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SA135 Short-Term Forecast for the Japanese Economy (2008/7-9—2010/1-3)

Economy to remain stagnant amid lack of economic drivers

"Dejima expansion" ending, with shocks from rising prices and tighter household spending

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- Economy stalled, with no recovery until 2H FY2009
- Emerging economies sole support as US economy remains sluggish
- Severe conditions to persist for SMEs and non-manufacturing

Having passed a turning point, the Japanese economy has become stalled. Preliminary GDP figures for the April-June quarter released recently show that the nation's real GDP fell by 0.6% Q/Q (down 2.4% annualized), falling for the first time in four quarters. However, it was not so much the negative growth reading itself which soured the economic outlook but decline in the export and personal consumption components.

In the economic expansion which began from the outset of 2002, exports have consistently been the locomotive, along with the associated private nonresidential investment. In describing these circumstances, I've found it useful to refer to Nagasaki's Dejima island, to which the Shogun limited external trade during Japan's sakoku period of self-imposed isolation. "Dejima companies" with access to global demand have flourished, and companies related to them have benefited as well. Through these "Dejima companies," Japan has benefited not only from US demand but from the diversifying growth engine of the global economy such as Brazil, Russia, India and China. And though the effect was gradual, this "Dejima" vigor spilled over into domestic demand and stimulated a long economic recovery.

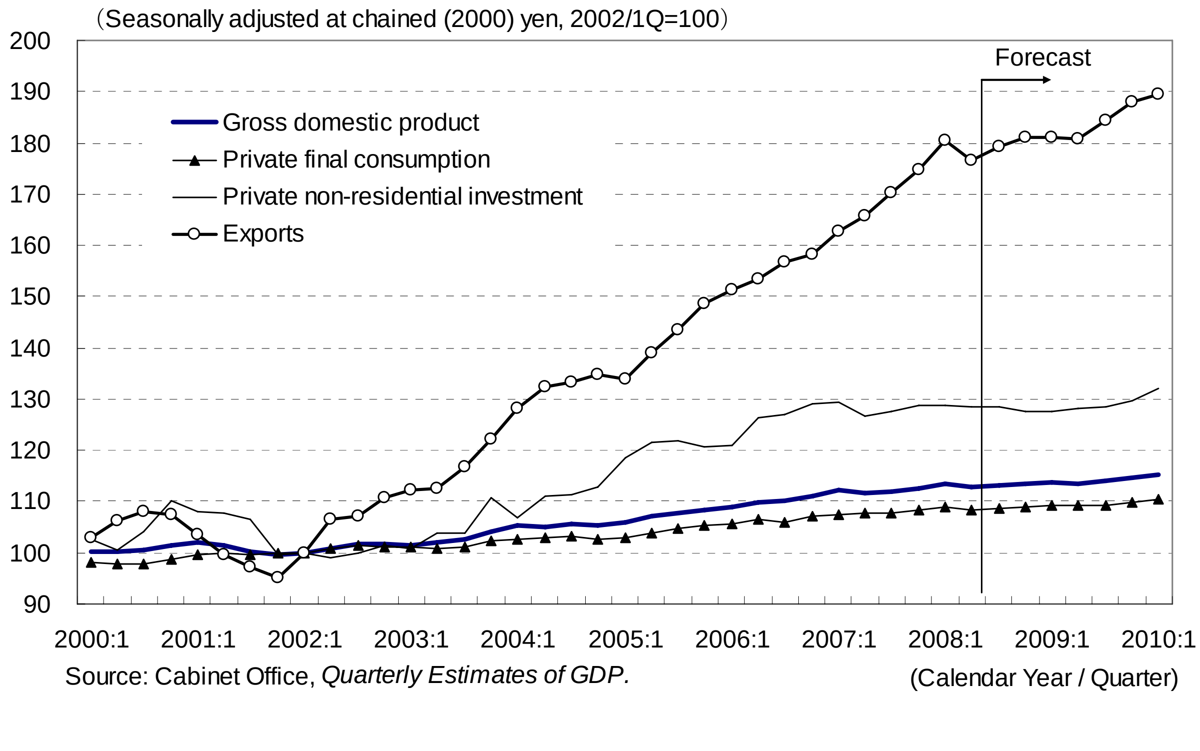
This growth engine began to undergo a change with the deterioration of the terms of trade caused by the rapid rise in the price of energy. In other words, the prices of raw materials Japan purchased from abroad rose, and at the same time, trade became unprofitable owing to the difficulty of passing on the price increases to exported goods such as machinery. Up to now, however, it has been possible to deal with the expanding trade losses by numbers alone, which is to say, by increasing the volume of exports. The recent decline in exports means that it is now no longer possible to cover the drain of income overseas by increasing the volume of exports. It shows that, given the rise in energy prices and the subprime loan problem, the negative impact of the global economic slowdown has become pronounced and the "Dejima expansion" is coming to an end.

