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Japan’s Economy: Monthly Review

China’s “shadow banking” problem requires continued monitoring

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Summary

- **Japan’s Economy Heads Toward Smooth Recovery:** Japan’s economy is moving into a smooth recovery trend. We now forecast real GDP growth of +1.1% in comparison with the previous year for FY14 and +1.5% in comparison with the previous year for FY15. (See Japan’s Economic Outlook No. 181 Update (Summary), (June 23, 2014), by Mitsumaru Kumagai et al.). Japan’s economy declined temporarily in the Apr-Jun 2014 period due to the effects of the increase in consumption tax, but is expected to get back on track and head toward recovery during the Jul-Sep period. Japan’s economy is expected to firm up in the near future due to the following positive factors: (1) The negative factors associated with the increase in consumption tax are believed to be limited, and (2) Firming up of exports due to US economic recovery.

- **Four Risk Factors Facing Japan’s Economy:** Risks that will need to be kept in mind regarding the Japanese economy are: (1) turbulence in emerging economies, (2) China’s shadow banking problem, (3) a reigniting of the European sovereign debt crisis, and (4) a surge in crude oil prices stemming from geopolitical risk. It is worth noting that the first is closely related to the second and third. Of these four risks, it is worth underscoring that the first and the second are of crucial importance. Looking at the world economic cycle, we see that in the past, advanced economies led by the US drove emerging economies. However, a decoupling is currently occurring—advanced economies are performing well but emerging economies are stagnating. We believe that this decoupling is occurring for three reasons: (1) the dwindling amount of loans from European financial institutions to emerging economies in light of the European debt crisis, (2) the sluggishness of the Chinese economy, and (3) concerns that money will be taken out of emerging economies based on worries that the FRB will adopt a hasty exit from quantitative easing. We anticipate that a further deterioration of emerging economies will be avoided as the US economy continues to expand. Nevertheless, we think the state and the future direction of the Chinese economy will continue to require close monitoring.

1. Japan's Economic Scenario

Main scenario: Japan's economy to continue growing

Japan's economy is moving into a smooth recovery trend. We now forecast real GDP growth of +1.1% in comparison with the previous year for FY14 and +1.5% in comparison with the previous year for FY15. (See Japan's Economic Outlook No. 181 Update (Summary), (June 23, 2014), by Mitsumaru Kumagai et al.). Japan's economy declined temporarily in the Apr-Jun 2014 period due to the effects of the increase in consumption tax, but is expected to get back on track and head toward recovery during the Jul-Sep period. Japan's economy is expected to firm up in the near future due to the following positive factors: (1) The negative factors associated with the increase in consumption tax are believed to be limited, and (2) Firming up of exports due to US economic recovery.

Real GDP growth rate revised upwards from 1st preliminary estimate

The real GDP growth rate for Jan-Mar 2014 (2nd preliminary est) was revised upwards from the preliminary est, recording +6.7% q/q annualized (+1.6% q/q) as compared to the preliminary figures (+5.9% q/q annualized, +1.5% q/q). The 2nd preliminary figures also exceeded market consensus (up 5.6% q/q annualized and up 1.4% q/q), due mainly to the upward revision of capex, which exceeded earlier expectations – all in all a positive report.

Japanese economy back on growth track by Jul-Sep 2014 period

As for the outlook for the Japanese economy, the period of Apr-Jun 2014 is likely to see declines in personal consumption and housing investment for the first time in 7 quarters. However the reactionary decline occurring after the last minute demand prior to the increase in consumption tax is seen as having hit bottom in April, and are expected to begin easing up, supported by increases in base wages by major corporations feeling pressured to raise wages due to the stringent supply and demand situation for labor. Therefore possibilities are good that personal consumption will enter a growth trend in q/q terms by the Jul-Sep quarter.

Meanwhile, exports are expected to grow as overseas economies, led by the U.S., continue to expand, and as Japan improves its global competitiveness thanks to the weak yen. Increasing exports will lead to production growth and improved earnings, and this is expected to trigger more capex. Hence we believe the Japanese economy will be back on the growth track by the Jul-Sep 2014 period.

BOJ's monetary policy

We expect additional monetary easing measures by the BOJ to carry over beyond the 2015 Jan-Mar period. While there is still a chance that the BOJ might reach its price target, our outlook as of this point in time is that the growth rate in consumer prices will not reach 2%.

