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Oct-Dec 2017 2nd Preliminary GDP Estimate

Rate of contribution to GDP revised upwards for private sector capital investment, public investment, and inventory, while real GDP grows +1.6% q/q annualized (+0.4% q/q)

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Summary

- The real GDP growth rate for Oct-Dec 2017 (2nd preliminary est) was revised upwards to +1.6% q/q annualized (+0.4% q/q) in comparison to the 1st preliminary report (+0.5% q/q annualized and +0.1% q/q), while at the same time exceeding market consensus (+0.8% q/q annualized and +0.2% q/q). Demand components receiving revisions included public investment receiving a reduction in the extent of its decline due to improvement in latest figures in fundamental statistics, while private sector capital investment was revised upwards due to positive results on corporate statistics (demand side statistics). Meanwhile, inventory investment was also revised upwards, getting a lift from material & supplies inventory, which is provisional on the 1st preliminary GDP estimate.

- 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 expansion in the world economy, providing support for Japan's economic growth. However, caution should be observed as overseas demand still has a strong sense of uncertainty, and domestic demand may be affected by rising prices and stagnant growth in real income. Moreover, some hesitation as regards capital investment may occur due to the strong yen, and housing investment could suffer a reactionary decline in response to recent growth spurred on by strategies in dealing with inheritance tax.

2017 Oct-Dec GDP (2nd Preliminary Estimate) **Chart 1**

		2016	2017				
		Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	
						First	Second
Real GDP	Q/q %	0.3	0.5	0.6	0.6	0.1	0.4
Annualized	Q/q %	1.1	1.9	2.4	2.4	0.5	1.6
Personal consumption	Q/q %	0.0	0.3	0.9	-0.6	0.5	0.5
Private housing investment	Q/q %	0.8	1.2	0.9	-1.7	-2.7	-2.6
Private non-housing investment	Q/q %	1.5	0.2	1.2	1.0	0.7	1.0
Change in private inventories (contribution to real GDP growth)	Q/q % pts	-0.2	0.1	-0.1	0.4	-0.1	-0.0
Government consumption	Q/q %	-0.2	0.1	0.2	0.1	-0.1	-0.0
Public investment	Q/q %	-1.9	-0.2	4.8	-2.6	-0.5	-0.2
Exports of goods and services	Q/q %	2.7	2.0	0.0	2.1	2.4	2.4
Imports of goods and services	Q/q %	0.6	1.7	1.9	-1.2	2.9	2.9
Domestic demand (contribution to real GDP growth)	Q/q % pts	-0.1	0.4	0.9	0.1	0.1	0.4
Foreign demand (contribution to real GDP growth)	Q/q % pts	0.4	0.1	-0.3	0.5	-0.0	-0.0
Nominal GDP	Q/q %	0.2	-0.0	0.9	0.7	-0.0	0.3
Annualized	Q/q %	1.0	1.1	3.6	2.7	-0.1	1.1
GDP deflator	Q/q %	-0.0	-0.2	0.3	0.1	-0.1	-0.1
	Y/y %	-0.1	-0.8	-0.3	0.2	0.0	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.

