

Monthly Report of Prospects for Japan's Economy

October 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 September 2018 issue of the original Japanese version.

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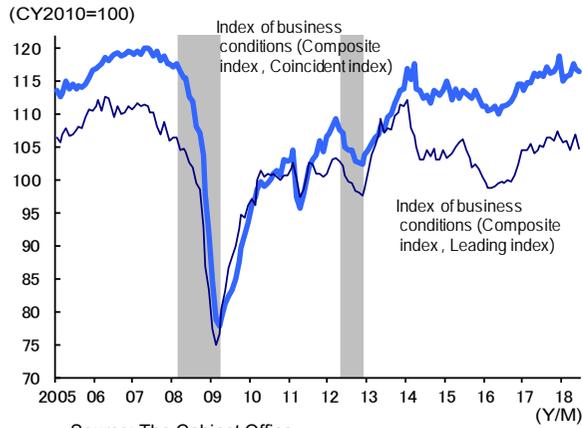
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The General Situation of Japan's Economy – Economic Recovery Trend Will Likely Continue

Figure 1-1 Economic Activity

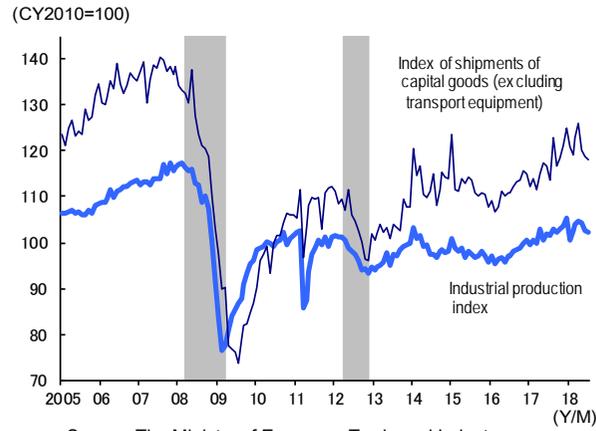
The CI coincident index fell for 2 months running, reflecting a decrease in the industrial production index.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

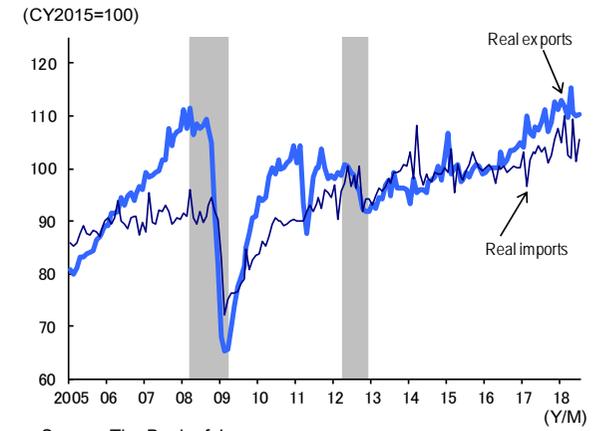
Industrial production decreased for 3 months in a row, due to the slowdown in the pace of rise in exports and the torrential rain in Western Japan.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

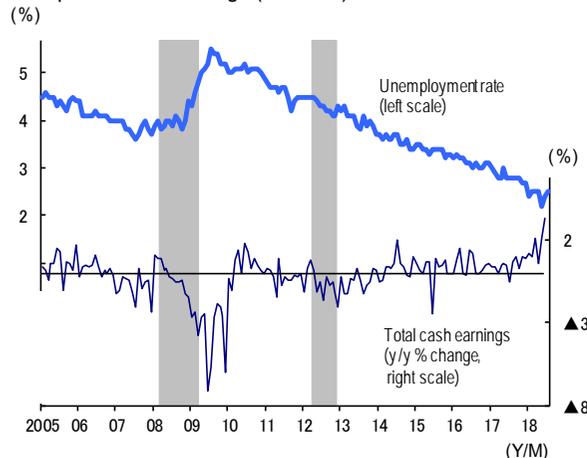
The pace of the increase in real exports slowed. Real imports, especially those of mineral fuels, increased.



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 special cash earnings (bonuses) accelerated.

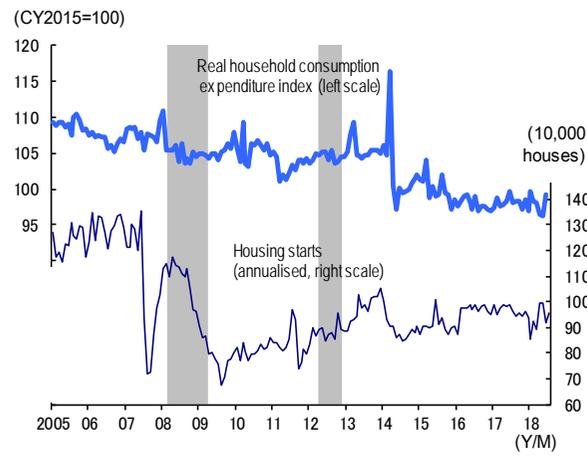


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labor and Welfare.

