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Jan-Mar 2017 1st Preliminary GDP Estimate

Growth picks up at +2.2% q/q annualized. Final numbers for FY2016 GDP also show accelerated growth at +1.3%

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Summary

- The real GDP growth rate for Jan-Mar 2017 (1st preliminary est) grew by +2.2% q/q annualized (+0.5% q/q), exceeding market consensus (+1.8% q/q annualized, +0.4% q/q). Almost all major GDP components exhibited growth, including personal consumption, capex, housing investment, public investment, government consumption, private sector inventory, exports, and imports (note: growth in imports is a negative contribution to growth rate). Performance was positive overall, and growth was led notably by domestic demand (contribution was +0.4% q/q). Meanwhile, terms of trade deteriorated due to growth in import prices, and the GDP deflator declined as a result.

- Current results show the FY2016 GDP growth rate to have accelerated in comparison to FY2015, with y/y growth at +1.3%. Until now the driving force behind Japan's economic growth was overseas demand (y/y contribution to GDP growth rate +0.8%pt), but domestic demand has also recorded favorable growth, centering on personal consumption, capex, and housing investment. On the other hand, private sector inventory declined to -0.3%pt y/y, and public investment continues on the low side declining by -3.2%. The GDP deflator declined by -0.2%, dragged down by the slow performance of the domestic demand deflator at -0.4%. This brings the nominal GDP growth rate to +1.2%.

- We expect Japan's economy to continue in a moderate expansion phase. Domestic demand is expected to maintain favorable performance despite ups and downs, while overseas demand is expected to expand due to recovery in the world economy, providing major support for Japan's economic growth. However, downside risk remains for overseas demand requiring caution due to US trade policy and rising geopolitical risk. Meanwhile, we also urge caution regarding rising interest rates accompanying the slowdown of the US economy, and the problem of capital outflows from the emerging nations.

Growth picks up at +2.2% q/q annualized. Almost all major components record growth

The real GDP growth rate for Jan-Mar 2017 (1st preliminary est) grew by +2.2% q/q annualized (+0.5% q/q), exceeding market consensus (+1.8% q/q annualized, +0.4% q/q). Almost all major GDP components exhibited growth, including personal consumption, capex, housing investment, public investment, government consumption, private sector inventory, exports, and imports (note: growth in imports is a negative contribution to growth rate). Performance was positive overall, and growth was led notably by domestic demand (contribution was +0.4% q/q). Meanwhile, terms of trade deteriorated due to growth in import prices, and the GDP deflator declined as a result.

2017 Jan-Mar GDP (1st Preliminary Estimate) **Chart 1**

		2016				2017
		Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
Real GDP	Q/q %	0.6	0.4	0.2	0.3	0.5
Annualized	Q/q %	2.6	1.7	1.0	1.4	2.2
Personal consumption	Q/q %	0.3	0.2	0.4	0.0	0.4
Private housing investment	Q/q %	1.1	3.1	2.7	0.4	0.7
Private non-housing investment	Q/q %	0.1	1.3	-0.2	1.9	0.2
Change in private inventories (contribution to real GDP growth)	Q/q % pts	-0.3	0.3	-0.4	-0.2	0.1
Government consumption	Q/q %	1.4	-1.1	0.2	0.1	0.1
Public investment	Q/q %	-0.3	0.7	-1.3	-3.0	-0.1
Exports of goods and services	Q/q %	0.5	-1.4	1.9	3.4	2.1
Imports of goods and services	Q/q %	-2.0	-1.1	-0.2	1.3	1.4
Domestic demand (contribution to real GDP growth)	Q/q % pts	0.2	0.5	-0.1	-0.0	0.4
Foreign demand (contribution to real GDP growth)	Q/q % pts	0.4	-0.1	0.4	0.4	0.1
Nominal GDP	Q/q %	0.9	0.2	0.1	0.4	-0.0
Annualized	Q/q %	3.7	1.0	0.3	1.7	-0.1
GDP deflator	Y/y %	0.9	0.4	-0.1	-0.0	-0.8

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.