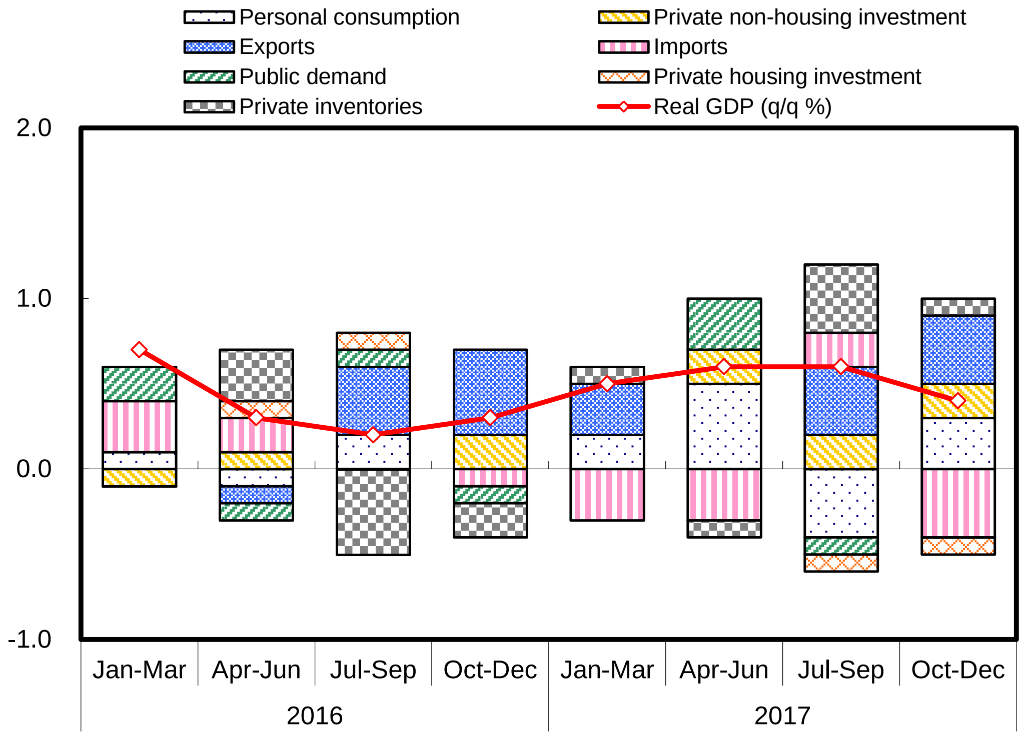
Real GDP growth rate revised upwards from 1st preliminary, while also exceeding market consensus

The real GDP growth rate for Oct-Dec 2017 (2nd preliminary est) was revised upwards to +1.6% q/q annualized (+0.4% q/q) in comparison to the 1st preliminary report (+0.5% q/q annualized and +0.1% q/q), while at the same time exceeding market consensus (+0.8% q/q annualized and +0.2% q/q). Demand components receiving revisions included public investment receiving a reduction in the extent of its decline due to improvement in latest figures in fundamental statistics, while private sector capital investment was revised upwards due to positive results on corporate statistics (demand side statistics). Meanwhile, inventory investment was also revised upwards, getting a lift from material & supplies inventory, which is provisional on the 1st preliminary GDP estimate.

Private sector capital investment was revised upwards in response to results of corporate statistics, registering +1.0% q/q (+0.7% on the 1st preliminary). As for gross fixed capital formation by type, other machinery and equipment maintained favorable growth at +1.6%. Meanwhile, transport equipment, which maintained favorable growth through FY2016, suffered declines for three consecutive quarters ever since the Apr-June 2017 period, declining by -0.6% in the Oct-Dec 2017 period. Intellectual property products (+0.0%) and other buildings & structures (+0.1%) were pretty much marking time.

Private sector inventory increased its contribution to GDP growth at +0.1%pt q/q (-0.1%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 to +0.0%pt (-0.1%pt on the 1st preliminary). As for other components, private sector housing was revised upwards to -2.6% (-2.7% on the 1st preliminary), while government consumption recorded -0.0% (-0.1% on the 1st preliminary), and public investment was at -0.2% (-0.5% on the 1st preliminary) due mainly to the most recent results of fundamental statistics.

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



Source: Cabinet Office; compiled by DIR.

Growth was led by domestic demand, but issues remain: (1) decline in housing investment, (2) weak consumption, and (3) capital investment deflator brings unease

Performance by demand component in the Oct-Dec 2017 2nd preliminary results shows private sector final consumption expenditure achieving growth for the first time in two quarters by +0.5% q/q. Stock price highs and the growing global economy brought support to an improvement in consumer confidence, while in addition, continued expansion of consumption was helped along by growth in consumption of durable goods (+3.4%) due to replacement demand. We have seen 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. Since 2016, moderate replacement demand for durables has appeared.

