MGSSI Japan Economic Quarterly January 2017

Global Economic & Political Studies Division
Mitsui Global Strategic Studies Institute

Moderate Recovery

Real GDP in the third quarter of 2016 rose by 0.3% (1.3% annualized) from the previous quarter, reaching all-time highs for three consecutive quarters. The recovery in exports, which moderately shrank in the second quarter, contributed to the growth.

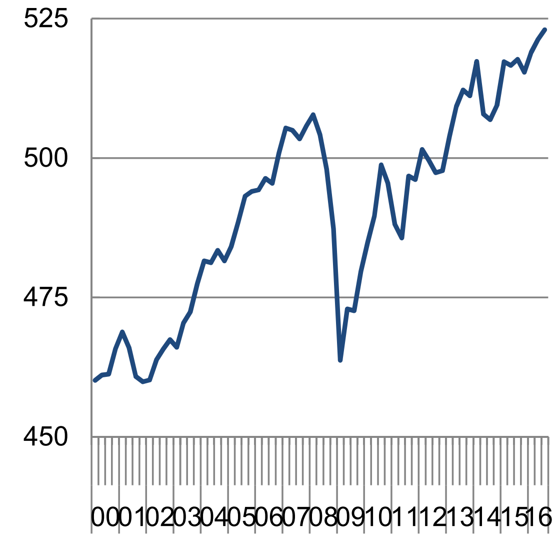
When it comes to private consumption* and private non-residential fixed investments – two main pillars of domestic private demand –, there are mixed results. The former rose by 0.3% from the previous quarter, recording positive growth for the third consecutive quarter, apparently contributed by the strong sales of mobile phones and other products. The latter saw a quarter-over-quarter decline of 0.4%. According to the Financial Statements Statistics of Corporations, nominal investment by the non-manufacturing sector grew thanks to the continuous growth of the transport business as well as the recovery in the retail business. However, nominal investment declined in most businesses in the manufacturing sector, such as machinery.

Private housing investment saw a quarter-over-quarter growth of 2.6%, increasing for three quarters in a row. However, the number of new housing starts in the third quarter, although remaining at a high level, declined for the first time in three quarters to a 980,000 annualized rate from a 1 million annualized rate in the second quarter. Rental housing starts grew by 4.7% from the previous quarter, posting positive growth for the third consecutive quarter, while condominium starts fell by 24.1% from the previous quarter. This decline is believed to be caused by a decrease in suitable land and rising construction material prices. It is also a negative factor that there are signs of housing loan interest rates increasing while they are still at low levels. It is increasingly possible that housing investment will be stagnant in the future.

Public investment rose by 0.1% from the previous quarter. This situation corresponds to the fact that the contract amount for public works projects, which reflects the trends of order

Real Gross Domestic Product

at 2011 Price, Annualized, Trillion Yen



Source: CAO

Real Gross Domestic Product (GDP)

at 2011 Price, Calendar year

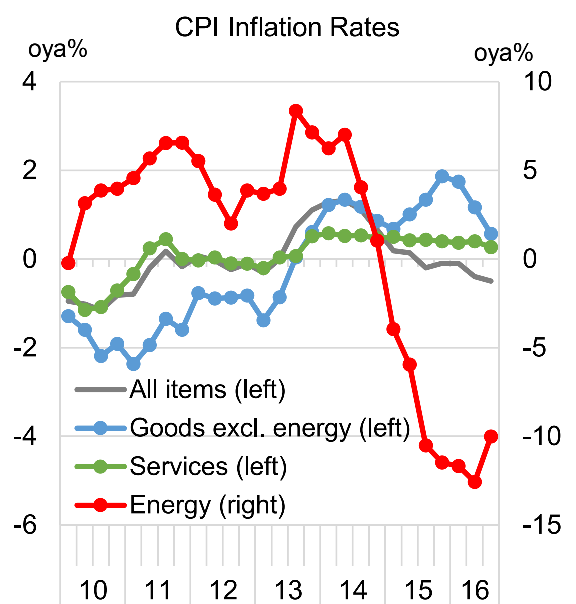
	2015	2016		
		1-3	4-6	7-9
	y/y%	q/q%	q/q%	q/q%
Real Gross Domestic Product	1.2%	0.7%	0.5%	0.3%
Private Consumption	-0.4%	0.4%	0.2%	0.3%
Private Housing Investments	-1.6%	1.3%	3.5%	2.6%
Private Non-Resi. Fixed Investments	1.2%	-0.3%	1.4%	-0.4%
Public Investments	-2.2%	-0.7%	1.6%	0.1%
Government Consumption	1.6%	1.3%	-1.1%	0.3%
Exports of Goods & Services	3.0%	0.8%	-1.3%	1.6%
(less) Imports of Goods & Services	0.1%	-1.2%	-0.9%	-0.4%

