

18 September 2014 (No. of pages: 12)

Japanese report: 18 Sep 2014

Japan's Economy: Monthly Review

Gradual move toward recovery seen for Japan's economy

Economic Intelligence Team

Mitsumaru Kumagai**Satoshi Osanai****Masahiko Hashimoto****Shotaro Kugo****Hiroyuki Nagai**

Summary

- **Outlook Revised:** In light of the second preliminary Apr-Jun GDP release (Cabinet Office), we have revised our economic growth outlook. We now forecast real GDP growth of +0.7% in comparison with the previous year for FY14 (+0.7% in the previous forecast) and +1.5% in comparison with the previous year for FY15 (+1.5% in the previous forecast). (See Japan's Economic Outlook No. 182 Update (Summary), (September 8, 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 gradually move toward recovery during the Jul-Sep period. Japan's economy is gaining support from the following positive factors: (1) The negative factors associated with the increase in consumption tax have pretty much played themselves out, and (2) Firming up of exports due mostly to the US economic recovery. Risks that will need to be kept in mind regarding the Japanese economy are: (1) stagnant personal consumption due to the decline in real income, (2) China's shadow banking problem, (3) a surge in crude oil prices stemming from geopolitical risk, and (4) tumult in the economies of emerging nations in response to the US exit strategy.
- **Will exports get back on track?:** Japan's exports are expected to gradually regain ground supported by the cyclical recovery in the US economy. However, of the 11.5 trillion yen trade deficit Japan carried as of 2013, approximately 7 trillion yen is due to the hollowing out effect, while another 4 trillion yen is attributed to the increase in imported oil and LNG after most of the country's nuclear power plants were shut down. Considering factors like these, Japan's trade balance will likely be bleeding red ink for some time to come.

1. Japan's Economic Scenario

Main Economic scenario for Japan

In light of the second preliminary Apr-Jun GDP release, we have revised our economic growth outlook. We now forecast real GDP growth of +0.7% in comparison with the previous year for FY14 (+0.7% in the previous forecast) and +1.5% in comparison with the previous year for FY15 (+1.5% in the previous forecast). (See Japan's Economic Outlook No. 182 Update (Summary), (September 8, 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 gradually move toward recovery during the Jul-Sep period. Japan's economy is gaining support from the following positive factors: (1) The negative factors associated with the increase in consumption tax have pretty much played themselves out, and (2) Firming up of exports due mostly to the US economic recovery.

Real GDP growth rate revised downwards slightly from First Preliminary

The real GDP growth rate for Apr-Jun 2014 (2nd preliminary est) was revised downward from the 1st preliminary estimate (-6.8% q/q annualized, -1.7% q/q) to -7.1% q/q annualized (-1.8% q/q). As in the 1st preliminary estimate, performance was in line with market consensus (-7.0% q/q annualized and -1.8% q/q). However, capex was revised downwards, while inventory investment was revised upwards, bringing a positive factor into the mix. Regarding the huge increase in inventory investment, this is considered to be partly an attempt to recover inventory levels after the temporary decline experienced as a result of last minute demand prior to the April tax hike, though the decline in domestic demand cannot be ignored as another major cause, hence this is not necessarily a positive element. Ultimately, performance was not as good as the figures make it look at first glance.

Capex revised downwards and inventory investment revised upwards

Performance by demand component as revised from the 1st preliminary estimate shows a considerable downward revision in capex to -5.1% in reaction to corporate statistics (it was -2.5% on the 1st preliminary estimate). Meanwhile, personal consumption was also revised downwards a tad to -5.1%pt in comparison to the 1st preliminary estimate (-5.0%pt q/q). Meanwhile, private sector inventories were revised upwards considerably from the 1st preliminary estimate in reaction to corporate statistics (extent of contribution to real GDP in q/q terms was +1.4%pt on the 2nd preliminary estimate as compared to +1.0%pt on the 1st preliminary estimate). As for public investment, revised figures are normally announced on the 2nd preliminary estimate to reflect the third full month of figures from the monthly construction statistics, but this time around there was practically no change.

Decline in personal consumption continues to push GDP figures downward

As for degree of contribution of domestic and overseas demand to the 2014 Apr-Jun period real GDP growth rate on a q/q basis, domestic demand contributed -2.9%pt (-2.8%pt on the 1st preliminary), while overseas demand contributed +1.1%pt (also +1.1%pt on the 1st preliminary). There is no major change from our conclusions on the 1st preliminary estimate, in which we referred to the major slump in the economy in the Apr-Jun period, due mainly to the reactionary decline in personal consumption which occurred after the increase in the consumption tax. The results did not prompt us to change our basic view of the economic environment.