* The shaded area indicates the recession phase.

Figure 1-5 The Household Sector

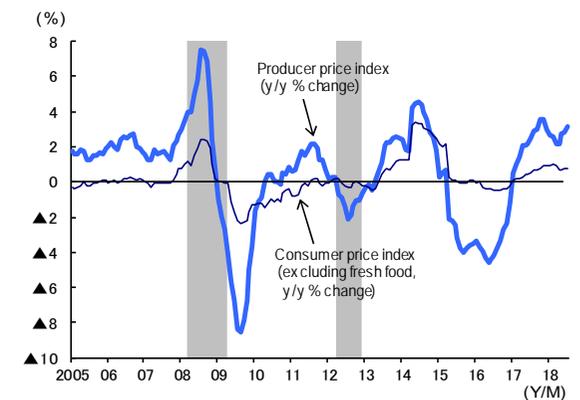
Real household consumption expenditure rose, led by that on durable goods. Housing starts seasawed.



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 those in core consumer prices flattened.



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

◆ The Growth Rate for the April-June Period Turned Positive

Japan's real GDP in the April-June period 2018 increased by 3.0 percent on an annualized quarter-on-quarter change basis (national accounts, the second preliminary estimates), a positive figure for the first time in two quarters. The figure of 1.9 percent in the first preliminary estimates was revised upwards considerably to 3.0 percent, due to a significant upward revision in business fixed investment. This makes it clearer that the economic recovery has been driven by domestic demand. Looking at consumer spending, in addition to a lull in the rising trend of fresh food prices, the growth in income also positively contributed to the expansion. Meanwhile, the momentum of exports further diminished.

◆ Industrial Production Stayed in a Holding Pattern

The Industrial Production Index for July fell 0.2 percent from the previous month, defying predictions of an increase. Reflecting the suspension of plant operations due to the heavy rainfall in Western Japan and the slowdown of Japan's buoyant exports,

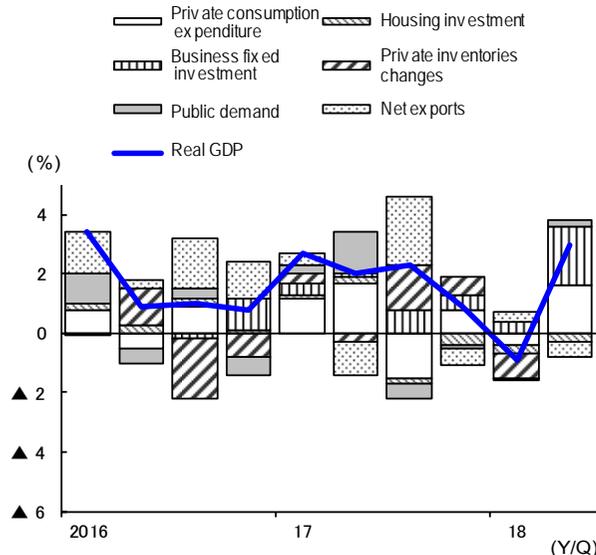
production decreased for transport equipment and machinery for general, production and commercial purposes. However, production will likely pick up on the back of a recovery production plan as industrial production is anticipated to increase 5.6 percent month over month in August (1.2 percent above METI's flash estimates) and increase 0.5 percent month over month in September.

◆ Employment and Income Conditions Remain Positive

The improving trend in the employment and income climate has continued. The active opening rate increased 0.01 points from the previous month in July to 1.63. As seen in the continued growth in the new job rate, labor demand supply remained tight. The unemployment rate rose by 0.1 percent points month over month to 2.5 percent, yet it continues to be at its lowest level in almost 25 years.

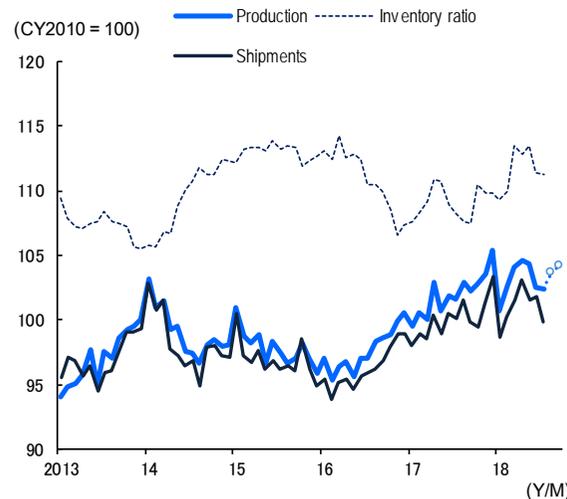
The rising trend in total cash earnings accelerated in June with a 3.6 percent increase year-on-year as a result of higher growth in all of scheduled, unscheduled (overtime) pay and special salaries (bonuses).

