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Japan’s Economy: Monthly Review

Japan’s economy moving gradually toward recovery, but there are four risk factors which require attention

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Summary

- **Japan’s Economy Moving Gradually Toward Recovery:** As of October 7, 2014 the Cabinet Office revised its Assessment of Coincident Index downward from “leveling off” to “signaling a possible turning point” toward a downturn. Currently, DIR sees a 50% chance that Japan’s 2014 Jan-Mar period and after may be officially declared an economic downturn. However, even if an economic downturn is officially declared, we believe that this is merely a short-term adjustment, and that Japan’s economy should move toward a gradual recovery in the near future for the following reasons. (1) As of this point the negative effects of the increase in consumption tax have for the most part completed their cycle, and (2) There are positive factors influencing Japan’s economy in the near future, such as exports, mainly to the US, gradually getting back on track.

- **Four risk factors facing Japan’s economy:** In this report we consider risk factors facing Japan’s economy. These include (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.

1. Japan's Economic Scenario

Cabinet Office revises Monthly Economic Report downward

As of October 7, 2014 the Cabinet Office revised its Assessment of Coincident Index downward from "leveling off" to "signaling a possible turning point" toward a downturn. Currently, DIR sees a 50% chance that Japan's 2014 Jan-Mar period and after may be officially declared an economic downturn.

Japan's economy to move gradually toward recovery in the near future

Even if an economic downturn is officially declared, we believe that this is merely a short-term adjustment, and that Japan's economy should move toward a gradual recovery in the near future for the following reasons. (1) As of this point the negative effects of the increase in consumption tax have for the most part completed their cycle, and (2) There are positive factors influencing Japan's economy in the near future, such as exports, mainly to the US, gradually getting back on track.

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. 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.

2. Four Risk Factors Facing Japan's Economy

2.1 Risk (1): Stagnant personal consumption due to decline in real income

Wage increases in Japan will be encouraged by (1) the weak yen, and (2) stable prices

The first major risk facing Japan's economy which will be discussed here is the problem of stagnant personal consumption due to a decline in real income.

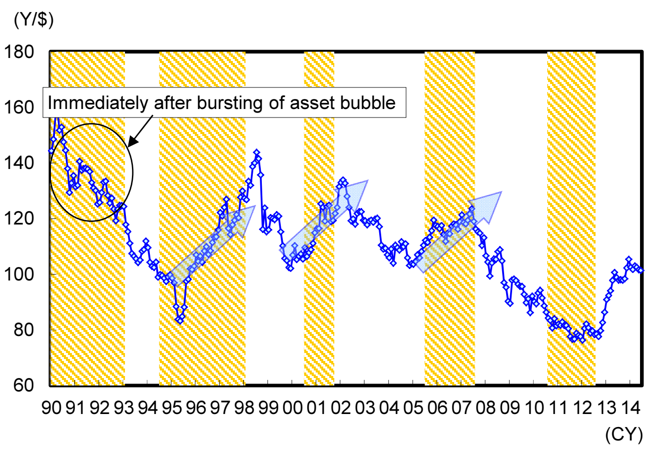
In our main scenario, we forecast two important developments in the Japanese economy. These are (1) a virtuous circle will develop in the economy made up of the following elements: production → personal income → consumption, and (2) the rise in prices associated with the increase in the consumption tax in April this year will eventually pass, and FY2015 real employee compensation will grow by +0.4% in comparison with the previous year.

Charts 1 and 2 analyze the data to identify the type of environment in which growth in real wages would be encouraged. The shaded areas in the charts indicate periods when the growth rate in nominal wages exceeded the growth rate in the consumer price index. In other words, these are growth periods for real wages. According to the charts, two common conditions tend to occur at the same time as these growth phases for real wages. First, as shown in Chart 1, the yen weakens against the dollar. Secondly, as shown in Chart 2, prices on the commodities markets trend downwards.

Interpreting these conditions is highly complex. When the yen is weak, corporate business performance improves. When this occurs, it is naturally easier for wages to rise. On the other hand, when the yen is weak, the price of imports goes up, and this can easily cause an increase in corporate business expenses. Therefore, the second situation mentioned above, that of a decline in commodities prices, is essential in order or the desired environment to develop. When commodities prices are in a downward trend, the extent to which corporate business expenses will rise is limited.