The US remains the driver of the world economy, not China

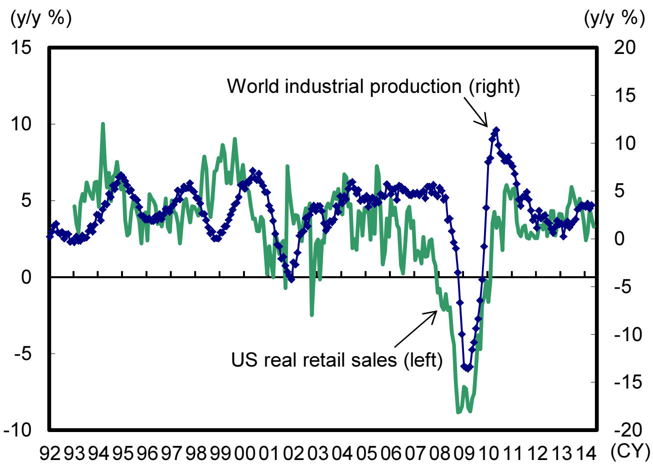
The main supporting factors for Japan's economy in the future are (1) the negative effects of the increase in the consumption tax are considered to be limited, and (2) exports are gradually getting back on track, centering on exports to the US.

The second factor listed above, one influenced very much by the fact that the US remains the driver of the world economy rather than China, is one which DIR would especially like to emphasize.

As is shown in Chart 1, US retail sales are leading world industrial production on a gradual recovery. In other words, the fact of being the region of final demand for many of the world's manufactured goods gives the US a leading role in the world's economy, one which it has performed for some time now.

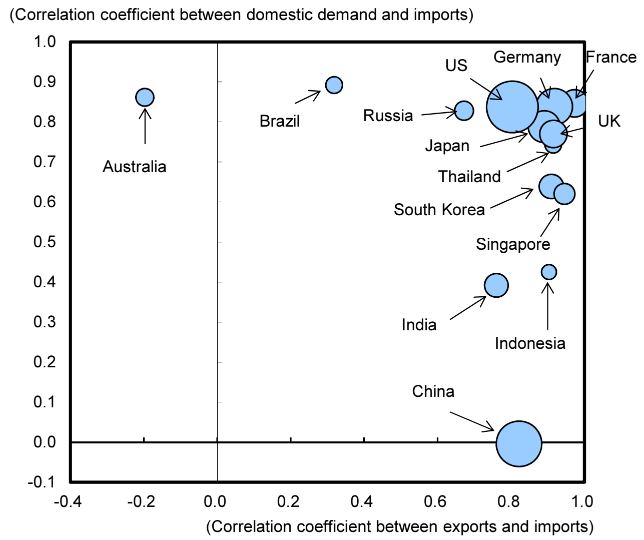
Chart 2 shows the relationship between imports and domestic demand amongst the world's leading nations, as well as the relationship between imports and exports. The horizontal axis shows the correlation coefficient between exports and imports, with the right-hand side indicating a higher correlation between exports and imports. The vertical axis shows the correlation coefficient between domestic demand and imports, with the upper-hand-side indicating a higher correlation between domestic demand and imports. The sizes of the circles indicate the percentage share of a nation's imports against imports as a whole. The chart reveals that a majority of major nations are positioned to the upper right, confirming that imports are correlated to a certain degree with both exports and domestic demand. China, however, is different. It is in the lower right-hand, suggesting that while its imports and exports are correlated, the correlation between domestic demand and imports is minimal. Recently, the problem of shadow banking in China has raised concerns that its economy will falter. If the Chinese economy rapidly deteriorates, as long as the deterioration comes from the contraction of domestic demand such as personal consumption and investments, the impact on Chinese imports and in turn the world economy should be minimal.

World Industrial Production and US Retail Sales
Chart 1



Source: Netherlands Bureau for Economic Policy Analysis, US Bureau of Economic Analysis; compiled by DIR.

Imports vs. Domestic Demand and Exports
Chart 2



Source: UN, IMF; compiled by DIR.
Notes: 1) Size of circles denotes world import share.
2) Correlation coefficients and import shares are for 2000-11 and 2012, respectively.

