

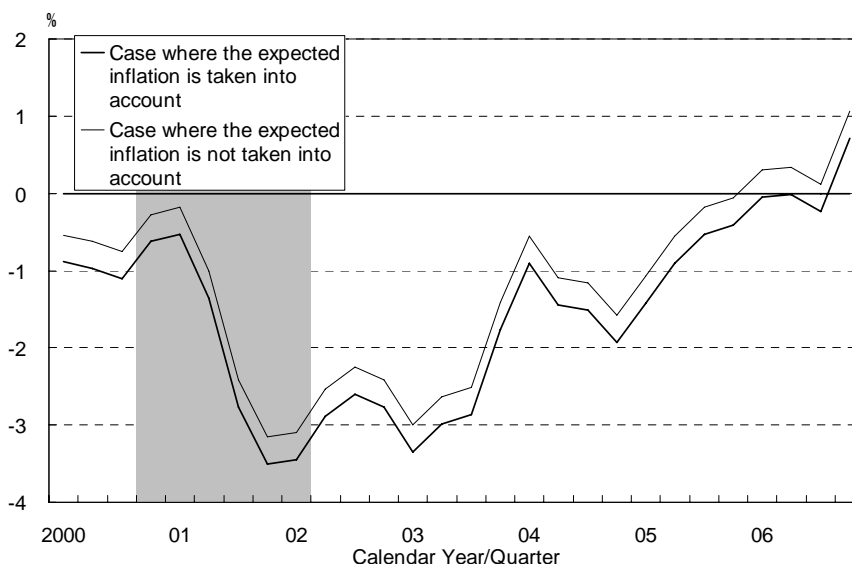
The Downside Risks in the Japanese Economy

– Return of Deflation and an Appreciating yen

This paper, 16th Report of the Financial Markets Group of the Japan Center for Economic Research (JCER), demonstrates downside risks for the Japanese economy: the possibility of getting back to the deflationary environment and the possibility of the appreciating yen.

Measuring the output gap, i.e., the deviation of actual output from statistically estimated non-accelerating-inflation level of potential output (Figure 1), this paper finds the unclear signal of a future rise in prices. In the case of the output gap measured by using the Phillips curve taking expected inflation into account, hitting its bottom for the 4th quarters of 2001, the output gap has exhibited a positive trend but negative until the 3rd quarter of 2006. The output gap for the 4th quarter of 2006 just turns positive. Given the difficulties in measuring the output gap, it is too early to assert whether the output gap is truly positive or not and sufficiently large or not. It is also too early to assert whether the deflation is over or not. Deflation still can be back in Japan.

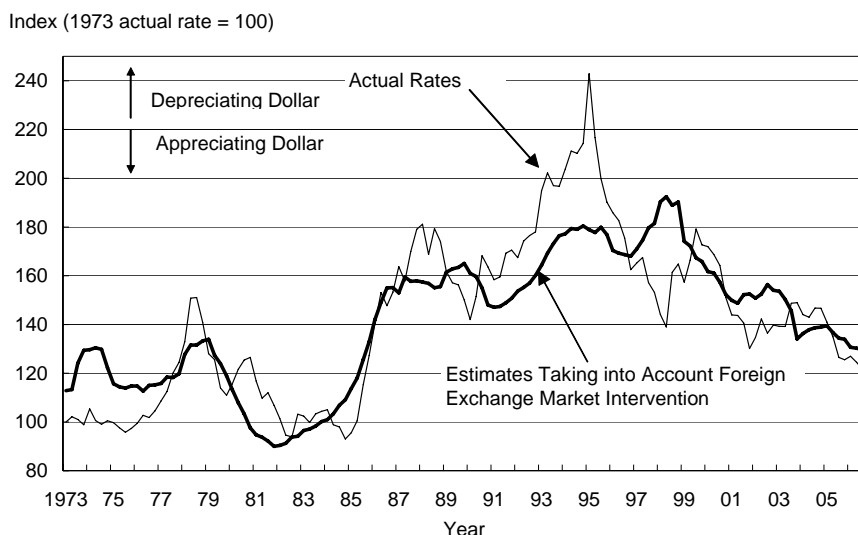
Figure 1: Estimations of GDP Gap



Note: Shaded area denotes recession.

The future yen's rise would also risk the Japanese economy. Figure 2 displays the estimation results of the yen/dollar exchange rates (index) regressed on the real interest rate differential and the sum of the accumulated current account and the accumulated net direct investment as a share of the world GDP. If real interest differentials between Japan and the US decrease by one percent point, the yen would become more attractive relative to the dollar and it would rise by 1.73%. The hike of short term interest rates by the Bank of Japan could trigger a shock in the FOREX markets, although the yen/dollar exchange rates have hovered near the historical low level in the last 20 years.

Figure 2: Estimates of the Yen/Dollar Rate Index



The future appreciation of the yen and depreciation of the US dollar would also take place by other reasons: growing global imbalances, foreign exchange reserves' switching away from the US dollar to other currencies, and a possible future recession of the US economy. Current global imbalances refer to the combination of the huge US current account deficit and the corresponding current account surpluses of other countries including Japan, China, and oil exporting countries. Those countries have sustained the recent large US current account deficit. Those countries would rapidly start diversifying away from their assets in terms of the US dollar, once the US economy enters into a recession and the US interest rates start falling. In addition, more structural adjustment of global imbalances has been taking place. The large share of foreign reserves in the world has been still held in the US dollar; however, the share has started shifting away from the US dollar to the Euro. The composition of Euro in world total official foreign exchange reserves accounts for 25% for the 3rd quarter of 2006.

Japan is currently in a delicate situation. Japan's economic recovery has been gradually going on, but consumer price inflation has been kept at a low level. The country has been becoming healthier, escaping from a severe deflationary trap, and normalizing the level of interest rates. Those factors, however, can result in an appreciation of the yen that can have negative impacts on the economy.

The BOJ would lose considerable credibility in the markets by the change in the guideline for money market operations of February 21. In the above mentioned economic environment, the BOJ has raised its key short-term interest rates to 0.5%. One of the most important objectives of the BOJ is the pursuit of price stability, so that it is natural for the BOJ to raise the short-term interest rates with fears of expected inflation. Now the output gap, however, is just above zero, and the core consumer prices are falling slightly. One of the conditions of lifting the quantitative easing monetary policy was the core CPI growth becoming equal or above 0% on average over several months. The quantitative easing monetary policy was lifted about a year ago, and this time the BOJ has raised interest rates while it has still been doubtful whether even the above condition has been met. Questions would be raised about the act of the Bank of Japan.