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Oct-Dec 2016 2nd Preliminary GDP Estimate

GDP revised upwards to +1.2% q/q annualized (+0.3% q/q) centering on capex

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Summary

- The real GDP growth rate for Oct-Dec 2016 (2nd preliminary est) was revised upwards to +1.2% q/q annualized (+0.3% q/q) in comparison to the 1st preliminary report (+1.0% q/q annualized and +0.2% q/q), while at the same time falling below market consensus (+1.6% q/q annualized and +0.4% q/q). Major revisions in comparison to the 1st preliminary report in terms of performance by demand component are as follows: fluctuations in private sector inventory, private sector housing investment, and public investment were all revised downwards, while private sector corporate capital investment and private sector consumption were revised upwards, bringing upward pressure on overall results.

- Though revised figures did not reach the level of market consensus, the main cause is considered to be advances achieved in inventory adjustment, and hence should not be cause for excessive pessimism. With an upward revision centering on capex, the most important development of note is the Japanese economy's gradual shift to more balanced growth, driven by both domestic and overseas demand rather than by overseas demand alone. Our main scenario for Japan's economy is reconfirmed by these results, which show the economy to be heading for a comeback after having been in a temporary lull.

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

		2015	2016				
		Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	
						First	Second
Real GDP	Q/q %	-0.2	0.5	0.5	0.3	0.2	0.3
Annualized	Q/q %	-1.0	1.9	2.2	1.2	1.0	1.2
Personal consumption	Q/q %	-0.6	0.4	0.2	0.3	-0.0	0.0
Private housing investment	Q/q %	-1.0	1.5	3.3	2.4	0.2	0.1
Private non-housing investment	Q/q %	0.1	-0.2	1.4	-0.1	0.9	2.0
Change in private inventories (contribution to real GDP growth)	Q/q % pts	0.0	-0.3	0.3	-0.3	-0.1	-0.2
Government consumption	Q/q %	0.7	1.3	-1.1	0.2	0.4	0.3
Public investment	Q/q %	-1.3	-1.2	1.0	-0.9	-1.8	-2.5
Exports of goods and services	Q/q %	-0.8	0.9	-1.2	2.1	2.6	2.6
Imports of goods and services	Q/q %	-0.8	-1.1	-1.0	-0.3	1.3	1.3
Domestic demand (contribution to real GDP growth)	Q/q % pts	-0.3	0.1	0.6	-0.1	-0.0	0.1
Foreign demand (contribution to real GDP growth)	Q/q % pts	0.0	0.3	-0.0	0.4	0.2	0.2
Nominal GDP	Q/q %	-0.2	0.7	0.4	0.1	0.3	0.4
Annualized	Q/q %	-0.8	2.7	1.4	0.5	1.2	1.6
GDP deflator	Y/y %	1.5	0.9	0.4	-0.1	-0.1	-0.1

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 upwards from 1st preliminary, but falls below market consensus

The real GDP growth rate for Oct-Dec 2016 (2nd preliminary est) was revised upwards to +1.2% q/q annualized (+0.3% q/q) in comparison to the 1st preliminary report (+1.0% q/q annualized and +0.2% q/q), while at the same time falling below market consensus (+1.6% q/q annualized and +0.4% q/q).

Though revised figures did not reach the level of market consensus, the main cause is considered to be advances achieved in inventory adjustment, and hence should not be cause for excessive pessimism. With an upward revision centering on capex, the most important development of note is the Japanese economy's gradual shift to more balanced growth, driven by both domestic and overseas demand rather than by overseas demand alone. Our main scenario for Japan's economy is reconfirmed by these results, which show the economy to be heading for a comeback after having been in a temporary lull.

Upward revision of private sector capex brings upward pressure on overall results

Major revisions in comparison to the 1st preliminary report in terms of performance by demand component are as follows: fluctuations in private sector inventory, private sector housing investment, and public investment were all revised downwards, while private sector corporate capital investment and private sector consumption were revised upwards, bringing upward pressure on overall results.

Private final consumption expenditure was up just a tad reflecting December fundamental statistics to +0.0% q/q (-0.0% on the 1st preliminary). Durable goods continued their strong performance, while semi-durables declined by a bit less than previously. Services expanded though extent of growth was small, and non-durables increased the extent of their decline.

Private-sector capital investment was revised upwards in response to corporate statistics to +2.0% q/q (+0.9% on the 1st preliminary). Gross fixed capital formation by category sees major growth in transport equipment, but momentum is gradually slowing. Other machinery and equipment, as well as intellectual property products were up and down, but managed in the end to record gains. On the other hand, housing investment and other buildings and structures, which had continued in a growth trend until the middle of 2016, shifted into decline though by a small amount.

Inventory investment was revised downwards to -0.2% q/q (-0.1% on the 1st preliminary). Looking at contribution to GDP by category we see that while there were upward revisions for raw materials inventory and finished goods inventory, work in progress inventory was revised downwards, bringing down overall performance along with it. Public investment was revised downwards reflecting the latest developments to -2.5% q/q (-1.8% on the 1st preliminary). There were no revisions to performance of imports and exports. While there were slight downward revisions for housing investment and government consumption, there was not much influence on the overall GDP figure.

Overseas demand the driving force, but domestic gradually increases contribution to overall GDP

Performance by demand component in the Oct-Dec 2016 2nd preliminary results shows private sector final consumption expenditure achieving growth, though small, for the fourth consecutive quarter at +0.0% q/q (-0.0% on the 1st preliminary). Prices rose for energy and fresh foods bringing downward pressure on durables and semi-durables, but the replacement cycle for durables which has been ongoing since the beginning of FY2016 provided an extra wind.

