

Research Japan

Running on all engines

- **Japan is showing itself to be in good shape as the economic upswing is the longest-standing since the crisis.**
- **We expect growth to continue through fiscal 2017, supported by a very strong labour market, the global economic recovery and extremely accommodative economic policies.**
- **As fiscal stimulus wanes next year, we are likely to see growth rates return to lower levels around potential.**
- **Underlying price pressure remains very low. Higher inflation does not seem impending.**

Strong momentum

The Japanese economy picked up speed in Q2 and grew at an annualised growth of 2.5% q/q. Thus, the economic upswing continued and the last six quarters now constitute the longest period of positive growth in Japan since before the crisis. According to Bank of Japan's TANKAN survey, businesses are turning increasingly upbeat, more companies have reported favourable conditions since Q2 16 and more companies are looking for favourable conditions in Q3. On the other hand, PMIs have decreased in July and August, particularly driven by the service sector, which could signal some slowdown in domestic demand. Manufacturing PMIs have also shown some signs of slowdown, which is also what we see in industrial production over the summer. Composite PMI now stands about one index point lower than Q2, which indicates a decrease in Q3 for the first time in 2017. PMIs thus point to some slowdown in GDP growth.

Growth was primarily driven by private consumption and investments in Q2. Looking back on the recent year, exports have been the key driver, though. We do expect more from private consumption going forward. Wage inflation remains stubbornly low but with a labour market that is turning increasingly hotter and unemployment that has fallen to even lower levels, total wage income is increasing, even if wages are not. We believe there is room for private consumption to continue contributing to growth. Consumer confidence has also remained upbeat over the summer, although it does look like some slowdown in private consumption in Q3. Both consumer surveys and auto sales have looked weak in August. Retail sales, on the other hand, was strong. We expect private consumption to stay on a positive trend but as long as wage increases remain depressed, it will probably be at a moderate pace.

On the private demand side, we have also seen a decent pick-up in investments recently. Both business and residential investments have been increasing since the current economic upturn began in Q1 16. Indicators are mixed, as housing starts decreased in July and businesses signal a slight increase in production capacity in Q3. Machinery orders, on the other hand, rebounded in July after a weak first half of the year. Looking beyond Q3, we expect the positive trend in business investments to keep up, as the output gap increases and labour becomes an increasingly scarce resource. At the same time, the Tokyo Olympics

Japan forecasts

	Calendar year average		
	2016	2017	2018
GDP	1.0	1.7	1.4
Private Consumption	0.3	1.5	1.6
Private Fixed Investments	2.0	3.2	2.7
- Residential investment	5.5	4.5	2.6
- Non-residential	1.4	3.0	2.7
Public Investments	-2.9	2.0	-3.8
Public Consumption	1.3	0.4	0.0
Exports	1.1	6.0	3.0
Imports	-2.3	3.7	2.5
Unemployment rate (%)	3.1	2.8	2.7
CPI, excl. fresh food (y/y)	-0.3	0.4	0.5
BoJ rate on deposit facility	-0.1	-0.1	-0.1

Source: Danske Bank, Japan Statistics Bureau, Bank of Japan

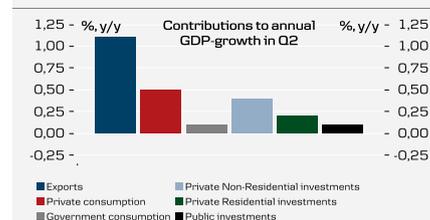
Economic upswing gained speed in Q2...



Note: TANKAN Index is calculated by subtracting the enterprises responding 'unfavourable' from those responding favourable.

Source: Danske Bank, Japan Statistics Bureau, Bank of Japan, Macrobond Financial

...mainly due to private consumption. But exports have been the key driver so far



Source: Japanese Cabinet Office and Macrobond

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2020 remains supportive for investments. Bank of Japan (BoJ) has estimated that investments in infrastructure, hotels, commercial properties, etc., amount to 1.3% of annual GDP spread out over the years 2014-2021.

Overall, exports have still been the main driver of the upturn, especially over the past year. Japan is particularly dependent on the US and China, which account for close to 40% of total exports. Particularly exports to China have been key, standing at close to 20% y/y in nominal terms, but also US demand has been strong. Whereas private demand could be slowing somewhat in Q3, exports have been strong and rebounded in July. An increasing share of companies are reporting excess demand in Q2 and expectations of the same in Q3. Japanese exporters strongly benefit from the global economic upturn and the relatively weak yen.

