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Jan-Mar 2017 2nd Preliminary GDP Estimate

GDP growth revised downwards unexpectedly due to progress in inventory adjustment; +1.0% q/q annualized (+0.3% q/q)

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Summary

- The real GDP growth rate for Jan-Mar 2017 (2nd preliminary est) was revised downwards to +1.0% 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 (+2.5% q/q annualized and +0.6% q/q). The downward revision was due mainly to progress in inventory adjustment associated with economic recovery, causing fluctuations in private sector inventory to be revised downward considerably. Hence, an overly pessimistic reaction is unnecessary.

- Overall, these results confirm our main scenario, which sees Japan's economy moving toward a moderate recovery. We again point out that Japan's economy has shifted notably into balanced growth driven equally by domestic and overseas demand.

2017 Jan-Mar GDP (2nd Preliminary Estimate) **Chart 1**

		2016				2017	
		Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar	
						First	Second
Real GDP	Q/q %	0.6	0.4	0.3	0.3	0.5	0.3
Annualized	Q/q %	2.5	1.6	1.0	1.4	2.2	1.0
Personal consumption	Q/q %	0.3	0.2	0.4	0.0	0.4	0.3
Private housing investment	Q/q %	1.2	3.1	2.6	0.2	0.7	0.3
Private non-housing investment	Q/q %	-0.1	1.3	-0.2	1.9	0.2	0.6
Change in private inventories (contribution to real GDP growth)	Q/q % pts	-0.3	0.3	-0.3	-0.2	0.1	-0.1
Government consumption	Q/q %	1.4	-1.2	0.2	0.0	0.1	-0.0
Public investment	Q/q %	-0.3	0.7	-1.3	-3.0	-0.1	-0.1
Exports of goods and services	Q/q %	0.5	-1.4	1.9	3.4	2.1	2.1
Imports of goods and services	Q/q %	-2.0	-1.1	-0.2	1.3	1.4	1.4
Domestic demand (contribution to real GDP growth)	Q/q % pts	0.2	0.5	-0.1	-0.0	0.4	0.1
Foreign demand (contribution to real GDP growth)	Q/q % pts	0.5	-0.1	0.4	0.4	0.1	0.1
Nominal GDP	Q/q %	0.9	0.2	0.1	0.4	-0.0	-0.3
Annualized	Q/q %	3.7	0.8	0.3	1.6	-0.1	-1.2
GDP deflator	Y/y %	0.9	0.4	-0.1	-0.0	-0.8	-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 basis.

Real GDP growth rate revised downwards from 1st preliminary, falls below market consensus

The real GDP growth rate for Jan-Mar 2017 (2nd preliminary est) was revised downwards to +1.0% 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 (+2.5% q/q annualized and +0.6% q/q). The downward revision was due mainly to progress in inventory adjustment associated with economic recovery, causing fluctuations in private sector inventory to be revised downward considerably. Hence, an overly pessimistic reaction is unnecessary. In terms of the inventory cycle, this most likely means that the inventory adjustment phase is about complete, and that we are about to move into an accumulation phase. Overall, these results confirm our main scenario, which sees Japan's economy moving toward a moderate recovery. We again point out that Japan's economy has shifted notably into balanced growth driven equally by domestic and overseas demand.

Downward revision of private sector inventory brings downward pressure on overall results

Major revisions in comparison to the 1st preliminary report in terms of performance by demand component are as follows: capex was revised upwards, while private sector final consumption expenditure and private sector inventory were revised downwards. The downward revision in private sector inventory was especially large, and brought downward pressure on overall results.

Private final consumption expenditure was down just a bit mainly due to March fundamental statistics to +0.3% q/q (+0.4% on the 1st preliminary). This was due to the fact that durable goods, semi-durables, and services were all revised downwards by a small amount.

Private-sector capital investment was revised upwards in response to the results of corporate statistics to +0.6% q/q (+0.2% on the 1st preliminary). Looking at the trend in gross fixed capital formation by type, we see that transport equipment grew considerably, but looks to be moving toward taking a breather from the growth phase it has been in up to now. Other machinery and equipment continues to record moderate growth, but intellectual property has been up and down, ultimately recording a decline for the Jan-Mar period.