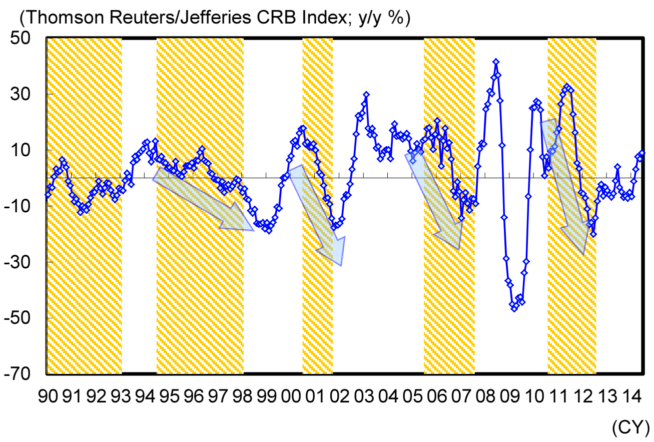
To summarize, the yen has become progressively weaker due to the BOJ's monetary easing policy. Theoretically, this should produce an environment where it is easier for real wages to increase. However, the important factor now is whether commodities prices begin to decline at some point in the future in order to limit the extra cost. We suggest keeping a sharp eye on developments in this area in the future.

Growth in Real Wages and Exchange Rates
Chart 1



Source: Banks of Japan, Ministry of Internal Affairs and Communications; compiled by DIR
Note: Shaded areas indicate periods when growth rate in nominal wages exceeded that of the consumer price index.

Growth in Real Wages and Commodities Prices
Chart 2



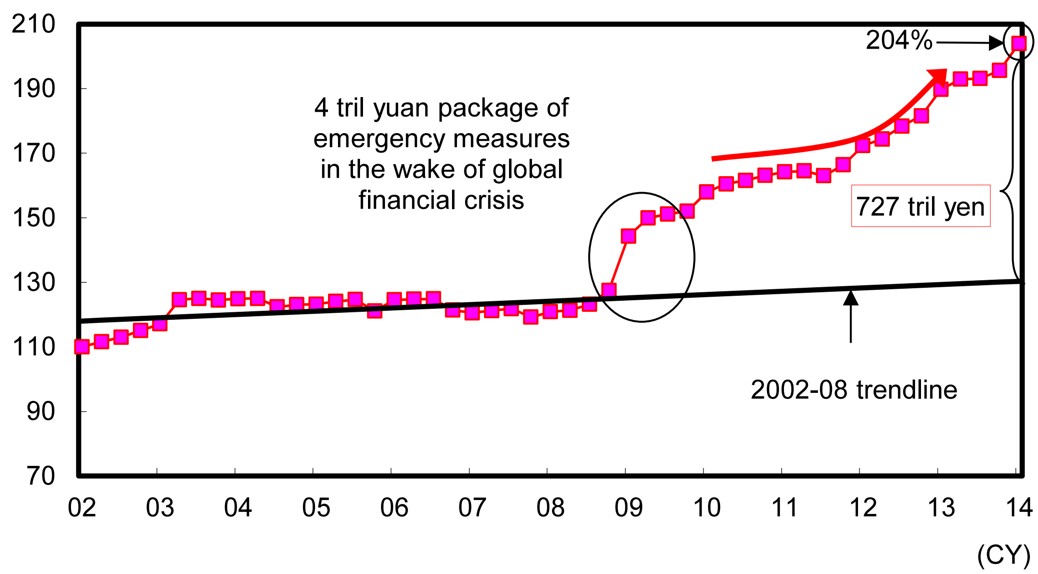
Source: Ministry of Internal Affairs and Communications, Haver Analytics; compiled by DIR
Note: Shaded areas indicate periods when growth rate in nominal wages exceeded that of the consumer price index.

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

The second major risk facing Japan's economy is 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 3 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 3**



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.

