

Monthly Report of Prospects for Japan's Economy

July 2019

Macro Economic Research Center
Economics Department



The Japan Research Institute, Limited

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

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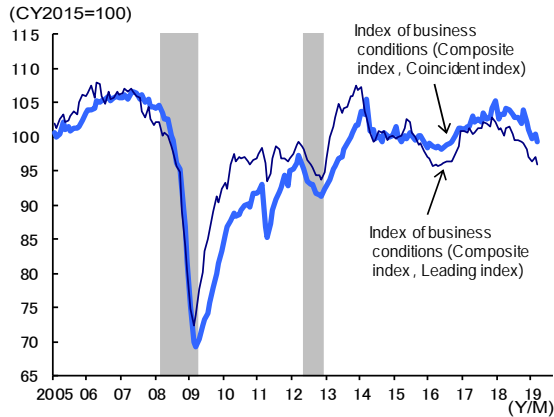
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The General Situation of Japan's Economy – A Sense of Standstill Is Felt in Economic Activity

Figure 1-1 Economic Activity

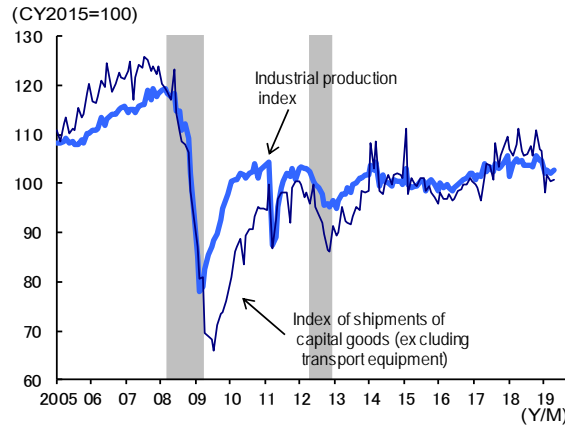
The CI coincident index remained at a lower level against the backdrop of reduced overtime and weak shipments of investment goods.



Source: The Cabinet Office.

Figure 1-2 The Corporate Sector

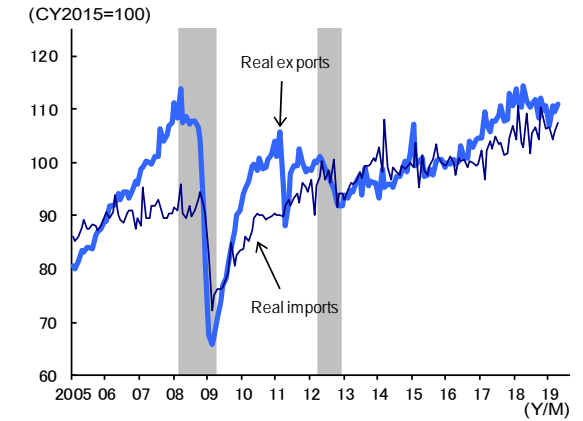
Industrial production remained unchanged due to a delay in the recovery of exports.



Source: The Ministry of Economy, Trade and Industry.

Figure 1-3 Overseas Demand

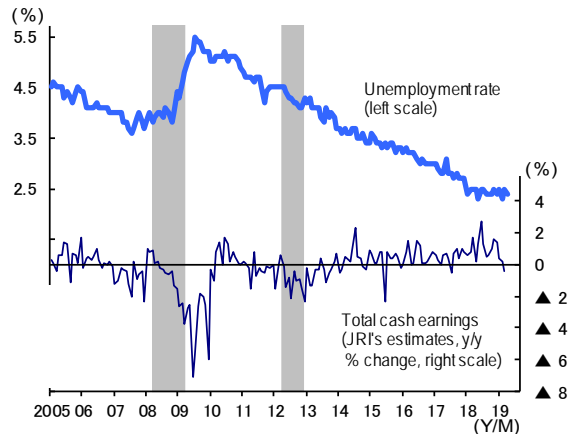
Exports, mainly to China, remained stagnant, while imports, particularly of food and electrical equipment, increased.



Source: The Bank of Japan.

Figure 1-4 Employment and Income

The unemployment rate is hovering around its lowest level since 1993. Nominal wages diminished due to a decline in special salaries.

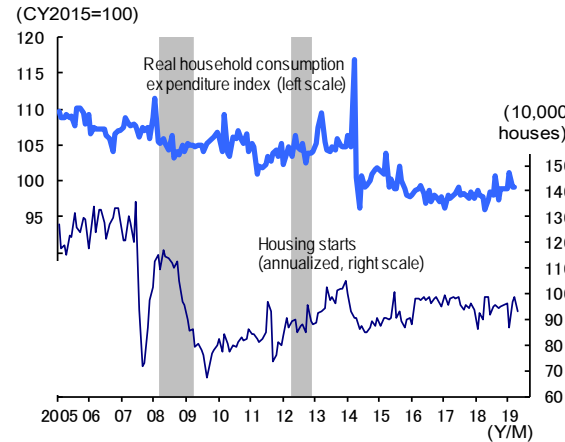


Source: The Ministry of Internal Affairs and Communications, The Ministry of Health, Labor and Welfare.

* The shaded area indicates the recession phase.

