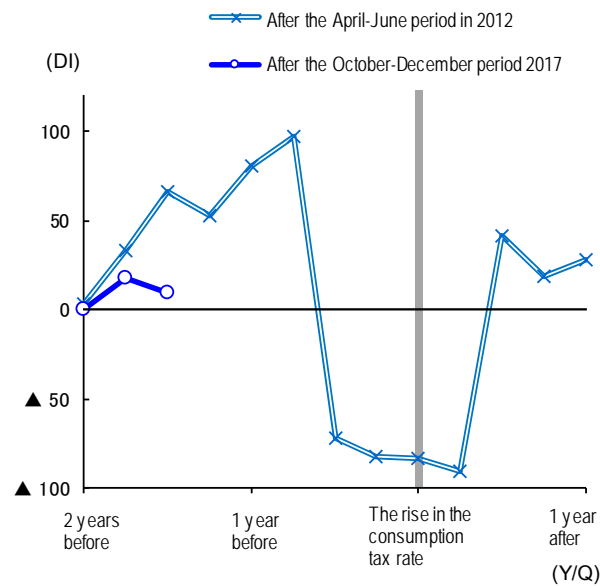
As for the future outlook, investment in owner-occupied housing is expected to pick up on the back of the rush in demand expected prior to the rise in the consumption tax scheduled for October 2019, in addition to the improvement in the employment and income environment. At the same time, the number of new construction projects for subdivision housing will likely decrease since the acquisition of land mainly in metropolitan areas is expected to remain difficult. The overall trend for housing starts is anticipated to remain weak given the fact that 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 6-1 BoJ's Consumption Activity Index
<year-on-year % change>



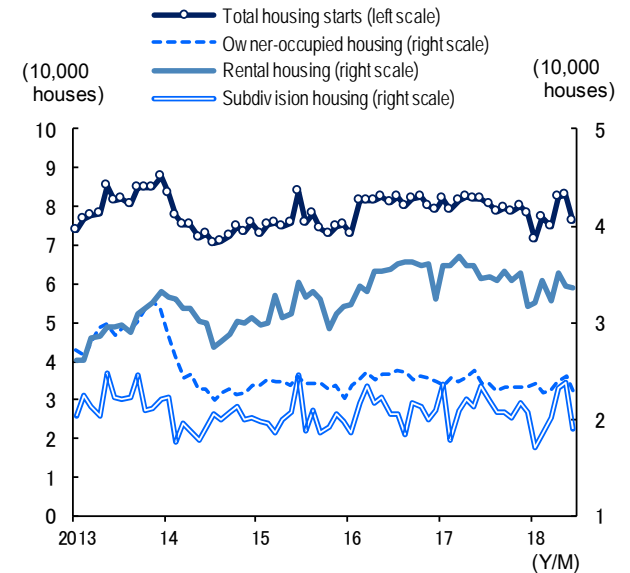
Source: The Japan Research Institute, Ltd. based on data of The Bank of Japan.

Figure 6-2 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 6-3 Housing Starts by Type
<seasonally adjusted>



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

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Topics: Mechanism of Virtuous Cycles Advanced Along with Rapid Wage Increases

◆ The Pace of Wage Increases Has Accelerated

The growth of total cash earnings has expanded since the beginning of 2018, driven by an increase in scheduled salaries for full-time workers.

While most companies had endeavored to reduce wages of full-time workers in an effort to prevent the deterioration of their financial position due to an increase in fixed costs since the beginning of Abenomics until last year, such conduct has recently seen significant and dramatic change.

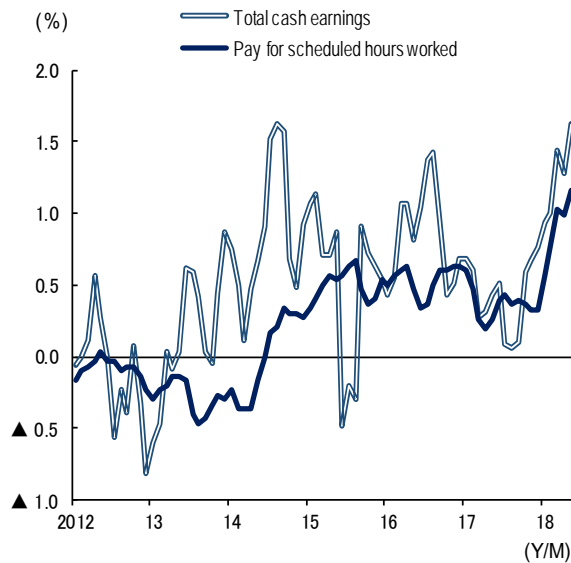
Against the backdrop of steady sales increases and progress in raising sales prices, the corporate sector has built up confidence towards the outlook of ongoing revenue increases. This has resulted in a shift in attitude by many companies toward greater positivity with regard to the expansion of personnel expenses. As a result, growth in scheduled salaries, which had been at a low 0 percent level in 2017, rose to around 1

percent. Since many companies tend to revise scheduled salaries once a year during the April-June period, it is likely that the strong growth in wages will be maintained for at least the next 12 months.