Stimulus in place but inflation remains stubbornly low

We expect monetary policy to remain extremely accommodative throughout the forecast period, which will also be supportive for demand, both domestically and abroad. BoJ has pledged to hold measures in place until the 2% inflation target is reached. Inflation has been increasing through 2017, but mainly due to rising energy prices. Underlying price pressure in Japan remains very low and BoJ's inflation target is currently nowhere within reach. Almost three decades of very low inflation mean companies are reluctant to raise prices and try to cut back on services and streamline their operations instead of raising wages. Low worker mobility and a preference for job security over wage increases are big obstacles for wage inflation.

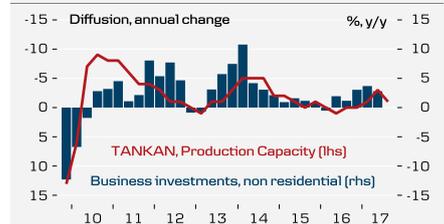
Public spending is also set to remain supportive for the economy through the fiscal year 2017, which runs from Q2 17-Q1 18. We expect to see GDP-growth around 2% q/q annualised through the rest of fiscal 2017 and a significant slowdown in fiscal 2018 when stimulus starts to wear off.

Increasingly tighter labour market paves the way for investments



Source: Japan Statistics Bureau, Japanese Ministry of Labour, Macrobond Financial.

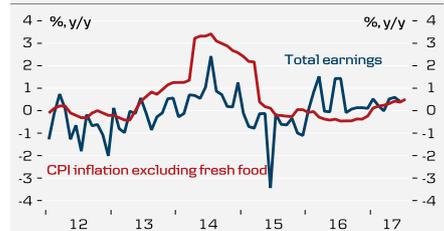
More businesses expect increasing production capacity in Q3 - trend points the other way, though



Note: TANKAN Index is calculated by subtracting the enterprises responding 'insufficient capacity' from those responding 'excess capacity'.

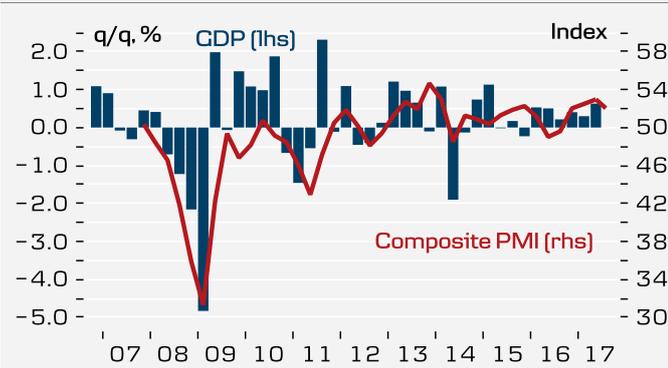
Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

Underlying price pressure remains very low



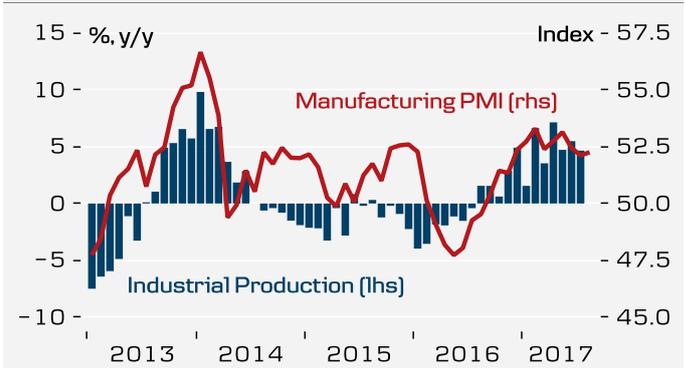
Source: Japan Statistics Bureau, Japanese Ministry of Labour, Macrobond Financial

PMIs point to a slowdown in Q3. Especially the service sector has been weaker. Still way above 50, though.



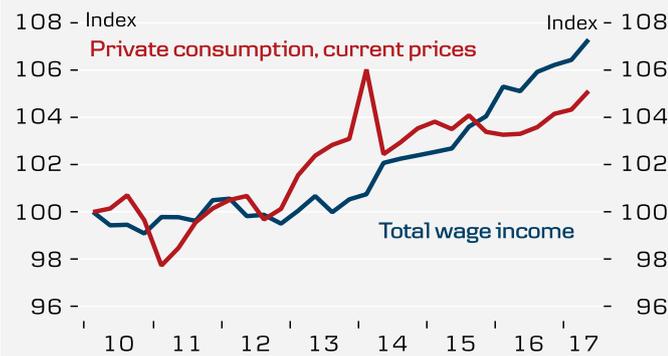
Note: The Q3 observation for PMI represents July-August
Source: Japanese Cabinet Office, Markit, Macrobond Financial

