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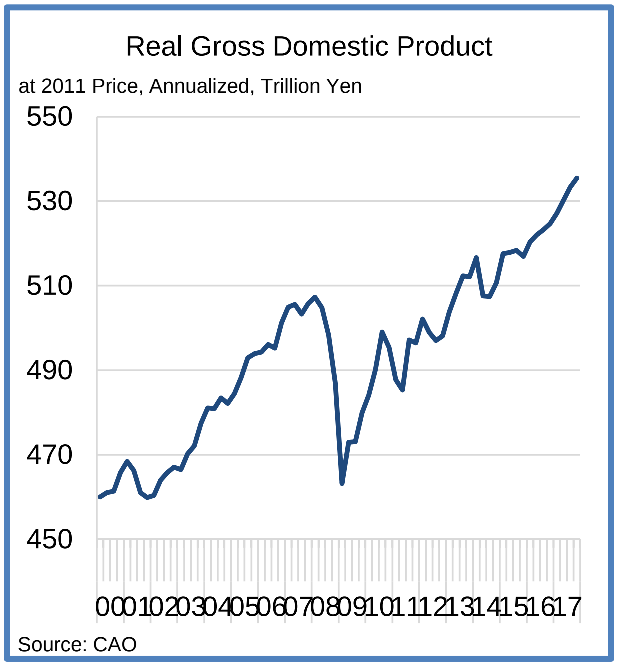
Positive Growth for Eight Straight Quarters

Real GDP in the fourth quarter of 2017 rose by 0.4% (1.6% annualized) from the previous quarter, recording positive growth for eight consecutive quarters for the first time in 28 years. Private consumption*, private non-residential fixed investment, and exports of goods and services served as a driving force of growth, working to boost real GDP growth by 0.9% points in total from the previous quarter. The economic expansion that began in November 2012 seems to be lasting for the second longest period in the post-war period. (*All subsequent references to GDP demand items are in real terms unless otherwise indicated.)



Private consumption rose by 0.5% from the previous quarter, posting quarter-over-quarter growth for the first time in two quarters. Spending on durable goods such as smartphones and automobiles recorded the first increase in three quarters. On the other hand, the total amount of wages paid by corporations declined by 0.4% in real terms against a backdrop of rising prices. With the ratio of private consumption to total wages paid by corporations remaining at the second lowest level since the third quarter of 2011, it is difficult to conclude that consumption has recovered.

Private non-residential fixed investment increased by 1.0% from the previous quarter, marking a fifth consecutive quarterly increase for the first time in about 11 years. According to the Financial Statements Statistics of Corporations, nominal non-residential fixed investment by the manufacturing industry grew significantly by 7.7% from the previous quarter. The electric and information & communication equipment contributed to the growth. Nominal non-residential fixed investment by the non-manufacturing industry remained almost unchanged, up 0.6% from the previous quarter, while recording growth in such sectors as

Real Gross Domestic Product (GDP)

at 2011 Price, Calendar year

	2017	2017		
		4-6	7-9	10-12
	y/y%	q/q%	q/q%	q/q%
Real Gross Domestic Product	1.7%	0.6%	0.6%	0.4%
Private Consumption	1.1%	0.9%	-0.6%	0.5%
Private Housing Investment	2.6%	0.9%	-1.7%	-2.6%
Private Non-Resi. Fixed Investment	3.0%	1.2%	1.0%	1.0%
Public Investment	1.2%	4.8%	-2.6%	-0.2%
Government Consumption	0.1%	0.2%	0.1%	0.0%
Exports of Goods & Services	6.8%	0.0%	2.1%	2.4%
(less) Imports of Goods & Services	3.6%	1.9%	-1.2%	2.9%

Source: CAO

services, leasing, and transport & postal services. According to the Bank of Japan's Tankan survey (Short-Term Economic Survey of Enterprises in Japan), companies' capital investment plans for Fiscal 2017 continued to be revised upward. Given this, private non-residential fixed investment is expected to continue to increase going forward.