On the other hand, consumption of goods other than durables left something to be desired. While the consumer price index grows centering on the price of fresh foods and energy, real employee compensation fell by -0.4% q/q and there are hints that on the other side of the recent demand for durables lies an increasing tendency to pinch pennies. As for trends in goods and services, semi-durables continue to expand at +2.5%, while non-durables marked time at +0.1% along with services at +0.3%.

Housing investment declined for the second consecutive quarter at -2.6% q/q. The positive effects of strategies in dealing with inheritance tax are beginning to disappear, and rising prices may be putting a damper on demand. Meanwhile, housing inventory continues to accumulate.

Capital expenditure grew for the fifth consecutive quarter at +1.0% q/q. Capital expenditure continues to maintain an undercurrent of growth due to the expansion of production activities associated with recent growth in exports, and the growing seriousness of the shortage of manpower. In addition, ample funds allow corporations to promote a stable expansion of capital expenditure. However, caution should be exercised, as demand for capital expenditure nears the limits of supply as can be seen in the balance of machinery orders which continue to accumulate at an unprecedented rate. This indicates that the growth rate in quantitative capital expenditure (in real terms) will remain at a more moderate rate in comparison to the strength of demand for the time being. Hence manufacturers who benefit from capex spending are expected to move toward improved earnings due to rising prices and higher profitability. However, as of this point, a definite increase in the capital investment deflator has not been seen.

Private sector inventory recorded an increase in its contribution to GDP growth for the second consecutive quarter at +0.1%pt. Material & supplies inventory contributed +0.0%pt, while work in progress inventory was at +0.0%pt, and finished goods contributed +0.1%pt. Distribution inventory was at -0.0%pt.

Public investment suffered a decline for the second consecutive quarter at -0.2% q/q. The balance of orders is at a high level, and with the FY2016 supplementary budget carried out mostly during the Apr-Jun period, a moderate decline was experienced after that point.

Exports grew for the sixth consecutive quarter at +2.4% q/q. According to trade statistics for the Oct-Dec period, exports to the US declined due to a downturn for automobiles, while semiconductor manufacturing equipment and ICs were favorable, leading to growth in exports to the EU and Asia. On the other hand, imports grew by +2.9% for the first time in two quarters due to the recovery in domestic demand. As a result, contribution of overseas demand to GDP growth marked time at -0.0%pt.

Growth Rate (Calendar Year) and Changes by Demand Component — Chart 3

Real Gross Domestic Expenditure (chained [2011]; Y tril)

(CY)	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP	492.0	491.5	498.8	508.8	510.7	517.6	522.5	531.4
(Y/y %)	4.2	-0.1	1.5	2.0	0.4	1.4	0.9	1.7
Domestic demand	490.6	494.1	505.6	517.7	519.7	524.7	526.6	532.8
(Y/y %)	2.4	0.7	2.3	2.4	0.4	1.0	0.4	1.2
Private final consumption	287.4	286.3	292.1	299.0	296.4	296.3	296.5	299.7
(Y/y %)	2.4	-0.4	2.0	2.4	-0.9	-0.0	0.1	1.1
Private housing investment	13.7	14.3	14.7	15.9	15.2	15.0	15.9	16.3
(Y/y %)	-3.7	4.9	2.5	8.0	-4.3	-1.0	5.6	2.6
Private capital investment	66.7	69.4	72.2	74.9	79.0	81.7	82.2	84.6
(Y/y %)	-0.9	4.0	4.1	3.7	5.4	3.4	0.6	3.0
Change in private inventories	0.1	1.0	1.2	-0.6	-0.3	1.2	0.2	-0.2
Government final consumption	97.3	99.2	100.9	102.4	102.9	104.5	105.9	106.0
(Y/y %)	1.9	1.9	1.7	1.5	0.5	1.5	1.3	0.1
Public fixed capital formation	25.5	23.9	24.5	26.2	26.4	25.9	25.9	26.2
(Y/y %)	-2.2	-6.3	2.7	6.7	0.7	-1.7	-0.1	1.2
Change in public inventories	-0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Export of goods and services	73.5	73.3	73.3	73.8	80.7	83.1	84.2	89.9
(Y/y %)	24.9	-0.2	-0.1	0.8	9.3	2.9	1.3	6.8
Import of goods and services	71.8	76.0	80.1	82.7	89.6	90.3	88.5	91.7
(Y/y %)	11.2	5.8	5.4	3.3	8.3	0.8	-1.9	3.6