Figure 1-5 The Household Sector

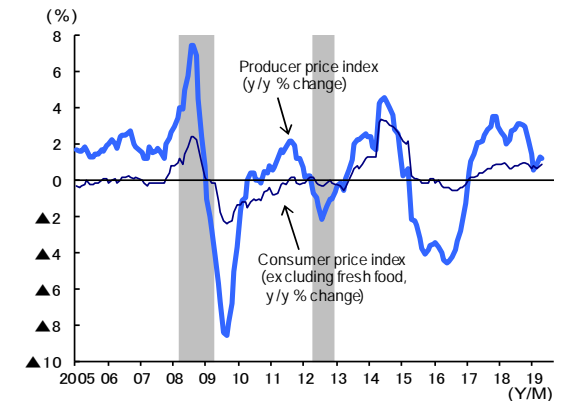
Real household consumption has picked up despite fluctuations. Housing starts decreased, primarily reflecting a reactionary decline for subdivision housing.



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

Figure 1-6 Prices

Producer prices stayed virtually flat, while the rise in consumer prices, mainly for accommodations, accelerated slightly.



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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Domestic Demand Stays Firm, While Overseas Demand Remains Sluggish

◆ Positive Growth for the Second Consecutive Quarter Recorded in the January-March Period

Japan's real GDP in the January-March 2019 period increased by 2.2 percent on an annualized quarter-on-quarter basis (national accounts, the second preliminary quarterly estimates of GDP), achieving positive growth for the second consecutive quarter. However, the growth was attributable mainly to a reactionary decline in imports, which had surged during the preceding quarter. Despite a positive revision with higher capital investment, both exports and domestic demand remained lackluster. The QE indicated that Japan's economy has remained at a standstill.

◆ Stagnant Industrial Production

While the Industrial Production Index for April increased for the first time in two months, up 0.6 percent from the previous month, the overall trend has been virtually flat. Industrial production saw increases in transportation machinery and machinery for production. On the other hand, industrial production declined for general and business purpose machinery as well as electronic parts and devices. The outlook for

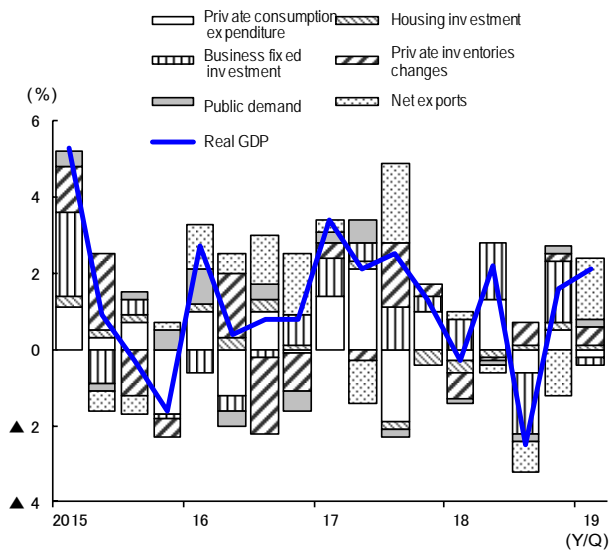
May is +1.5 percent on a month-over-month basis (METI's estimate, after correcting for a bias error in the forecasting index) with an increase in production. Industrial production, however, is anticipated to decline in June.

As the background for the aforementioned results, there has been a delay in improvement in the export environment. While exports increased in April for the first time in four months, full-fledged recovery has yet to be achieved. Exports to the United States and Europe have been firm. On the contrary, the pace of the rebound in exports to China has been slow due to a delay in the recovery of private investments within China.

◆ Signs of Recovery Witnessed in Public Investment

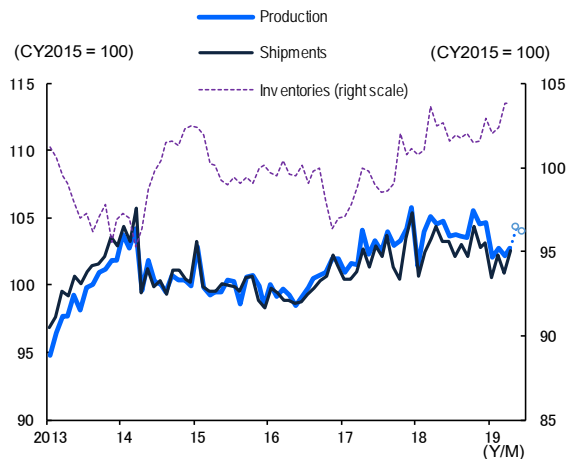
Public investment, which had been diminishing since the latter half of the previous year, has been on the rise as the supplementary budget for FY2018 began being executed in full scale. The contract amount for public works projects, which serves as a leading indicator, was up 2.5 percent month-over-month in April, recording an increase for three straight months.

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



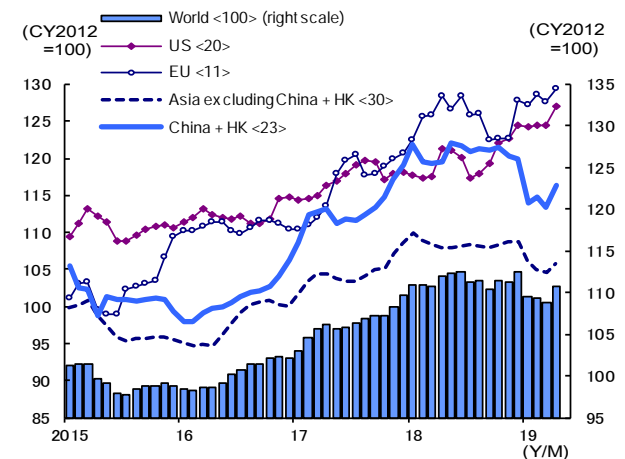
Source: The Japan Research Institute, Ltd. based on data of The Cabinet Office.