Housing investment achieved growth, though small, for the fourth consecutive quarter at +0.1% q/q (+0.2% on the 1st preliminary). Housing investment has maintained its growth trend up to this point as a result of lower interest rates on housing loans, 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. However, there are recently signs of peaking out as the effects of last minute demand begin to dwindle.

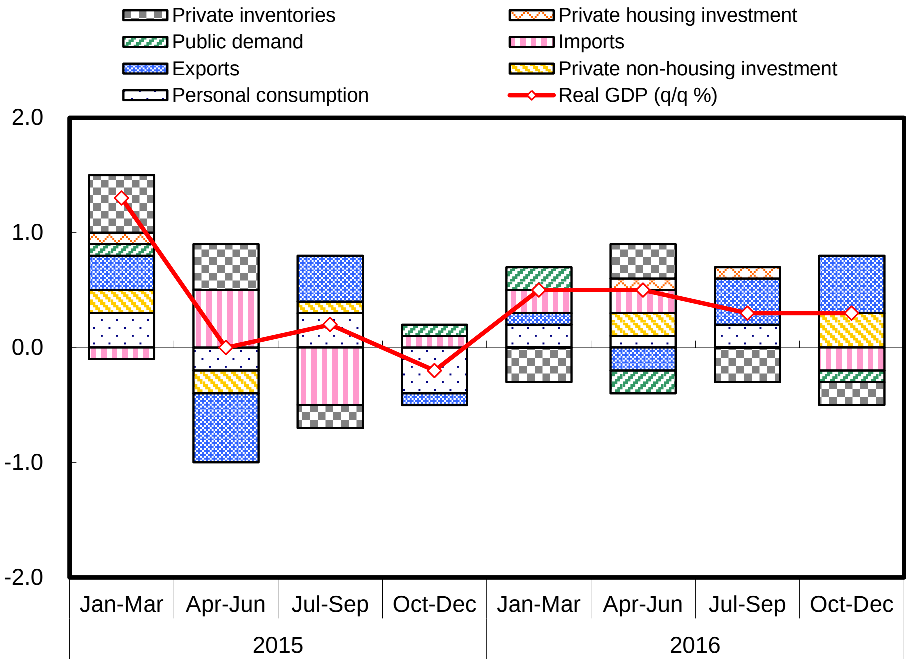
Capital expenditure on the part of private sector corporations is maintaining a firm undertone despite ups and downs at +2.0% q/q (+0.9% on the 1st preliminary). Corporate earnings remain at a high level, and this has pushed up capital expenditure, especially in labor-saving and rationalization due to the continuing labor shortage. In addition, there has been growth in demand for construction as non-manufacturers focus on distribution facilities and warehouses, bringing a positive contribution to capex spending.

Private sector inventory declined for the second consecutive quarter at -0.2%pt q/q (-0.1%pt on the 1st preliminary), making a negative contribution to GDP. Overall, inventory adjustment I progressing, but distribution inventory made a major negative contribution, thereby pulling down overall results.

Public investment declined for the second consecutive quarter at -2.5% q/q (-1.8% on the 1st preliminary). The positive effects of past stimulus packages are now falling away, and this is seen as having brought a negative contribution to GDP. Government consumption was up by +0.3% (+0.4% on the 1st preliminary). When averaged out this constitutes a continuation of the growth trend.

Exports grew for the second consecutive quarter at +2.6% q/q (+2.6% on the 1st preliminary). Exports of various goods were favorable, especially to Asia, but the US and EU as well. Exports of automobiles to the US maintained a steady undertone, while exports of transport equipment to Asia, including passenger vehicles, buses and trucks were also favorable, in addition to exports of ICs. Meanwhile, imports achieved growth for the first time in five quarters at +1.3% q/q (+1.3% on the 1st preliminary). As a result, contribution of overseas demand to GDP increased by +0.2%pt q/q, bringing a positive contribution to GDP for the second consecutive quarter.

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



Source: Cabinet Office; compiled by DIR.

Moderate recovery expected for Japan's economy, but risk of possible downturn remains

We expect Japan's economy to continue in a moderate expansion phase. However, caution is required even as overseas demand continues its gradual expansion. 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, causing a slowdown in the US economy or capital outflow from the emerging nations. Meanwhile, the future of the world economy could become increasingly uncertain if US trade policy becomes more protectionist oriented. These are all risk factors which could bring negative pressure on Japan's economic growth, which is driven by overseas demand.

Personal consumption is expected to continue in a moderate expansion phase. The supply of labor remains tight, and this should provide underlying support for personal consumption through growth in employee compensation. However, the one worrisome point is that the CPI has been on the rise since last October due to rising prices of fresh foods. Meanwhile, the government is encouraging corporations to increase base salary rates during the annual spring labor offensive in 2017. However, many corporations, which are becoming worried about future business performance, are taking the stance that they will raise annual salaries but not monthly wages. Keeping in mind the influence of prices, if real wages begin to stagnate, households will likely tighten the purse strings.

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 condominiums, and housing investment is also expected to begin declining after that point.

Capex is expected to see gradual growth. The supply of labor continues to be tight, and this should provide underlying support for investment in labor-saving and rationalization due to the continuing labor shortage in the non-manufacturing industries. Meanwhile, research & development expenses, which were to be recorded after the Jul-Sep period 2nd preliminary report, should also be a factor pushing up capex spending. However, it is important to be aware that although corporate earnings remain at a high level, this is due merely to the decline in input cost and not growth in volume. A more substantial increase in capex spending would be dependent on an increase in operating rate, and this can come only from the expansion of overseas demand.

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

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. However, if the US becomes extremely protectionist in its trade policy, it could cause world trade to stagnate. We expect this to remain as a mid to long-term risk factor. If trade friction with the US comes to the surface, Japan's export industries, especially the automobile industry, would likely take a serious hit.