Exports of goods and services recorded high growth of 2.4% from the previous quarter. According to the export volume index, exports of major items, such as general machinery (machine tools, etc.) and transport equipment (automobiles, etc.), grew across the board. By region, exports to the United States and the European Union remained sluggish, while exports to China and other Asian countries increased. Imports of goods and services grew by 2.9% from the previous quarter, the largest increase in the past 15 quarters. According to the import volume index, imports of machineries and equipment including smartphones, chemical products, food products and raw materials increased. By region, imports from the EU, the US and Asia all increased. Meanwhile, since both exports and imports increased, net exports did not boost real GDP. The world's trade volume expanded for seven consecutive quarters, and the world's economy is expected to continue to grow going forward. Therefore, exports will continue to be on an uptrend. On the other hand, sales of smartphones, which have contributed to increasing imports, appear to be declining.

Private residential investment declined by 2.6% from the previous quarter. It declined for two consecutive quarters, and the rate of decline increased. Due to the sense of oversupply of homes for both rental and sale, the number of new housing starts stood at 948,000 units (annualized). In particular, the number of rental housing starts, which was on an uptrend as part of inheritance tax-saving measures, declined for the third consecutive quarter. In addition, the number of condominium starts moderately declined for two quarters in a row. On the other hand, of homes for sale, single-detached housing starts grew by 6.4% from the previous quarter. Compared to condominiums, they are apparently seen as affordable, and so single-detached housing starts outnumbered condominium starts for seven straight months. Given that abundant uncompleted construction contracts ahead of the Tokyo Olympics held by construction companies constrain ability to launch new projects, residential investment is likely to remain sluggish.

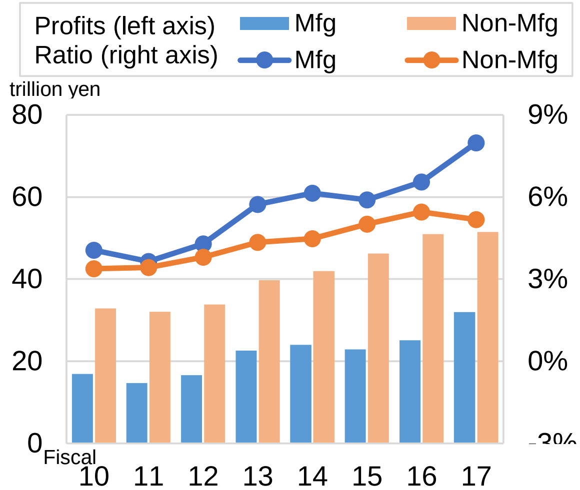
Public investment fell by 0.2% from the previous quarter. After posting a moderately high quarter-over-quarter growth of 4.6% in the second quarter of 2017, it fell for two consecutive quarters as a reactionary decline. The contract amount for public works projects, which is a leading indicator, declined by 2.9% from the previous quarter, remaining low following a dramatic decline in the third quarter. However, in the Fiscal 2017 supplementary budget passed in February 2018, the central government increased investment-related spending by 1.5 trillion yen. In the Fiscal 2018 budget, 9.1 trillion yen was allocated to investment, which is the same as the amount in the initial budget for Fiscal 2017. Though public investment could slow down in the latter half of Fiscal 2018 depending on the presence or absence of a supplementary budget, it is likely to turn around in coming months.

According to an ESP Forecast survey (March 2018), the average of forecasts of private economists on real GDP growth, real GDP is expected to grow 1.4% year on year in 2018, while in 2019, the expected year-on-year GDP growth rate is 1.1%, given the effects of the consumption tax hike from 8% to 10% scheduled in October 2019. While the real GDP growth rate is expected to gradually decline, it is highly likely that the Japanese economy will continue to grow moderately, supported by consumption and exports for the time being. If the forecast turns out to be accurate, Japan will achieve the same length of growth phase it experienced from 2000 to 2007, during which Japan's real GDP grew for eight consecutive years thanks to the emerging country boom, while the expected growth rates are slightly lower than those during the period.

