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Jul-Sep 2016 2nd Preliminary GDP Estimate

GDP revised downwards. Changes in how GDP is estimated have limited effect on our assessment of the economy

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Summary

- The real GDP growth rate for Jul-Sep 2016 (2nd preliminary est) was revised downwards to +1.3% q/q annualized (+0.3% q/q) in comparison to the 1st preliminary report (+2.2% q/q annualized and +0.5% q/q), while at the same time falling below market consensus (+2.3% q/q annualized and +0.6% q/q).

- Despite the negative outcome for the revised version, its major cause is thought to be the short-term downturn due to inventory fluctuation and major revisions in methods and standards used in estimating GDP. Hence there is no need for pessimism because of these results. Looking at the basic tone of real GDP, our current assessment of the Japanese economy is that it is beginning to move toward making a comeback that should pull it out of its recent lull.

- Performance by demand component in light of revisions from the 1st preliminary results shows that while private final consumption expenditure was revised upwards, private-sector capital investment, fluctuations in private sector inventory, and net exports were all revised downwards, bringing downward pressure on overall results.

2016 Jul-Sep GDP (2nd Preliminary Estimate) **Chart 1**

		2015		2016			
		Jul-Sep	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	
						First	Second
Real GDP	Q/q %	0.2	-0.4	0.7	0.5	0.5	0.3
Annualized	Q/q %	0.8	-1.8	2.8	1.8	2.2	1.3
Personal consumption	Q/q %	0.5	-0.7	0.4	0.2	0.1	0.3
Private housing investment	Q/q %	1.8	-1.2	1.3	3.5	2.3	2.6
Private non-housing investment	Q/q %	0.6	0.4	-0.3	1.4	0.0	-0.4
Change in private inventories (contribution to real GDP growth)	Q/q % pts	-0.2	-0.1	-0.1	0.2	-0.1	-0.3
Government consumption	Q/q %	0.4	0.7	1.3	-1.1	0.4	0.3
Public investment	Q/q %	-0.5	-2.8	-0.7	1.6	-0.7	0.1
Exports of goods and services	Q/q %	2.1	-0.6	0.8	-1.3	2.0	1.6
Imports of goods and services	Q/q %	2.5	-0.9	-1.2	-0.9	-0.6	-0.4
Domestic demand (contribution to real GDP growth)	Q/q % pts	0.3	-0.5	0.3	0.5	0.1	-0.0
Foreign demand (contribution to real GDP growth)	Q/q % pts	-0.1	0.1	0.4	-0.1	0.5	0.3
Nominal GDP	Q/q %	0.6	-0.3	0.8	0.2	0.2	0.1
Annualized	Q/q %	2.3	-1.0	3.1	1.0	0.8	0.5
GDP deflator	Y/y %	1.8	1.5	0.9	0.4	-0.1	-0.2

Source: Cabinet Office; compiled by DIR.
Notes: 1) Due to rounding, contributions do not necessarily conform to calculations based on figures shown.
2) Q/q figures seasonally adjusted basis.

Real GDP growth rate revised downwards from 1st preliminary

The real GDP growth rate for Jul-Sep 2016 (2nd preliminary est) was revised downwards to +1.3% q/q annualized (+0.3% q/q) in comparison to the 1st preliminary report (+2.2% q/q annualized and +0.5% q/q), while at the same time falling below market consensus (+2.3% q/q annualized and +0.6% q/q). But despite the negative outcome for the revised version, its major cause is thought to be the short-term downturn due to inventory fluctuation and major revisions in methods and standards used in estimating GDP. Hence there is no need for pessimism because of these results. Looking at the basic tone of real GDP, our current assessment of the Japanese economy is that it is beginning to move toward making a comeback that should pull it out of its recent lull.