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



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

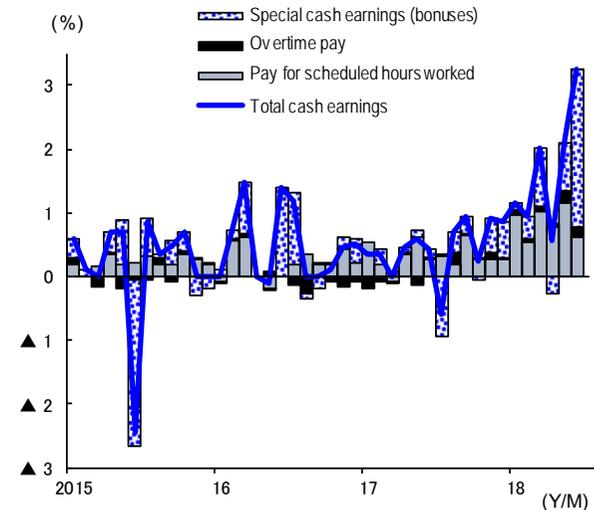
Figure 2-2 Indices of Industrial Production
<seasonally adjusted>



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 METI's flash estimates and the production forecast index.

Figure 2-3 Total Cash Earnings
<year-on-year % change>



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

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Exports Will Likely Follow a Mild Rising Path

◆ Buoyant Exports Have Slowed

Japan's exports have remained at a standstill since the beginning of this year following a rapid increase in volume at the end of the previous year.

By category, while buoyant exports of electronic components and devices had slowed down due to a lull in demand for smartphones during the first half of this year, the trade volume has slightly picked up recently on the back of a rise in demand for smartphone related components bound for Asia. Exports of capital goods continued to remain brisk owing to a recovery in global capital investment demand. On the contrary, exports of transport equipment weakened. This seems to have reflected the suspension of operations by some automobile manufacturers that had been affected by heavy rainfall in Western Japan in July.

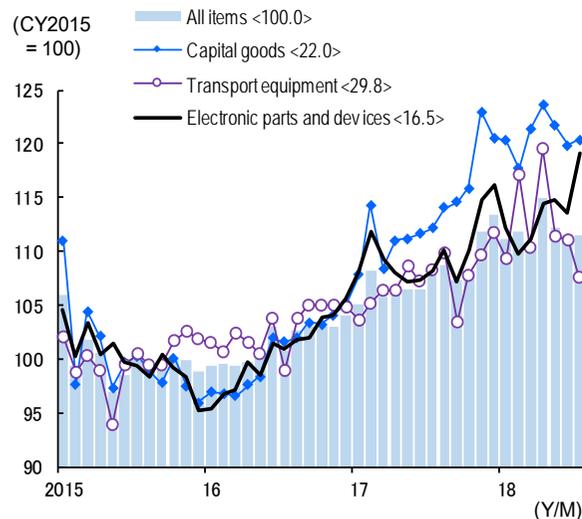
◆ Exports Will Likely Continue on a Moderate Increasing Trend

In terms of the future outlook, exports are anticipated to increase moderately mainly for transport equipment and capital goods. Transport equipment exports will

likely pick up as the effects of the heavy rainfall in Western Japan diminishes. Among emerging countries in Asia as principal export destinations, as for capital goods, 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 remained at a high level except in the case of South Korea, exceeding the 50-point mark that indicates a general trend of economic expansion.

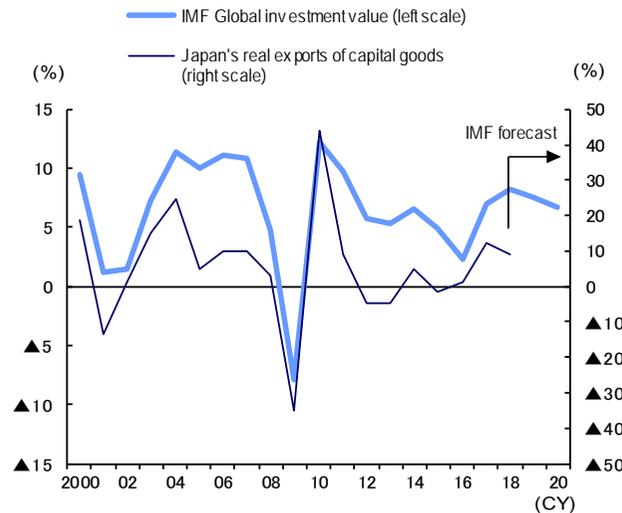
Nevertheless, the Trump administration's hardline trade policies and the intensification of trade friction triggered therefrom remain as risks. If the Trump administration decides to raise tariffs on automobiles and automotive parts, downward pressure on Japan's exports will follow. Furthermore, should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