The second point regards personal consumption, which has declined for the first time in seven quarters. As wages and salaries stall, households are battling rising prices by shifting to a defensive posture. As is frequently pointed out, consumers are no doubt choosing to stay at home rather than travel and dine out while sacrificing living standards to save on expense. The deterioration in soft data such as consumer sentiment from the middle of last year is finally showing up in the hard data like spending activity.

Accordingly, we have revised our outlook for the economy through fiscal year 2009 (April 1, 2009 through March 31, 2010) based on such factors as recent preliminary GDP data as well as financial and economic conditions.

We now expect real GDP to grow at a pace of 0.7% in FY2008 (versus 1.6% in our previous forecast) and 0.9% in FY 2009 (versus 1.8%). These changes amount to a substantial downward revision compared to our last forecast. A broad view of the economic trend indicates that the economy will grow increasingly weak throughout FY2008. Even after the beginning of FY2009, there will be no factors in the first half to trigger an economic recovery. That will likely come only in the second half of the fiscal year as exports, production and corporate earnings regain their footing.

Figure 1. Growth of GDP Components during the Last Economic Expansion



Source: Cabinet Office, *Quarterly Estimates of GDP.*

We believe the consumer price index (ex-fresh foods, for the nation as a whole) will come in at 1.9% in FY2008 (versus 1.1% in our last forecast) and at 1.0% in FY2009 (versus 0.8%). We have revised our forecast up to reflect the rise in crude oil prices as well as renewed price hikes for foods. With regard to FY2009, we have assumed that oil prices remain unchanged and that past and present rises in the price of grains will for the time being continue to be passed on. We believe, however, that prices will for the most part remain unchanged for goods and services other than energy and foods. The reason for this will be weak pressure for both rising wages and final demand.

Under these economic and price conditions, we believe the Bank of Japan's policy stance will lean in the direction of promoting growth, and that no hike in interest rates will come until the end of FY2009. We also see the recovery of stock prices being pushed back to the July-September quarter of 2009, and even after that time the rebound will likely be weak. Given the difficult investment environment, any rise in long-term yields will be slow. As a result, we expect the yen to gradually weaken due mainly to a widening interest rate gap between Japan and the rest of the world.

The rolling back of expectations for economic recovery in the US as well as the downturn in personal consumption have played a significant part in this downward revision of our economic outlook.

In the first half of this year, the US economy showed unexpected resilience on such factors as rising exports to emerging countries and tax rebates to consumers. However, the environment surrounding personal consumption is becoming increasingly severe as employment conditions deteriorate and prices of crude oil and grains rise. For this reason, adjustments in the real economy are more likely to intensify going forward.

Turmoil in financial markets has now continued for a full year since the long-standing corrections in the housing market surfaced, and that turmoil is still showing signs of spreading. It is possible that the recent US economic adjustments originating in the financial and asset market turmoil will drag on and that the timing of a clear economic recovery will be pushed back to mid-2009. The drivers of the global economy are diversifying, but it would be unwise to ignore the impact of an extended economic correction in the United States.

Owing to rising prices and the deteriorating personal income environment, weakness in the household sector is likely to be pronounced. As corporate earnings worsen, bonuses should begin to shrink, and negotiations next spring for wage hikes will likely be unable even to maintain real wages at present levels.

Given the delay in indexing pensions to inflation, pension payments to the retiring generation will erode. During the “Dejima” expansion, private consumption has been firm while household income has risen only modestly. This has been due to personal spending by the very elderly, who have a high propensity to consume. The impact of an erosion of pensions in real terms should not be taken lightly.