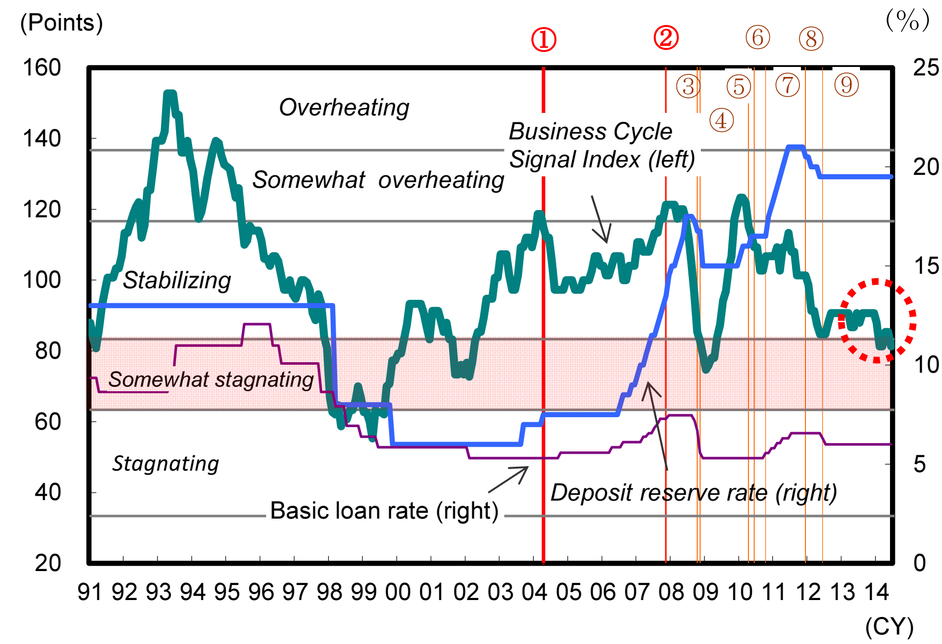
How will the world economy be affected by the collapse of China's debt bubble?

We believe that the impact on the world economy of the collapse of China's debt bubble should not be excessively overstated. Chart 4 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 4**



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

2.3 Risk (3): A surge in crude oil prices stemming from geopolitical risk

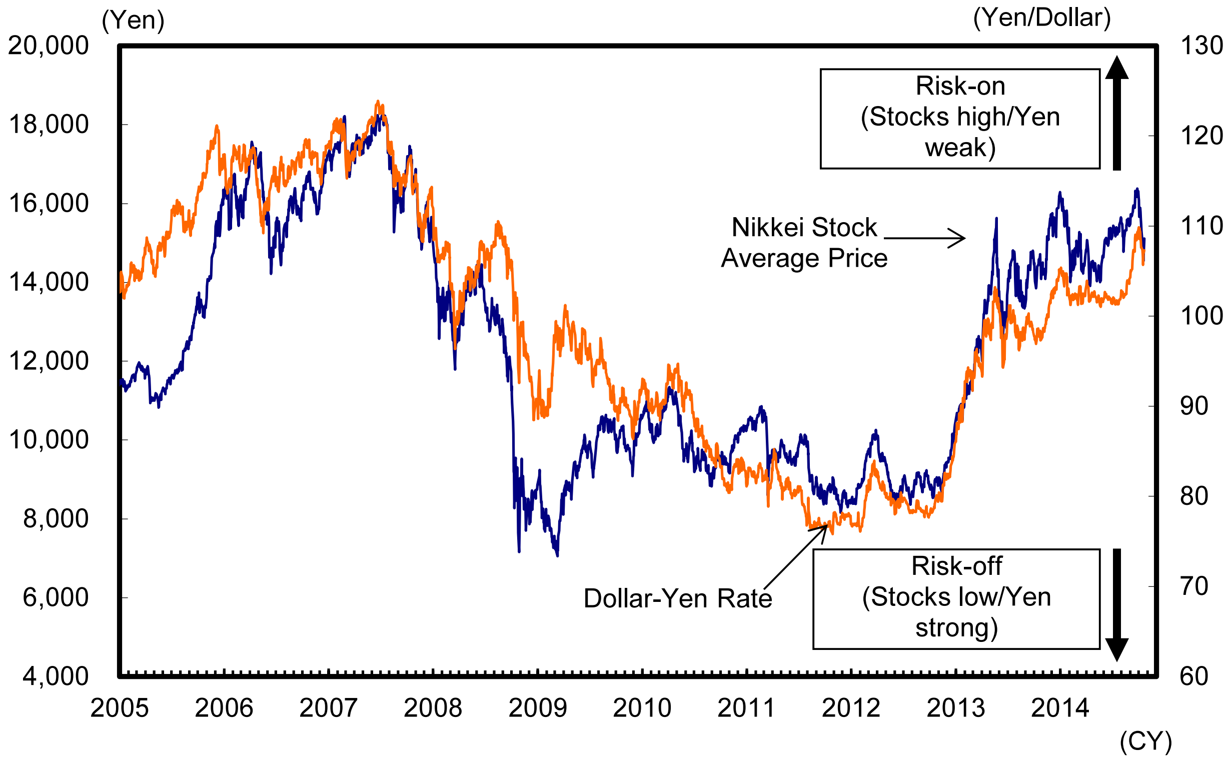
Will investors switch from risk-on to risk-off?