Performance by demand component shows personal consumption down considerably by 5.1% q/q, helping to push GDP downwards. Durables, which experienced especially brisk last minute demand during the Jan-Mar period, suffered a major decline of -19.3% q/q. Meanwhile, semi-durables and non-durables, which did not see much last-minute demand in the last quarter, also recorded considerable

declines of -12.6% and -6.9% respectively. In addition to the reactionary decline, the decline in real income, resulting from the increase in prices of goods, were factors in reducing personal consumption.

Capex was revised downwards this time around, falling considerably in comparison to the previous period at -5.1% for the Apr-Jun quarter. However, considering the fact that capex rose so dramatically during the Jan-Mar period, the decline is not an especially serious one. With the halting of Windows XP support by Microsoft during the Jan-Mar period along with last minute demand, this can actually be interpreted as meaning that capex is actually exhibiting a gradual growth trend.

Public investment was down by -0.5% in comparison to the previous period. The effects of past economic policy measures are now wearing thin and this represents the second consecutive quarter in which public investment has been in decline. Front-loading the FY2013 supplementary budget and the FY2014 budget has reduced the extent to which public investment otherwise would have declined on a q/q basis, hence in the final view it is continuing at a high level.

Overseas demand became a plus factor for the first time in four quarters. However, the main reason was the shrinking of domestic demand as a result of a major decline in imports. Exports were down by -0.5% q/q, their first decline in three quarters, and are continuing at a sluggish pace.

Jul-Sep 2014 GDP to turn in positive direction

As for the outlook for the Japanese economy, the period of Jul-Sep 2014 is expected to see a comeback in GDP, with a continuation of economic expansion foreseen. A great deal of attention will be drawn to the announcement of Jul-Sep 2014 period GDP figures to be announced in mid-November. This is because of the great weight they are expected to carry in determining whether or not to increase the consumption tax yet again (next hike planned in October 2015). Chances are good that GDP figures will return to positive growth during the Jul-Sep period.

The reactionary decline in personal consumption following the raising of the consumption tax in April brought major downward pressure on Apr-Jun GDP. However, if we look at performance on a monthly basis, we see that personal consumption hit bottom in April and then began making a comeback in May and June. Up to now, personal consumption had been slowing down, but with help from the monthly carryover effect, there is a good chance that Jul-Sep period personal consumption will return to positive growth. Moreover, public investment related orders have been growing rapidly since early in FY2014. Public investment is expected to exhibit unequivocal growth during the Jul-Sep period, and is seen providing support for growth in real GDP. Meanwhile, capex, which suffered from a slowdown during the Apr-Jun period, is seen returning to a growth trend during the Jul-Sep period and beyond. Although recent production activity has been stagnant due to the effects of the reactionary decline after the tax hike went into effect, industry is showing signs of feeling a shortage in equipment and facilities especially in the non-manufacturing industries. The positive attitude of corporations toward capex has been reflected in various business surveys including the BOJ Tankan, and chances are good that capex will continue developing underlying strength. As for exports, the yen has weakened further of late, and is expected to remain at the same level for some time. However, shifting our view toward the external environment, we see that the US economy is exhibiting underlying strength and should continue moving toward recovery. Meanwhile the EU is slowly but surely moving toward economic expansion. The world economy is gradually expanding, and Japan's exports are expected to move toward a comeback

Four risk factors facing Japan's economy

Risks that will need to be kept in mind regarding the Japanese economy are: (1) stagnant personal consumption due to the decline in real income, (2) China's shadow banking problem, (3) a surge in

crude oil prices stemming from geopolitical risk, and (4) tumult in emerging markets in response to the US exit strategy.

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%.

2. Will exports get back on track?

Stagnant world economy leads to sluggish exports

For our third issue facing Japan's economy we examine the export trend. The yen has weakened rapidly since the end of 2012, yet despite this fact, export volume has remained stagnant. There are indications that progress in the hollowing out effect has made it structurally difficult for Japan's exports to grow. In this section, we consider factors contributing to Japan's sluggish exports.