Figure 2-2 Industrial Production Index <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 the industrial production index are forecasts for May and June based on METI's estimate and the production forecast index, respectively.

Figure 2-3 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 CY2018.

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Exports Are Expected to Pick up

◆ Exports of Goods Are Expected to Pick up

The declining trend for exports of goods came to a halt at last. While exports of capital goods, mainly to China, have been weak, signs of bottoming out have been seen for exports of electronic parts and devices as sluggish sales of smartphones in China and ASEAN countries levelled off. Moreover, exports of transportation machinery, primarily to the United States, increased, reflecting firm SUV demand.

As for future prospects, exports, mainly to China, are anticipated to pick up, as the economic slowdown in the country will likely come to a halt thanks to economic stimulus measures taken by the Chinese government. Looking at Manufacturing PMIs for China, a level exceeding the 50-point mark, which indicates economic expansion, has been maintained since March.

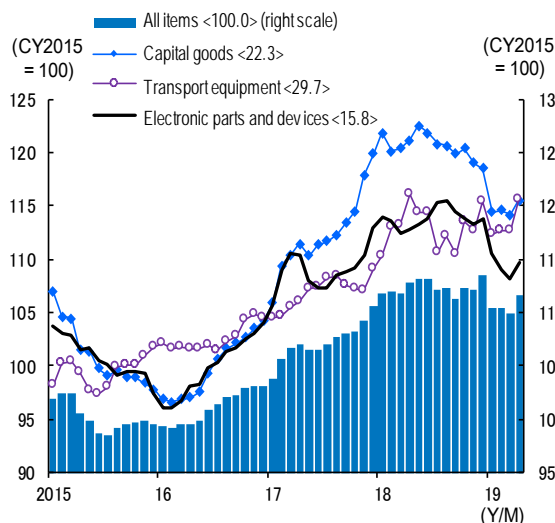
However, if the trade friction between the United States and China further intensifies, downward pressure on Japan's exports to China will likely grow.

◆ Demand Related to Inbound Tourism Is Picking up

Demand related to inbound tourism has continued to pick up. However, the number of tourists that visited Japan in April declined by 1.6 percent from the previous month, as tourists mainly from South Korea and Taiwan avoided congested tourist spots during the 10 consecutive holidays from the end of April to early May.

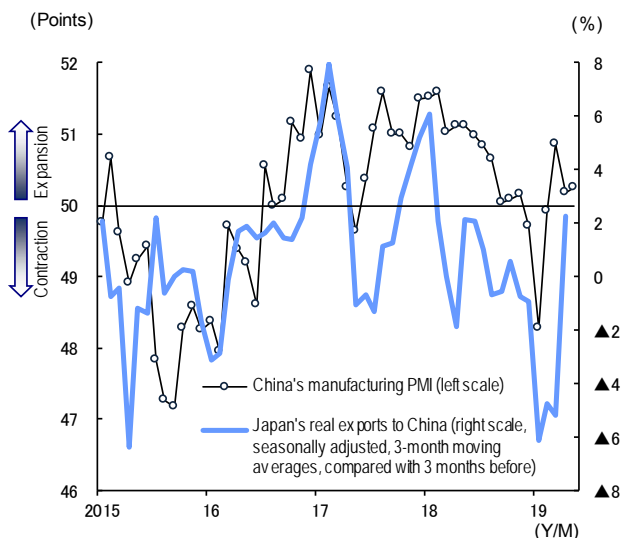
In terms of future outlook, demand related to inbound tourism is expected to continue growing moderately, driven by an expanding middle class in emerging Asian countries and better infrastructure and services for receiving tourists in Japan.

Figure 3-1 Real Exports by Item
<seasonally adjusted,
3-month moving averages>



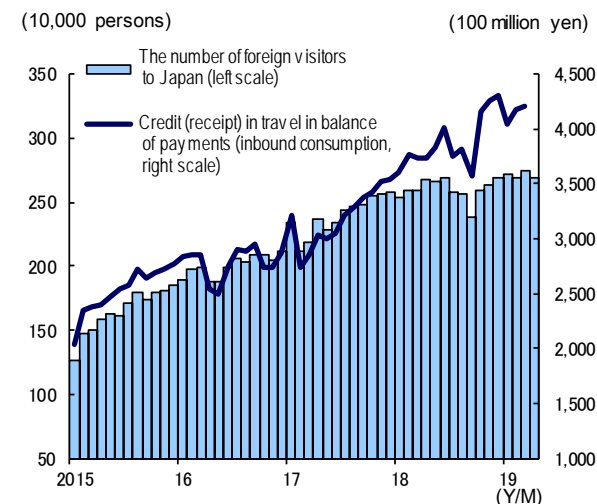
Source: The Japan Research Institute, Ltd. based on data of The Ministry of Finance.
Note: Figures in the angled brackets show the shares in total nominal exports in CY2018.