The third risk factor which the Japanese economy faces is geopolitical.

When the sense of caution increases in the business world due to geopolitical risk, the global financial markets tend to move away from risk-on to risk-off investment behavior. Chart 5 shows changes in the yen/dollar rate and the Nikkei stock average price over the last several years. In recent years, the yen exchange rate and the Nikkei average have exhibited a close linkage. As the global economy has begun to recover, investors have shown more willingness to take risks in their investments. This is called "risk-on" behavior. The Bank of Japan's monetary easing measures have also had an effect on investor behavior, and ever since the last part of 2012, investors have acted with a positive, risk-on behavior. The weak yen and rising stock prices have been moving in tandem since that time. In the future, caution in regard to geopolitical risk may encourage investors to switch to a risk-off approach, and the yen could strengthen again, influencing Japan's export business negatively. If this occurs, caution will also be necessary in regard to downward pressure on personal consumption due to falling stock prices.

In addition to a strong yen and falling stock prices, if a greater sense of urgency regarding the situation in the Middle East develops, there will also be the risk of surging oil prices. Over 80% of Japan's oil imports are shipped through the Strait of Hormuz. According to our simulation, if crude oil prices rise by $50/bbl above our standard scenario, real GDP level is forecast to shrink by 0.2% in FY2015.

Dollar-Yen Rate and Nikkei Stock Average Chart 5



Source: Bloomberg; compiled by DIR.

Which countries are most susceptible to geopolitical risk?

Next we examine how the economies of various countries might be affected by geopolitical risk if the Russia-Ukraine situation, as well as developments in Iraq, get any worse (see Chart 6).

First we take a look at geopolitical risk in Russia. Considering Russia's trade relations, we see that the greater share of Russia's exports are to the Netherlands, Italy, and Germany. Russia is closely linked with the EU via energy exports. The balance of credit to Russia is also significant for members of the EU such as France and Italy. As far as we can see by the above data, if geopolitical risk associated with Russia were to worsen in the near future, it is quite possible that Europe would be most susceptible to negative influence in both the financial area and in the real economy.

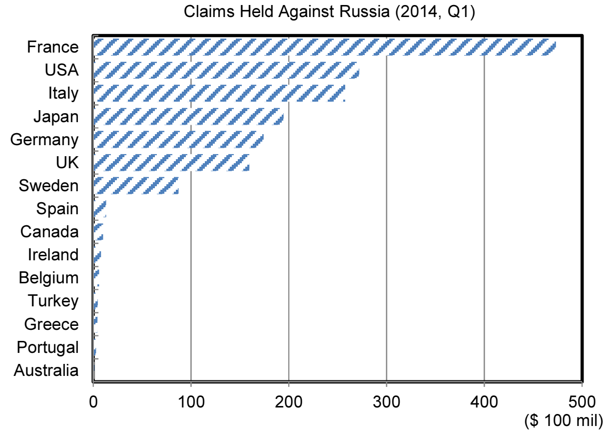
In contrast, if geopolitical risk in Iraq worsens, direct influence on the EU would be limited, as trade levels and credit balance are rather low. However, there is some collateral risk such as the possibility of a surge in the price of crude oil. Countries with an especially high dependence on imported oil could see economic conditions deteriorate rapidly. Hence geopolitical risk in these areas should be continually monitored.