◆ Mechanism of Virtuous Cycles Getting into Full Swing

Reflecting the above, the distribution of income from the corporate sector to the household sector has been expanding, as labor's share returned to growth in line with the rapid pace of wage increases. It is likely that the economic recovery will become more substantial in the future as consumer spending gains strength in line with an increase in household income, thereby boosting a self-sustained recovery led by domestic demand.

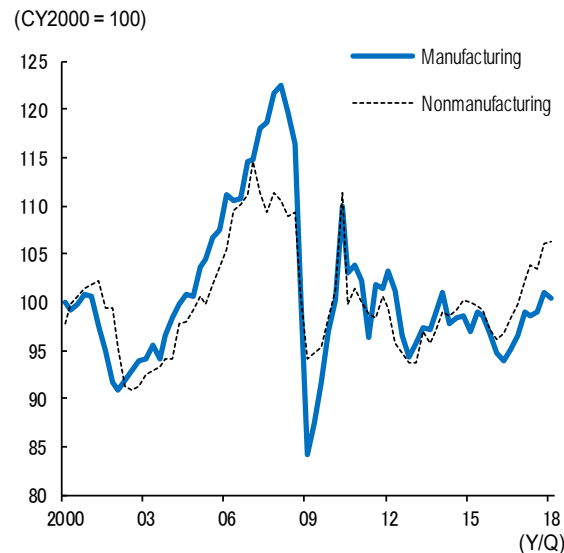
Figure 7-1 Wages of Full-time Workers
<year-on-year % change>



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

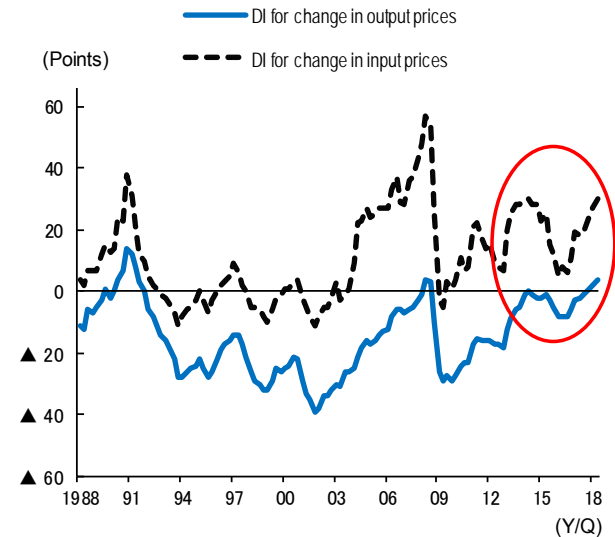
Note: The figures show year on year % changes of 3-month moving averages.

Figure 7-2 Sales Value by Type
<seasonally adjusted>



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

Figure 7-3 DIs for Changes in Output and Input Prices



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

Note: Diffusion index shows "Rise" minus "Fall" for change in output or input price.

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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 Return to a Recovery Trend Again, Driven by Firm Domestic Demand

(1) Japan's real GDP in the April-June period 2018 increased by 1.9 percent on an annualized quarter-on-quarter change basis (national accounts, the first preliminary estimates), a positive figure for the first time in 2 quarters.

Viewed by demand item, exports decelerated due to the temporary fall in exports of transport-related services. However, private consumption expenditure grew at a higher pace because the negative effect of bad weather seen in the previous quarter faded away. Business fixed investment also firmed. Thus, Japan's economic activity returned to growth, driven by domestic demand.

(2) Looking ahead, the Japanese economy is predicted to return to a recovery path, as robust domestic demand will likely continue. Fixed business investment is expected to remain firm in the areas of investment for labor saving and replacement buoyed by a shortage of workers and superannuated production facilities. Other positive factors include aggressive research and development investment by the corporate sector in response to new technologies such as AI and automated operations.

(3) In the household sector, the pace of wage increases is predicted to slightly accelerate, as the attitude of enterprises toward wage rises seems to have gradually become positive. Promising signs in consumer spending will likely emerge gradually as household income is boosted not only by an increase in the number of employees but also through the shift to a more substantial rise in cash earnings based on wage increases for individual workers.

(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 stays solid. Specifically, it is forecast that the annual real GDP growth rate will be 1.3 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.