2. Four Risk Factors Facing Japan's Economy

In this section, we examine four risks facing Japan's economy. Risks that will need to be kept in mind regarding the Japanese economy are: (1) turbulence in emerging economies, (2) China's shadow banking problem, (3) a reigniting of the European sovereign debt crisis, and (4) a surge in crude oil prices stemming from geopolitical risk. It is worth noting that the first is closely related to the second and third. Of these four risks, it is worth underscoring that the first and the second are of crucial importance, and we will analyze them more closely in the paragraphs below.

2.1 Risk (1): Turbulence in emerging economies

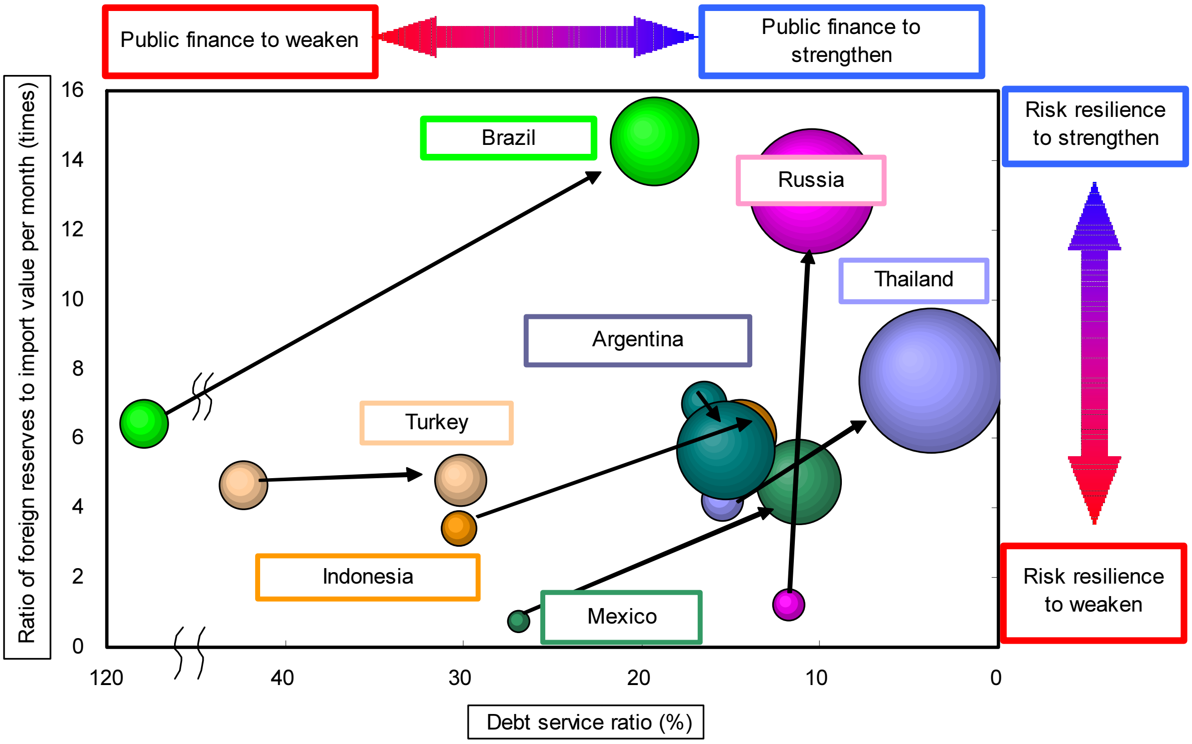
First, to examine turbulence in emerging economies, we analyze the world economic cycle. In the past, advanced economies led by the US drove emerging economies. However, a decoupling is currently occurring—advanced economies are performing well but emerging economies are stagnating. We believe that this decoupling is occurring for three reasons: (1) the dwindling amount of loans from European financial institutions to emerging economies in light of the European debt crisis, (2) the sluggishness of the Chinese economy, and (3) concerns that money will be taken out of emerging economies based on worries that the FRB will adopt a hasty exit from quantitative easing. We anticipate that a further deterioration of emerging economies will be avoided as the US economy continues to expand. Nevertheless, we think the state and the future direction of the Chinese economy will continue to require close monitoring.

