February 2009

SA137 Short-Term Forecast for the Japanese Economy (2009/1-3—2011/1-3)

Worst crisis since war hits hard, foreign and domestic demand evaporating - bold stimulus for new fields critical

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- New fiscal year to bring unprecedented contraction
- Japan resilience weak despite stimulus abroad
- State and business must huddle to produce clear roadmap

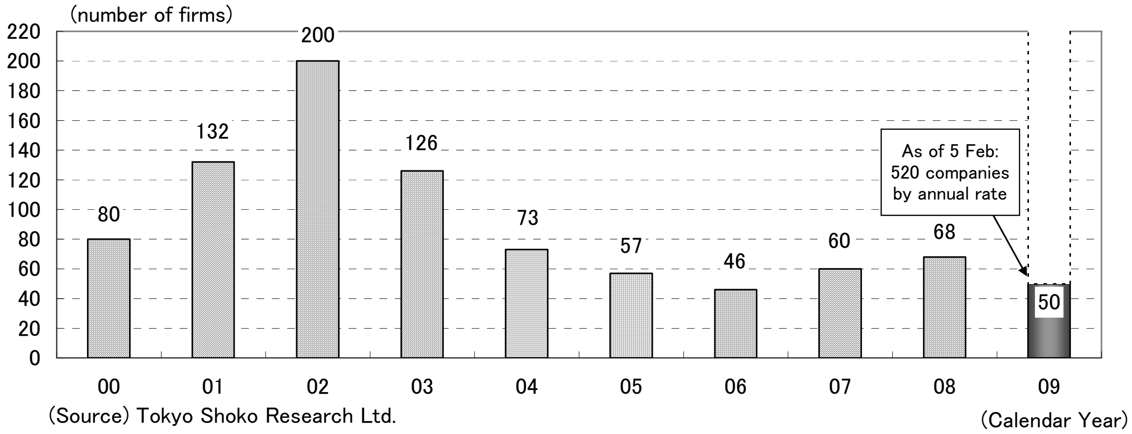
Led by the business sector, Japan's economy continues to drop dramatically. The present recession began in November of 2007 amid confusion associated with the amendment of the Building Standard Law and deepened with the economic slowdown in the United States. Following those negative factors, the spike in energy and material prices also hit the Japanese economy hard. By the July-September quarter of 2008, real gross domestic product (GDP) had already contracted for two consecutive quarters.

Chaos in international financial and capital markets triggered by "the Lehman shock" was followed by a dramatic simultaneous decline in economic activity worldwide which negatively affected the Japanese economy as well. The fall of stock prices, the yen's appreciation and the financial crisis spread to emerging economies, all of these events delivered a stunning blow to the Japanese economy. Real GDP in the October-December quarter posted its steepest decline in thirty-five years since the oil shock in 1974.

In terms of the nature of the shock, the impact was particularly severe for "Dejima" companies with strong overseas links and deep roots in the global economy. Manufacturing industry production levels as of the end of this fiscal year are expected to plummet to 70% of levels prevailing before the Lehman shock, with many observers fearing further declines. Large firms, mainly manufacturing, have lowered their break-even point ratios during the latest economic expansion, but at current level these firms are sure to fall into the red. The shock to Dejima companies is spreading to small and medium size firms, manufacturers and non-manufacturers alike.

Uneasy about their cash flows, companies are abating risk assets and cutting back on nonessential expenditures. In addition to cutbacks on overdue labor force, companies are postponing fixed investments and tightening the reins on selling, general and administrative (SG&A) expenses. This kind of survival strategy on the part of individual companies has given rise to a "fallacy of composition" undermining the economy as a whole.

Figure 1. Companies that encouraged voluntary / early retirement



(Source) Tokyo Shoko Research Ltd.

Having already kept a tight grip on the purse strings, Japanese households have adopted an even more defensive posture. The safety net has been strengthened, but as indicated by the bearish tone of the market since mid February, fears of bankruptcy risks remain undiminished towards the end of this fiscal year.