Recovery in Sales and Ordinary Profits of the Manufacturing Industry

For April-December 2017, total ordinary profits of Japanese corporations rose by 9.3% from a year earlier. Ordinary profits of the manufacturing industry grew significantly by 27.2% from the same period the previous year. Total ordinary profits of six businesses in the machinery sector, including production machinery, such as machine tools and semiconductor production equipment, grew by 36.6% year over year. Moreover, supported by improved market conditions, ordinary profits of the steel sector grew dramatically by 117.7% year on year. Ordinary profits of the non-manufacturing industry saw year-on-year growth of 1.8%. However, profits of pure holding companies in the services increased significantly in the same period of the previous year due to a special factor, and there was a reaction to the increase. Therefore, if they are excluded, ordinary profits of the non-manufacturing industry grew by 9.5% year on year. The wholesalers, the banking & insurance, the transport & postal services contributed to increasing profits.

Ordinary Profits and the Profit-to-Sales Ratio



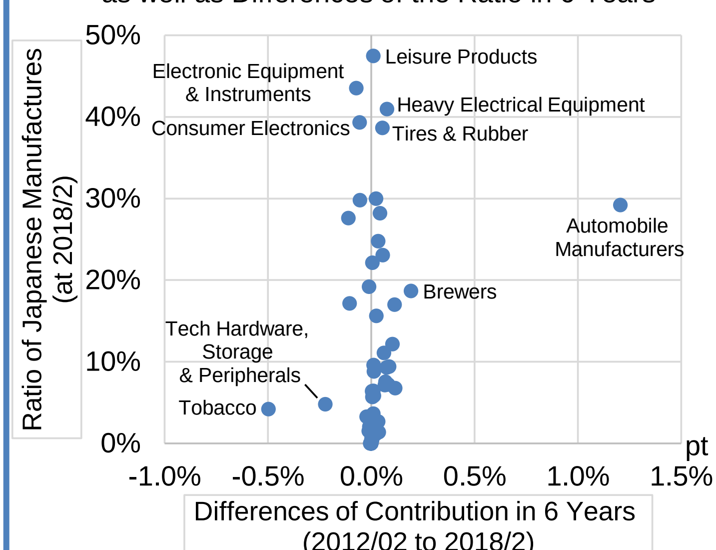
Note: Finance & insurance aren't included in non-manufacturing. Figures for fiscal 2017 are estimated with the results for April to December.
Source: MOF

Following the case of ordinary profits, sales also turned around. For April-December 2017, sales of the manufacturing industry grew by 4.5% from a year earlier, and sales of the non-manufacturing industry (excluding the banking & insurance) grew by 6.3% from a year earlier. In particular, as for the manufacturing industry, sales grew only by 0.4% year on year in the April-December period of 2013 and the same period of 2014, respectively. Given this, the manufacturing industry effectively posted sales growth for the first time in seven years. On the other hand, the profit-to-sales ratio in the manufacturing industry rose to 7.7%. Compared to Fiscal 1989 when Japan enjoyed strong growth during the bubble economy and Fiscal 2006 just before the world financial crisis, the ratio is at a considerably high level. This indicates that there was a shift to a structure where increased sales could easily lead to a large growth in profits.

Signs of Improvement in the Global Competitiveness of the Manufacturing Industry

After the Great East Japan Earthquake in March 2011, we often heard the words "sextuple pain." This is the claim that Japan's global competitiveness is undermined by the following six factors: (1) a high yen; (2) a heavy burden of corporate tax and social insurance premiums; (3) delays in the conclusion of economic partnership agreements; (4) an inflexible labor market, (5) unreasonable environmental regulations and; (6) electricity supply shortages and high costs. However, the number of Japanese companies included in the world's top 3,000 manufacturing companies increased from 380 at the end of February 2012 to 414 at the end of February 2018. The share of net profits earned by Japanese manufacturers among top 3,000 companies also increased from 8.2% to 10.6% over the same period. For the six-year period, net profits of the world's top 3,000 manufacturers grew by 15.9% in total. The Japanese manufacturing industry achieved a recovery surpassing this growth.

