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# Jul-Sep 2017 2nd Preliminary GDP Estimate

## GDP growth up by +2.5% q/q annualized (+0.6% q/q) due to major upward revision for private sector capital investment

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### Summary

- The real GDP growth rate for Jul-Sep 2017 (2nd preliminary est) received a major upward revision to +2.5% q/q annualized (+0.6% q/q) in comparison to the 1st preliminary report (+1.4% q/q annualized and +0.3% q/q), while at the same time significantly exceeding market consensus (+1.5% q/q annualized and +0.4% q/q). Demand components receiving upward revisions included private sector capital investment and inventories, which gained especially notable upward revisions in their contributions to GDP growth, government consumption, and public investment, which saw minor upward revisions. On the other hand, private sector housing investment suffered a slight downward revision.

- We expect Japan's economy to continue in a moderate expansion phase. Domestic demand is expected to continue its expansion centering on personal consumption, while overseas demand is expected to maintain steady growth backed by the recovery in the world economy, providing support for Japan's economic growth. However, downside risk remains for overseas demand requiring caution, due to fears that China's economy may slow down after the National Congress of the Communist Party, and increased geopolitical risk. Meanwhile, we also urge caution regarding the slowdown of the US economy accompanying the Fed's tight money policy, and the problem of capital outflows from the emerging nations.

**2017 Apr-Jun GDP (2nd Preliminary Estimate)** **Chart 1**

| | | 2016 | | | | 2017 | |
|---|---|---|---|---|---|---|---|
| | | Jul-Sep | Oct-Dec | Jan-Mar | Apr-Jun | Jul-Sep | |
| | | | | | | First | Second |
| Real GDP | Q/q % | 0.2 | 0.3 | 0.4 | 0.7 | 0.3 | 0.6 |
| Annualized | Q/q % | 0.9 | 1.4 | 1.5 | 2.9 | 1.4 | 2.5 |
| Personal consumption | Q/q % | 0.4 | 0.1 | 0.4 | 0.9 | -0.5 | -0.5 |
| Private housing investment | Q/q % | 3.0 | 0.2 | 0.9 | 1.3 | -0.9 | -1.0 |
| Private non-housing investment | Q/q % | -0.2 | 1.5 | 0.2 | 1.2 | 0.2 | 1.1 |
| Change in private inventories (contribution to real GDP growth) | Q/q % pts | -0.5 | -0.1 | -0.1 | -0.0 | 0.2 | -0.0 |
| Government consumption | Q/q % | 0.5 | -0.3 | 0.2 | 0.2 | -0.1 | 0.0 |
| Public investment | Q/q % | 0.3 | -2.4 | 0.3 | 4.6 | -2.5 | -2.4 |
| Exports of goods and services | Q/q % | 2.1 | 3.0 | 1.9 | -0.1 | 1.5 | 1.5 |
| Imports of goods and services | Q/q % | 0.1 | 1.3 | 1.3 | 1.5 | -1.6 | -1.6 |
| Domestic demand (contribution to real GDP growth) | Q/q % pts | -0.1 | 0.0 | 0.3 | 1.0 | -0.2 | 0.1 |
| Foreign demand (contribution to real GDP growth) | Q/q % pts | 0.3 | 0.3 | 0.1 | -0.2 | 0.5 | 0.5 |
| Nominal GDP | Q/q % | -0.1 | -0.0 | 0.1 | 0.8 | 0.6 | 0.8 |
| Annualized | Q/q % | -0.4 | 1.9 | 0.3 | 3.2 | 2.5 | 3.2 |
| GDP deflator | Y/y % | -0.1 | -0.1 | -0.9 | -0.4 | 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.