Nominal Gross Domestic Expenditure (Y tril)

(CY)	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP	500.4	491.4	495.0	503.2	513.9	532.0	538.4	546.5
(Y/y %)	2.2	-1.8	0.7	1.7	2.1	3.5	1.2	1.5
Domestic demand	493.0	494.1	502.6	514.8	526.5	534.2	533.2	541.5
(Y/y %)	1.3	0.2	1.7	2.4	2.3	1.5	-0.2	1.6
Private final consumption	289.0	286.3	290.2	296.7	300.1	301.2	299.9	303.5
(Y/y %)	0.9	-0.9	1.4	2.2	1.1	0.4	-0.4	1.2
Private housing investment	13.6	14.3	14.6	16.1	16.0	15.9	16.7	17.4
(Y/y %)	-4.5	5.1	1.6	10.5	-0.9	-0.2	4.9	4.4
Private capital investment	67.6	69.4	72.0	74.9	79.9	83.4	83.2	86.2
(Y/y %)	-2.0	2.7	3.7	4.1	6.7	4.3	-0.3	3.6
Change in private inventories	-0.1	0.9	1.1	-0.7	-0.3	1.2	0.1	-0.3
Government final consumption	97.5	99.2	100.2	101.5	103.6	105.3	106.5	107.0
(Y/y %)	1.5	1.7	1.0	1.2	2.1	1.7	1.1	0.5
Public fixed capital formation	25.5	23.9	24.4	26.3	27.2	27.1	26.9	27.7
(Y/y %)	-2.8	-6.3	2.2	7.8	3.4	-0.4	-0.9	2.8
Change in public inventories	0.0	0.0	0.1	0.0	0.1	0.1	0.0	0.0
Export of goods and services	75.2	73.3	72.0	80.1	90.1	93.6	86.8	96.6
(Y/y %)	22.8	-2.5	-1.8	11.2	12.6	3.8	-7.2	11.3
Import of goods and services	67.9	76.0	79.6	91.7	102.8	95.8	81.6	91.6
(Y/y %)	15.9	11.9	4.8	15.2	12.1	-6.8	-14.9	12.3

Deflator (chained [2011])