Domestic demand becomes driving force, centering on consumption and housing investment

Performance by demand component in the Jan-Mar 2017 results shows private sector final consumption expenditure exhibiting growth for the fifth consecutive quarter by +0.4% q/q. In addition to continued improvements in the employment environment due to the labor shortage, the issue of higher prices for fresh foods, which weighed down consumption during the Oct-Dec 2016 period, appears to be resolving. Coupled with improvement in consumer confidence, this has contributed to a comeback in personal consumption. Looking at personal consumption by sector we see durables maintaining a steady undertone at +2.0% and services continuing to expand at +0.4%. Positive results have been encouraged by the gradual dissipation of the negative effects of pre-consumption over demand and Eco-car related tax breaks, which helped to increase consumption since 2009 along with the Ecopoint program effecting household electronics, as well as last-minute demand prior to the increase in consumption tax. Meanwhile, a comeback was also seen for semidurables (+3.2%), which were weak throughout CY2016. On the other hand, non-durables suffered their fourth consecutive quarter of decline at -0.6%, weighed down by the previously mentioned price factor.

Housing investment grew for the fifth consecutive quarter at +0.7% q/q. Housing investment has continued its growth trend with the help of a variety of factors, including low interest housing loans, growth in the construction of rental housing as a strategy in dealing with inheritance tax, and last minute demand associated with the additional increase in consumption tax originally planned for April 2017.

Capital expenditure is maintaining moderate growth at +0.2% q/q. Capital expenditure continues to maintain favorable performance backed by the high level of corporate earnings and coping with the labor shortage. Meanwhile, though small, private sector inventory brought a positive contribution to GDP growth for the first time in three quarters at +0.1%pt. Material & supplies inventory is provisional on the 1st preliminary GDP estimate and hence contributed -0.0%pt, while work in progress inventory contributed +0.0% and distribution inventory contributed +0.1%pt. Finished goods inventory contributed +0.0%pt.

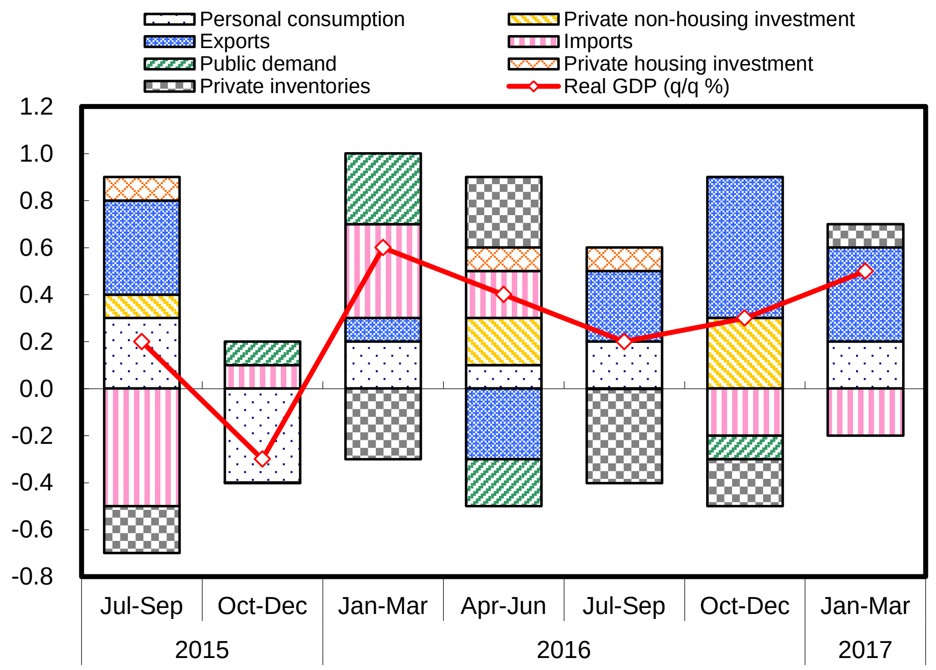
Public investment declined for the third consecutive quarter though just slightly by -0.1% q/q. The government's FY2016 second supplementary budget appears to be behind schedule in implementation. Government consumption up by +0.1%, and on average is continuing in a growth trend.