Figure 3-1 Real Exports by Item
<seasonally adjusted>



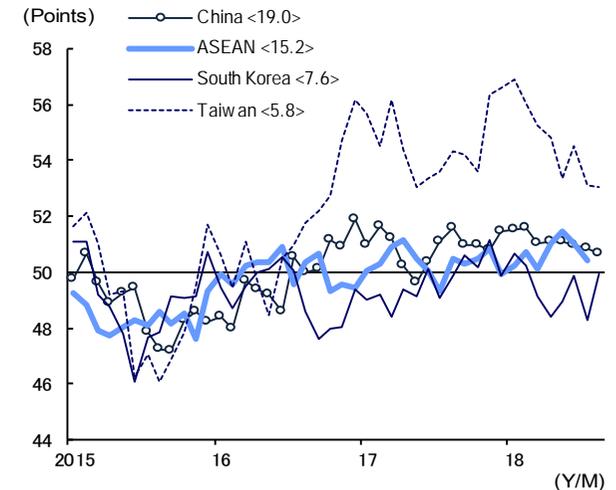
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Finance.
Note: Figures in the angled brackets show the shares in total nominal exports in FY2017.

Figure 3-2 Global Investment Value and Japan's Real Export of Capital Goods <year-on-year % change>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Finance, The Bank of Japan, IMF.
Note: The figure of Japan's real exports of capital goods in 2018 is for January-July 2018.

Figure 3-3 Manufacturing PMIs in Major Export Destinations in Asia



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. According to Financial Statements Statistics of Corporations by Industry, Quarterly, both corporate sales value and profits for the April-June period increased for the second consecutive quarter. Operating profits and current profits set new record highs.

In addition to the rebound in consumer spending and capital investment, a rise in sales prices of goods and services contributed to an increase in sales. Moreover, non-operating revenues significantly increased including dividends from overseas subsidiaries. While a rise in personnel expenses against the backdrop of worsening labor shortages continued to exert downward pressure on corporate earnings, labor's share declined as the growth in sales more than offset such negative effects.

Looking at the future outlook, corporate earnings continue to follow a mild recovery path. As a result of reinforcement of financial position through the reduction of

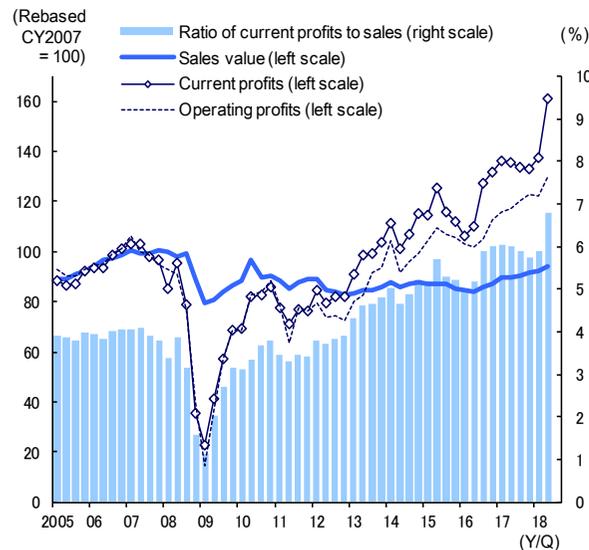
variable expenses among others, the break-even point ratio in sales value has significantly decreased, thus realizing a structure where an increase in sales can directly lead to expansion of bottom line profits.

◆ 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 estimate Japan's future 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.

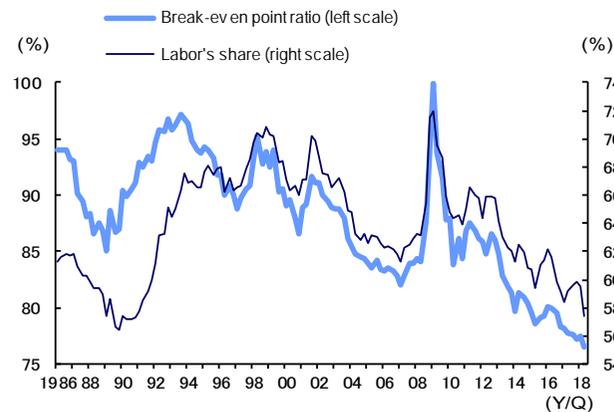
Figure 4-1 Sales Value and Ratio of Current Profits to Sales <seasonally adjusted>



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

Note: All industries except for financial services and insurance.