Figure 3-2 China's Manufacturing PMI
and Japan's Exports to China



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

Figure 3-3 Receipt in Travel in
Balance of Payments
<seasonally adjusted>



Source: The Japan Research Institute, Ltd. based on data of The Ministry of Finance, Japan National Tourism Organization (JNTO).

Corporate Profit Growth and Business Fixed Investment Have Stalled

◆ Momentum in Corporate Profit Growth Has Stalled

Corporate earnings have seen some ups and downs while maintaining a high level. According to the Financial Statements Statistics of Corporations in the Industry quarterly report, sales for the period of January-March 2019 declined for the first time in one and a half years, reflecting sluggish sales for the manufacturing industry against the backdrop of a decline in exports to China. Current profits increased for the first time in three quarters thanks to improvement in profitability due to a decline in crude oil prices and large dividends from pure holding companies.

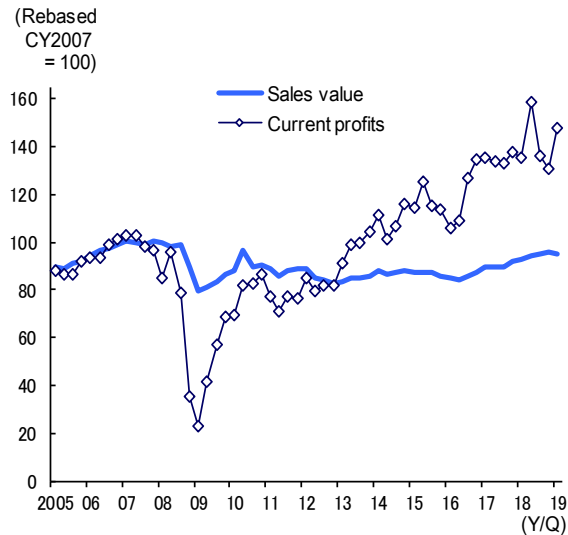
As for the outlook for corporate earnings, while a downward trend is anticipated as the temporary factors seen during the January-March period dissipate, overall corporate earnings will likely continue to expand in line with strong domestic demand and the rebound in exports.

◆ Business Fixed Investment Has Stalled

Capital investment has been delayed mainly in the manufacturing industry, reflecting sluggish exports as a result of the slowdown of the Chinese economy.

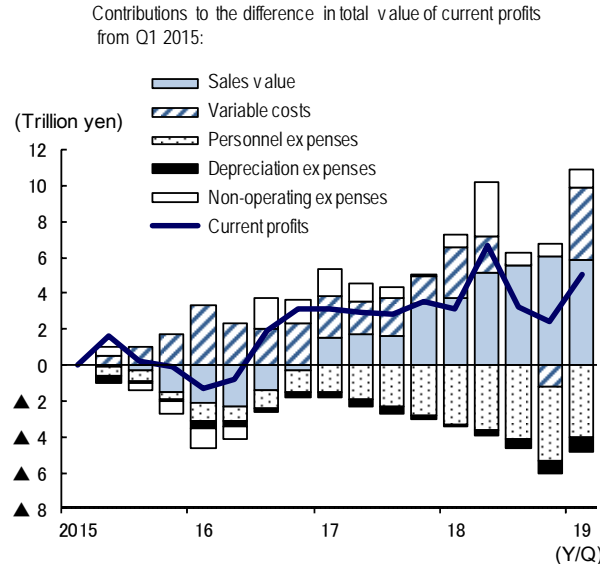
Despite the foregoing, business fixed investment is anticipated to return to a moderate recovery path in the future. Amid a strong appetite for investments in the fields of rationalization and labor saving as well as maintenance and upgrade demand due to labor shortages and dilapidated equipment, postponed investment projects are likely to be executed as exports pick up. In fact, the outlook for machinery orders, which had been sluggish since the end of last year, has improved significantly for the April-June period, indicating a recovery path for the future. However, this outlook for machinery orders was as of March, and it is necessary to factor in the flare-up in U.S.-China trade friction after the beginning of May.

Figure 4-1 Sales Value and Profits of Japanese Enterprises
<seasonally adjusted>



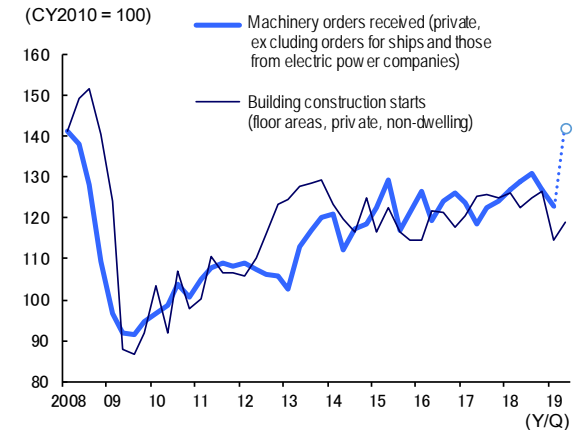
Source: The Japan Research Institute, Ltd. based on the data of The Ministry of Finance.
Note: All industries except for financial services and insurance.

Figure 4-2 Contributions of Factors to Change in Total Value of Current Profits
<seasonally adjusted>



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

Figure 4-3 Machinery Orders and Building Starts
<seasonally adjusted>



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

Note: The figure in Q2 2019 in machinery orders is a forecast, and that in building starts is for April 2019.