Possibility of a serious crisis in emerging economies is limited

We believe there is a limited possibility that emerging economies will experience a serious crisis similar to the Asian currency crisis in 1997. Chart 3 depicts changes in risk resilience of emerging market nations from the year each nation experienced a financial crisis. Learning from past financial crises, these nations have amassed huge foreign currency reserves. Not only has the absolute size of such reserves increased, but the size of foreign currency reserves relative to goods and services imports (vertical axis) and that relative to short-term foreign debt (the sizes of circles) have also improved for most nations. Moreover, the debt service ratio, defined as debt service payments for external debt as a percentage share of good and service exports, a leading indicator used to determine country risk, has fallen for the most part (conditions have improved) since the financial crisis.

As far as we can see from this chart, the possibilities of turmoil occurring in the world financial markets after January 2014 are rather slim. The ignition point for the last crisis was Argentina, but it seems to be an exception. Looking at the emerging nations overall, we see steady improvement in the fundamentals.

Risk Resilience of Emerging Market Economies Chart 3



Source: Haver Analytics; compiled by DIR.
Notes: 1) Arrows denote shift of positions at critical moments to 2012.
2) Year of crises defined as 1994 for Mexico, 1997 for Thailand and Indonesia, 1998 for Russia, 1999 for Brazil, 2001 for Turkey, and 2002 for Argentina.
3) Size of circles shows ratio of foreign reserves to foreign debt with less than one-year maturity. The larger the circle, the greater the resilience.

US exit strategy will benefit Japanese economy

In this section we contemplate how the global financial markets have been evaluating the US exit strategy since 2013.

We believe that the US exit strategy will hold many beneficial points for the Japanese economy. Possibilities are good that US the long-term interest rate will rise gradually in a mirroring of the recovery in the actual economy. Chart 4 shows changes in the US long-term interest rate and TOPIX. Movements of these two indices have fairly close linkage.

The question is why are the US long-term interest rate and Japanese stocks so closely linked?

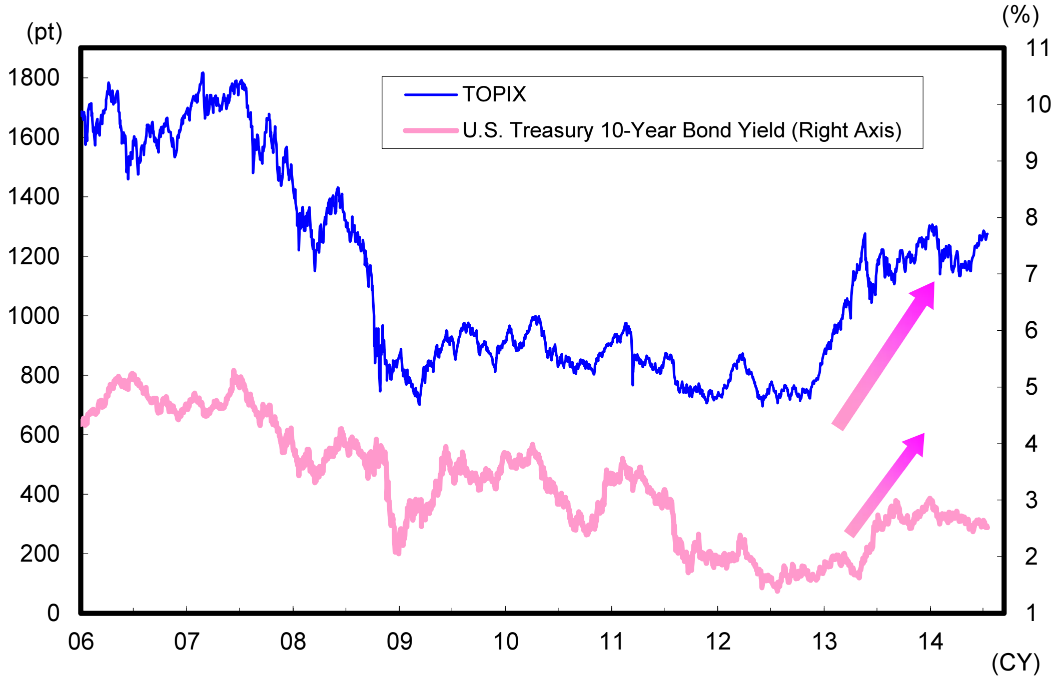
The first reason is that the difference between US and Japan interest rates widens the more the US long-term interest rate rises, and this becomes a factor in the current weak yen/strong dollar relationship. As yen depreciation progresses, the amount of exports that Japan's corporations can achieve grows.

