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Fluctuating Economic Situation Continues

Real GDP in the first quarter of 2016 rose by 0.5% (1.9% annualized) from the previous quarter. It reached the second highest following the amount for the first quarter of 2014, when there was a high last-minute demand before the consumption tax hike. However, Japan failed to pull itself out of the fluctuating economic situation that has been continuing since the first quarter of 2015.

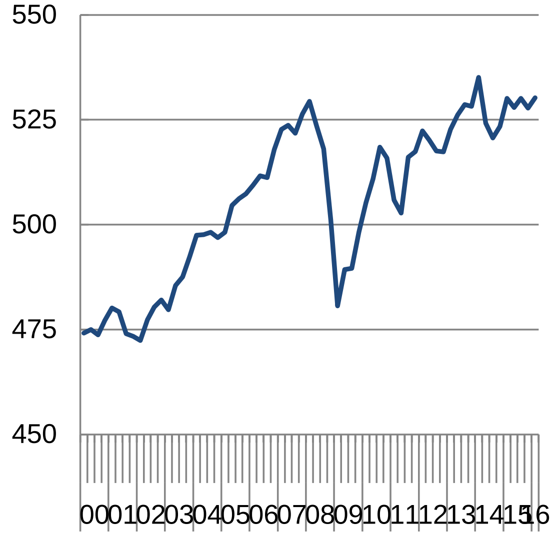
Private consumption* grew by 0.6% from the previous quarter. Spending on durable goods such as TV sets and on services such as eating out and recreation apparently increased. However, the figure is 0.5% lower than that for the first quarter of 2015, and nominal expenditure, which is closer to out-of-pocket household spending, fell 0.8% from the previous quarter despite a 2.5% quarter-over-quarter increase in compensation of employees. There is no doubt that private consumption is sluggish.

Private housing investments fell 0.7% from the previous quarter, which apparently reflects the two consecutive quarter decline in housing starts, a leading indicator, in the second half of 2015. However, in the first quarter of 2016, housing starts were up 9.1% from the previous quarter. Rental housing starts, which slipped in the fourth quarter of 2015 for the first time in five quarters, rose 7.3% from the previous quarter, and condominium starts significantly grew by 24.5%. Declining housing loan rates due to the Bank of Japan's quantitative and qualitative monetary easing with a negative interest rate likely will give a boost. Housing investments are expected to increase in the future.

Private non-residential fixed investments also marked a 0.7% quarter-over-quarter decline. The Financial Statements Statistics of Corporations indicates that private non-residential fixed investments decreased in the electric, information and communications technology machinery as well as the real estate industry, while they increased in the electricity, gas and water utility industries as well as the information and communication industry and the chemical industry. An unclear outlook for the corporate results is apparently behind the decline. While ordinary profit of corporations (excluding financial and insurance companies; with capital of 10 million yen or more) for the first quarter of 2016 still surpasses the peak recorded in the first quarter of 2007 before the Great Recession, it fell

Real Gross Domestic Product

at 2005 Price, Annualized, Trillion Yen



Source: CAO

Real Gross Domestic Product (GDP)

at 2005 Price, Calendar year

	2015	2015 7-9	2015 10-12	2016 1-3
	y/y%	q/q%	q/q%	q/q%
Real Gross Domestic Product	0.5%	0.4%	-0.4%	0.5%
Private Consumption	-1.2%	0.5%	-0.8%	0.6%
Private Housing Investments	-2.5%	1.7%	-1.0%	-0.7%
Private Non-Resi. Fixed Investments	1.5%	0.8%	1.3%	-0.7%
Public Investments	-2.5%	-2.4%	-3.6%	-0.7%
Government Consumption	1.2%	0.2%	0.7%	0.7%
Exports of Goods & Services	2.8%	2.6%	-0.8%	0.6%
(less) Imports of Goods & Services	0.3%	1.7%	-1.1%	-0.4%

Source: CAO

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

6.8% from the previous quarter. Compared to the second quarter of 2015 that marked a record-high ordinary profit, ordinary profit declined by 2 trillion yen in the manufacturing industry and by 1 trillion yen in the non-manufacturing industry over three quarters. However, private machinery orders (excluding orders for ships and those from electric power companies), which can be considered as leading indicators, rose for two consecutive quarters, while the floor space of new private non-residential buildings started to increase for the first time in three quarters. It is less likely that private non-residential fixed investments will continue to decrease further, while there is a low probability that they will shift upward drastically.

Public investments fell 0.7% from the previous quarter. This is the third consecutive quarter decline, with the figure dipping to the level recorded in the fourth quarter of 2012 when Prime Minister Shinzo Abe's second Cabinet was inaugurated. However, the contract amount for public works projects, which reflects the trends of order placement, rebounded in the first quarter of 2016 for the first time in three quarters, and further increased in April. Uncompleted construction contracts held by construction companies estimated by the Ministry of Land, Infrastructure, Transport and Tourism have been also increasing. Public investments are expected to turn around.