Inventory investment was revised downwards to -0.1% q/q (+0.1% on the 1st preliminary). Looking at contribution to GDP by category we see that while there were upward revisions for work in progress inventory and finished goods inventory, distribution inventory was marking time. The extent to which raw materials inventory was revised downwards was especially large, and this contributed to overall results moving further downwards.

Public investment was marking time reflecting the latest fundamental statistics to -0.1% q/q (-0.1% on the 1st preliminary). There were no revisions to performance of imports and exports. While there were downward revisions for housing investment and government consumption, there was not much influence on the overall GDP figure.

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

Performance by demand component in the Jan-Mar 2017 2nd preliminary results shows private sector final consumption expenditure achieving growth for the fifth consecutive quarter at +0.3% q/q (+0.4% on the 1st preliminary). The employment environment continued to improve due to the labor shortage, and price hikes for energy and fresh foods, which had been a drag on consumption, seem to have completed their rounds. This has contributed to improvement in consumer confidence, and is contributing to a comeback for personal consumption.

Housing investment achieved growth for the fifth consecutive quarter at +0.3% q/q (+0.7% on the 1st preliminary). Housing investment has maintained its growth trend throughout FY2016 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.

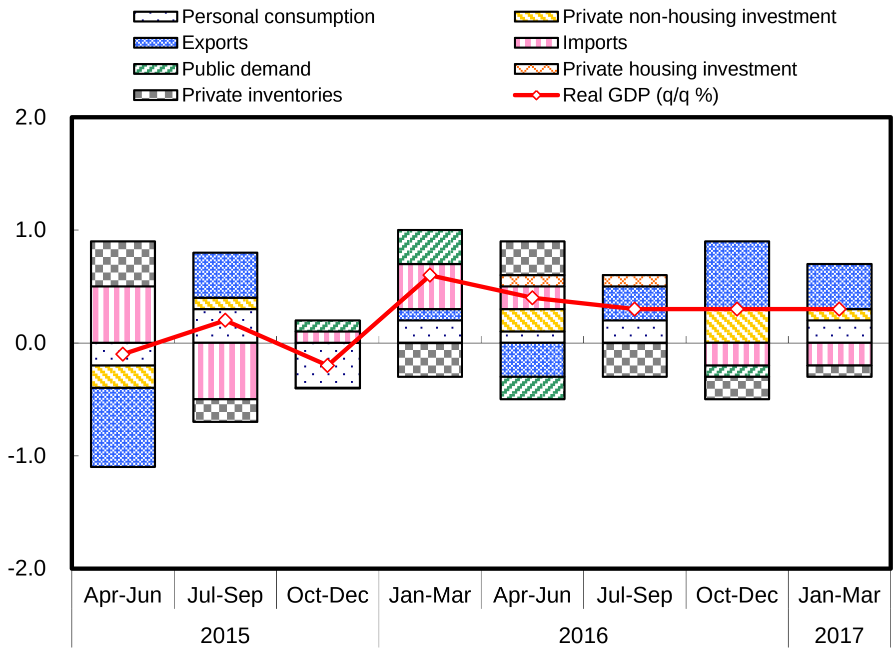
Capital expenditure on the part of private sector corporations is maintaining a moderate growth trend at +0.6% q/q (+0.2% on the 1st preliminary). Corporate earnings remain at a high level, and this has pushed up capital expenditure as a means of dealing with the labor shortage.

Private sector inventory declined for the third consecutive quarter at -0.1%pt q/q (+0.1%pt on the 1st preliminary), making a negative contribution to GDP. Overall, inventory adjustment is progressing, but raw materials inventory made a major negative contribution. As for the recent decline in inventory, this has been due to progress in inventory adjustment associated with growth in shipments, and is not cause for excessive worry.

Public investment declined for the third consecutive quarter at -0.1% q/q (-0.1% on the 1st preliminary). The government's FY2016 second supplementary budget appears to be behind schedule in implementation. Government consumption continues to mark time at -0.0% (+0.1% on the 1st preliminary).

Exports grew for the third consecutive quarter at +2.1% q/q (+2.1% on the 1st preliminary). 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. Imports grew for the second consecutive quarter at +1.4% (+1.4% on the 1st preliminary). As a result, contribution of overseas demand to GDP growth increased for the third consecutive quarter at +0.1%pt.

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, focusing on personal consumption, 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 at the end of CY2016. 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 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 comeback 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. Exports to the US 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.