Source: CAO

* All subsequent references to GDP demand items are in real terms unless otherwise indicated.

placement, grew for two consecutive quarters until the second quarter. However, in the third quarter, the contract amount took a downward turn, and uncompleted construction contracts held by construction companies estimated by the Ministry of Land, Infrastructure, Transport and Tourism have also peaked out. In the supplementary budget passed in October 2016, the government increased investment-related spending by nearly 2 trillion yen, but it will be difficult to expect an increase in public investment in coming months.

Exports of goods and services rose by 1.6% from the previous quarter. In addition to a recoil increase from the 1.3% quarter-over-quarter decline in the second quarter, exports of semiconductor production equipment, electronics and telecommunications devices, as well as steel products appear to have increased. By region, exports to China are believed to have grown for two quarters in a row. Imports declined by 0.4% from the previous quarter. Imports of iron ore, energy such as crude oil and natural gas, as well as professional services for companies apparently contributed to the decline. The decline continued for four consecutive quarters, down 3.3% from the level a year earlier, while nominal imports declined by 18.4% due to the appreciation of the yen and falling crude oil



Note: Excluding fresh foods. Effects by consumption tax rate hike are adjusted.
Source: MIC, MGSSI

prices. In the third quarter, net export helped push up real GDP by 0.3 percentage points from the previous quarter.

Along with the release of the latest GDP statistics (System of National Accounts: SNA), the Cabinet Office made a revision accompanying changes to the standards for compiling the statistics. A particularly large change is that the government now considers spending on research and development as investment, formerly regarded as intermediate consumption. Of total investment in 2015 (gross fixed capital formation including housing investment), investment in research and development accounted for 15%. Compared to investment in machinery and equipment or buildings and structures, investment in research and development has steadily increased, while the rate of real increase over the 20 years since 1995 is not necessarily high at 1.5% on an annualized basis.

Moreover, because past real GDP estimates were revised, an impression on the past trajectory of the Japanese economy slightly changed. In particular, although there is no doubt that the economy deteriorated after the consumption tax rate hike in April 2014, by the first quarter of 2015, about a year later, the economy almost recovered to the level it was at in the first quarter of 2014 that saw a surge in last-minute demand before the consumption tax rate hike. Entering 2016, the levels of real GDP reached all-time highs for the third consecutive quarter, indicating that the economy, although at a moderate pace, continues to recover. According to Bloomberg's aggregation of forecasts of economists in the private sector, the real GDP is expected to grow at an annual rate of 0.9% in 2016 from the previous year and 1.0% in 2017 on average.

The Birth of President Trump

After the victory of Republican presidential candidate Donald Trump was confirmed, stock prices and the dollar started rising in the United States, while Japan experienced a surge in stock prices and a fall in the yen. The Nikkei Stock Average rose to 19,114 at the end of December from the close of the day before the U.S.