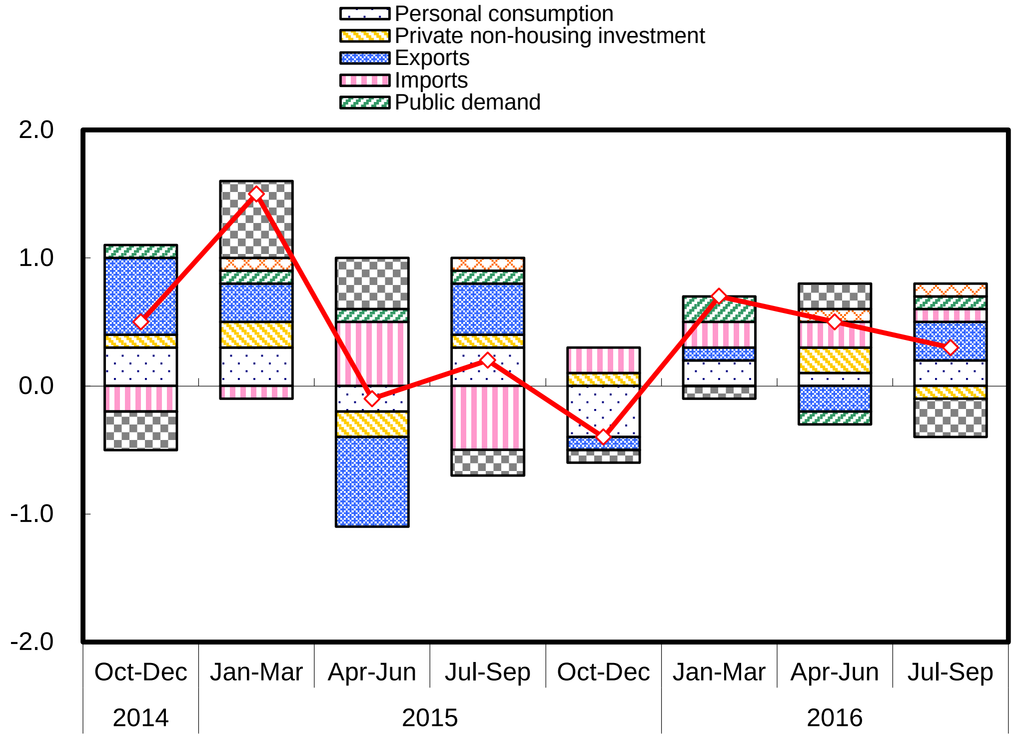
Downward revision of private sector capex, inventory, and net exports brings downward pressure on overall results

Performance by demand component indicates that, while private final consumption expenditure was revised upwards, private-sector capital investment, fluctuations in private sector inventory, and net exports were all revised downwards, bringing downward pressure on overall results.

Private final consumption expenditure was revised upwards to +0.3% q/q (+0.1% on the 1st preliminary). Meanwhile, of particular note is the fact that the overall trend in consumption since the beginning of 2016 has been revised upwards due to major revisions in methods and standards used in estimating GDP. Private-sector capital investment was revised downwards to -0.4% q/q (+0.0% on the 1st preliminary). This was due to the inclusion of data from corporate statistics and the considerable upward shift of Apr-Jun 2016 results to a higher level as a result of revisions in methods and standards used in estimating GDP, which then brought on a reactionary decline on the Jul-Sep period report. When we check on the midterm revision situation, we find that the contribution to real GDP growth of capex is appropriately assessed in a way that gives it a gentle upward revision. Inventory investment's contribution was revised downwards to -0.3%pt q/q (-0.1%pt on the 1st preliminary), falling below market consensus (-0.1%pt). Looking at GDP contribution by inventory class, we see that of the four inventory classes, the downward revision of finished goods had the largest influence on GDP. Meanwhile, exports were revised downwards, while imports were revised upwards. This resulted in the downward revision of net exports (exports – imports).

As for other items, housing investment and government fixed capital formation were revised upwards from the 1st preliminary, while government consumption was revised downwards, but the effect on overall GDP was negligible.

Contribution to Real GDP (% pt; seasonally adjusted basis) Chart 2



Source: Cabinet Office; compiled by DIR.

Major revisions in methods and standards used in estimating GDP: Three changes come one on top of the other

It is especially important to note that the Jul-Sep 2016 2nd Preliminary GDP Estimate has felt the effect of three major changes in methods of estimating GDP coming one on top of the other. These are (1) First annual estimate (previously referred to as *Kakuhō*), (2) Revision of standards (switch from 2005 standard to 2011 standard, and (3) Change in international standard – System of National Accounts (SNA). (Switch from 1993 SNA to 2008 SNA.) The last time a switch was made in international standards was in 2000 when Japan switched from use of 1968 SNA to 1993 SNA.

Results on the Jul-Sep 2016 2nd Preliminary GDP Estimate were affected as follows: (1) The level of capital expenditure shifted upwards considerably due to capitalization of R&D, and the midterm trend in capex was revised moderately upwards, (2) Private final consumption expenditure was revised upwards from the beginning of 2016, and (3) Changes had limited effect on our assessment of the economy.

Overseas demand the driving force; consumption continues to bottom out

Performance by demand component in the Jul-Sep 2016 results (2nd preliminary) shows private sector final consumption expenditure up for the third consecutive quarter by +0.3% q/q (+0.1% on the 1st preliminary). Results were favorable despite the negative effects of typhoons which hit Japan in greater number than normal this year, and the unusually hot weather nationwide which continued into early autumn, taking a bite out of growth in purchase of seasonal items.

Housing investment grew for the third consecutive quarter at +2.6% (+2.3% on the 1st preliminary). New housing starts, a leading indicator for housing investment as a portion of GDP, are continuing to grow as a result of lower interest rates, growth in rental property construction as an inheritance tax strategy, and last-minute demand which developed on the assumption that the consumption tax would again be increased in April of 2017. This in turn gave a lift to housing investment, which is recorded on a progressive basis.

