MGSSI Japan Economic Quarterly

January 2019

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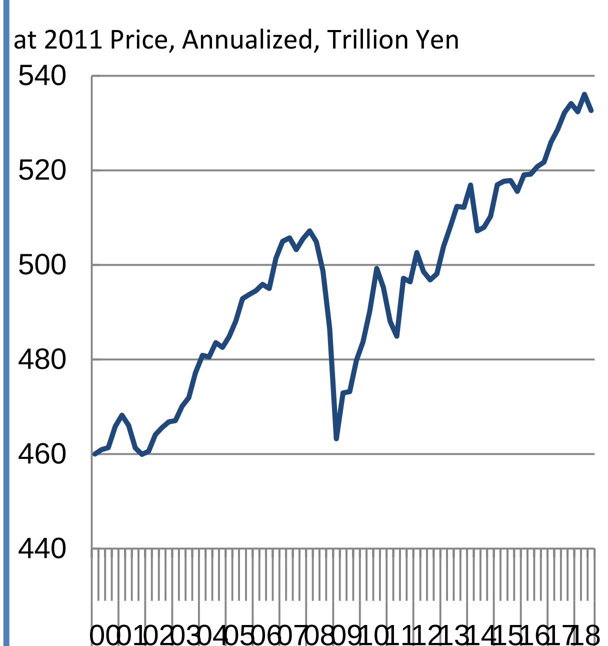
First Negative Growth in Two Quarters

Real GDP in the third quarter of 2018 was down 0.6% (2.5% annualized) from the previous quarter, turning negative from the previous quarter's positive growth.

Both private consumption* and private non-residential fixed investment – two major indicators of domestic private demand – declined due to floods and landslides triggered by torrential rain in western Japan (July), an earthquake in Hokkaido (September), and typhoons and extremely hot days that struck various parts of the country. (*All subsequent references to GDP demand items are in real terms unless otherwise indicated.)



Source: CAO

Private consumption decreased 0.2% from the previous quarter. Natural disasters hindered store operations and the supply of products, while also causing a decline in the number of foreign tourists to Japan. Private non-residential fixed investment saw a fairly large decline of 2.8% from the previous quarter, the first decrease in eight quarters. However, the level of investment remains high, as it is the third highest in the past after the previous quarter that marked a record high by surpassing the level recorded in the fourth quarter of 1997 on a nominal basis. According to the Financial Statements Statistics of Corporations, nominal investment in the manufacturing industry and the non-manufacturing industry (excluding the financial and insurance sectors) both saw quarter-over-quarter declines of 5.3% and 3.3%, respectively. These declines seem to be partly due to a reaction to the big increase in the previous quarter. A Bank of Japan's Short-Term Economic Survey of Enterprises in Japan ("Tankan" survey) shows that capital investment plans for FY2018 are expected to grow 10.1%

Real Gross Domestic Product (GDP)

at 2011 Price, Calendar year

	2017	2018		
		1-3	4-6	7-9
	y/y%	q/q%	q/q%	q/q%
Real Gross Domestic Product	1.9%	-0.3%	0.7%	-0.6%
Private Consumption	1.1%	-0.3%	0.7%	-0.2%
Private Housing Investments	2.1%	-2.1%	-1.9%	0.7%
Private Non-Resi. Fixed Investments	3.9%	0.4%	2.8%	-2.8%
Public Investments	0.7%	-0.5%	-0.5%	-2.0%
Government Consumption	0.3%	0.2%	0.1%	0.2%
Exports of Goods & Services	6.8%	0.5%	0.3%	-1.8%
(less) Imports of Goods & Services	3.4%	0.2%	1.0%	-1.4%

Source: CAO

year on year in all industries as of December, with a particularly large increase of 15.4% expected in the manufacturing industry. Given these estimates, private non-residential fixed investment is expected to continue to grow for the time being.

Public investment declined 2% from the previous quarter, down for five straight quarters to the lowest level since the fourth quarter of 2012. However, since the FY2018 first supplementary budget (935.6 billion yen), which focuses on measures against natural disasters, was passed in November 2018, public investment likely will turn around in the short-term. In addition, government consumption continued a moderate expansion, up 0.2% from the previous quarter.

Most demand categories declined, while private housing investment increased 0.7% from the previous quarter, slightly improving for the first time in five quarters. However, the number of new housing starts was down 1.6% from the previous quarter at 952,000 annually.