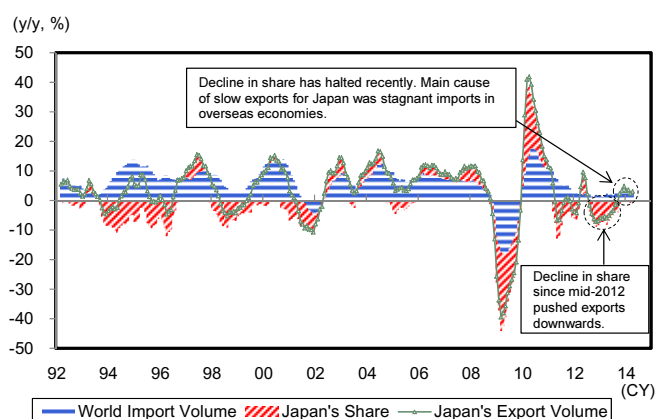
Export volume from Japan is a product of the world's overall export volume (= import volume) and Japan's share of said volume. It is possible to view the former as reflecting the strength of overseas demand, while the latter can be understood as Japan's competitiveness. Chart 1 is a factor analysis of changes in Japan's export volume as seen from the viewpoint of changes in world import volume and Japan's share of world import volume. Focusing on developments from the 1990s on, the biggest factor influencing Japan's exports has been world import volume, in other words overseas demand. Influence from changes in share is relatively minor. World import volume has not grown much at all since 2012, and it is this sluggish condition of world demand that is the main cause of Japan's stagnant exports. Japan experienced an economic slowdown from mid-2012 till the end of the second half. World demand was also stagnant during this time and Japan's share of world import volume brought the downturn in exports. By the end of 2012 Japan's share of world demand had stopped declining.

World import volume is basically an expression of how the world economy is doing. The major influence here is the economic condition of the advanced countries which hold the lion's share of the world's final demand. Chart 2 shows changes in economic trends of the advanced nations (OECD CLI) and import volume. The data tell us that the world economy bottomed out at the beginning of 2012 and has been continuing to improve since then, but import volume has been slower to improve, and is still comparatively sluggish. Structural factors may be partly responsible for sluggish import volume, such as the tendency for US manufacturers to bring production operations back home to domestic locations, but historical data show us that there is a tendency for improvement in import volume to lag somewhat behind a recovery in the overall economy. Therefore, in cyclical terms, the world's import volume should be increasing its growth rate in the near future.

In conclusion, we foresee according to our main economic scenario that Japan's exports will gradually get back on track supported by the cyclical recovery of the US economy. However, it must be kept in mind that in comparison to the trends seen before the US economic crisis, the speed of recovery in the advanced nations is much more gradual. Hypothetically speaking, if a slower growth rate becomes entrenched in the advanced nations, it follows that world import volume, or in other words Japan's export volume, will also experience slower growth than in the past. This is a possibility which should be made note of.

Factor Analysis of Japan's Export Volume

Chart 1

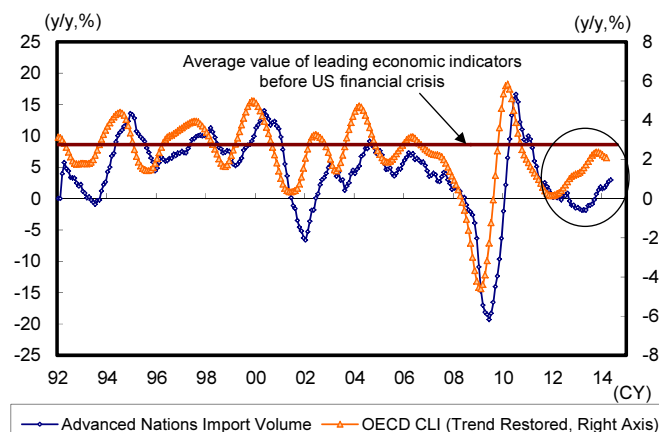


Source: Netherlands Bureau for Economic Policy Analysis; compiled by DIR.

Note: Comparison with previous year's 3-month moving average.

Import Volume of Advanced Nations and Leading Economic Indicators

Chart 2



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

The weak yen is a plus, but growth in exports is hindered by the hollowing out effect

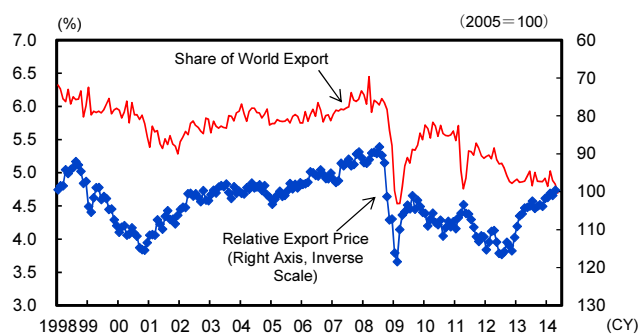
As of this point our investigations have confirmed that the major factor leading to sluggish export volume is the slow pace of world economic expansion. However, though Japan's share of exports has been showing signs of hitting bottom any time soon, it has somehow remained in the doldrums. Share of exports is an expression of Japan's export competitiveness. Increasing export competitiveness is an important issue in increasing Japan's economic vitality, so obtaining a sufficient grasp of the factors causing a stagnant share of exports is meaningful.