(CY)	2010	2011	2012	2013	2014	2015	2016	2017
GDP deflator	101.7	100.0	99.2	98.9	100.6	102.8	103.1	102.8
(Y/y %)	-1.9	-1.7	-0.8	-0.3	1.7	2.1	0.3	-0.2
Domestic demand	100.5	100.0	99.4	99.4	101.3	101.8	101.3	101.6
(Y/y %)	-1.1	-0.5	-0.6	0.1	1.9	0.5	-0.5	0.4
Private final consumption	100.6	100.0	99.4	99.2	101.2	101.6	101.1	101.3
(Y/y %)	-1.4	-0.6	-0.6	-0.1	2.0	0.4	-0.5	0.2
Private housing investment	99.7	100.0	99.2	101.4	105.0	105.9	105.2	107.0
(Y/y %)	-0.8	0.3	-0.8	2.3	3.5	0.9	-0.7	1.7
Private capital investment	101.3	100.0	99.6	100.1	101.2	102.1	101.2	101.8
(Y/y %)	-1.1	-1.3	-0.4	0.4	1.2	0.9	-0.9	0.6
Government final consumption	100.2	100.0	99.4	99.1	100.6	100.7	100.5	100.9
(Y/y %)	-0.5	-0.2	-0.6	-0.3	1.5	0.1	-0.2	0.3
Public fixed capital formation	100.0	100.0	99.6	100.6	103.3	104.7	103.9	105.6
(Y/y %)	-0.6	0.0	-0.4	1.0	2.7	1.4	-0.8	1.6
Export of goods and services	102.3	100.0	98.2	108.5	111.7	112.6	103.1	107.4
(Y/y %)	-1.7	-2.3	-1.8	10.4	3.0	0.8	-8.5	4.2
Import of goods and services	94.6	100.0	99.4	110.9	114.8	106.1	92.1	99.9
(Y/y %)	4.3	5.8	-0.6	11.5	3.5	-7.5	-13.2	8.4

Source: Cabinet Office; compiled by DIR.

Negative factors of the previous year had run their course by 2017, and balanced growth was recorded

Looking at the 2017 real GDP growth rate based on calendar year, we see that growth sped up in y/y terms to +1.7%, recording the sixth consecutive year of growth for GDP. As for contribution to growth, domestic demand was responsible for +1.2%pt, while overseas demand brought +0.6%pt, indicating a continuation of balanced growth with domestic demand leading growth in relative terms. The year 2016 experienced turmoil in the global financial markets and the effects of a strong yen, while additionally, a negative wealth effect appeared in association with stock price lows. Neither exports, capital expenditure or consumption were influenced by these events, but negative factors were indeed present, and finally played themselves out, paving the way for each of the demand components to recover and head toward balanced growth, which seems to summarize the events of 2017. However, the concern is that the effects of price pass through are still weak while import prices have risen, causing the GDP deflator to record negative growth at -0.2%. As a result, the nominal growth rate remained at +1.5%.

Looking at growth rate by demand component, we see that private sector final consumption expenditure was up by +1.1% y/y, representing a major increase in growth rate. The effects of the previously explained replacement cycle are thought to have contributed greatly, but it is also very possible that stock prices rising in comparison to the lows experienced in 2016, as well as the positive effect on consumption produced by the asset effect amongst wealthy and retired persons, also contributed to the subsequent improvement of consumer confidence. Meanwhile, there are various undercurrents providing support for growth in consumption especially amongst younger people and women, including growth in employment, as well as growth in hourly wages and improvement in employment conditions such as changing employee status from non-regular to regular, implemented by corporations as a means of dealing with the labor shortage. Meanwhile, we should not ignore the positive effect of growth in the number of dual income households and the increase in the number of hours worked by women employees bringing the issue of the need to reduce number of hours worked to the fore.

On the other hand, while the employment and income environment is improving for the younger generation and women, promotions and raises for middle senior male regular employees are being delayed, resulting in a fairly moderate growth rate for overall nominal compensation of employees. The growth rate in real compensation of employees peaked out in the middle of 2017 due mostly to growth in the price of fresh foods and energy. Because of these factors, the environment surrounding consumption is somewhat patchy.

Housing investment registered its second consecutive year of growth at +2.6% y/y, but the growth rate is now slowing down. Housing investment declined in 2014 and 2015 due to the reaction to last minute demand which appeared just prior to the increase in consumption tax in 2014, but then the use of housing investment as a strategy in dealing with inheritance taxes brought upward pressure, while low interest on housing loans contributed to growth in demand. However, by the latter part of the year rising prices began to bring downward pressure on demand, and housing inventory accumulated. Hence housing investment declined during the latter part of 2017 in comparison to earlier in the year.