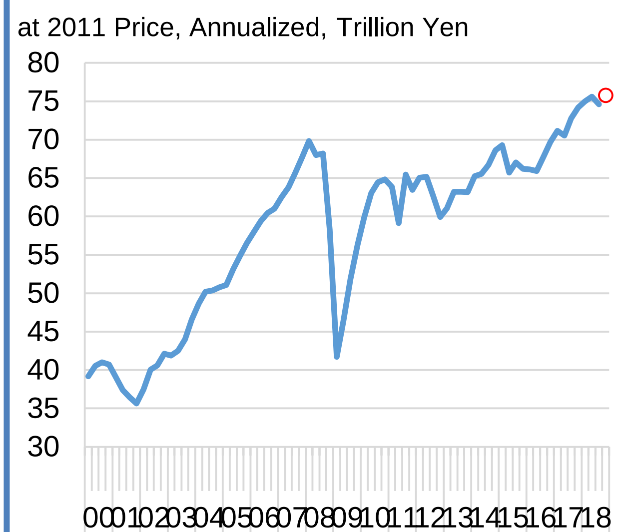
Exports of goods and services were down 1.8% from the previous quarter, the first decline in five quarters. According to real exports calculated by the Bank of Japan, there were considerable declines in exports of automobile-related goods and capital goods. By region, exports to NIEs, ASEAN, etc., increased, while those to the EU and the U.S. declined 4.9% and 0.4% from the previous quarter, respectively. Imports of goods and services declined 1.4% from the previous quarter. Since the decrease of exports surpassed that of imports, net exports contributed to cut real GDP growth by 0.1% point from the previous quarter.

Given that production and export turned around in October, the impact of natural disasters seems to have ceased already. A look at the averages of forecasts by private economists of real GDP growth compiled by an ESP Forecast survey (December 2018) reveals that real GDP will grow year on year by 0.8% in 2018 and 0.9% in 2019. The Cabinet Office officially acknowledged that the economic expansion phase that has continued since December 2012 exceeded the 57-month-long Izanagi boom during the high-growth period (from November 1965 to July 1970), becoming the second-longest economic boom in postwar Japan. If positive growth continues until January 2019, it will exceed the eight consecutive years of growth from 2000 to 2007 when emerging economies were booming, although the growth rate will be slightly weaker.

Dark clouds looming over the future of exports

Real exports of goods increased 14.7% for the two years until the second quarter of 2018. According to estimates by the Bank of Japan, exports of capital goods, such as metal processing machinery and construction machinery, recorded significant growth of 21.9% over the same period. In addition, exports of automobile-related goods grew 15.4% and that of information-related goods including computing machinery and electronic components such as semiconductors increased 14.4%. The exports of these machinery and equipment apparently accounted for about 90% of real export growth in Japan over the same period.

Real Exports of Goods

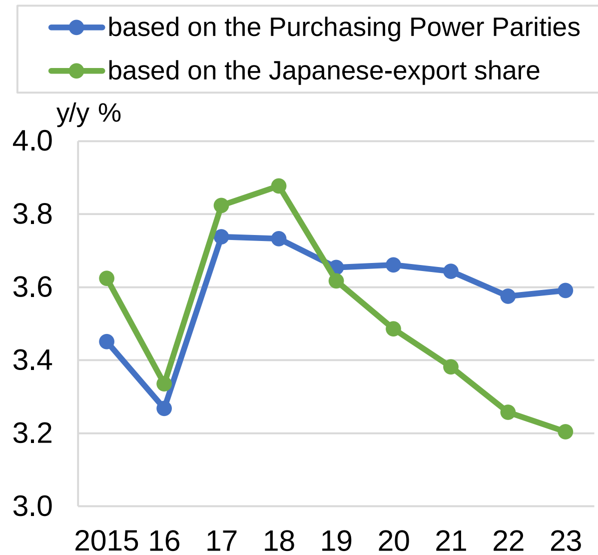


Note: Based on GDP statistics. The data for the fourth quarter of 2018 (O) is estimated based on the average of "Real Exports" in October and November 2018 calculated by the BOJ.

Source: CAO, BOJ

However, the outlook is not so bright. The International Monetary Fund (IMF) predicts that the world real GDP growth rate will remain the same at 3.7% from 2017 to 2020 in purchasing power parity (PPP) terms. However, according to estimates based on the export value of Japan in 2017, the growth is expected to slightly speed up to 3.9% in 2018 from 3.8% in 2017, and then slow down to 3.6% in 2019. Of the world's top 10 economies by GDP in PPP terms, six countries including India, Russia and Brazil are expected to see faster economic growth at least, while all of Japan's top 10 export destinations are likely to experience economic slowdown. For Japan, exports to South Korea and Taiwan are relatively large, and those to India are small. Whether good or bad, Japan could be easily affected by boom and bust cycles in global IT-related sectors, but not in emerging economies.

