Japan Center for Economic Research

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SA136 Short-Term Forecast for the Japanese Economy (2008/10-12—2011/1-3)

Japan's economy facing deep and protracted recession, slumping consumption and investment and two straight years of economic contraction

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- Synchronized global recession unavoidable
- Frozen credit forcing financial self-reliance
- Turning crisis into a strategy for medium- and long-term growth

Japan's economy is deteriorating. Recently released GDP figures for the July-September quarter show the Japanese economy shrinking by -0.1% Q/Q, following the sharply negative growth seen in the April-June quarter (-0.9% Q/Q) and as a result, shrinking for two consecutive quarters. Until now, however, the only influence came from deteriorating terms of trade on the rising price of commodities such as crude oil and from adjustments in the U.S. economy, above all the housing market.

The collapse of the U.S. investment bank Lehman Brothers in the middle of September accompanied a credit crunch and suddenly transformed the backdrop of global economy. Stocks plunged, the yen surged, and powerful downward pressure was brought to bear on the Japanese economy.

The turmoil in financial markets which followed the Lehman shock was eased somewhat through massive injections of liquidity and interest rate cuts by central banks as well as measures taken by policymakers, including capital injections for financial institutions. Due to stubborn fears about the financial viability of counterparties, however, financial market transactions and intermediation have been functioning poorly.

The basic task of finance is to provide financial intermediation among economic agents which need funds at different times and to facilitate the flow of money from those having a savings surplus to those having a savings deficit. As a result, funds can flow among agents without restriction, thus furthering consumption and investment. Under the present circumstances, economic agents have to rely to some extent on self-reliance, in which they finance their economic activity with their own funds. This credit crunch has sharply impacted the real economy for the worse. In Western countries, cutbacks on loans have crimped consumption of durable goods and residential investment, and banks have tightened standards on loans to business firms.

In an effort to fund their operations on their own, business firms and financial institutions have been pressed to raise cash by selling off financial assets. Falling global stock markets, the flight of capital from some emerging countries, and an appreciation of the yen have all arisen from this behavior.

We, Japan Center for Economic Research, have revised the economic outlook based on preliminary GDP data for the July-September quarter as well as recent financial and economic developments overseas.

We believe the real GDP growth rate will fall by -0.4% in fiscal year 2008 (April 1, 2008 through March 31, 2009) and by another -0.8% in FY2009, posting two consecutive years of negative growth. We expect real GDP to recover to a +1.2% rate of positive growth in FY2010, still below the economy's potential growth rate of 1.5% to 2%.

In terms of the general development of the economy, we believe demand overall will retreat in the October-December quarter and thereafter. First, a decline in Japanese exports will be inevitable. Given the uncertain future, domestic demand will not receive much support from either household or business spending. Businesses have moved quickly to cut back production, but demand has fallen so unexpectedly that they will be forced to cut production even further. As a result, both corporate earnings and employment conditions will deteriorate. The economy will face its most difficult period between now and early FY2009, and caution will be needed against large bankruptcies and other event risks.

Unfortunately, this period will correspond exactly to the time when business firms are formulating their business plans such as fixed investment for FY2009 and completing labor negotiations on wages. For this reason, any improvement in the terms of trade due to the oil price’s fall or benefits from economic measures conducted by government will be cancelled out. As a result, we believe the economy will remain in recession through 2009. A turnaround the Japanese economy will probably not come until overseas economies recover.

Predicting the global economic outlook at the present stage involves profound uncertainties. We believe that, around the end of 2009, financial intermediation will start to function again and the first signs of a bottom will appear in the U.S. housing market, which is also the epicenter of the crisis.

Japan’s economy is likely to head toward recovery after the beginning of 2010, shortly after overseas economies find their footing. However, the pace of recovery will be modest due to the global credit crunch, the unwinding of over-consumption in the U.S. and the collapse of the housing bubble in Western countries such as the U.S. and Britain. As a result, we do not expect to see a V-shaped recovery not only in the global economy but also in Japan.