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Income Is Recovering Steadily

◆ Employment and Income Conditions Continue to Improve

The pace of improvement in the employment situation has slowed down. While momentum was maintained in the non-manufacturing industry, including the medical and welfare industry, partly reflecting the need to increase personnel in line with the new regulation which requires a minimum interval between the time employees leave work and when they return the following morning, the employment situation remained weaker than the previous year in the manufacturing industry due to stagnant production.

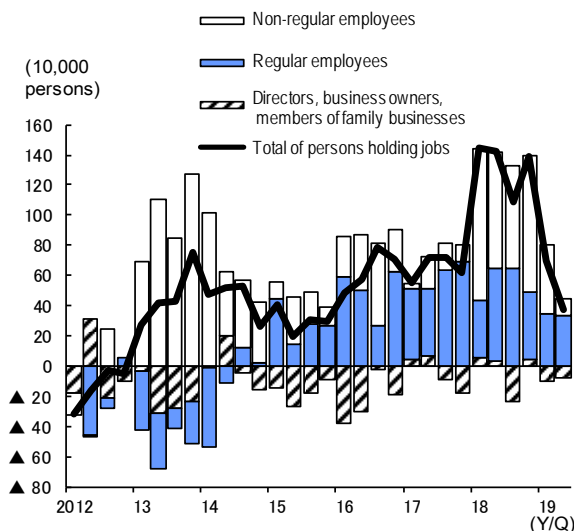
Meanwhile, nominal wages remained on a rising trend against the backdrop of labor shortages at levels exceeding those during the bubble economy. Looking at scheduled salaries for full-time workers, growth at around 1 percent on a year-on-year basis was maintained according to data from common establishments that are free from the effects of sample switchover. In fact, this year's spring labor offensive

secured a year-on-year wage growth of 2.1 percent, which was similar to the previous year.

◆ Real Income Is Likely to Increase Firmly

A look at future prospects shows a high likelihood that growth in the number of employees will slow down as the population continues to decline and labor participation approaches the upper limit of supply. At the same time, nominal wages will likely remain on a steady rise given the tight labor supply demand conditions. In addition, there is a prospect that the provision of free education and nursery care is expected to minimize price increases as a result of the hike in the consumption tax. As a result, growth at around the mid-1 percent level will likely be maintained in real compensation for employees, although a slight slowdown in its pace of improvement is possible.

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

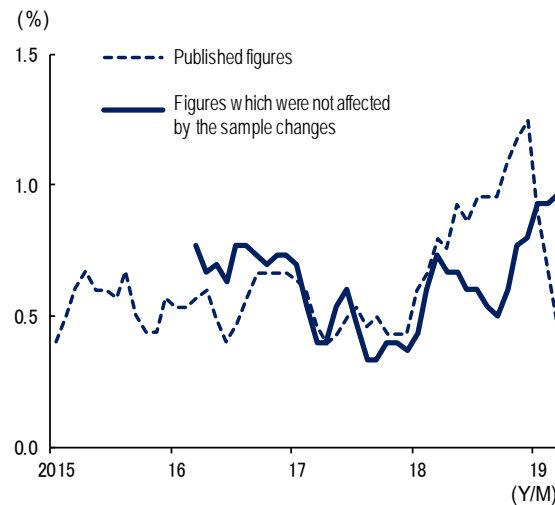


Source: The Japan Research Institute, Ltd. based on data of The Ministry of Health, Labor and Welfare.

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

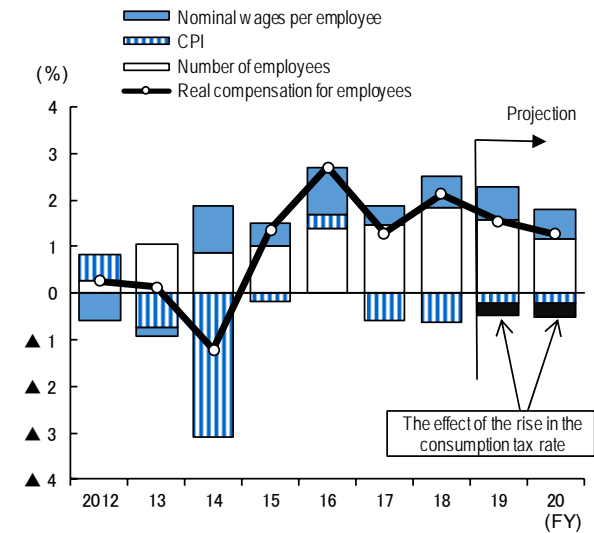
2. The figures in Q2 2019 are for April 2019.

Figure 5-2 Scheduled Salaries for Full-time Workers <year-on-year % change, 3-month moving averages>



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

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 Is Increasing Moderately

◆ Private Consumption Is Increasing Moderately

Private consumption maintained a mild recovery trend on the back of improvement in employment and income conditions.

Service consumption remained robust. Travel consumption in particular grew, thanks to subsidies for supporting tourism as well as the favorable effects of 10 consecutive holidays. Consumption of durable goods also increased due to positive effects from the launch of new vehicle models.