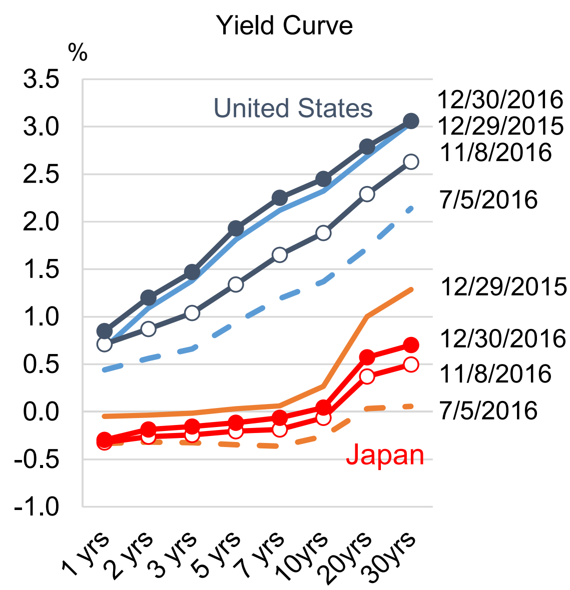
presidential election at 17,171. The dollar-yen exchange rate fell to 117 yen/dollar from 105 yen/dollar over the same period of time.

The yen exchange rate took a downward turn, prompting expectations for a boost to corporate earnings in Japan. In the third quarter of 2016, the ordinary profits of corporations increased by 10.9% from a year earlier, the first positive growth in a year. This is because the non-manufacturing sector took an upturn, recording a year-over-year earnings growth of 20.8%, while earnings of the manufacturing sector fell by 12.2% from a year earlier, falling below the levels of a year earlier for six consecutive quarters. However, the depreciation of the yen is expected to push up profits of manufacturing companies. If expectations for the recovery of corporate earnings grow, this will help increase the rates of wage hikes in the "shunto" spring wage negotiations that will virtually start in February.

Meanwhile, due to the falling yen and improving market conditions for international commodities, mainly crude oil prices, it is possible that the rate of increase in consumer prices will be higher. When items making up the consumer price index are separated into goods and services, prices for services (adjusted for consumption tax hike) rose by around 0.5% compared to the previous year. While the rate of increase slightly slowed down in 2016, given that there are no signs of the labor shortage being resolved, a further decline is unlikely to take place going forward.

The rate of increase in energy prices in the CPI started declining in late 2014, when crude oil prices fell to below 100 dollars/barrel, and in 2015, it fell below the previous year's levels. In the fourth quarter of 2015, prices for goods excluding energy and fresh foods whose prices are volatile rose by 1.9% from the same month of the previous year, while the rate of increase went down to 0.6% year-over-year in the third quarter of 2016.

The yen started falling in September 2012, when Prime Minister Shinzo Abe was elected as the president of the Liberal Democratic Party again. A look at the relationship between Japan's CPI, the yen exchange rate and crude oil prices



Note: Yields of government bonds with various maturities are connected.
Source: MOF, FRB

over about two years until crude oil prices started falling reveals that a 1% increase in crude oil prices on a dollar basis corresponded to an increase of about 0.42% in energy prices in the CPI. In addition, a 1% decline in the yen corresponded to an increase of about 0.06% in prices for goods excluding energy and fresh foods. Moreover, based on the assumption that prices for services will continue to grow about 0.5% year-over-year, and that the yen exchange rate will remain at around 115 yen/dollar and crude oil prices at around 55 dollars/barrel, CPI inflation rates are estimated to reach nearly 1.5% year-over-year around summer or autumn in 2017.

Rising Interest Rates Will Have Minor Impact

The major cause for the depreciation of the yen is a rise in interest rates in the United States. Many predict that, if President Trump implements large-scale investment in social capital and tax cuts, it will lead to high growth and fiscal deterioration, and as a result, prices and interest rates will increase. While the Federal Reserve Board (FRB) lifted the zero-interest-rate policy on December 16, 2015, for the first time in seven years, the interest rates on two-year and 10-year government bonds fell to 0.56% and

1.37%, respectively, on July 5, 2016 against the backdrop of receding expectations for additional rate hikes. However, as of the end of December, the interest rates on two-year and 10-year government bonds rose to 1.20% and 2.45%, respectively, surpassing the levels they were at a year ago.