Also manufacturing sector has slowed somewhat lately, still solid progress, though



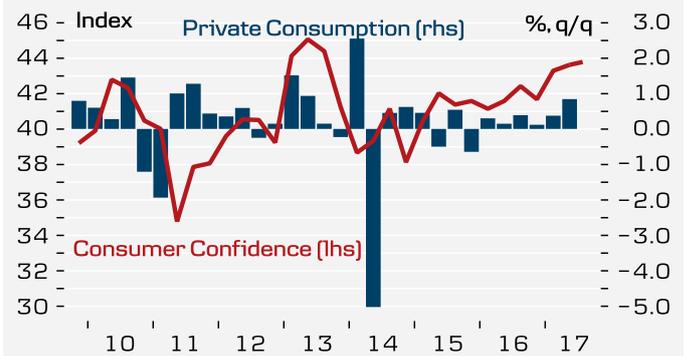
Source: Japanese Ministry of Economy, Markit, Macrobond Financial

Strong labour market means wage income is increasing even if wages are not...



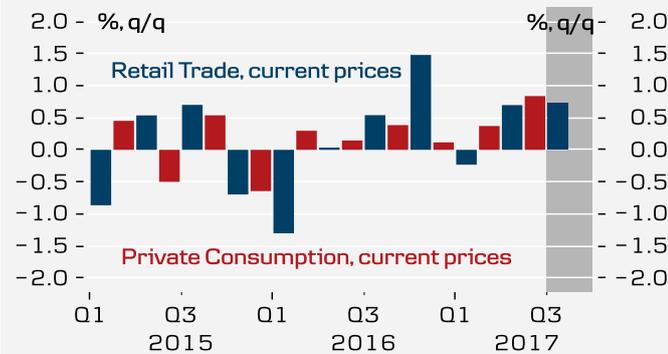
Source: Japanese Cabinet Office, Macrobond Financial

... consumer confidence has turned more upbeat over the summer...



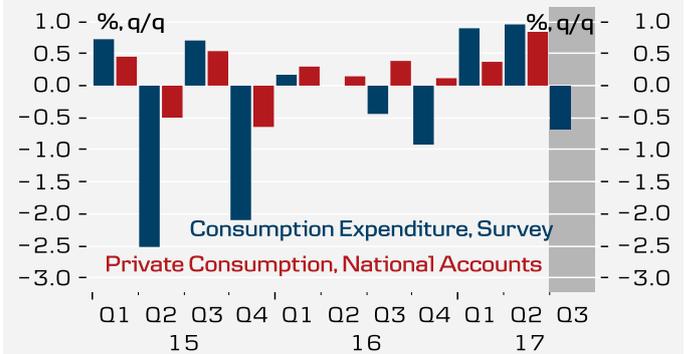
Source: Japanese Cabinet Office, Macrobond Financial

... and retail sales actually looked strong in July...



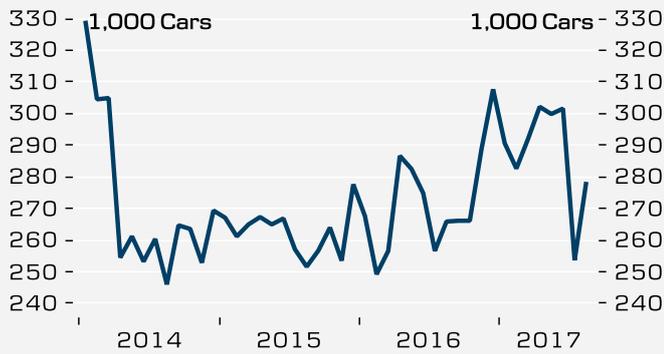
Note: Shaded area holds July growth compared to Q2.
Source: Japanese Cabinet Office, Japanese Ministry of Economy, Macrobond Financial

... but consumer survey from July indicates weaker consumption in Q3...