Figure 4-2 Labor's Share and Break-even Point Ratio in Sales Value



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

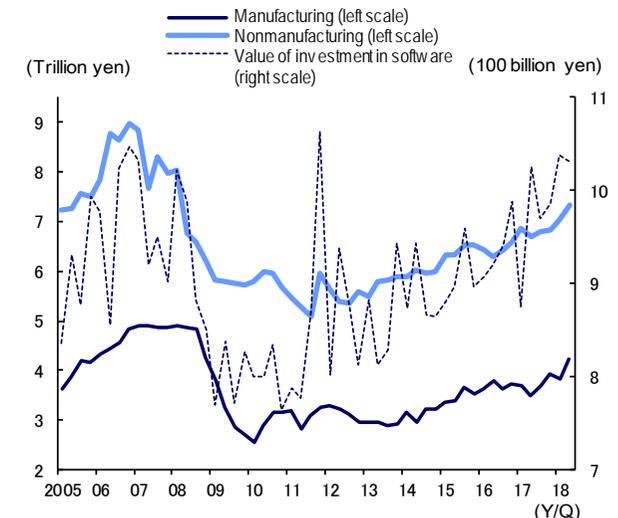
Note: The break-even point ratio =
break-even point sales value / sales value

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 4-3 Value of Business Fixed Investment of Corporations <seasonally adjusted>



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

Note: All industries except for financial services and insurance.

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Income Is Likely to Recover Steadily

◆ Employment and Income Conditions Continue to Improve

The employment situation continued to improve. Since mid-2015, an increasing trend of hiring workers as regular employees has taken root, and the pace of increase has recently been accelerating slightly. As the number of male non-regular employees has decreased from the previous year, it is assumed that the shift to regular employment has progressed, indicating that 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.

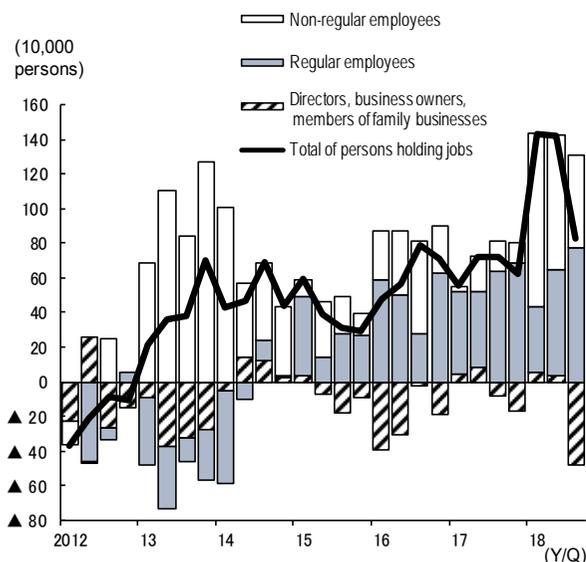
◆ Real Income Is Likely to Increase Firmly

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 across all industries, the situation of which is the severest since the bubble economy, labor demand and supply conditions are likely to remain tight. Since the rate of wage increases as a result of the unions' "shunto" spring wage offensive was relatively high this year, nominal wages will also likely continue to grow at 1 percent or higher on a year-on-year basis.

Furthermore, the upward pressure on prices that pushed down real income for the January-March 2018 period has peaked out. We predict that real compensation for employees will continue to grow by around the high 2 percent to 3 percent range on a year-on-year basis through the end of the year. However, this increasing trend will likely slow down due to a rise in prices after 2019.

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

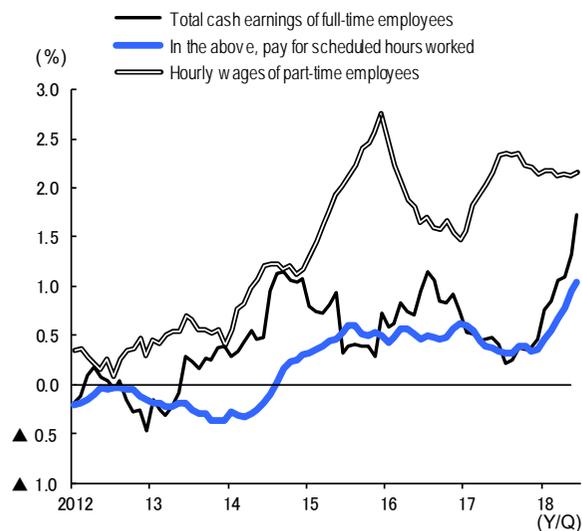


Source: The Japan Research Institute, Ltd. based on data of The Ministry of Health, Labor and Welfare.

Note: 1. Regular employees are persons employed for an indefinite period.

2. The figures in Q3 2018 are for July 2018.

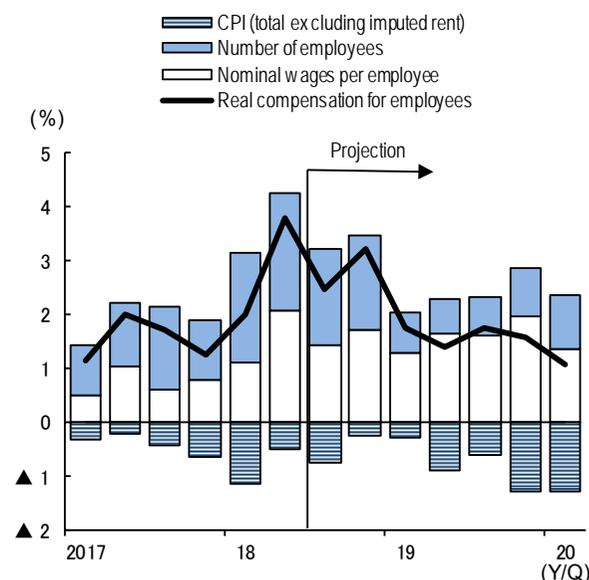
Figure 5-2 Year-on-year Change Rates of Wages by Type of Employees <6-month moving averages>