One of the main factors indicating export competitiveness is the exchange rate. When the value of a nation's currency goes down, prices denominated in that currency will then decline when expressed in another nation's currency. Hence corporations can get a price cut while still maintaining earnings, and products gain price competitiveness against those of other countries. Japan's relative export price as shown in Chart 3 experienced rapid decline after the end of 2012. However, as was confirmed by the data in Chart 1, Japan's share of world exports has still not increased, even though the decline in share has been halted. The tendency in the past was for share of world exports and the relative export price to move in tandem, but recently, the weakening yen and improvement in price competitiveness has not led to an increase in share.

While Japan's export competitiveness rises as a result of the weak yen, its share of world exports remains stagnant. Behind this is a major structural factor – that of the hollowing out effect. When the practice of local (overseas) production of goods once produced domestically and then exported progresses, even if overseas demand remains fixed, Japan's exports decline as a result. We estimated Japan's share of world exports assuming the influence of the weak yen factor, as well as the overseas production factor, and found that although the weak yen helps to push up export share, said share is then immediately eroded by the growing tendency to carry out production of Japanese products overseas (see Chart 4). In conclusion, even if we include overseas production in the calculation of the share of world exports held by Japanese corporations (in which case we can see an improvement), the progress of the hollowing out effect has made it structurally difficult for Japan's exports to obtain growth.

Relative Export Price and Japan's Share of World Export Volume

Chart 3

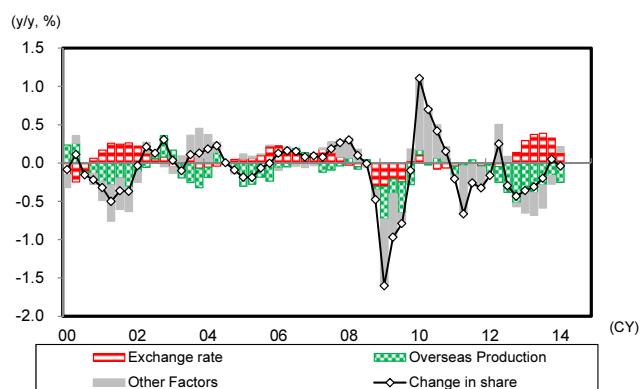


Source: Cabinet Office, IMF, Netherlands Bureau for Economic Policy Analysis; compiled by DIR.

Note: Relative export price = Japan's export price (US dls) / World import price.

Factor Analysis of Fluctuations in Export Share

Chart 4



Source: Ministry of Economy, Trade and Industry, Bank of Japan, Ministry of Finance, Netherlands Bureau for Economic Policy Analysis; compiled by DIR.

Note: Estimates calculated as follows:

$$\text{Share} = 12.84 - 0.02 \cdot \text{REER} - 0.12 \cdot \text{FP}$$

Coefficients all have a significance of 1%.

Share: Share of world exports held by Japan's export volume.

REER: Real effective exchange rate.

FP: Sales of overseas subsidiaries / (Overseas subsidiary sales + Amount of Japanese exports).

Hollowing out effect adds 7 tril yen to trade deficit; nuclear power plant shutdown adds 4 tril yen

In this section we examine fluctuations in Japan's balance of trade in recent years as related to factors previously covered.