The Ratio to Net Profits of Japanese Manufactures in the World's Top 3,000 Manufactures as well as Differences of the Ratio in 6 Years



Note: The ratio is increased by 2.4%pt from 8.2% to 10.6% in 6 years and the differences shows contributions to this 2.4%pt by sector in 6 years. Sector classification is based on GICS.
Source: Bloomberg. Calcurated by MGSSI

By sector, recovery in the automobile manufacturers is remarkable. Over the past six years, the ratio of Japanese companies grew by 2.4% points. About half of this increase are accounted by the automobile manufacturers. Furthermore, of all 57 sectors in the manufacturing industry, the growth rate of net profits exceeded the world's average in 35 sectors, including the diversified chemicals and the commodity chemicals. On the other hand, the growth rates of net profits in the electronic equipment manufacturers and the technology hardware, storage & peripherals were lower than the world's average.

Furthermore, coinciding with the recovery in profits, overseas evaluations for the Japanese manufacturing industry began improving. For example, in the Global Manufacturing Competitiveness Index prepared by the U.S. Council on Competitiveness and the Deloitte Touche Tohmatsu Limited, Japan's ranking climbed to 4th in 2016 from 10th in 2013, winning high evaluations in the fields of talent, social capital and innovation policies. In addition, the Readiness for the Future of Production Report issued by the World Economic Forum in January 2018 evaluated Japan as having the world's strongest Structure of Production score at present, because it has a complex and diverse product mix.

The exchange rate was 85 yen per dollar when Prime Minister Shinzo Abe's second Cabinet was launched. After that, the yen has depreciated significantly. The effective corporate tax rate declined from 34.62% to 29.74% in Fiscal 2018. Japan signed the Trans-Pacific Partnership agreement in February 2016, while the negotiations between Japan and the EU on the economic partnership agreement were finalized in December 2017. The central government has not requested cooperation for energy saving since the winter of Fiscal 2015. Issues remain in respective fields, while there is no doubt that there has been some progress. Today, we seldom hear the words "sextuple pain." Japan is now facing new challenges to promote the fourth industrial revolution. However, the good news is the business environment surrounding the Japanese manufacturing industry is improving, and Japanese manufacturers are regaining international competitiveness.

Selected Economic Indicators

	Fiscal Year		2017			
	2015	2016	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec
GDP at current prices (SAAR, Trillion Yen)	533.9	539.3	540.7	545.5	549.2	550.7
Real GDP at 2011 prices (SA, q/q%)	1.4%	1.2%	0.5%	0.6%	0.6%	0.4%
Industrial Production Index (SA, 2010=100)	97.5	98.6	100.0	102.1	102.5	104.3
Exports (SA, Trillion Yen)	74.1	71.5	19.2	19.0	19.7	20.5
Imports (SA, Trillion Yen)	75.2	67.5	18.3	18.7	18.7	19.7
Balance on Current Account (SA, Trillion Yen)	17.9	20.4	5.5	5.0	5.7	5.8
Corporate Bankrupcies	8,684	8,381	2,079	2,188	2,032	2,106
Unemployment Rate (SA, %)	3.3%	3.0%	2.9%	2.9%	2.8%	2.7%
Wage Index (SA, 2010=100)	100.2	100.6	100.9	100.7	101.2	101.2
Consumer Prices (y/y%)	0.2%	-0.1%	0.3%	0.4%	0.6%	0.6%
Nikkei Stock Average	18,841	17,520	19,241	19,503	19,880	22,188
Japanese Government Bond Yields (%)	0.29	-0.05	0.07	0.04	0.05	0.05
Foreign Exchange Rate (Yen/ Dollar)	120.1	108.4	113.6	111.1	111.0	113.0

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