Trade Relations with Russia and Iraq and Claims Held Against Them **Chart 6**

Russian Imports & Exports (2013)

Exports		Imports	
Country	Share (%)	Country	Share (%)
EU	39.4	EU	31.2
Netherlands	13.3	China	16.9
Italy	7.5	Germany	12.0
Germany	7.0	USA	5.3
China	6.8	Ukraine	5.0
Turkey	4.8	Italy	4.6
Ukraine	4.5	Belarus	4.4
Belarus	3.8	Japan	4.3
Japan	3.7	France	4.1
Poland	3.7	Korea	3.3

Source: Statistics from IMF; compiled by DIR.

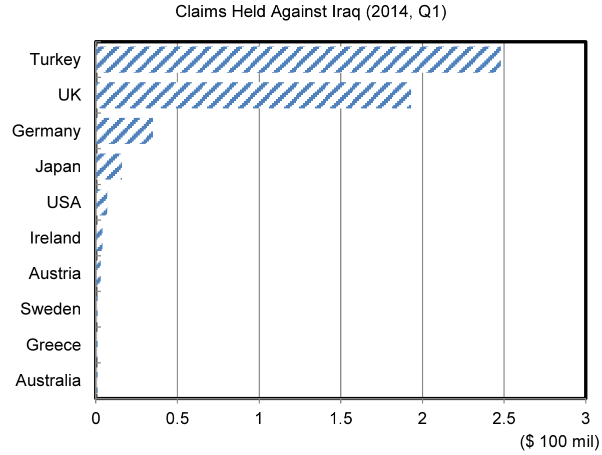


Source: Statistics from BIS; compiled by DIR.

Iraq Imports & Exports (2013)

Exports		Imports	
Country	Share (%)	Country	Share (%)
India	21.6	Turkey	25.4
China	19.8	Syria	18.1
EU	15.1	China	14.7
USA	14.6	EU	11.2
Korea	10.2	USA	4.3
Greece	5.3	Korea	4.2
Italy	4.3	Germany	3.5
Canada	3.8	Italy	3.5
Singapore	3.3	Jordan	2.6
Japan	2.9	India	2.0

Source: Statistics from IMF; compiled by DIR.



Source: Statistics from BIS; compiled by DIR.

2.4 Risk (4): Tumult in emerging markets in response to the US exit strategy

The US exit strategy will be a plus for the Japanese economy

The fourth risk factor facing Japan's economy is the question of whether or not the US exit strategy will cause tumult in the emerging markets.

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 the US long-term interest rate will rise gradually in a mirroring of the recovery in the actual economy. Chart 7 shows changes in the US long-term interest rate and TOPIX. Movements of these two indices have fairly close linkage.

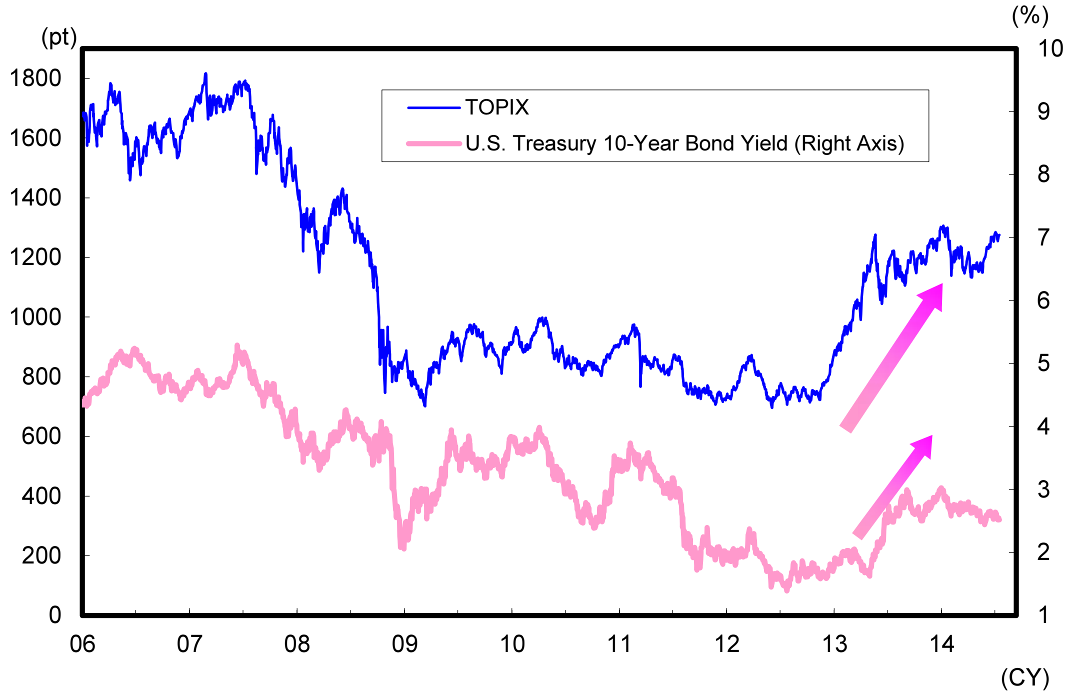
The question is why are the US long-term interest rate and Japanese stocks so closely linked?