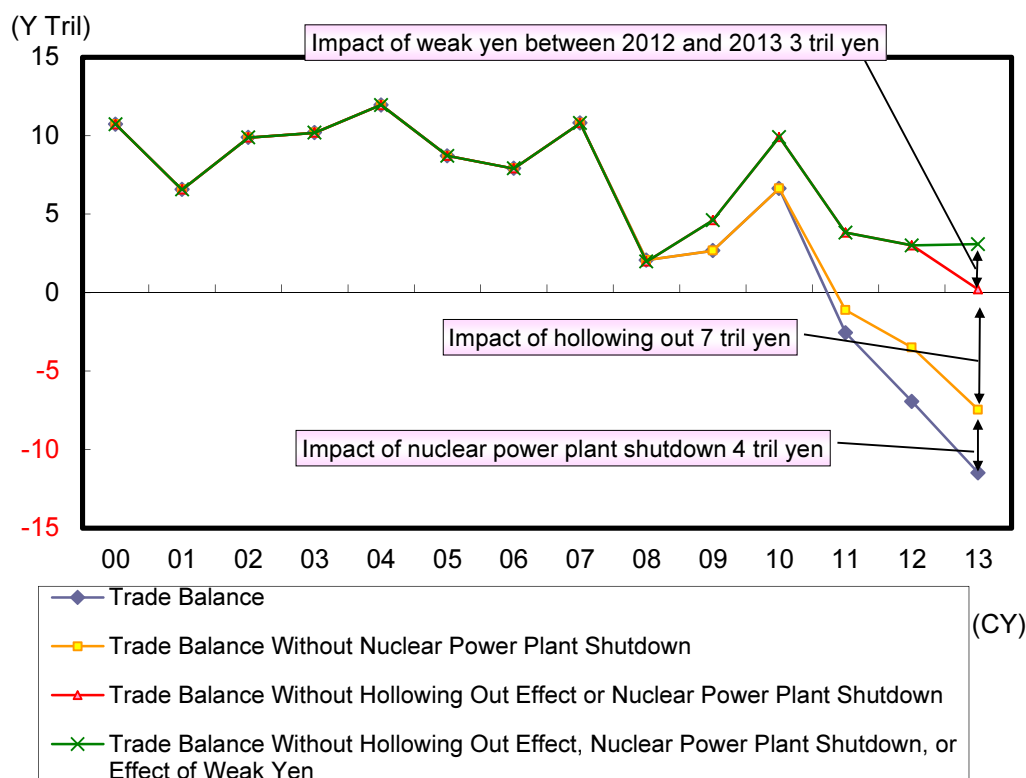
According to international balance of payments statistics gathered by the Ministry of Finance and the Bank of Japan, the 2013 current account balance was at 3.2 trillion yen, the smallest current account surplus Japan has had since 1985. The size of Japan's current account surplus has shrunk dramatically in recent years and is continuing to do so. There are those who say that if things don't change, the current account deficit will be here to stay. The main factor behind the current account deficit is the growing trade deficit. Japan's trade balance on a customs clearance basis in 2013 recorded a deficit of 11.5 trillion yen, or 8.8 trillion yen on an international balance of payments basis. Both of these figures are the largest ever for Japan.

Is Japan's trade deficit here to stay?

Japan's trade balance began recording deficits in 2011, and since then has continue to grow in leaps and bounds. The major factors behind this have been the growing tendency to move production overseas (the hollowing out effect) and the shutdown of the country's nuclear power plants after the earthquake and tsunami of 2011 [the Great East Japan Earthquake].

Chart 5 shows how the hollowing out effect and the shutdown of nuclear power plants have influenced the current account balance. As of 2013, out of the total trade deficit of 11.5 trillion yen, approximately 7 trillion yen was accounted for by the hollowing out effect, while around 4 trillion yen was associated with the shutdown of nuclear power plants.

In conclusion, we foresee according to our main economic scenario that Japan's exports will gradually get back on track supported by the cyclical recovery of the US economy. However, considering the above mentioned structural factors, Japan's trade balance will likely be bleeding red ink for some time to come.



Source: Ministry of Finance; compiled by DIR.

Resurgent US economy provides support for Asia's emerging markets

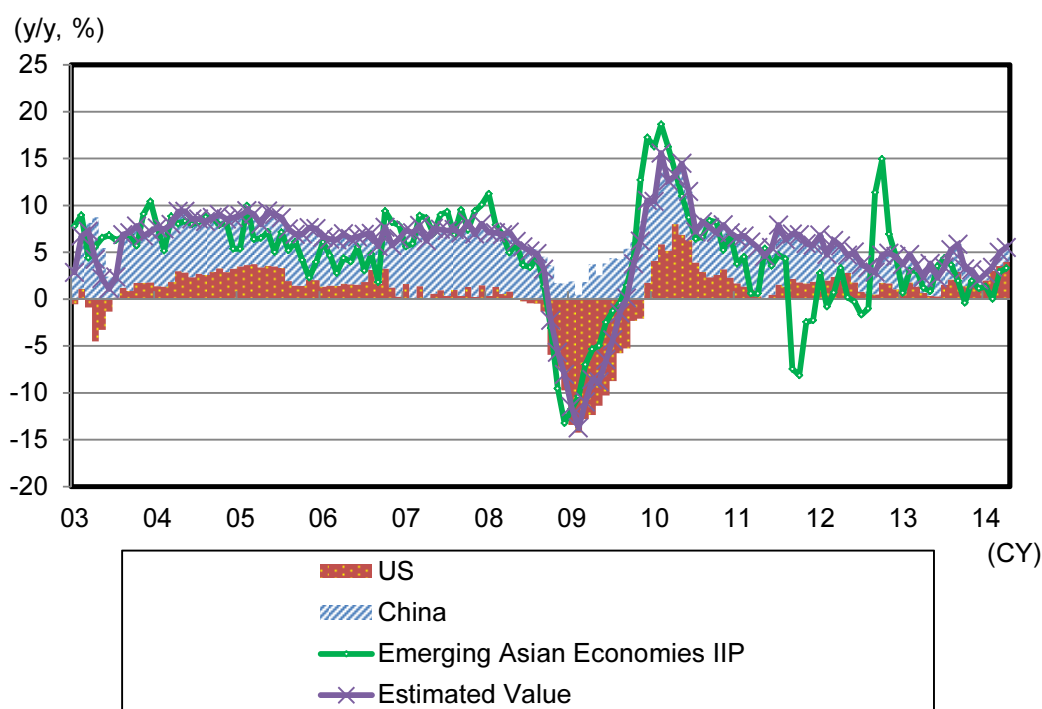
The key to future trends in exports is Asia and its emerging markets. In this section we consider trends in the emerging Asian economies from the perspective of the influence of the US and China.