Capital expenditure grew for the seventh consecutive year by +3.0% y/y. Capital expenditure continues to maintain an undercurrent of growth due to expansion of production activities associated with recent growth in exports, and the growing seriousness of the shortage of manpower. In addition, ample funds allow corporations to promote a stable expansion of capital expenditure. The rapid appreciation of the yen in 2016 along with turmoil in the global financial markets encouraged the practice of restraint when it came to capital expenditure. But these factors played themselves out by 2017 and the growth rate in capital expenditure increased.

Private sector inventory experienced a decline in its contribution to GDP growth for the second consecutive year at -0.1%pt y/y. Meanwhile, public investment grew for the first time in three years at +1.2%. Implementation of the FY2016 supplementary budget is seen as having increased the rate of contribution to GDP by public investment.

Exports achieved a major increase in growth rate at +6.8% y/y in their fifth consecutive year of growth. The global economy continues to expand, and negative factors experienced in 2016, including appreciation of the yen and turmoil in the global financial markets, played themselves out, opening the way for a rebound. Meanwhile, imports grew for the first time in two years by +3.6%, due to the recovery in domestic demand.

Japan’s economy to continue moderate expansion, but risk remains in the future for both domestic and 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 expansion of the world economy, providing support for Japan’s economic growth. However, caution should be observed as overseas demand still has a strong sense of uncertainty, and domestic demand may be affected by rising prices and stagnant growth in real income. Moreover, some hesitation as regards capital investment may occur due to the strong yen, and housing investment could suffer a reactionary decline in response to recent growth spurred on by strategies in dealing with inheritance tax.

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. Meanwhile, with all eyes on the spring labor offensive which will be working toward an increase in wages, there is a concern that the strong yen may bring a worsening of corporate earnings. Meanwhile, the price of fresh foods and energy continue to grow, hence caution is required in regard to the possible downward pressure this could have on consumption as a result of the situation of real income.

Housing investment is expected to take a breather from its recent growth trend, and then move into a gradual descent from its current plateau. Low interest housing loans continue to provide underlying support. However, the positive effects of strategies in dealing with inheritance tax are beginning to disappear, and a reaction to recent performance may appear in the near future, hence caution is urged. There is a concern that a future slowdown in housing investment could bring down Japan’s overall economy along with it. Caution is required regarding the possible ripple effects caused by the decline in construction demand spreading to related industries. Meanwhile, though nothing has been detected as of this point, we also recommend being on the lookout for the possible limiting effects of deteriorating housing prices due to oversupply on consumption and other demand components in the form of the negative wealth effect.

Capex is expected to see moderate growth. Production activities in the manufacturing sector are on the rise due to the expansion of exports thanks to the recovery in the world economy. Meanwhile, investment in labor-saving and rationalization due to the continuing labor shortage is expected to continue its growth. In addition, investment in research & development oriented toward increasing profitability has also been on the rise, and is expected to become a factor in pushing up capex with support provided by improvements in free corporate cash flow. However, as was mentioned previously, caution is required regarding suppliers of products associated with capex spending, as they may be close to reaching their limits in terms of ability to supply. Meanwhile, concerns such as were present in 2016 that the strong yen could lead to a worsening of corporate earnings and hence to the practice of restraint in capital expenditure are beginning to resurface.

As for public investment, we expect to see a gradual decline though retaining relatively high levels, due to the increasing disappearance of the positive effects of the government's FY2016 supplementary budget.

As for exports, with overseas economies continuing moderate growth, we can expect exports to maintain a firm undertone. However, caution is required regarding downside risk. As for the US, the Fed is continuing to implement its tight money policy. There is a risk that the tight money policy may bring downward pressure on both the market and the real economy. The Fed's tight money policy may also cause an acceleration of capital flows from emerging nations. On the other hand, China's economy risks the possibility of slowing down now that the meeting of the National Congress of the Communist Party is over. A reactionary decline in demand could occur now that the economic measures which had kept it artificially high are no longer being implemented. 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.