In retrospect, prior to the turmoil associated with the amendment of the Building Standards Law, households faced rising housing prices and moved quickly to cut back on acquisitions. Such behavior differs from that seen during the bubble period in the late 80's, but their spending activity is consistent with their recent response to price increases in daily necessities. Ultimately, households are cautious about expenditures not only on deeply entrenched fears regarding employment but also on fears they may be unable to receive their expected level of steady income, including salary during their years of employment and pensions after retirement. Given the foregoing, chances are strong that personal consumption will remain weak even if prices show signs of stabilizing in FY2009. Any recovery of consumption, therefore, will likely be slow.

Business firms are also experiencing a clear erosion in earnings. By comparison, private nonresidential investment, mainly among manufacturers and large corporations, has been holding firm. Even so, this will not have the strength to drive the economy, and the risk of a decline remains.

As indicated above, chances are strong that the Japanese economy will remain stalled for the present owing to the lack of economic drivers. Any economic recovery from and after the second half of FY2009 will also depend on "favorable scenario," or stabilization of crude oil prices and continuing economic strength in emerging and resource-rich nations until such time as the US economy recovers.

In this way, the Japanese economy will remain highly dependent on rising exports to emerging and resource rich economies for the present. Hopes are that crude oil prices will come down, but the matter is not that simple. In order for resource rich countries to hold out, it will be necessary not for crude prices to plummet but to fall by just the right degree. The question concerns just what degree of decline this "just the right degree" means. In light of the political situation in resource rich countries, that would be difficult to gauge, just as achieving it artificially would be a difficult feat.

Even if the economy could depend on emerging nations, the only companies to prosper would be those able as before to benefit from that situation. Severe conditions would continue for small and medium sized firms unable to harness global demand. As energy prices remain high, little can be gained by increasing sales alone, and worsening business conditions will be unavoidable. Bankruptcies are already on the rise. It will be necessary to bear in mind the risks that job adjustments by SMEs will present for the economy as a whole.

A look back over the economic expansion continuing since 2002 shows that rising exports led the economic recovery, which took place amid favorable conditions rarely seen in overseas economies. Perhaps it indeed was an economic expansion not sensed directly by the household sector, but it was significant that wage growth was held in check despite the expansion of corporate earnings and tightness in the labor market.

As the economic expansion extended in length, however, its impact progressed, if slowly, from large companies to SMEs, from manufacturing to non-manufacturing, from business firms to households, and from the cities to the localities. The difficult problem the nation now faces is the slowdown in overseas economies, the engine of that expansion. This means that the source of economic vitality for the localities, non-manufacturing and SMEs is weakening. In considering economic countermeasures, the question is whether to emphasize the problem of distribution or to focus on the growth sectors serving as the source of vitality. That will ultimately become a choice for the public to make, no doubt, and this kind of debate will be coming.

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Table. The Outlook for Japanese Economy