The cyclical recovery of the US economy is expected to provide support for improvements in the emerging economies of Asia. Meanwhile, from a structural viewpoint, China's economy is exhibiting increasing influence in the emerging economies of Asia.

Chart 6 performs a regression analysis to estimate the rate of influence US and Chinese production have over industrial production in the emerging economies of Asia.

The chart suggests that during the recovery phase of 2009 following the US financial crisis, it may have been the recovery in the Chinese economy which provided the impetus for improvement in the Asian emerging economies. In contrast to this, we can see that it is the increase in production in the US which provides fundamental support for production in the Asian emerging economies. In 2013 the FRB announced it would begin tapering its quantitative easing policy, creating turmoil in the financial markets. This in turn led to panic in the emerging Asian economies. However, more recently, improvements in the US real economy have provided the impetus for a sure-footed recovery in Asia.

We expect the US economy to continue a steady recovery, and for this cyclical recovery to in turn provide support for a recovery in the emerging Asian economies.



Source: Haver Analytics; compiled by DIR.

Note: A rolling regression was performed in order to calculate extent of contribution of US IIP (y/y chg) and China's IIP (y/y chg) on the IIPs of the emerging Asian economies (y/y chg).

From a structural viewpoint, influence of China's economy on the emerging Asian economies should grow stronger in the future

Despite the above findings, the influence of China's economy on the emerging Asian economies has grown steadily stronger.

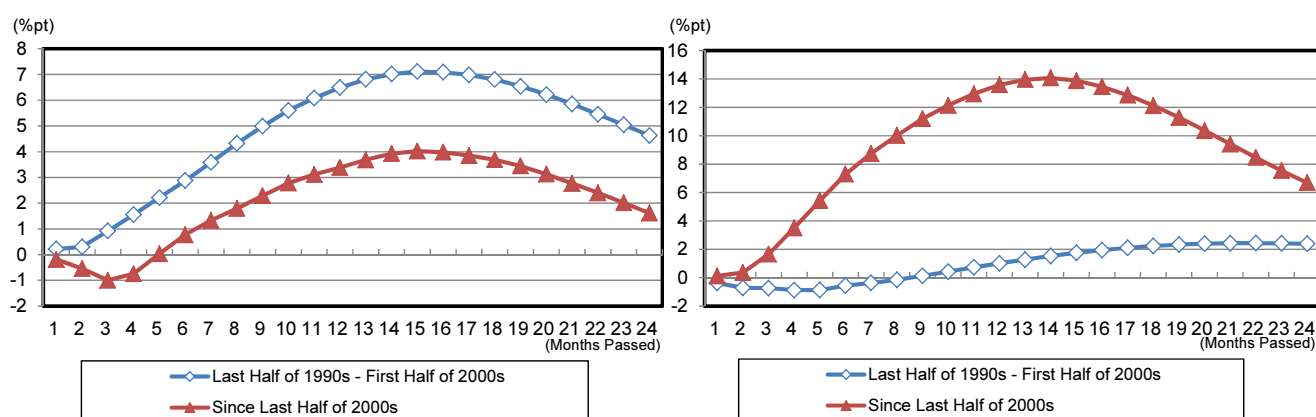
In Chart 7, a calculation is performed to figure the extent of influence of fluctuations in US and Chinese production on industrial production in the emerging Asian economies. The vertical axis represents the extent of influence on industrial production in the emerging Asian economies, while the horizontal axis indicates amount of time elapsed since occurrence of the shock.

Taking a look at the US economy's influence on Asian economies, we find that since the last part of the 2000s, there has been less influence than the period spanning the mid-1990s to the first half of the 2000s. In contrast, China's influence has grown stronger since the last half of the 2000s. This shows that the emerging Asian economies have become more susceptible to China's economic influence in structural terms, while also suggesting that US influence has declined.