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 7**



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

Simulation of influence US exit strategy and growth rate in domestic demand will have on world economy

In considering the future of the global economy, it is necessary to pay particular attention to the direction of the US. At this time there are a few factors causing a bit of concern, but all in all, the US economy is continuing growth with a steady undertone, focusing on domestic demand. With the turnaround of the economy, the FRB is now starting to decrease the extent of its quantitative monetary easing (i.e., tapering). Some observers report that interest rates will be raised some time in 2015.

US economic growth, which will be followed by growth in imports, will jump-start the world economy. On the other hand, the raising of US interest rates may bring pressure for a correction in global money flow, and therefore could have the effect of slowing the global economic growth rate due to the raising of interest rates and fluctuation in exchange rates in the advanced nations and emerging nations.

The question for the future will be whether, amongst all of the factors present which will influence the rest of the world, it will all come down more on the positive or the negative side. A simplified model is shown in Chart 8, which analyzes the influence which the pace of the US exit strategy and trends in US domestic demand will have on the world economy. The results of this analysis indicate that the emerging nations will be influenced by the pace of the US exit strategy, while the advanced nations will find trends in US domestic demand to be more important.

For instance, if the pace of the raising of US interest rates is moved up to the beginning of 2015 and the increase in interest rates progresses rapidly, GDP in the emerging nations will fall 0.89% below the base scenario in 2016. In comparison, the percentage of decline in the advanced nations would be only 0.09%, a rather more limited effect than in the case of the emerging nations.

Looking at the influence brought by fluctuation in US domestic demand, a slowdown of around 1.01% for the advanced nations can be assumed, while a downward swing of 0.16% can be predicted for the emerging nations. In other words, those advanced nations with a direct connection to the US will be more influenced by fluctuations in US domestic demand.

To sum up the above analysis, if the Federal Reserve takes a careful approach to its exit strategy, going at an appropriate pace in relation to the recovery of the real economy, then the world economy will also get back on the road to steady recovery.

Influence of US Exit Strategy and Growth in Domestic Demand on World Economy **Chart 8**

Deviation (%) from 2016 GDP Base Scenario		Growth Rate of US Domestic Demand: Slower Pace		Base Scenario		Rapid	
Pace of Exit Strategy	Gradual	Advanced Nations	-0.92	Advanced Nations	0.09	Advanced Nations	1.12
		Emerging Nations	0.72	Emerging Nations	0.89	Emerging Nations	1.06
		World	-0.39	World	0.35	World	1.10
	Base Scenario	Advanced Nations	-1.01	Base Scenario		Advanced Nations	1.03
		Emerging Nations	-0.16			Emerging Nations	0.17
		World	-0.74			World	0.75
	Rapid	Advanced Nations	-1.10	Advanced Nations	-0.09	Advanced Nations	0.93
		Emerging Nations	-1.06	Emerging Nations	-0.89	Emerging Nations	-0.72
		World	-1.09	World	-0.35	World	0.40