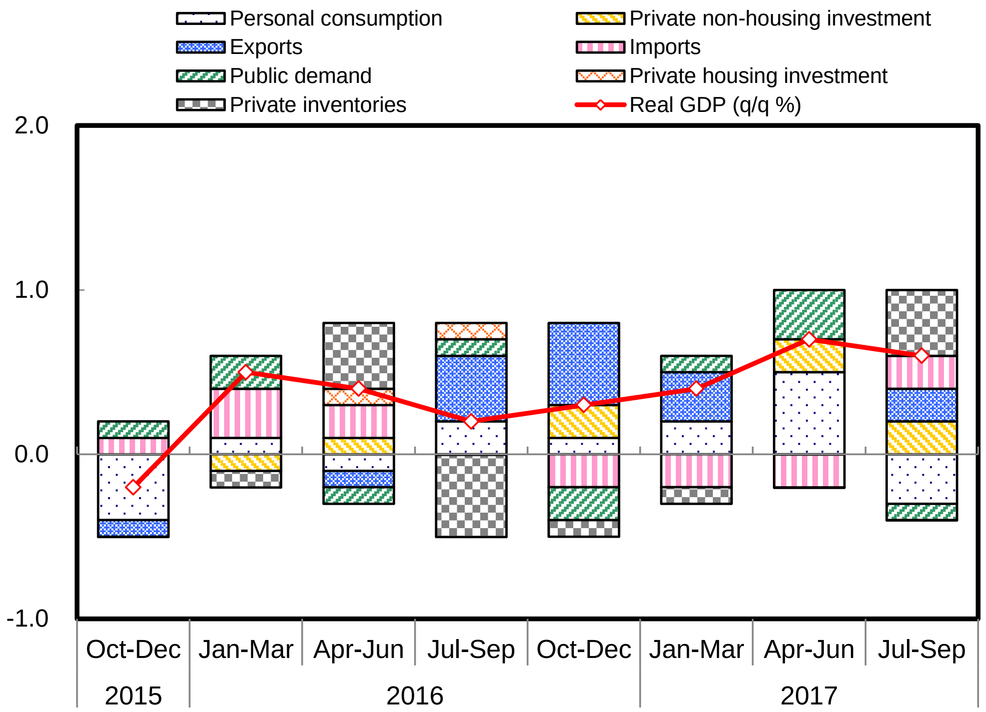
## Real GDP growth rate gains major upward revision from 1st preliminary, while also exceeding market consensus

The real GDP growth rate for Jul-Sep 2017 (2nd preliminary est) received a major upward revision to +2.5% q/q annualized (+0.6% q/q) in comparison to the 1st preliminary report (+1.4% q/q annualized and +0.3% q/q), while at the same time significantly exceeding market consensus (+1.5% q/q annualized and +0.4% q/q). Demand components receiving upward revisions included private sector capital investment and inventories, which gained especially notable upward revisions in their contributions to GDP growth, government consumption, and public investment, which saw minor upward revisions. On the other hand, private sector housing investment suffered a slight downward revision.

Private sector capital investment won a major upward revision in response to results of corporate statistics, registering +1.1% q/q (+0.2% on the 1st preliminary). As for gross fixed capital formation by type, residential investment and other buildings & structures suffered a q/q decline this time around due partly to the reaction to last quarter's strong performance. Transport equipment had been maintaining favorable growth up until the Jan-Mar period, but then suffered declines for two consecutive quarters (the Apr-June period and the Jul-Sep period). On the other hand, other machinery and equipment is maintaining firm growth, while in addition, growth in intellectual property products also contributed to overall growth in capital investment.

Private sector inventory increased its contribution to GDP growth at +0.4%pt q/q (+0.2%pt on the 1st preliminary). This was due to the fact that material & supplies inventory, which is provisional on the 1st preliminary GDP estimate, increased its contribution at +0.2%pt (+0.0%pt on the 1st preliminary). As for other components, government consumption recorded +0.0% (-0.1% on the 1st preliminary) due mainly to the most recent results of fundamental statistics, while public investment managed a slight upward revision at -2.4% (-2.5% on the 1st preliminary). On the other hand, private sector housing investment was revised downwards slightly at -1.0% (-0.9% on the 1st preliminary).

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




Source: Cabinet Office; compiled by DIR.

## Consumption and public investment shift into decline, while exports and capex take up role of driving growth

Performance by demand component in the Jul-Sep 2017 2nd preliminary results shows private sector final consumption expenditure suffering a decline for the first time in five quarters at -0.5% q/q. The employment environment improved and consumer confidence maintained at a positive level. However, bad weather was a drag on personal consumption with a historically long period of rain in Eastern Japan in August, while major typhoons hit many areas of Japan in September. Moreover, a reactionary decline in response to positive performance during the Apr-Jun period (+0.9%) was also part of the mix.

Looking at trends in goods and services, we see that the above mentioned weather situation brought on a decline for services at -0.7% q/q, while semi-durables grew slightly at +0.3%, and non-durables registered +0.0%. Even durables were down for the first time in seven quarters by -1.2%, which is worthy of note after having continued in a growth trend since 2016. The disappearance 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, generated replacement demand for durable goods for the past six quarters straight. However, it appears that this effect may be about to peak out.