Next, shifting our gaze over to the Chinese economy as it gains more influence, we see that as of the end of last year its economy slowed down. However, policies which support the economy have been effective more recently, and China is now showing signs of a comeback. China is faced with a variety of issues, including a real estate bubble and excess production capacity, but for the most part, these problems can be left on the side for the next year or two. Hence in the short-term, China's economy is not expected to hit bottom.

From both a cyclical and a structural point of view, recovery in the US and the Chinese economies is expected to provide underlying support for further improvement in the emerging Asian economies.

Influence on Industrial Production in Emerging Asian Economies (Left Side: US, Right Side: China) **Chart 7**



Source: Haver Analytics; compiled by DIR.

Notes: 1) US IIP (y/y), China IIP (y/y), and Emerging Asian Economies IIP (y/y) estimated using a VAR model.

2) Sample period "Last Half of 1990s - First Half of 2000s" utilizes data from January 1997 to December 2006, while sample period "Last Half of 2000s" utilizes data since January 2007.

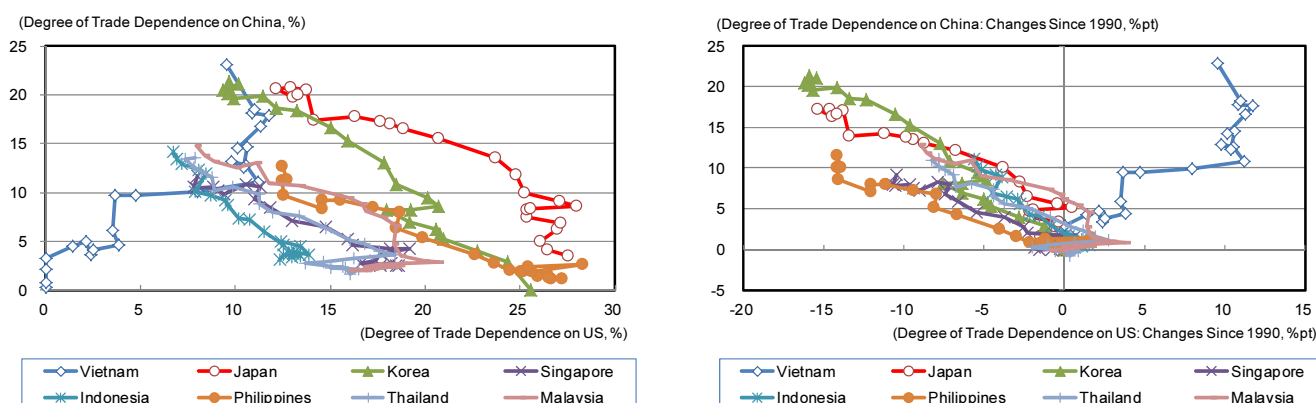
Dependence of emerging Asian economies on China is growing

In this section we consider the reasons for China’s growing influence over the emerging Asian economies.

The major way in which the economy of one country has influence over economies of other countries is trade. Taking a look at the degree of trade dependence the emerging Asian nations have on China and the US, we see that most of the countries included in this category show a growing dependence on China, while the degree of dependence on the US is on the decline (see Chart 8). The degree of trade dependence is defined as the percentage of export and import value accounted for by trade with a particular country (China or the US).

Since 1990 China’s economy has grown in leaps and bounds, and as its economy has expanded, the amount in trade it engages in has also grown. Trade relations have become particularly close with the Southeast Asian countries due to their close geographic location. Trade dependence of these countries on China is especially strong. As a result, trade dependence of the emerging Asian nations on the US has weakened. For a variety of structural reasons, the influence of China’s economy on the emerging Asian nations continues to grow, while the influence of the US economy is on the decline.

Changes in Trade Dependence on the US and Chinese Economies **Chart 8**



Source: IMF statistics; compiled by DIR.

Source: IMF statistics; compiled by DIR.

Japan's participation in global value chains

Lastly, for comparative purposes, we consider the global value chain participation quotient of Japanese corporations.

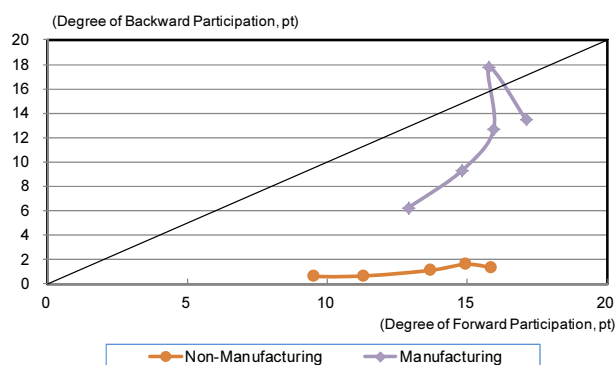
The concept of the global value chain takes into consideration the stage at which a country's production of goods and services links up with the global economy. Participation in cross-border production of export goods and services upstream is referred to as "forward participation", while participation downstream is called "backward participation".