Capital expenditure on the part of private sector corporations declined for the second consecutive quarter at -0.4% q/q (+0.0% on the 1st preliminary), apparently taking a breather from its growth trend. Though corporate earnings remain at a high level, the source of growth is not volume, but rather the decline in the cost of input and growth in the calculated price of exports. It has not led to an increase in operating rates. Moreover, the slowdown in the overseas economy and the progressively strong yen which lasted through summer create a major headwind for capex.

Private sector inventory's contribution declined for the first time in two quarters at -0.3%pt q/q (-0.1%pt on the 1st preliminary). Contribution of distribution inventory to real GDP growth was negative. Meanwhile, work in progress inventory and material & supplies inventories, which are provisional on the 1st preliminary GDP estimate, also made negative contributions. Finished goods contributed zero on a q/q basis.

Public investment grew for the second consecutive quarter at +0.1% q/q (-0.7% on the 1st preliminary), but came in pretty much at the level of marking time. While the government having front-loaded the FY2015 supplementary budget brought a plus, the positive effect of past economic policies on public investment has begun to peter out. Government consumption was up by +0.3% q/q (+0.4% on the 1st preliminary). When averaged out this constitutes a continuation of the growth trend.

Exports grew for the first time in two quarters at +1.6% q/q (+2.0% on the 1st preliminary). As for exports of goods, Asia has maintained the favorability of the previous quarter, while exports to the US and the EU show signs of a comeback. As for Asia, export volume of ICs expanded in anticipation of the marketing of new smart phone models. Meanwhile, export volume of automobiles to the US maintained a firm undertone despite some fluctuations. In a reflection of stagnant domestic demand, imports declined for the fourth consecutive quarter at -0.4% q/q (-0.6% on the 1st preliminary). As a result, overseas demand had a positive contribution of +0.3%pt (+0.5%pt on the 1st preliminary) to GDP.

Moderate recovery expected for Japan's economy, but caution required regarding the policies of President elect Trump

We expect Japan's economy to continue in a moderate expansion phase. However, caution is required as domestic demand continues to lack strength. Overseas demand is expected to continue its gradual expansion. However, if the world economy becomes more uncertain in the future, this could cause domestic demand to stagnate, and to become a negative factor bringing downward pressure on Japan's overall economy. A further risk is the expectation that the US Fed will increase interest rates within the year. Doing so could cause a slowdown in the US economy, or capital outflow from the emerging nations associated with interest hikes. Meanwhile, caution is required regarding worldwide stock price lows and a rapid depreciation of the dollar due to risk-off behaviors, which could occur depending on future policy decisions of President elect Donald Trump.

Personal consumption is expected to continue in a moderate expansion phase. The supply of labor continues to be tight, and this should provide underlying support for personal consumption through growth in employee compensation. Meanwhile, the growth rate in the consumer price index has turned in the negative direction, and this promises to continue pushing up real wages. This should provide a boost to personal consumption. On the other hand, since the election of Donald Trump to the US presidency, the possibility has appeared that the yen may become progressively weaker and materials prices may increase. The price of crude oil has already gone up in response to OPEC's recent decision to cut production. Just recently the price of fresh foods has gone up, and the CPI risen especially on imports. Households may become more budget-minded in the future because of these developments, hence caution is required.

Meanwhile, housing investment is expected to gradually slow down. Interest on housing loans remains low, and therefore should provide continued underlying support. However, housing starts, which had rapidly expanded with the expectation that there would be a rush to purchase homes before the additional increase in consumption tax originally planned for April 2017, are expected to decrease in the future, especially for urban area condominiums, and housing investment is also expected to begin declining after that point.

Capex is expected to continue marking time. The balance of supply and demand for labor continues to be tight, and this should provide underlying support for replacement and renovation investment in the non-manufacturing industries. On the other hand, the stagnant world economy and the strong yen/weak dollar situation, especially in manufacturing, bring an increasing sense that corporate earnings are about to peak out. Corporations are therefore likely to become more cautious as regards capex spending in the future.

Public investment is expected to move toward a comeback as we approach fiscal year-end. The government’s second supplementary budget, which includes economic policy measures, has taken shape, and this should gradually provide more upward pressure for public investment as we move closer to the end of the fiscal year.

As for exports, with overseas economies continuing moderate growth, we can expect exports to maintain a firm undertone, centering on consumer goods. Looking at exports of goods by region, consumer goods are expected to maintain a strong undertone in the US, EU, and Asia backed by improvements in employment environment, the effects of monetary easing, and favorable personal consumption in all regions. On the other hand, growth in corporate earnings in the US is at a low level, and overcapacity in Asia, especially in the steel industry, requires adjustment. There is a good possibility that exports of capital goods and materials will continue to be slow.