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

Consumer spending has been on a recovery trend. On the back of an improvement in the employment and income situation, private consumption expenditure continued to recover mainly in the service industry, as seen in a year-on-year increase in sales continuing for food services.

Having said that, downward pressure emerged in July due to weather factors such as record summer heat, heavy rainfall and typhoons. At department stores and restaurants, the number of customers declined as people refrained from going out. Meanwhile, due to the rise in temperature, sales of air conditioners and beverages surged, which underpinned consumption.

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

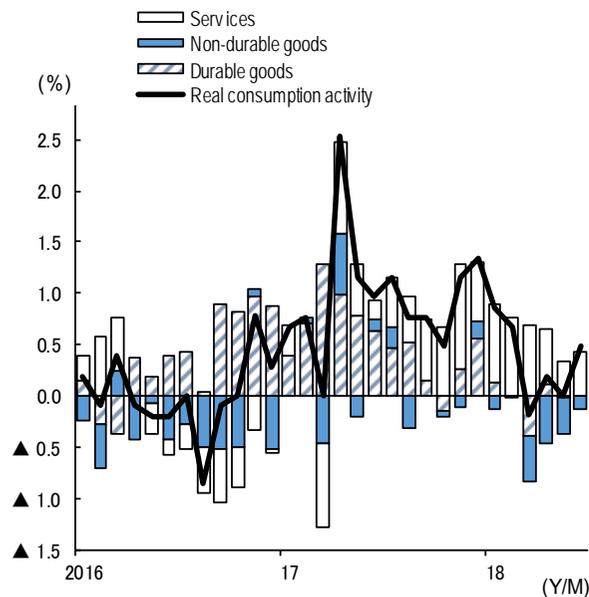
despite possible fluctuations due to weather factors

◆ Housing Investment Will Likely Remain Weak

The number of housing starts is forecasted to remain weak.

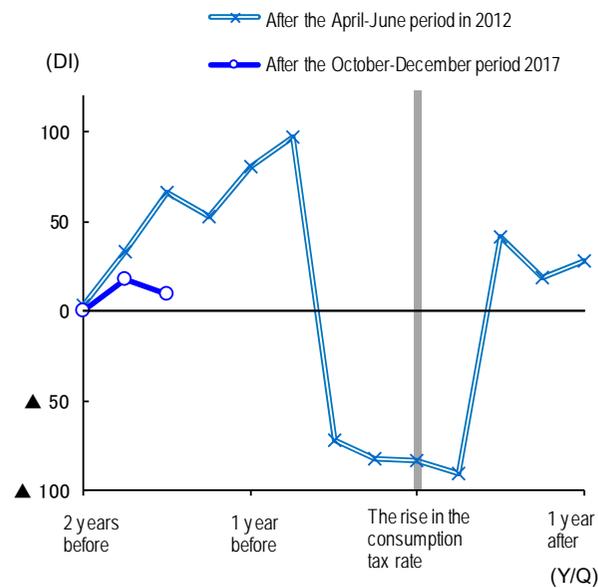
Investment in owner-occupied housing is expected to pick up on the back of the rush in demand anticipated prior to the rise in the consumption tax scheduled for October 2019, in addition to the improvement in the employment and income environment. At the same time, the number of new construction projects for subdivision housing will likely decrease since the acquisition of land mainly in metropolitan areas is expected to remain difficult. Further, 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>



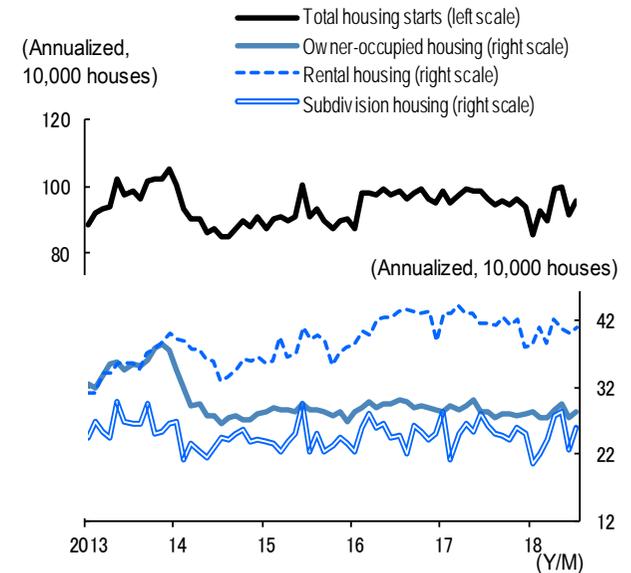
Source: The Japan Research Institute, Ltd. based on data of The Bank of Japan.