Global Real GDP Growth Rate



Note: The growth rate based on the Japanese-export share are calculated with fixed-weight in 2017.
Source: IMF, MOF

U.S. real GDP growth is expected to decelerate to 2.5% in 2019 from 2.9% in 2018, and the eurozone's growth will slow down to 1.9% from 2% over the same period. Given the tight labor market and steady wage increase, a drastic deceleration of consumption is unlikely. On the other hand, investment (gross fixed capital formation, private investment + public investment), which collapsed after the world financial crisis, eventually picked up in the U.S. in 2010 and in the eurozone in 2014, and seems to have reached levels matching, or even surpassing, potential growth rates. Based on the capital-stock-cycle hypothesis, investment is more likely to decelerate, if expectations on future growth become brighter, or unless equipment becomes obsolete more rapidly than expected. Given that machinery and equipment have supported Japan's export growth, the slowdown of investment could become a strong headwind.

Global sales of new automobiles began declining in September last year, and the sales of semiconductors have peaked out. According to a survey that asked Japanese manufacturers about the number of orders they received for facility machines, external demands declined for three consecutive quarters until the third quarter of 2018 after peaking in the fourth quarter of 2017. For now, it will be difficult to expect the growth of machinery and equipment exports.

The development of the smart society holds the key

However, the main cause for the decline of real exports in the second quarter is the impacts of heavy rains and earthquakes, and the average of October and November picked up. According to an ESP Forecast survey, many believe that real exports (including exports of services) in GDP statistics will continue to increase while decelerating until the first quarter of 2020, the last quarter of the current count period. As reports concerning trade frictions caused by U.S. trade policy make headlines, some Japanese companies are reviewing their production bases, with most of such cases involving exports from the U.S. to China or those from China to the U.S. While the U.S.-China trade row is escalating, it seems to have a limited direct negative impact on Japan's exports for the time being.

Rather, the focus should be placed on developments after 2020. In the mid- and long-term, there are growing expectations for the advent of a smart society, which is filled with new values and services created through innovations and sophisticatedly integrates virtual and real spaces. If realized, the utilization of big data will become more familiar, and robots and self-driving cars will no longer be rare. As the maturity of the smartphone market and the end of the virtual currency boom are reported, some IT-related sectors are experiencing sluggish growth. However, demands for semiconductors such as integrated circuits (IC), electronic components such as condensers, and parts for secondary batteries and their manufacturing equipment could increase going forward.

Meanwhile, the IMF predicts real GDP growth of 1.4% both for the U.S. and the eurozone in 2023, respectively. In addition, China's real GDP growth rate is expected to decline from 6.6% in 2018 to 5.6%. Even though the impact of the trade friction remains limited, the world economy is highly likely to become sluggish in the medium term, which will put pressure on the sentiments of companies and investors. The future of Japan's exports will depend on which sentiments are stronger, either expectations or concerns, which are mixed towards the future.

Selected Economic Indicators

	Fiscal Year		2017	2018		
	2016	2017	10-12	1-3	4-6	7-9
GDP at current prices (SAAR, Trillion Yen)	536.8	547.4	550.8	547.7	550.5	546.7
Real GDP at 2011 prices (SA, q/q%)	0.9%	1.9%	0.4%	-0.3%	0.7%	-0.6%
Industrial Production Index (SA, 2010=100)	100.6	103.5	104.4	103.3	104.5	103.1
Exports (SA, Trillion Yen)	71.5	79.2	20.3	20.0	20.5	20.6
Imports (SA, Trillion Yen)	67.5	76.8	19.6	19.8	20.3	21.0
Balance on Current Account (SA, Trillion Yen)	21.0	21.8	5.9	4.7	5.5	4.2
Corporate Bankrupcies	8,381	8,367	2,106	2,041	2,107	2,017
Unemployment Rate (SA, %)	3.0%	2.7%	2.7%	2.5%	2.4%	2.4%
Wage Index (SA, 2010=100)	100.6	101.3	101.2	102.2	102.7	102.2
Consumer Prices (y/y%)	-0.1%	0.7%	0.6%	1.3%	0.6%	1.1%
Nikkei Stock Average	17,518	20,960	22,182	22,333	22,348	22,624
Japanese Government Bond Yields (%)	-0.05	0.05	0.05	0.06	0.04	0.09
Foreign Exchange Rate (Yen/ Dollar)	108.3	110.8	113.0	108.1	109.1	111.4

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