Housing investment suffered a decline for the first time in seven quarters at -1.0% q/q. Housing investment has gained underlying support from lower interest rates on housing loans until now. However, positive factors such as growth in rental property construction as an inheritance tax strategy are gradually losing their effect, and growth in prices is beginning to keep demand in check.

Capital expenditure grew for the fourth consecutive quarter at +1.1% q/q. Past growth in operating rates associated with export expansion, and growing seriousness of the shortage in manpower are thought to be an undercurrent helping to maintain favorable capex spending.

Private sector inventory's contribution grew for the first time in five quarters at +0.4%pt q/q. Contribution of raw materials inventory grew by +0.2%pt, while work in progress inventory at +0.0%pt, and finished goods at +0.1%pt, and distribution inventory at +0.1%pt.

Public investment suffered a decline for the first time in three quarters at -2.4% q/q. Implementation of the government's FY2016 supplementary budget was concentrated mostly in the Apr-Jun period, when public investment grew by +4.6%. A reactionary decline has appeared in the July-Sep period. Meanwhile, government consumption is marking time at +0.0%.

Exports grew for the first time in two quarters at +1.5% q/q. Looking at trade statistics for the Jul-Sep period, we see that exports to the EU declined due to a drop in automobile exports, while positive performance of semiconductor manufacturing equipment pushed up overall exports, and contributed to growth in exports to the US and Asia. On the other hand, domestic demand declined, bringing a decline in imports for the first time in five quarters at -1.6%. As a result, overseas demand made a positive contribution to GDP for the first time in two quarters with a major plus of +0.5%pt.

Terms of trade improved as import prices settled down, and domestic price pass-through has made moderate progress. As a result, the GDP deflator grew for the second consecutive quarter at +0.2% q/q. Nominal GDP also grew for the fourth consecutive quarter at +3.2% q/q annualized (+0.8% q/q).

## Moderate growth seen continuing, but risk remains for overseas demand

We expect Japan's economy to continue in a moderate expansion phase. Domestic demand is expected to continue its expansion centering on personal consumption, while overseas demand is expected to maintain steady growth backed by the recovery in the world economy, providing support for Japan's economic growth. However, downside risk remains for overseas demand requiring caution, due to fears that China's economy may slow down after the National Congress of the Communist Party, and increased geopolitical risk. Meanwhile, we also urge caution regarding the slowdown of the US economy accompanying the Fed's tight money policy, 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 is becoming increasingly tight, and this should provide underlying support for personal consumption through growth in employee compensation. However, caution is advised here as corporations may try to compensate for the cost of wage increases by flattening the wage curve and placing restrictions on overtime. This could create a slowdown in the pace of growth in employee compensation, as well as the expansion of consumption. In the short-term, the downward pressure on consumption from bad weather in October is worrisome. Moreover, new car sales, which had been maintaining favorable performance, have recently begun to weaken. This suggests that replacement demand may be about to peak out as was mentioned earlier in this report. There is a good chance that, coupled with the halting of production and shipments by one automobile manufacturer at its domestic factories, this could very well put a damper on consumption of durables.

Housing investment is expected to experience a lull in its growth trend, and then move into a gradual descent from its current plateau. Interest on housing loans remains low, and therefore should provide continued underlying support. However, caution is required regarding a possible reactionary decline as the positive effect of inheritance tax strategies disappears.

Capex is expected to see moderate growth. Operating rates in the manufacturing sector are on the rise 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. In addition, investment in research & development with an aim to increase profitability is also expected to become a factor in pushing up capex spending in the future, partly supported by improvement of free cash flow of corporations.

As for public investment, we expect the positive effect of the government's FY2016 supplementary budget to gradually disappear, and while levels may remain high, we expect a moderate decline on into the future.

As for exports, with overseas economies continuing moderate growth, we can expect exports to maintain a firm undertone. However, caution is required regarding underlying risk. As for the US, the Fed is continuing to implement its tight money policy. Meanwhile, there are signs of demand for Japan's major export to the US, passenger vehicles, peaking out, and the tight money policy may bring further downward pressure on the economy. The Fed's tight money policy may also cause an acceleration of capital flows from emerging nations. On the other hand, as regards China's economy, now that the curtain has closed on the National Congress of the Communist Party, there is risk that the economy could come under downward pressure due to a reactionary decline in demand, which had been kept artificially high until now by the implementation of economic measures. Other issues include geopolitical risk such as rising tensions in North Korea and the Middle East. 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 downward pressure on Japan's economy.