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: Small and Medium-sized Manufacturers Have Taken a Positive Stance Toward Business Fixed Investment

◆ Small and Medium-sized Manufacturers Activated Business Fixed Investment

The appetite for capital investment has significantly improved among small and medium-sized manufacturers. Looking at capital investment plans for FY 2018, the growth in capital investment will exceed 10 percent on a year-on-year basis for the first time since FY 2013. Machinery orders through agencies, which are known for their higher ratio of orders to small and medium-sized manufacturers, have seen a significant increase since the beginning of spring.

◆ Business Environment Has Improved

The background of the shift to aggressive capital investment includes changes in the business environment for small and medium-sized manufacturers.

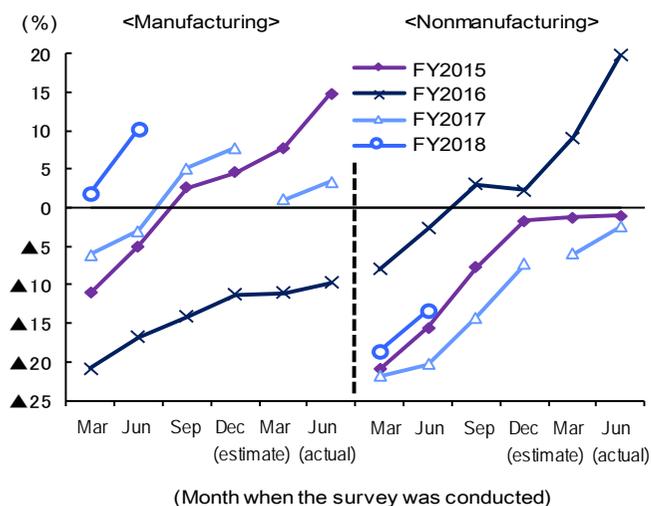
Firstly, there has been a significant improvement in financial position. The ratio of current profits to sales of small and medium-sized manufacturers has been rapidly

increasing and has exceeded the level of the bubble period recently. The attributable factors include the establishment of a structure to bring about more profits as a result of the decline in the break-even point in sales and the progress of price pass-through due to the elimination of the supply-demand gap.

Secondly, labor shortages have become more severe. Difficulty in securing sufficient workforce has posed bigger problems for small and medium-sized enterprises than large enterprises. Amid the anticipation that labor demand and supply conditions will become even tighter in the future, more small and medium-sized enterprises have activated investment for labor saving.

Thirdly, investment need for replacement of superannuated equipment has been increasing. The average age of equipment has been rising, unlike the case of large enterprises. Reflecting the improvement in cash flow, more small and medium-sized enterprises have been replacing aged equipment with the latest models.

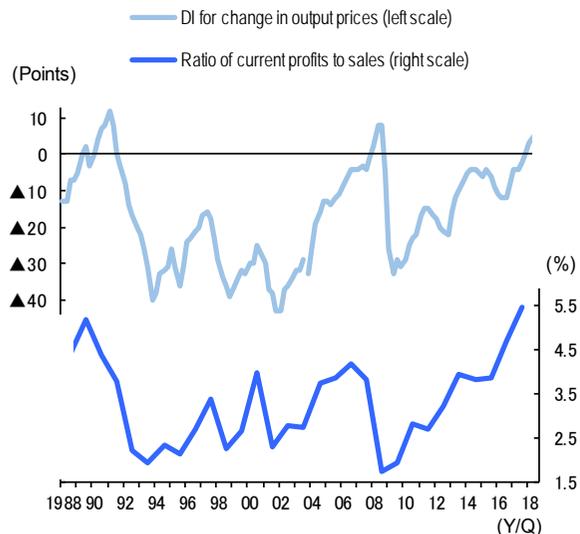
Figure 7-1 Change over Time in Planned Business Fixed Investment for Each Fiscal Year in Small and Medium-sized Enterprises <year-on-year, %>



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

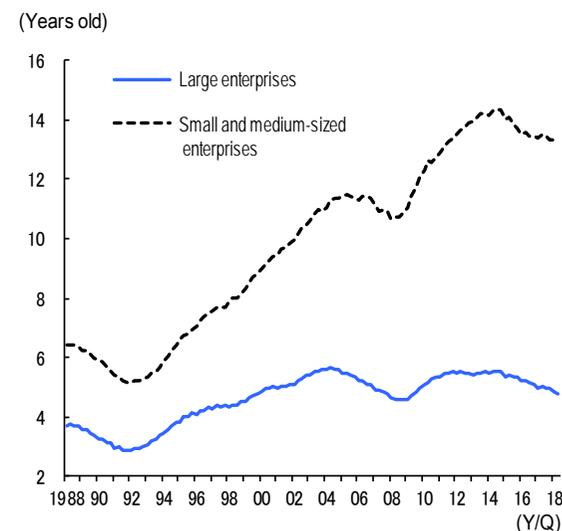
Note: Including software investment, excluding land purchasing expenses and R & D investment.