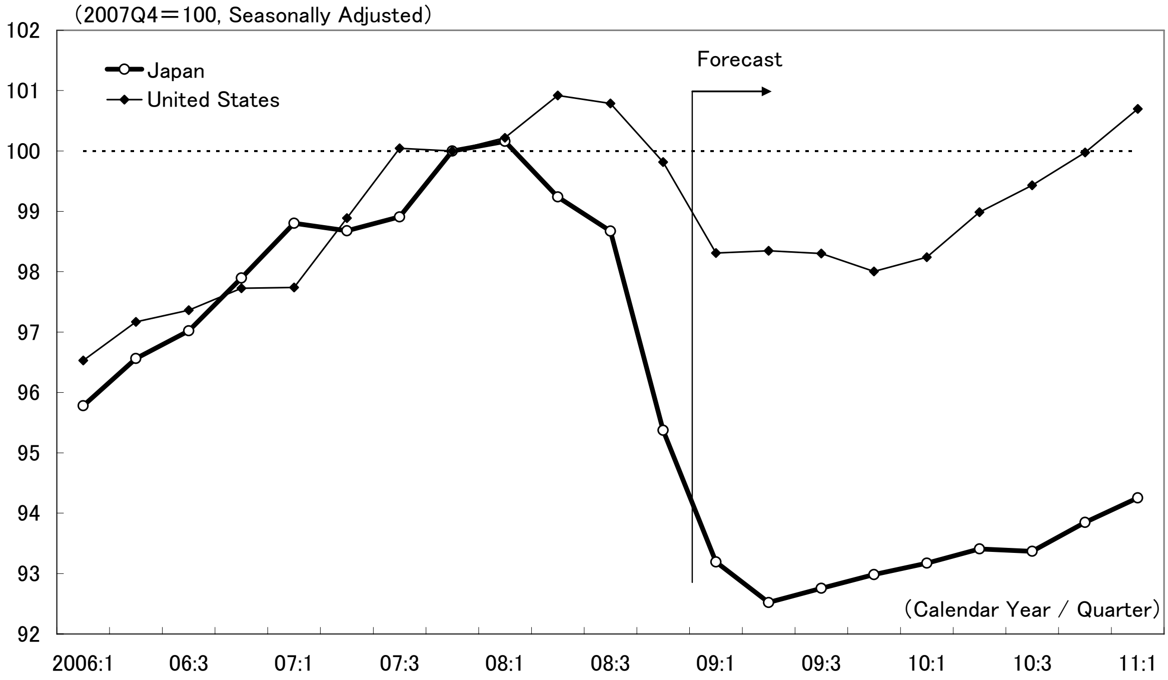
In view of the foregoing, we have revised our economic outlook. We now believe that Japanese economic growth will be sharply negative in both fiscal year 2008 (April 2008 - March 2009) and fiscal year 2009 (April 2009 - March 2010). Japan faces the most severe recession in the postwar era. Compared to the forecasts of other institutions, however, ours is among the top third most optimistic.

An assessment of the course of the economy indicates that economic conditions will continue to deteriorate through the April - June quarter of 2009, although the pace of deterioration will ease to some extent. Firms will likely give top priority to securing cash while building up cautious business plans. For the present, emerging economies will set back, so some portion of existing production capacity will be idle. Accordingly, although projects to increase capacity account for about forty percent of nonresidential fixed investment in the manufacturing industry, these will for the most part be frozen.

Companies are able to some degree to absorb excess employment through such means as personnel transfers and temporary layoffs. In practice, companies in Japan are restricted in their ability to dismiss regular full-time employees individually or in a restructuring. In light, also, of the ongoing debate regarding corporate social responsibility, it will not be easy in the near future for them to lay off even part-time workers whose status is similar to that of regulars. Even so, as voluntary retirements are promoted and bankruptcies increase, concerns over job insecurity will as well (see figure 1). With the traditional spring labor negotiation for higher wages not materializing and huge cuts made in bonuses, households will likely become even more inclined to save money.

Unfortunately, it will be impossible to expect the government to provide much effective demand. Under the series of economic measures worked out by the government, stress has been placed on providing a safety net for small and medium size companies. In general, fiscal spending in real terms is to be 12 trillion yen, with additional but conditional spending also provided for. These amounts represent the top limit of possible expenditures. There exists skeptical views among

Figure 2. GDP forecasts of Japan and U.S.



(Source) Cabinet Office, *Quarterly Estimates of GDP*; U.S. Department of Commerce

economists how much effective demand can be created through government stimulus tax refund and reductions both in highway tolls and in employment insurance premiums. Local governments also face huge shortfalls in revenues and are therefore seen limiting their spending on the public projects they finance on their own.