(6) Nevertheless, there is a risk that the Trump administration's protectionist commercial policies will exert downward pressure on Japan's economy. If measures such as raising tariffs on automobiles are enacted, a slowdown in exports cannot be avoided. Furthermore, if tariff hikes by the United States and retaliatory measures by China and the EU are not stopped, there is a concern that a global trade war may break out. In such a case, in addition to an economic downturn in line with the slowdown in global trading activities, rapid appreciation of the yen due to risk avoidance and a sharp drop in stock prices will weigh down exports, fixed investments and consumer spending, thus derailing the economic recovery in a worst-case scenario.

◆ The Year-on-year Change Rate in the Core CPI Will Likely Continue to Flatten

(7) While energy prices returned to a rising trend, the core CPI, which excludes fresh food, remained flat, reflecting a slowdown in the pace of the rise in prices of other items. Looking ahead, it is predicted that the year-on-year increase rate in the core CPI will be around 1 percent. This is because, while the upward pressure will likely strengthen from the supply-demand perspective due to improvement in employment and income conditions, the pace of the rise in energy prices will likely gradually slow down.

Figure 9 Projections for GDP Growth and Main Indicators of Japan (as of August 10, 2018)

	(seasonally adjusted, annualised % changes from the previous quarter)									(% changes from the previous fiscal year)			
	CY2018				CY2019				CY2020	FY2016	FY2017	FY2018	FY2019
	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)	(Projection)	(Projection)	(Projection)	(Projection)	(Actual)	(Actual)	(Projection)	(Projection)
Real GDP	▲ 0.9	1.9	2.0	1.9	1.6	1.3	2.3	▲ 3.7	1.3	1.2	1.6	1.3	1.0
Private Consumption Expenditure	▲ 0.8	2.8	1.6	1.5	1.5	1.8	5.2	▲ 9.1	1.3	0.3	0.8	1.1	0.8
Housing Investment	▲ 8.7	▲ 10.3	1.0	3.3	8.1	0.0	▲ 2.4	▲ 9.9	▲ 7.2	6.2	▲ 0.3	▲ 5.1	▲ 0.3
Business Fixed Investment	2.0	5.2	4.0	3.8	3.8	2.8	2.7	2.3	2.3	1.2	3.1	3.8	3.0
Private Inventories (percentage points contribution)	(▲ 0.8)	(0.2)	(▲ 0.4)	(0.1)	(0.0)	(▲ 0.1)	(▲ 0.5)	(0.3)	(0.3)	(▲ 0.3)	(0.1)	(0.0)	(▲ 0.1)
Government Consumption Expenditure	0.0	0.9	1.0	1.0	1.0	0.6	0.6	0.6	0.6	0.5	0.7	0.7	0.7
Public Investment	▲ 1.7	▲ 0.5	8.0	0.5	▲ 6.2	0.0	1.0	0.5	0.3	0.9	1.4	▲ 0.1	▲ 0.4
Net Exports (percentage points contribution)	(0.3)	(▲ 0.5)	(0.4)	(0.1)	(0.1)	(▲ 0.1)	(▲ 0.7)	(1.0)	(▲ 0.0)	(0.8)	(0.4)	(0.1)	(0.0)
Exports of Goods and Services	2.6	0.8	4.3	3.4	3.4	3.0	3.0	2.6	2.6	3.6	6.3	3.7	3.1
Imports of Goods and Services	0.7	3.9	2.2	3.0	3.0	3.6	6.8	▲ 3.1	2.7	▲ 0.8	4.1	3.3	3.0
(Ref.) Domestic Private Demand (percentage points contribution)	(▲ 1.1)	(2.2)	(1.2)	(1.7)	(1.7)	(1.3)	(2.8)	(▲ 4.7)	(1.2)	(0.3)	(1.0)	(1.1)	(0.9)
(Ref.) Public Demand (percentage points contribution)	(▲ 0.1)	(0.2)	(0.6)	(0.2)	(▲ 0.1)	(0.1)	(0.2)	(0.1)	(0.1)	(0.1)	(0.2)	(0.1)	(0.1)

	(% 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	FY2016	FY2017	FY2018	FY2019
Nominal GDP	1.5	1.1	1.0	1.4	2.6	2.5	2.6	1.6	1.5	1.0	1.7	1.5	2.1
GDP deflator	0.5	0.1	0.1	0.2	0.7	0.7	0.8	1.3	1.2	▲ 0.2	0.1	0.3	1.0
Consumer Price Index (excluding fresh food)	0.8	0.8	1.1	1.0	1.1	1.0	1.0	2.0	2.0	▲ 0.2	0.7	1.0	1.5
(excluding fresh food, consumption tax)	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 (%)	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3	3.0	2.7	2.4	2.3
Exchange Rates (JY/US\$)	108	109	111	111	112	112	111	110	109	108	111	111	111
Import Price of Crude Oil (US\$/barrel)	67	71	75	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.