In Japan, the interest rates on two-year government bonds rose to minus 0.187% at the end of December from minus 0.32% on July 5, while the interest rates on 10-year government bonds rose to 0.043% from minus 0.257% over the same period of time. If the rise in interest rates further accelerates in the future, this could hinder the growth of the Japanese economy. Rising interest rates on housing loans are one of the possible negative factors. There is also a possibility that more companies will go under. According to Tokyo Shoko Research, Ltd., 8,446 companies went bankrupt in 2016, the lowest level since 1990. Moreover, according to a survey by the Bank of Japan, when it comes to the diffusion index (DI) of the lending attitude of financial institutions to the financing demands of SMEs (“favorable” minus “unfavorable”), the number of SMEs saying “favorable” reached the levels of 1989. However, if the rise in interest rates accelerates, it is no wonder that more companies will face difficulty paying interest.

In addition, if interest rates increase, prices of bonds held will decline in general. Therefore, some may have brief thoughts that it would be detrimental to the balance sheet of banks. According to a recent estimate by the BOJ, if interest rates rise by one percentage point, the appraised value of bonds held by banks and shinkin banks (excluding Japan Post Bank, etc.) will decline by 7.4 trillion yen. However, in an estimate released in April 2013, the central bank stated that a rise of around one percentage point will have a minor impact because interest revenue from bank lending will increase.

Thus far, the amount of increase in interest rates is smaller in Japan, and the interest rates still remain below the levels of a year ago. Even though considering the recent depreciation of the yen and rising crude oil prices, it is still less likely that consumer prices will increase more than 2% year-over-year. The recent rise in interest rates does not accompany an increase in CPI inflation and so created unexpected circumstances. Even so, if the rise in interest rates accelerates going forward, the BOJ certainly will try to contain the rise with the Quantitative and Qualitative Monetary Easing with Yield Curve Control. Therefore, one may not need to be concerned about an impact on the real economy by the interest rate hike for the time being.

(Yusuke Suzuki, Senior Economist)

Selected Economic Indicators

	Fiscal Year		2015	2016		
	2014	2015	Oct-Dec	Jan-Mar	Apr-Jun	Jul-Sep
GDP at current prices (SAAR, Trillion Yen)	517.9	532.2	531.3	535.4	536.7	537.3
Real GDP at 2011 prices (SA, q/q%)	-0.4%	1.3%	-0.4%	0.7%	0.5%	0.3%
Industrial Production Index (SA, 2010=100)	98.4	97.4	97.1	96.1	96.3	97.6
Exports (SA, Trillion Yen)	74.7	74.1	18.4	17.5	17.1	17.0
Imports (SA, Trillion Yen)	83.8	75.2	18.3	17.0	16.2	16.0
Balance on Current Account (SA, Trillion Yen)	8.7	18.0	4.8	5.0	4.6	4.9
Corporate Bankrupcies	9,543	8,684	2,152	2,144	2,129	2,087
Unemployment Rate (SA, %)	3.5%	3.3%	3.3%	3.2%	3.2%	3.0%
Wage Index (SA, 2010=100)	99.0	99.2	99.1	99.7	99.1	99.9
Consumer Prices (y/y%)	2.9%	0.2%	0.3%	0.1%	-0.4%	-0.5%
Nikkei Stock Average	16,273	18,841	19,053	16,849	16,408	16,497
Japanese Government Bond Yields (%)	0.48	0.39	0.31	0.05	-0.12	-0.13
Foreign Exchange Rate (Yen/ Dollar)	109.9	120.1	121.5	118.1	108.2	102.4

Note: SAAR means Seasonally Adjusted Annual Rate. SA means Seasonally Adjusted.
q/q% means %change from a quarter earlier. y/y% means %change from a year earlier.
Source: CAO, METI, MOF, Tokyo Shoko Research, MIC, MHLW, Nihon Keizai Shimbun, CEIC, BOJ