As for future prospects, while an increasingly cautious consumer mindset due to uncertainty over economic outlook will negatively weigh on private consumption, the mild recovery will likely continue, underpinned by improvement in employment and income conditions. In terms of the effects of a hike in the consumption tax rate scheduled for October 2019, a significant decline is likely to be avoided, as household burden will be roughly half that in 2014 thanks to measures to limit the

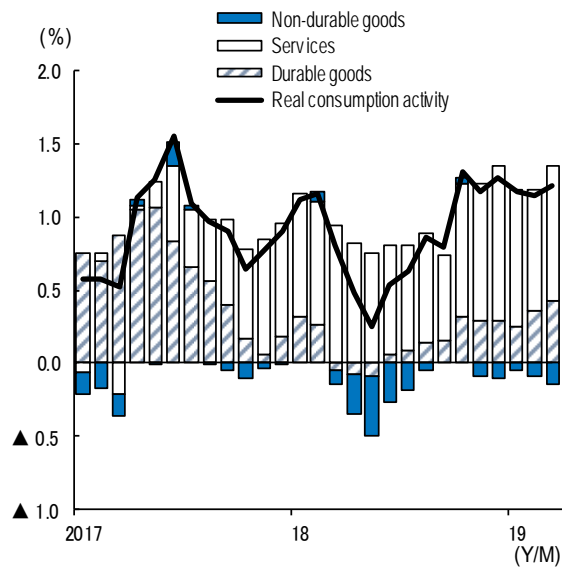
impact of the hike, including the provision of free education and nursery care.

◆ Housing Investment Is Also Increasing Moderately

The number of housing starts remained virtually flat in April. While rental housing has been weak due to concerns about oversupply, owner-occupied and subdivision housing have increased moderately on the back of a rush in demand prior to the consumption tax rate hike and favorable income conditions.

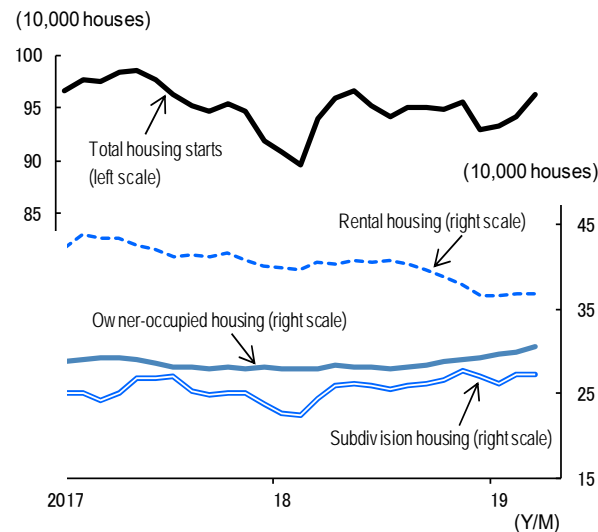
As for the future outlook, housing starts will likely turn towards a decline after experiencing a rise until around July. In fact, the housing market index, a leading indicator of housing starts, deteriorated by 8 points for the April-June period. While acknowledging this result, the rush demand and subsequent reactionary decline will likely be minimal given the lower rise in the consumption tax rate compared with the previous tax hike and the government's measures for leveling consumer burden.

Figure 6-1 BoJ's Consumption Activity Index
<year-on-year % change,
3-month moving averages>



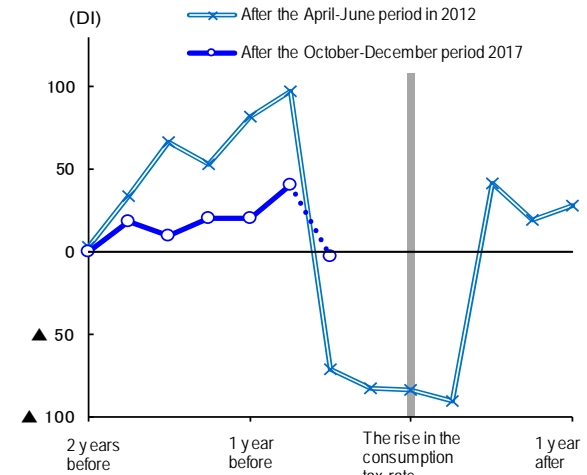
Source: The Japan Research Institute, Ltd. based on data of The Bank of Japan.

Figure 6-2 Housing Starts by Type
<annualized, seasonally adjusted,
3-month moving averages>



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

Figure 6-3 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.

Note: The dotted line indicates a forecast for April-June 2019.

Topic: What Is the Impact of the U.S.-China Trade Dispute on Trade in Value Added Basis?

◆ Small Impact Through Supply Chains

Looking at value-added exports, China's positioning for Japan changed from an exporting base to a source of final demand over the past ten years. As a result, consequences have changed with regard to the negative effects of the U.S.-China trade friction on Japan.

First, the decline in China's exports to the United States will have a minimal impact on Japan through its supply chains. Japanese value-added embodied in China's exports to the United States will be limited, as they account for roughly only 0.2 percent of Japan's GDP. Even if some of the aforementioned value-added is diminished, downward pressure on the Japanese economy will likely be limited.