The second reason is that when the US long-term interest rate is tending upwards, it is usually because the US economy is strong. A favorable US economy provides fundamental support for Japan's overall exports.

Finally, if the FRB gives its official stamp to the recovery of the actual US economy, allowing for the moving ahead of a serious exit strategy, this will provide more confidence in the economy. FRB chair Janet Yellen recently announced that she would gradually move forward with an exit strategy while carefully observing the recovery in the actual economy. In conclusion, we believe that any risk of the

FRB's exit strategy being too fast, hence leading to major confusion in the international markets, especially emerging nations, is extremely limited.

TOPIX and U.S. Treasury 10-Year Bond Yield **Chart 4**

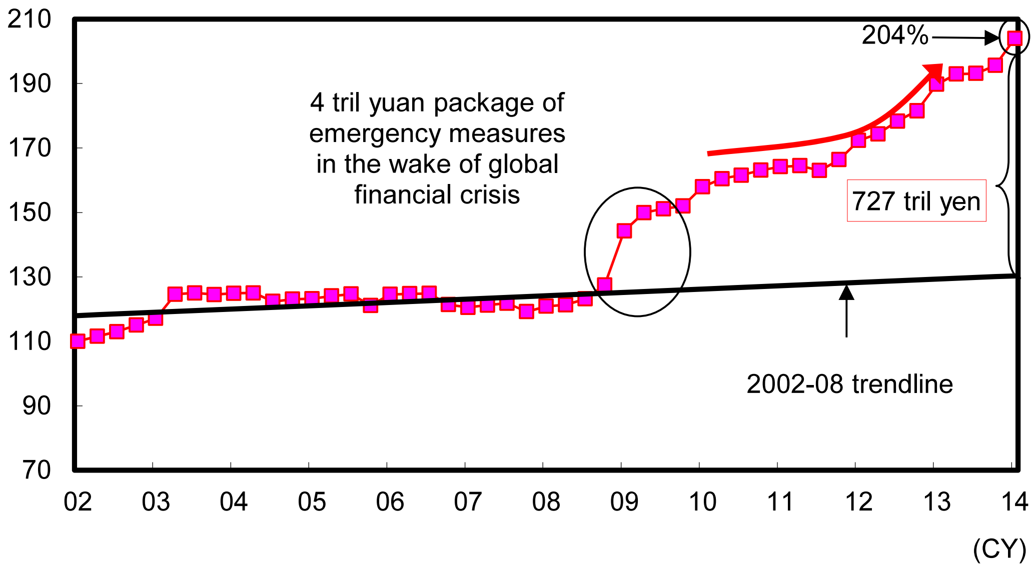


Source: Tokyo Stock Exchange and FRB; compiled by DIR.

2.2 Risk (2): China's shadow banking problem

Excessive lending has become a problem in China in the wake of its response to the global financial crisis in 2008. Chart 5 provides an estimate of total social financing in China as a proportion of China's GDP. Such financing jumped from its long-term trend in 2009 and has continued to expand, reaching 204% of nominal GDP at the end of March 2014. Comparing current levels to the long-term trend, we estimate excessive lending in China to be around Y727 trillion. Should part of these assets become non-performing, this could cause major turbulence in China and global financial markets. Risk scenarios that should be kept in mind include (1) China drawing down its foreign currency reserves (around $3.5 tril) to deal with non-performing debt, causing long-term interest rates to surge in the US, and (2) the yen appreciating from a global flight to quality.

China's Total Social Financing (% of GDP) **Chart 5**



Source: People's Bank of China, National Bureau of Statistics of China; compiled by DIR.
Assumption: Outstanding balance of total social financing as of end-Mar 2002 to be 1.1 times bank lending.