Exports of goods and services rose only 0.1% from the previous quarter. By item, exports of ships, non-ferrous metals, travel services (domestic consumption by foreign visitors) increased. However, exports of goods and services have remained stagnant as a whole after reaching a record high in the first quarter of 2015. Unless overseas economies accelerate, exports are unlikely to increase further. Meanwhile, imports saw a 0.4% quarter-over-quarter decline. Among goods imports of medicines and petroleum products declined while those of energy, electronics devices and personal-use articles increased. Among service categories payments for engineering and special technologies declined. As a result, net export contributed to real GDP growth of 0.2 percentage points from the previous quarter.

Consumption Tax Hike Postponed

At a press conference on June 1, Prime Minister Abe announced that he would postpone the planned consumption tax hike from 8% to 10% from April 2017 to October 2019. For that, the fear of a downward pressure on the economy after April 2017 subsided, while the possibility also disappeared that the economy would be boosted by increased last-minute demand before the consumption tax hike. According to the ESP Forecast Survey, which compiles real GDP growth rate forecasts of economists in the private sector, real GDP for the second quarter of 2016 will remain almost unchanged mainly due to the effects of Kumamoto Earthquake, while in following quarters real GDP is expected to see quarter-over-quarter growth of more than 0.2% (annualized 0.8%). The economy will grow by 0.5% in 2015 and by 1% in 2016 respectively.

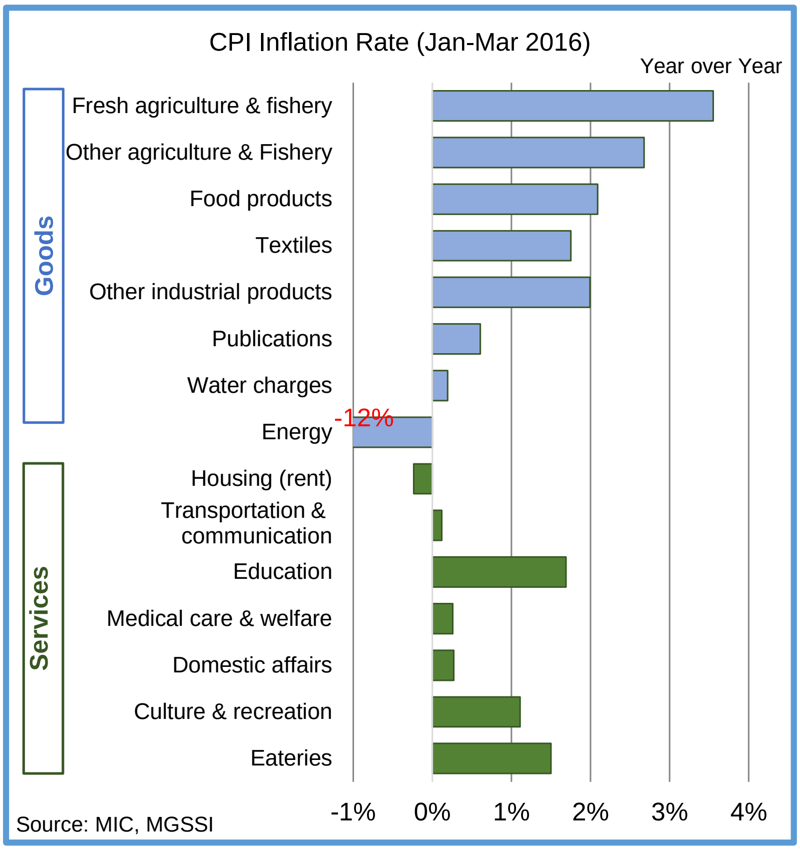
With the planned consumption tax hike, tax revenues for the central and local governments were expected to increase by about 4.6 trillion yen. Meanwhile, after the launch of the second Abe Cabinet, the economy turned around at least, and tax revenue, which assumed at the supplemental budget, increased to 98.1 trillion yen in fiscal 2015 from 80.7 trillion yen in fiscal 2012. If the revenue increase from the April 2014 consumption tax hike is deducted, the tax revenue apparently increased by 9 trillion yen over the three years. A simple calculation suggests that if nominal GDP continues to grow, the tax revenue is expected to increase by around 1.8 trillion yen annually even based on a relatively conservative estimate.

The Ministry of Health, Labour and Welfare estimates that the portion of social security benefits paid at public expense will likely increase by around 2.9 trillion yen per year by fiscal 2020. There is of course a possibility that tax revenue would increase further if the economic growth accelerated. However, there is no doubt that the latest postponement of the additional consumption tax hike will make it more difficult to achieve the fiscal reconstruction goal of turning the primary balance positive by fiscal 2020. With regard to 2019, when the consumption tax rate hike is re-planed, the government likely will raise the tax rate as planned to maintain confidence in fiscal policy while admitting that it would be impossible to achieve the fiscal reconstruction goal.

Rising Prices, Stagnant Prices

The consumer price index (CPI) increased just 0.1% on a year-over-year basis in the first quarter of 2016. While more than three years have passed since the Bank of Japan set a “price stability target” of 2% in terms of the year-on-year rate of increase in consumer prices, the bank has failed to achieve the goal.