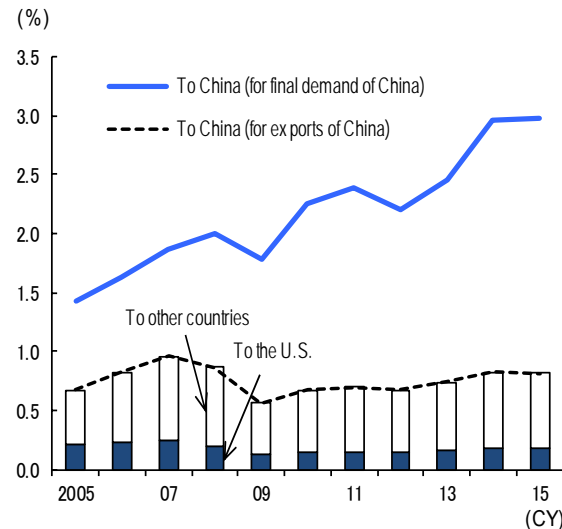
◆ China's Sluggish Domestic Demand Will Have a Significant Negative Impact

Despite the foregoing, negative effects from China's sagging domestic demand will

be significant. As Japan's value-added exports to China have increased to around 3 percent of its GDP, the level of dependency of the Japanese economy on China's domestic demand has been growing. In particular, China's sluggish personal consumption and private investment will have a significant negative impact on Japan's economy. Since nearly half of Japan's value-added exports to China are intended for investment goods and durable consumption goods sectors, China's sluggish domestic demand will lead to a decline in Japan's exports to China.

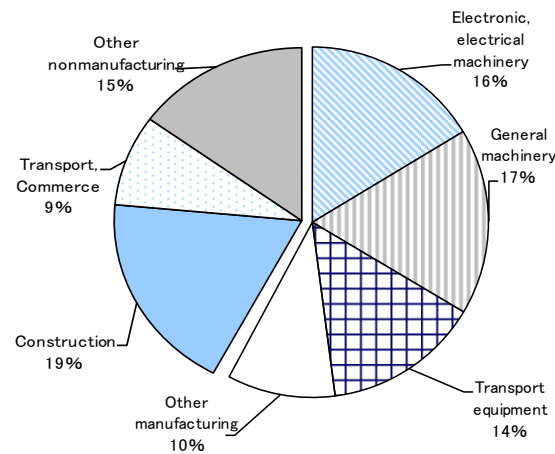
If China's domestic demand further diminishes as the result of intensification of the U.S.-China trade dispute, negative effects will likely spread over not only the manufacturing industry but also throughout broader industries in Japan. Looking at the Japanese value-added structure, the non-manufacturing industry, such as transportation and commerce, serves as the value-added source for slightly less than half of Japan's exports to China.

Figure 7-1 Japan's Value-added Exports <ratio to Japan's GDP>



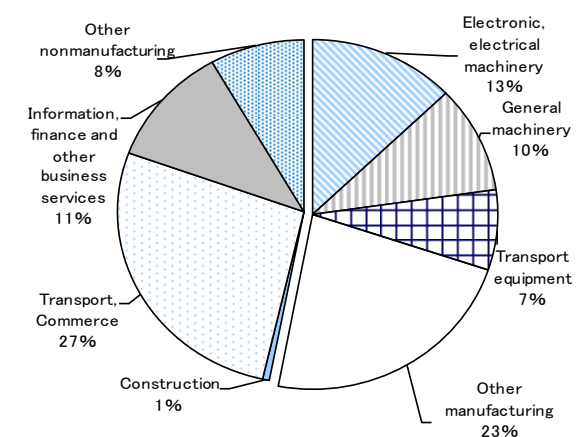
Source: The Japan Research Institute, Ltd. based on the data of OECD.

Figure 7-2 Final Demand in China by Industry for Japan's Value-added Exports to China



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

Figure 7-3 Industries in Japan which Produced Japan's Value-added Exports to China



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

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Prospects for Japan's Economy - Projected Real GDP Change; 0.8% in FY2019 and 0.9% in FY2020

◆ Japan's Economy Is Likely to Return to its Recovery Path as Foreign Demand Bottoms out and Domestic Demand Picks up

(1) In the Second Preliminary Quarterly Estimates of GDP (2nd QE), Japan's real GDP growth for the January-March 2019 period was revised slightly upward to +2.2% on an annualized quarter-on-quarter change basis (up 0.6% from the preceding quarter) from the First Preliminary Quarterly Estimates of GDP (1st QE) (+2.1% on an annualized quarter-on-quarter change basis and up 0.5% from the preceding quarter). Despite a positive revision with higher capital investment, both exports and domestic demand remained lackluster. The 2nd QE indicated that Japan's economy has remained at a standstill.

(2) Despite the foregoing, Japan's economy will likely return to its recovery trend after April. Looking at the trend of the overseas economy, the Chinese economy seems to have bottomed out thanks to economic stimulus measures by the government and the decline in exports has begun to come to a halt. Meanwhile, appetite for investment in the corporate sector remains firm mainly in the fields of upgrade investment for dilapidated equipment and investments aimed at labor saving and rationalization against the backdrop of labor shortages. With the bottoming-out of exports, postponed investment projects in the manufacturing industry are likely to be executed gradually.

(3) Personal consumption is also anticipated to pick up, supported by an improvement in income conditions and rush demand prior to the hike in the consumption tax rate. While personal consumption will likely drop temporarily following the hike in the consumption tax rate due to a reaction to the rush demand, measures to minimize the impact of the consumption tax rate hike, such as the introduction of a reduced tax rate and provision of free education and nursery care, are expected to reduce the burden on households. Therefore, we believe that a downward shift in consumer spending is likely to be avoided. After the reactionary decline runs its course, private consumption is forecast to return to a moderate rising trend.