As for price trends, the consumer price index (overall prices nationwide, ex-fresh foods) will likely show a slowing rate of growth year-on-year mainly due to the falling price of oil and other factors, and we see the CPI growth rate turning negative in the middle of 2009. Concerns over secondary inflationary effects such as rising wages on the higher cost of natural resources have turned out to be unnecessary due to the recession. Depending on how the economic cycle develops, deflation may instead be the concern.

Given the state of the economy and price trends, we believe the Bank of Japan will cut interest rates again within the current fiscal year. With the retreat of inflationary concerns, the BoJ is then likely to maintain a very easy monetary stance before beginning to tighten again around the end of 2010. We also believe the yen will continue strong for some time further, but once the global economy shows signs of recovery, the Japanese currency should weaken as interest rate spreads between Japan and other nations widen. We see stock prices continuing weak for a time before firming up in FY2010, although the rebound is likely to be weak.

Until a few months ago, we believed that, although some risk of a prolonged recession did exist, that the recession this time would not be severe. However, the Lehman shock has compelled us to revise our outlook for the economy owing to the following three reasons, and we now believe the recession may be deep and prolonged.

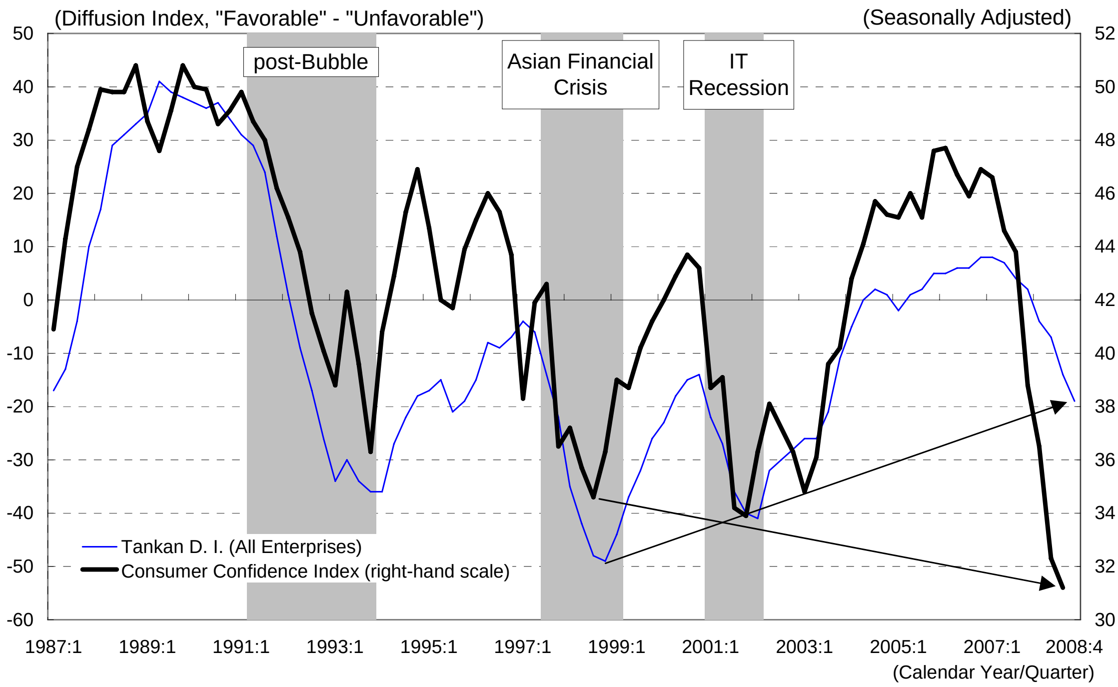
First, we are cautious in our view of the outlook for economies overseas. China and the Middle East may to some extent show a resilient economy. Their capacity to absorb export demand from the advanced industrial nations, however, will be limited, and the strong yen will work against Japan's competitiveness. As a result of the global credit crunch, moreover, emerging economies will have difficulty not only in maintaining their mechanism for growth based on the influx of direct investment but in financing their foreign trade. The global economic growth rate is bound to slow.