Chart 9 indicates changes in Japan's participation quotient in global value chains

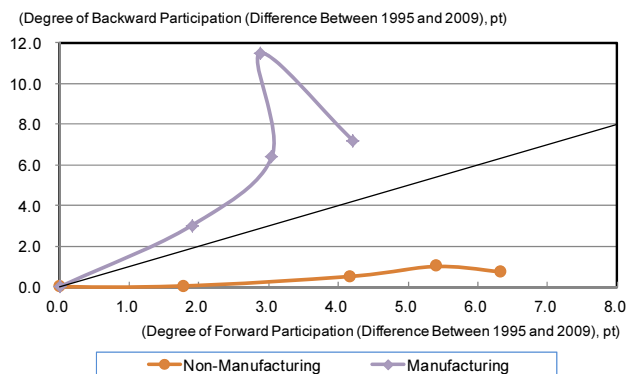
Taking a look at the global value chain activities of the manufacturing industry, with the exception of 2009 which was affected by the US financial crisis, the trend has been toward an increase in backward participation. In other words, in the process of Japan's manufacturing industry building a system of global division of labor, the tendency to use intermediate inputs from other countries in manufacturing products for export has become more common. On the other hand, Japan's forward participation in global value chains has increased as well. This is where Japan supplies intermediate goods for another country to produce products for export.

In contrast, the global value chain participation of Japan's non-manufacturing industry shows an excessively low degree of backward participation, while it has an excessively high degree of forward participation – proof that services such as transport and communications are now developing their businesses on the global level.

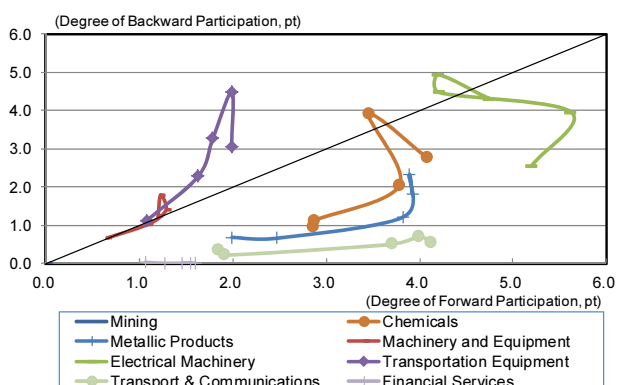
Changes in Global Value Chain Participation Chart 9



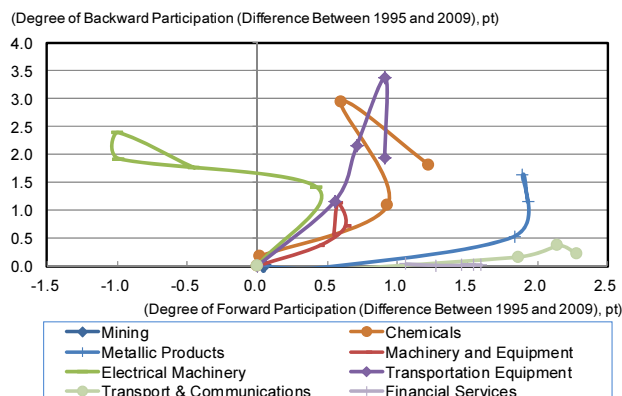
Source: OECD; compiled by DIR.



Source: OECD; compiled by DIR.



Source: OECD; compiled by DIR.



Source: OECD; compiled by DIR.

Economic Indicators and Interest Rates

Chart 10

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	-0.5	6.0	-7.1	4.8	3.0	2.1				
Y/y %	2.5	3.0	-0.1	0.8	1.5	0.4	0.7	2.3	0.7	1.5
Current account balance										
SAAR (Y tril)	0.0	-5.5	2.6	2.6	3.3	3.9	4.2	0.8	3.1	6.3
Unemployment rate (%)	3.9	3.6	3.6	3.7	3.5	3.5	4.3	3.9	3.6	3.4
CPI (excl. fresh foods; 2010 prices; y/y %)	1.1	1.3	3.3	3.3	3.2	3.3	-0.2	0.8	3.3	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	0.50	0.55	0.60	0.76	0.66	0.56	0.70

Source: Compiled by DIR.

Note: Estimates taken from DIR's Japan's Economic Outlook No. 182 Update.