(4) Consequently, the Japanese economy is expected to grow moderately in FY2019 and FY2020 at around the 1.0% level, which is close to its potential growth rate.

(5) However, attention must be paid particularly to the United States' protectionist stance to trade as the outlook for the overseas economy remains increasingly uncertain. As for the impact of the raising of tariffs on \$200 billion worth of Chinese goods in May, negative impact on Japan will likely be limited given the fact that (i) Japan's added value included in China's exports to the United States is as low as 0.2% of Japan's GDP; and that (ii) the negative impact on the Chinese economy can be fully offset by economic stimulus measures which have already been scheduled to be implemented. However, if China's domestic demand heads downward as a result of further increases in items subject to retaliatory tariffs, additional negative effects on the Japanese economy will not be able to be avoided. In addition, there are risks that the United States will impose quantitative restrictions on automobile exports by Japan and demand the inclusion of a clause to mitigate currency risk.

◆ The Year-on-year Change Rate in the Core CPI Will Likely Continue to Be Slightly below 1 Percent

(6) The pace of rise in the core CPI, which excludes fresh food, accelerated slightly mainly because of the rises in food prices and accommodation charges, despite easing energy price rise. Looking ahead, it is predicted that the year-on-year increase rate in the core CPI will continue to be slightly less than 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 rise in energy prices will likely slow down further.

Figure 9 Projections for GDP Growth and Main Indicators of Japan (as of June 10, 2019)

	(seasonally adjusted, annualised % changes from the previous quarter)									(% changes from the previous fiscal year)		
	CY2019				CY2020				CY2021	FY2018	FY2019	FY2020
	1~3	4~6	7~9	10~12	1~3	4~6	7~9	10~12	1~3	(Actual)	(Projection)	(Projection)
	(Actual)	(Projection)	(Projection)	(Projection)	(Projection)	(Projection)	(Projection)	(Projection)	(Projection)	(Actual)	(Projection)	(Projection)
Real GDP	2.2	1.0	2.2	▲ 3.9	2.0	1.6	2.4	▲ 0.6	1.2	0.7	0.8	0.9
Private Consumption Expenditure	▲ 0.2	2.6	4.2	▲ 8.5	3.4	1.9	2.5	▲ 0.6	1.2	0.4	0.6	0.7
Housing Investment	2.5	3.2	0.0	▲ 4.5	▲ 3.1	0.8	1.6	2.0	2.0	▲ 4.3	1.4	▲ 0.3
Business Fixed Investment	1.4	0.2	3.8	▲ 1.4	2.5	2.2	2.0	1.8	1.8	3.5	1.7	1.8
Private Inventories (percentage points contribution)	(0.2)	(▲ 0.3)	(▲ 0.4)	(0.2)	(0.1)	(0.0)	(0.0)	(0.0)	(0.0)	(0.1)	(▲ 0.0)	(0.0)
Government Consumption Expenditure	▲ 0.4	0.8	0.7	0.7	0.9	1.0	2.2	▲ 1.1	1.2	0.9	0.8	0.9
Public Investment	4.7	5.0	1.9	0.8	▲ 1.8	▲ 1.6	0.0	0.0	0.0	▲ 3.9	1.4	▲ 0.5
Net Exports (percentage points contribution)	(1.6)	(▲ 0.6)	(▲ 0.6)	(1.0)	(▲ 0.3)	(0.0)	(0.2)	(▲ 0.4)	(0.0)	(▲ 0.1)	(▲ 0.1)	(0.0)
Exports of Goods and Services	▲ 9.3	4.2	2.2	1.8	1.6	1.6	3.4	▲ 1.4	1.8	1.3	0.0	1.6
Imports of Goods and Services	▲ 17.2	7.7	5.9	▲ 3.8	3.5	1.5	2.3	0.8	1.8	2.0	0.3	1.5
(Ref.) Domestic Private Demand (percentage points contribution)	(0.4)	(1.2)	(2.6)	(▲ 4.9)	(2.3)	(1.4)	(1.8)	(0.0)	(1.0)	(0.8)	(0.6)	(0.7)
(Ref.) Public Demand (percentage points contribution)	(0.2)	(0.4)	(0.2)	(0.2)	(0.1)	(0.1)	(0.4)	(▲ 0.2)	(0.2)	(▲ 0.0)	(0.2)	(0.2)

	(% 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	FY2018	FY2019	FY2020
Nominal GDP	1.0	1.0	2.4	1.5	1.3	1.5	1.4	1.9	1.6	0.5	1.6	1.6
GDP deflator	0.1	0.3	0.6	1.1	1.1	1.0	0.9	0.5	0.5	▲ 0.2	0.8	0.7
Consumer Price Index (excluding fresh food)	0.8	0.8	0.5	0.8	1.0	0.9	1.1	0.8	0.8	0.8	0.8	0.9
(excluding fresh food, consumption tax, education free of charge)	0.8	0.8	0.5	0.5	0.6	0.6	0.8	0.9	0.9	0.8	0.6	0.8
Unemployment Rate (%)	2.5	2.4	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.4	2.3	2.2
Exchange Rates (JY/US\$)	110	109	109	108	108	107	107	107	107	111	109	107
Import Price of Crude Oil (US\$/barrel)	63	72	69	68	68	68	68	68	68	72	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.