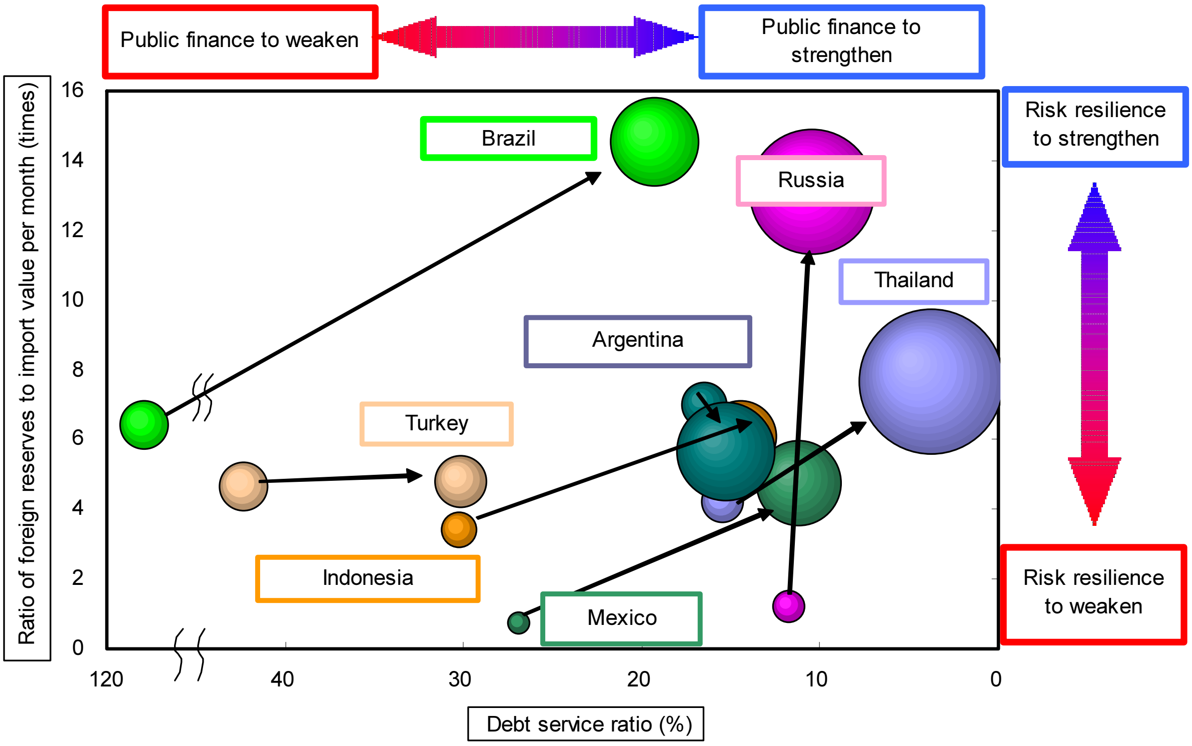
Source: Compiled by DIR.
Note: Growth rate of US domestic demand since 2014 and estimated fluctuations in term premium. The more rapidly the exit strategy progresses, the more steep the term premium's rise. Here influence of increases in term premium of the US Treasury bond on real interest of advanced nations and emerging nations was calculated, along with the influence of the growth rate in US domestic demand on world export/import volume.

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 9 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 9



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.

Economic Indicators and Interest Rates — Chart 10

Indicator	2013 Oct-Dec	2014 Jan-Mar	2014 Apr-Jun	2014 Jul-Sep	2014 Oct-Dec	2015 Jan-Mar	FY12	FY13	FY14	FY15
	Actual			DIR estimates			Actual		DIR estimates	
Real GDP										
Q/q %, annualized	-0.5	6.0	-7.1	3.1	3.0	2.1				
Y/y %	2.5	3.0	-0.1	0.3	1.1	0.0	0.7	2.3	0.3	1.4
Current account balance SAAR (Y tril)	0.0	-5.5	2.6	2.3	3.0	3.6	4.2	0.8	2.9	6.0
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	3.2	3.0	3.1	-0.2	0.8	3.2	1.8
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; %)	0.61	0.61	0.59	0.52	0.55	0.60	0.75	0.63	0.56	0.70

Source: Compiled by DIR.
Notes: 1) Estimates taken from DIR's Japan's Economic Outlook No. 182 Update.
2) Estimates for FY2014 and FY2015 are provisional.