Figure 7-2 The Ratio of Current Profits to Sales and Output (Selling) Prices in Small and Medium-sized Manufacturers



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

Figure 7-3 The Average Age of Equipment in Manufacturers



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

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Prospects for Japan's Economy - Projected Real GDP Change; 1.4% in FY2018 and 1.0% in FY2019

◆ Japan's Economic Activity Will Likely Continue Its Recovery Trend, Driven by Firm Domestic Demand

(1) Japan's real GDP in the April-June period 2018 increased by 3.0 percent on an annualized quarter-on-quarter change basis (national accounts, the second preliminary estimates), a positive figure for the first time in two quarters. The figure of 1.9 percent in the first preliminary estimates was revised upwards considerably to 3.0 percent, due to a significant upward revision in business fixed investment. This makes it clearer that the economic recovery has been driven by domestic demand. Looking at consumer spending, in addition to a lull in the rising trend of fresh food prices, the growth in income also positively contributed to the expansion. Meanwhile, the momentum of exports further diminished.

(2) Looking ahead, it is predicted that the real GDP growth rate in the July-September quarter will slow down. This is mainly due to 1) business fixed investment is likely to see a temporary and reactionary decline from the high growth rate in the previous quarter, and 2) negative effects of typhoons which struck Western Japan and the earthquake which hit Hokkaido will have emerged.

However, there is no alteration in JRI's view that the Japanese economy is predicted to continue its recovery path, driven by robust domestic demand. For the time being, an increase in public investment will support the total growth rate, as the supplementary budget in FY2017 is implemented. Also, business fixed investment is expected to return to its increasing trend against the background of firm demand in the areas of investment for labor saving and replacement buoyed by a shortage of workers and superannuated production facilities, as well as the improvement in the attitude of small and medium-sized enterprises toward capital investment.

(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 1.4 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 trade policies will exert downward pressure on the Japanese 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 other countries 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 investment and consumer spending, thus derailing the economic recovery in the worst-case scenario.

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

(7) While energy prices accelerated their rising trend, the core CPI, which excludes fresh food, remained flat, reflecting a slowdown in the pace of the rise in food prices. 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 September 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)	(Actual)	(Actual)	(Projection)	(Projection)						
Real GDP	▲ 0.9	3.0	1.0	1.8	1.6	1.4	2.3	▲ 3.7	1.3	1.2	1.6	1.4	1.0
Private Consumption Expenditure	▲ 0.8	2.9	1.8	1.2	1.5	1.8	5.2	▲ 9.1	1.3	0.3	0.8	1.1	0.8
Housing Investment	▲ 9.6	▲ 9.3	1.0	3.3	8.1	0.0	▲ 2.4	▲ 9.9	▲ 7.2	6.2	▲ 0.4	▲ 5.0	▲ 0.3
Business Fixed Investment	2.7	12.8	▲ 3.1	3.3	3.8	2.9	2.8	2.6	2.6	1.2	3.1	4.4	2.7
Private Inventories (percentage points contribution)	(▲ 0.8)	(0.0)	(▲ 0.1)	(0.2)	(0.0)	(▲ 0.1)	(▲ 0.5)	(0.3)	(0.3)	(▲ 0.3)	(0.1)	(0.0)	(▲ 0.1)
Government Consumption Expenditure	0.0	0.8	1.0	1.0	1.0	0.6	0.6	0.6	0.6	0.5	0.7	0.6	0.7
Public Investment	▲ 1.6	0.1	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)	(0.3)	(0.2)	(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	0.9	2.6	3.5	3.4	3.0	3.0	2.6	2.6	3.6	6.3	3.4	3.0
Imports of Goods and Services	0.7	3.8	1.1	2.7	3.0	3.4	6.8	▲ 3.0	2.7	▲ 0.8	4.1	3.1	2.8
(Ref.) Domestic Private Demand (percentage points contribution)	(▲ 1.1)	(3.3)	(0.4)	(1.5)	(1.7)	(1.3)	(2.8)	(▲ 4.6)	(1.2)	(0.3)	(1.0)	(1.2)	(0.8)
(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	1.4	1.1	1.4	2.6	2.3	2.6	1.6	1.5	1.0	1.7	1.6	2.0
GDP deflator	0.5	0.1	0.1	0.1	0.7	0.7	0.8	1.3	1.2	▲ 0.2	0.1	0.2	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	112	112	112	111	110	109	108	111	111	111
Import Price of Crude Oil (US\$/barrel)	67	71	76	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.