Exports grew for the third consecutive quarter at +2.1% q/q. Considering trade statistics for the Jan-Mar period, exports to the US appear to be about to peak out, but exports to the EU and Asia continue to be favorable. Exports to the EU centered on passenger vehicles, while exports to Asia focusing especially on smartphone related business in China saw IC exports especially favorable. On the other hand, imports grew for the second consecutive quarter at +1.4% thanks to the comeback in domestic demand. As a result, contribution of overseas demand to GDP growth increased for the third consecutive quarter at +0.1%pt.

The GDP deflator suffered a major decline at -0.6% q/q. The domestic demand deflator declined to -0.0%, while the import deflator grew to +6.5% due to the rise in prices of natural resources, and the weak yen. The export deflator was also up at +2.8%, thereby suppressing growth of the overall deflator. Meanwhile, nominal GDP declined by -0.1% q/q annualized (-0.0% q/q).

Current results show the FY2016 GDP growth rate to have accelerated in comparison to FY2015, with y/y growth at +1.3%. Until now the driving force behind Japan's economic growth was overseas demand (y/y contribution to GDP growth rate +0.8%pt), but domestic demand has also recorded favorable growth, centering on private final consumption expenditure (+0.5% y/y), private housing investment (+6.5%), and private sector capital investment (+2.3%). On the other hand, contribution to GDP by private sector inventory declined to -0.3%pt y/y, and public investment continues on the low side at -3.2%. The GDP deflator declined by -0.2%, dragged down by the slow performance of the domestic demand deflator at -0.4%. This brings the nominal GDP growth rate to +1.2%.

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



Source: Cabinet Office; compiled by DIR.

Moderate recovery expected with balanced domestic & overseas demand. Overseas factors present sole risk

We expect Japan's economy to continue in a moderate expansion phase. Domestic demand is expected to maintain favorable performance despite ups and downs, while overseas demand is expected to expand due to recovery in the world economy, providing major support for Japan's economic growth. However, downside risk remains for overseas demand requiring caution due to US trade policy and rising geopolitical risk. Meanwhile, we also urge caution regarding rising interest rates accompanying the slowdown of the US economy, and the problem of capital outflows from the emerging nations.

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 due to growth in the price of crude oil. If real wages stagnate due to the influence of prices, personal consumption could also be suppressed. 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. 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 in urban areas, and housing investment is also expected to begin declining after that point.

Capex is expected to see moderate growth. Operating rates in the manufacturing sector have been on the rise since the latter part of last year due to the expansion of exports thanks to the recovery in the world economy. However, if uncertainty grows regarding the future of the world economy, corporations are likely to lose their willingness to invest in capex, hence caution is required. On the other hand, research & development which is in growth phase, is expected to continue pushing up overall capex figures in the future. Meanwhile, investment in labor-saving and rationalization due to the continuing labor shortage is expected to continue its growth trend centering on the non-manufacturing industries. As for public investment, we expect a gradual to accompany implementation of the government's second and third supplementary budgets.

As for exports, with overseas economies continuing moderate growth, we can expect exports to maintain a firm undertone. US exports appear to be about to peak out, while exports to the EU and Asia are maintaining a firm undertone. Exports of construction equipment and electronic parts to China are expected to maintain favorable orders. Exports to China are expected to be the driving force of exports overall.

However, caution is required regarding overseas demand due to possible downside risk. As for the US, the Fed implemented an interest rate increase in March 2017, and may raise rates multiple times during the rest of the year. Meanwhile, growth in personal consumption in the US began to soften during the Jan-Mar period, and with doubts now being raised regarding the Trump administration's policies, downside risk for the US economy has now appeared causing another worrisome point. If President Trump pushes through protectionist trade policies, the world economy could stagnate. This is a mid to long-term risk factor. Other issues include geopolitical risk such as rising tensions in North Korea. All of these risks require caution. Our main scenario sees the world economy continuing its moderate growth. However, if uncertainty grows regarding the future of the world economy, Japan's exports are likely to decline, bringing the risk of causing downward pressure on Japan's economy.