Forecast →

	FY2007 1st Qtr	2nd	3rd	4th	FY2008 1st Qtr	2nd	3rd	4th	FY2009 1st Qtr	2nd	3rd	4th	FY2007 Actual	FY2008 Forecast	FY2009 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	-0.4	0.2	0.6	0.8	-0.6	0.4	0.2	0.2	-0.2	0.3	0.6	0.6	1.6	0.7	0.9
Real gross domestic expenditures (year-on-year)	1.8	1.7	1.6	1.2	1.0	1.2	0.8	0.2	0.6	0.6	1.0	1.4			
Private final consumption (qtr.-to-qtr.)	0.3	0.0	0.3	0.7	-0.5	0.3	0.2	0.2	0.0	0.2	0.4	0.5	1.4	0.5	0.8
Private housing investment (qtr.-to-qtr.)	-4.3	-7.3	-9.8	4.3	-3.4	4.1	2.9	-0.0	-1.0	-1.5	-1.0	0.2	-13.3	-3.1	-0.2
Private non-residential investment (qtr.-to-qtr.)	-2.1	0.6	1.1	-0.1	-0.2	0.0	-0.7	-0.1	0.5	0.3	0.9	1.6	-0.1	0.1	1.2
Private inventory investment (contribution)	-0.2	-0.0	0.0	-0.1	-0.0	-0.0	-0.0	0.0	0.0	-0.0	0.0	-0.0	-0.0	-0.1	0.0
Government final consumption (qtr.-to-qtr.)	0.2	0.1	0.9	-0.5	0.1	0.2	0.4	-0.1	0.1	0.2	0.5	0.2	0.7	0.5	0.7
Public fixed capital formation (qtr.-to-qtr.)	-2.6	-2.0	0.1	1.0	-5.2	-2.8	0.6	4.4	-4.8	-2.4	0.2	2.7	-1.8	-5.7	-3.1
Public inventory investment (contribution)	0.0	-0.0	0.0	-0.0	0.0	0.0	0.0	-0.0	0.0	0.0	0.0	-0.0	0.0	-0.0	0.0
Domestic demand (contribution)	-0.6	-0.2	0.3	0.3	-0.6	0.2	0.1	0.2	-0.1	0.1	0.4	0.7	0.3	-0.0	0.6
Net exports of goods and services (contribution)	0.1	0.5	0.3	0.4	0.0	0.2	0.1	-0.1	-0.1	0.3	0.2	-0.1	1.2	0.7	0.3
Exports of goods and services (qtr.-to-qtr.)	1.9	2.6	2.7	3.4	-2.3	1.6	1.0	0.0	-0.1	1.9	2.0	0.8	9.5	3.8	3.4
Imports of goods and services (qtr.-to-qtr.)	1.2	-0.3	0.8	1.2	-2.8	0.4	0.5	0.6	0.4	0.3	1.6	1.8	2.1	-1.0	2.7
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.5	-0.0	-0.1	0.2	-0.7	0.2	0.5	0.3	-0.1	0.5	0.6	0.5	0.6	-0.1	1.2
Domestic corporate goods price index (year-on-year)	1.8	1.6	2.4	3.4	4.8	6.5	5.7	4.7	2.5	0.4	0.9	1.2	2.3	5.4	1.3
Consumer price index (year-on-year)	-0.1	-0.1	0.5	1.0	1.5	2.3	2.2	1.8	1.7	1.0	0.8	0.7	0.3	1.9	1.0
Call rate (Uncollateralized, Overnight, %)	0.51	0.50	0.50	0.51	0.51	0.50	0.50	0.50	0.50	0.50	0.50	0.61	0.50	0.50	0.53
WTI Crude oil price (dollar / barrel)	65.0	75.2	90.5	97.8	123.8	123.1	123.4	124.0	124.0	123.6	123.6	123.6	82.1	123.6	123.7
Yen : Dollar exchange rate (yen / dollar)	120.8	117.9	113.2	105.2	104.5	108.2	106.8	106.8	109.1	110.9	112.1	113.7	114.2	106.6	111.5
Unemployment rate (%)	3.8	3.8	3.8	3.8	4.0	4.2	4.3	4.4	4.4	4.3	4.2	4.0	3.8	4.2	4.2
Indices of Industrial Production (qtr.-to-qtr.)	0.6	1.7	0.9	-0.7	-0.8	-1.0	0.2	0.7	0.4	0.5	0.9	1.0	2.6	-1.0	1.8
Current account / Nominal GDP (%)	5.0	4.9	4.9	4.3	3.8	3.0	3.3	3.2	3.2	3.2	3.5	3.2	4.8	3.2	3.2
Real GDP of U.S.A. (qtr.-to-qtr.)	4.8	4.8	-0.2	0.9	1.9	1.0	0.2	0.5	1.3	2.0	2.4	2.8	2.0 (C.Y.)	1.6 (C.Y.)	1.1 (C.Y.)

[Notes] 1. Figures in percentage changes; contribution is contribution to real GDP growth.
2. Figures for items comprising national expenditures are at chained (2000) yen.
3. Figures for consumer price index, domestic corporate goods price index and indices of industrial production are at 2005 base.
4. Figures for GDP components, unemployment rate, indices of industrial production and current account are seasonally adjusted.
5. Figures for real GDP of U.S.A. are seasonally adjusted annual rates, at chained (2000) dollars.

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