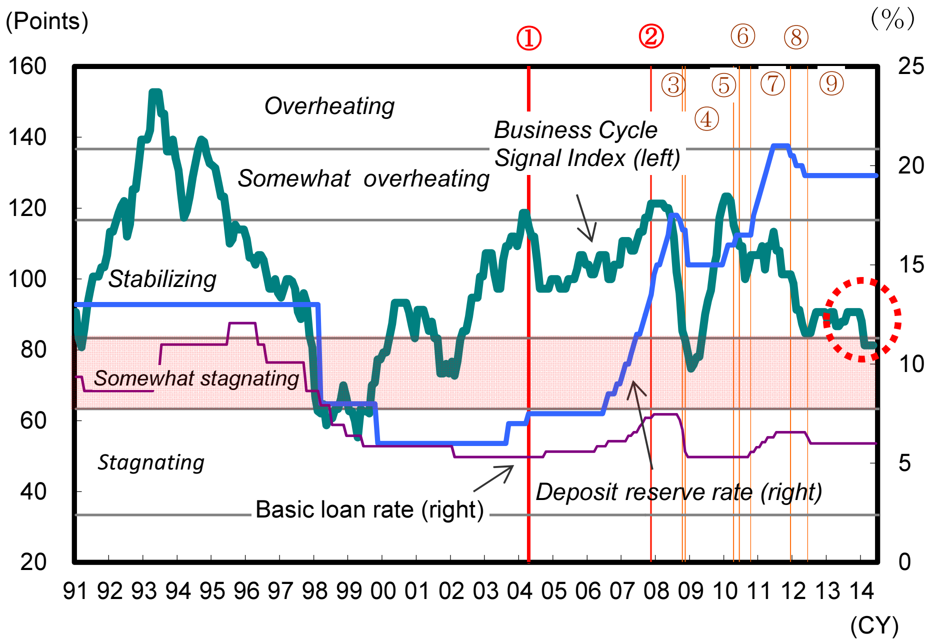
How will the world economy be affected by the collapse of China's debt bubble?

We believe that the impact on the world economy of the collapse of China's debt bubble should not be excessively overstated. Chart 6 presents the Business Cycle Signal Index for China. According to this index, we can confirm that China's economy has slowed significantly. After peaking at 123.3 in February 2010, the index has fallen to the lower bound of the zone signaling stability, between 83.33 and 116.66. Similar to previous instances when the economy has slowed to this extent, the likelihood is high that authorities will respond with some form of a stimulus measure and that the collapse of China's economy will be avoided one way or another.

Key phrases are "socialist market economy," "collective leadership," and "gradualism"

China being a socialist market economy rather than a pure capitalist economy may also be a factor supporting the economy for the time being. During the change in political leadership that occurs once a decade, it is natural for leaders to want to circumvent a rapid deceleration of the economy as much as possible. Politically speaking, collective leadership and a policy of gradualism could also be factors that preclude a short-term relapse of the Chinese economy. In fact, there are growing views that the lower limit for the growth rate of real GDP in China is currently around 7% based on comments such as those recently made by Premier Li Keqiang.

China: Business Cycle Signal Index — Chart 6



Source: National Bureau of Statistics of China, People's Bank of China, CEIC Data; compiled by DIR.

1. Apr 2004: Restrictions on aggregate loans strengthened
2. Oct 2007: Restrictions on aggregate loans strengthened
3. Oct 2008: Restrictions on aggregate loans eased
4. Nov 2008: Stimulus package of 4 tril yuan announced
5. Apr 2010: Real estate regulations strengthened
6. Jun 2010: More flexible regime for control of yuan exchange rate
7. Oct 2010-Jul 2011: Period of loan rate hikes
8. From Dec 2011: A series of deposit reserve rate lowering moves began
9. From Jun 2012: A series of loan rate cuts began

Economic Indicators and Interest Rates — Chart 7

Indicator	2013	2014				2015	FY12	FY13	FY14	FY15
	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar				
	Actual		DIR estimates				Actual		DIR estimates	
Real GDP										
Q/q %, annualized	0.3	6.7	-4.2	2.5	2.1	2.1				
Y/y %	2.5	3.0	1.0	1.3	1.7	0.5	0.7	2.3	1.1	1.5
Current account balance SAAR (Y tril)	0.0	-5.6	-1.9	-0.5	0.8	1.9	4.2	0.8	0.1	3.4
Unemployment rate (%)	3.9	3.6	3.6	3.6	3.6	3.6	4.3	3.9	3.6	3.5
CPI (excl. fresh foods; 2010 prices; y/y %)	1.1	1.3	3.3	3.1	3.0	3.0	-0.2	0.8	3.1	1.9
Unsecured overnight call rate (period end; %)	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100	0.100
10-year JGB yield (period average; %)	0.64	0.61	0.59	0.60	0.65	0.70	0.76	0.66	0.63	0.80

Source: Compiled by DIR.
Note: Estimates taken from DIR's Japan's Economic Outlook No. 181 Update.