The major reason for stagnant prices is falling energy prices such as gasoline and electricity, and they pushed the CPI inflation rate in the first quarter of 2016 down by one percentage point. Meanwhile, prices for perishable agricultural, fishery and animal products and industrial food products rose 3.6% and 2.1% year-over-year respectively, while prices for textile products and other industrial products also were up 1.8% and 2% from the same period in the previous year, respectively. According to an estimate on prices for goods excluding energy, they rose 2.2% from the same period in the previous year, which means that the level targeted by the price stability goal has been achieved for three consecutive quarters since the third quarter of 2015.



Due to a significant increase in public high school tuition fees and public kindergarten fees, prices for education-related services rose 1.7% year-over-year. Prices for eating out as well as culture and recreation-related services also increased. But prices for services are generally stable, marking a just 0.4% year-over-year increase, while prices for services excluding housing (rent) rose 0.8%.

No Risk of Rising Prices?

Consumer prices in May fell 0.4% from the same month in the previous year, and the inflation rate for goods excluding energy slowed to just 0.9%. Due to a lack of momentum in the economy, price hikes were apparently postponed in April, when fiscal year starts in Japan. Of 434 items among goods, 57% saw a rise in the rate of increase in prices from March to April in 2015, while in 2016, the rate increased in 33%.

There is a strong view that prices in Japan will not increase. The major reason is the strong yen. In May, import prices of consumables fell 9.4% from the same month in the previous year, with 6.1% of the decline having been due to the appreciation of yen. This is a big difference from the fact that currency effects pushed up import prices of consumables by 28.5% over the three years since mid-2012, when the yen started falling, until mid-2015. The further appreciation is anticipated stronger after the referendum of the United Kingdom on which British favor withdrawal from the European Union with more uncertainty in financial market.

However, there are factors that push prices up in Japan. One is recovery of oil prices, which would turn to rise from the same period in the previous year in the fourth quarter of 2016, according to the U.S. Energy Information Administration (EIA). Even after the UK referendum, the spot price of Dubai crude oil maintains around 45 dollars per barrel, the highest level since October 2015. In 2017, CPI inflation rate would be supported gradually by energy prices unless deteriorated again.

The other factor is wages. There is a perception that the corporate sector performance has hit the ceiling, and according to the Japanese Trade Union Confederation (Rengo), in the 2016 Shunto annual spring wage offensive, the average wage increase rate was 2% (calculated on June 1, with a rise equivalent to the regular annual wage hike included), 0.2 percentage points down from 2015. Given the fact, a cynical view spread that it would be difficult to expect a further acceleration of wage increases. However, in May, the unemployment rate declined to 3.2%, and the ratio of job openings to job seekers rose to 1.36. The average hourly wage continues to post a year-over-year increase of nearly 1% since the third quarter of 2015. Moreover, the unit labor cost (the average cost of labor per unit of output, calculated by compensation of employees over real GDP) rose 2.5% year-over-year in the first quarter of 2016 after temporarily declined. If demand continue to surpass supply in the labor market, it will likely help push prices up even at a slow pace.

According to a questionnaire survey conducted on 39 economists at the end of May, only one respondent said that the CPI inflation rate would surpass 2% from the previous year by the first half of 2018. In Japan, it is undeniable that people are so used to the decline in prices, which has lasted for many years. It might be necessary to pay attention to the risk of people not being able to adapt to the situation in which rising prices become obvious, because it is an unexpected situation.

(Yusuke Suzuki, Senior Economist)

Selected Economic Indicators

	Fiscal Year		2015			2016
	2014	2015	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
GDP at current prices (SAAR, Trillion Yen)	489.6	500.4	497.4	501.1	500.2	503.2
Real GDP at 2005 prices (SA, q/q%)	-0.9%	0.8%	-0.4%	0.4%	-0.4%	0.5%
Industrial Production Index (SA, 2010=100)	98.4	97.4	98.0	97.0	97.1	96.1
Exports (SA, Trillion Yen)	74.7	74.1	18.9	18.9	18.4	17.6
Imports (SA, Trillion Yen)	83.8	75.2	19.8	19.7	18.4	17.0
Balance on Current Account (SA, Trillion Yen)	8.7	18.0	4.0	4.0	4.8	4.9
Corporate Bankrupcies	9,543	8,684	2,296	2,092	2,152	2,144
Unemployment Rate (SA, %)	3.5%	3.3%	3.4%	3.4%	3.3%	3.2%
Wage Index (SA, 2010=100)	99.0	99.2	98.7	99.5	99.1	99.7
Consumer Prices (y/y%)	2.9%	0.2%	0.5%	0.2%	0.3%	0.1%
Nikkei Stock Average	16,273	18,841	20,049	19,412	19,053	16,849
Japanese Government Bond Yields (%)	0.48	0.39	0.40	0.40	0.31	0.05
Foreign Exchange Rate (Yen/ Dollar)	109.9	120.1	121.3	122.2	121.5	118.1

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