Second, we have revised our outlook for private nonresidential investment. Japanese business firms have become increasingly able to cope with the "three excesses" (in capacity, staff and debt) particularly at large companies. In recent years, however, private nonresidential investment has been influenced by the outlook for exports, and given the current state of the global economic outlook, a decline in investment will be unavoidable. Corporate profits have been inflated by a longstanding weak-yen bubble, and in the face of a serious decline in earnings, entrepreneurs are bound to be less willing to invest.

Third, sluggishness in personal consumption is likely to be prolonged. Some observers believe that consumers may loosen up their purse strings if the erosion in real wages eases mainly due to the falling prices for daily necessities such as gasoline. However, with scant prospects for either success in spring wage negotiations or for bonuses, job insecurity is likely to emerge once more. Given worries about pensions and the large fiscal deficit, households will have little choice but to remain defensive.

If Japan experienced only slight direct impact from the current financial crisis, why, one might ask, should the nation be facing a deep and protracted recession? I would look for the causes in excessive dependency on exports, weakness in the household sector, the bloated fiscal deficit and extremely low interest rates.

Figure. Tankan Diffusion Index and Consumer Confidence Index



First, such is the structure of Japan's economy that business conditions are vulnerable to trends in exports. The economic expansion which began in early 2002 was hinged on consistently rising exports. In the context of our last forecast in August, I referred to this as the "Dejima economy." When there is a change in external demand, the sole engine of growth, the Japanese economy quickly loses steam. The stock market, policymakers and the business community all react sensitively to strength in the yen.

The second factor is weakness in personal consumption. Under the Dejima economy, business firms retained most of the benefits from growth, while labor's relative share declined consistently. Companies stepped up hiring of part-time workers and resisted increases in base pay in an effort to hold down labor costs. In the course of overcoming the "lost fifteen years" in this way, efforts to improve competitiveness were tilted to the corporate sector. This may have been unavoidable in the face of intensifying global competition, but in the end, in was unbalanced.

What is significant here is that surveys such as the BoJ's Tankan show that business sentiment remains high compared to past recessions. On the other hand, consumer sentiment is lower than it was during the domestic financial crisis (during 1997-98) and the IT recession (during 2001-02) and remains low still (see Figure).

Third, there is little room for macroeconomic stimulus. The BoJ has scant remaining leeway to lower interest rates, and the government's outstanding debt balance is huge. Under the present circumstances, the government has little room to maneuver in the face of shocks and few means at its disposal to ease the pain which comes in the wake of structural reforms.

With the longest post-war expansion giving way to a deep and protracted recession, it will be "three steps forward, two steps back." Another concern is the fading of both a sense of crisis and the momentum for reform. The imminent protracted recession should not simply be endured. Rather, efforts should be made to build a strategy for medium- and long-term growth through mergers and acquisitions, resource diplomacy, and helping to draft international rules for trade and finance. The crisis can be turned into a good opportunity.

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Table. The Outlook for Japanese Economy