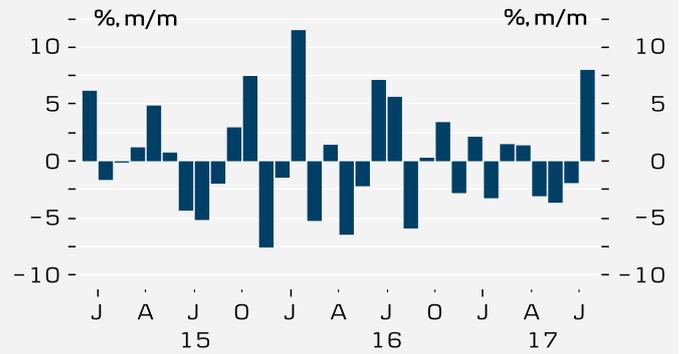
Note: Shaded area holds July growth compared to Q2.
Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

... and auto sales have also decreased in July and August



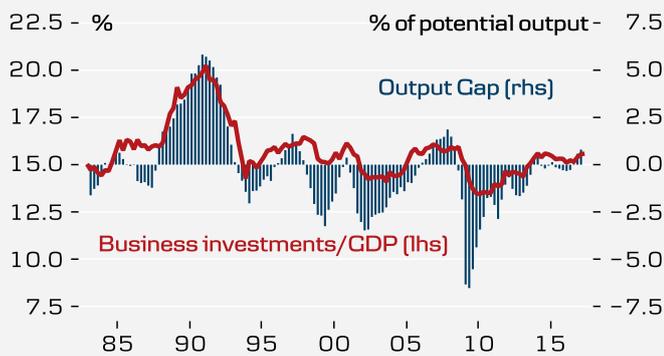
Source: Japanese Automobile Dealers Association, Macrobond Financial

Machinery orders look promising for Q3 following a weak first half of the year...



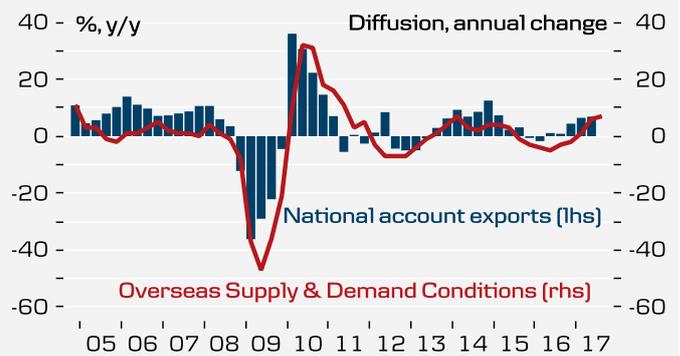
Source: Japanese Cabinet Office, Macrobond Financial

... and when output gap increases, investments should follow suit



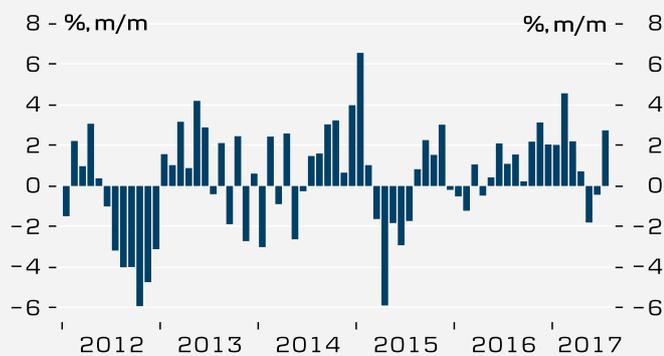
Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

Businesses expect increasing foreign demand in Q3...



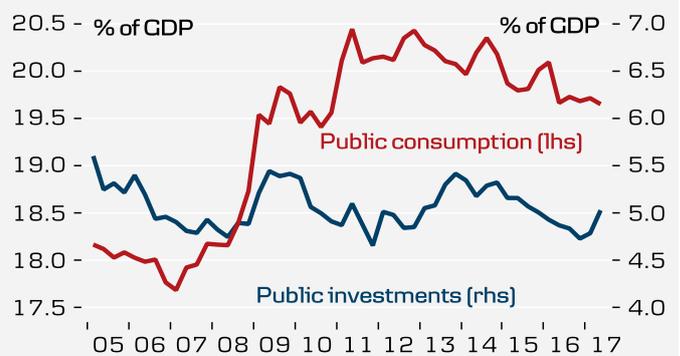
Note: TANKAN Index is calculated by subtracting the enterprises responding excess supply from those responding excess demand.
Source: Japanese Cabinet Office, Bank of Japan, Macrobond Financial

... and exports rebounded in July after a weak Q2



Note: Chart displays monthly export volumes from BoJ.
Source: Bank of Japan, Macrobond Financial

Public spending at high levels and turning more expansive through fiscal 2017



Source: Japanese Cabinet Office, Macrobond Financial

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Bjørn Tangaa Sillemann, Analyst.

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None.

Date of first publication

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