Forecast →

	FY2008 1st Qtr	2nd	3rd	4th	FY2009 1st Qtr	2nd	3rd	4th	FY2010 1st Qtr	2nd	3rd	4th	FY2007 Actual	FY2008 Forecast	FY2009 Forecast	FY2010 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	-0.9	-0.1	-0.2	-0.3	-0.3	-0.2	-0.2	0.5	0.4	0.1	0.7	1.1	1.7	-0.4	-0.8	1.2
Real gross domestic expenditures (year-on-year)	0.7	-0.1	-0.6	-1.4	-0.9	-1.0	-1.1	-0.3	0.4	0.7	1.6	2.3				
Private final consumption (qtr.-to-qtr.)	-0.6	0.3	-0.2	0.1	0.2	0.1	-0.2	0.2	0.2	0.3	0.4	0.5	1.7	0.2	0.2	0.8
Private housing investment (qtr.-to-qtr.)	-3.1	4.0	-1.0	-1.3	-1.5	1.2	2.2	1.7	0.1	0.0	0.0	-0.0	-13.3	-4.8	0.4	2.8
Private non-residential investment (qtr.-to-qtr.)	-1.4	-1.7	-1.8	-2.0	-2.2	-2.2	-0.6	0.4	1.5	1.1	2.1	2.9	-0.1	-3.5	-6.7	3.7
Private inventory investment (contribution)	-0.0	0.0	0.1	-0.2	0.0	0.0	0.0	-0.1	-0.0	-0.0	0.0	0.0	-0.0	-0.1	-0.0	-0.1
Government final consumption (qtr.-to-qtr.)	-0.1	0.1	1.0	0.8	-0.1	0.0	0.0	2.1	-0.1	-1.3	0.0	0.6	0.7	0.7	1.5	0.6
Public fixed capital formation (qtr.-to-qtr.)	-5.5	0.4	-0.2	5.0	-0.7	-0.8	-2.3	-3.7	0.1	0.3	-0.4	-0.8	-1.8	-3.7	0.3	-4.2
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	0.0
Domestic demand (contribution)	-0.9	0.1	-0.1	-0.2	-0.3	-0.2	-0.2	0.4	0.3	0.1	0.5	0.8	0.5	-0.7	-0.7	0.9
Net exports of goods and services (contribution)	-0.0	-0.2	-0.0	-0.1	-0.1	-0.0	0.0	0.1	0.1	-0.0	0.2	0.3	1.3	0.4	-0.1	0.3
Exports of goods and services (qtr.-to-qtr.)	-2.6	0.7	-2.2	-1.8	-1.2	0.4	0.4	0.9	0.5	0.8	2.7	3.6	9.5	0.7	-2.8	4.4
Imports of goods and services (qtr.-to-qtr.)	-3.0	1.9	-3.1	-1.8	-1.4	0.6	0.6	0.4	0.0	1.5	2.1	2.7	2.0	-2.4	-3.0	3.7
Nominal gross domestic expenditures (qtr.-to-qtr.)	-1.2	-0.5	0.8	-0.1	-0.5	-0.6	-0.1	0.1	0.1	-0.1	0.9	1.1	0.7	-1.1	-0.8	0.6
Domestic corporate goods price index (year-on-year)	4.9	7.1	3.8	1.1	-1.7	-4.5	-1.8	-0.3	0.4	0.5	0.7	0.9	2.3	4.2	-2.1	0.6
Consumer price index (year-on-year)	1.5	2.3	1.4	0.7	0.5	-0.6	-0.4	-0.6	-0.5	-0.3	-0.2	0.1	0.3	1.5	-0.3	-0.2
Call rate (Uncollateralized, Overnight, %)	0.51	0.50	0.37	0.23	0.15	0.15	0.15	0.15	0.15	0.15	0.31	0.69	0.50	0.40	0.15	0.33
WTI Crude oil price (dollar / barrel)	123.8	118.2	66.2	60.5	62.9	64.6	65.3	65.9	66.2	66.2	66.2	66.2	82.1	92.2	64.7	66.2
Yen : Dollar exchange rate (yen / dollar)	104.5	107.6	99.2	97.7	97.2	96.7	97.4	97.7	97.4	97.6	97.9	102.3	114.2	102.3	97.3	98.8
Unemployment rate (%)	4.0	4.1	4.3	4.6	4.9	5.1	5.2	5.2	5.1	5.0	4.8	4.6	3.8	4.2	5.1	4.9
Indices of Industrial Production (qtr.-to-qtr.)	-0.8	-1.3	-4.8	-3.1	-1.5	-0.4	-0.4	0.5	0.4	0.5	1.0	1.8	2.6	-4.6	-6.9	1.7
Current account / Nominal GDP (%)	3.8	2.7	3.9	4.3	5.1	4.9	4.6	4.4	5.3	5.3	4.7	4.8	4.8	3.7	4.5	4.8
Real GDP of U.S.A. (qtr.-to-qtr.)	2.8	-0.3	-2.6	-1.4	0.1	-1.6	0.4	1.0	1.8	2.4	2.9	3.2	2.0 (C.Y.)	1.4 (C.Y.)	-0.9 (C.Y.)	1.0 (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.
6. Japan's fiscal year is April 1 to March 31.

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