Ultimately, it seems inevitable that any Japanese economic recovery will be dependent on fiscal stimulus measures taken by the U.S. and China. To be sure, the American stimulus plan, which amounts to a total of about 800 billion dollars, will help prevent the economy from taking another leg down. However, as long as households are compelled to strengthen their balance sheets, they are more likely to save the bulk of the tax cuts, which have been increased to one third of the entire package. It will be hard to count on any increase in the government spending package being either effective or timely. Owing to the weakness of the financial system, deflationary pressure on asset prices will persist for some time. In this context, it will be impossible for fiscal stimulus measures to encourage a recovery in private demand. The U.S. economy may tentatively bottom out with the fiscal expenditures, but the economy is likely to experience a double-dip, with recovery being pushed back to around mid-2010. Going forward, the pace of the recovery will likely be moderate as U.S. households rein in their excessive consumption and the economy moves to a system relying on low levels of leverage.

The Chinese economy is also interlinked with the global economy, and for the present, China will face a retrenchment phase mainly due to sluggish exports and fixed investment. However, it appears that the country's massive fiscal stimulus package will provide support for the economy, such that China should maintain growth in excess of 6% in FY2009 as well. Having decided on stimulative macro-economic policy rapidly, China has a long list of projects relating to infrastructure, as did Japan during its phase of rapid economic growth. In addition to creating effective demand, infrastructure projects relating to the nation's electric power and rail network have the potential both to induce domestic fixed investment and to attract foreign direct investment. The Chinese stimulus package will provide support for the global economy.

That said, the induced exports accompanying the American and Chinese fiscal stimulus measures will be woefully inadequate in bringing about sustainable economic recovery for Japan. Even if the economy stops declining in the April - June quarter of 2009, it will likely continue hugging the bottom in an L-shaped pattern (see figure 2). The unemployment rate will likely continue to inch up, approaching 6% in the latter half of FY2010. If this is left unchecked as deflationary signs strengthen, the Japanese economy could even tumble into a crisis which could adversely impact the global economy.

The Bank of Japan has resorted to unconventional monetary policies, such as buying up commercial paper. Although the effect in providing liquidity to the economy has been substantial, the effectiveness of the move in stimulating effective demand is seen as limited.

With many observers now fearing the economy will deteriorate further, they will be expecting, following formulation of the FY2009 budget, to see a massive fiscal stimulus package designed to bring Japan out of the crisis under its own power as soon as possible. If that transpires, one would hope the focus would not be on orthodox public investment but on financing brave new fields in the context of a growth strategy aimed at having quick and far-reaching impact. Ideas should be solicited from the private sector and elsewhere with a view to arriving at some unconventional formulation of fiscal policy. Examples might include public sector purchases of, or bold subsidies for, terrestrial digital broadcasting or environment-friendly cars, or efforts to promote construction of solar houses. The impact of such measures would be considerable, and the associated industries are presently struggling to reduce huge unintended inventories. This would mean adopting a "priority production system" using fiscal policy such as implemented during postwar era. Among public investment projects, work to expand Haneda Airport might be rolled forward. Construction of linear express trains is another option. Even plans to move the capital out of Tokyo might be revived. The essential point is to present a future plan and take steps toward the process of “constructive destruction”.

Compared to the United States and Europe, Japan has suffered comparatively little damage to its financial system from the adverse shock originated from sub-prime loan problems, and Japanese business firms and households both have sufficient assets. One hopes that, as the second largest economy in the world, Japan will overcome this crisis on its own and go on to occupy a respected position in the international community.

Following the crisis, Japan should move to overhaul institutions and structures in a variety of fields.

One of these would be the labor market. The government quickly overhauled the safety net in the field of finance based on lessons learned from the financial crisis during so called “lost decade”. In contrast, because of unprecedented and unparalleled adjustments in production following the lifting of the ban of temp staff in the manufacturing industry, the safety net for irregular employees was not ready when needed.

Dealing with these issues is presently emerging as a major policy issue, but the means of remedy is not to re-impose a ban temp staff in manufacturing. It is not realistic to assume that companies exposed to substantial changes in production and intense global competition can at all times maintain levels of employees suitable only to periods of maximum output.

It is also necessary to be able to provide a diversity of working styles for the public. One example is creation of a new unemployment insurance compensation system for non-regular employees, with the expense being borne mainly by employers. Under such a system, companies would compensate for the benefits they enjoyed in utilizing limited-term employment by paying the losses incurred by employees when they are laid off. At the same time, it may be necessary to review the "excessive protection" given to regular employees.

Also needed will be effort toward building a new international financial architecture after the crisis passes. We've learned from this crisis how deeply Japan is interconnected with the global economy and how impossible it will be in the future to remain insulated from its major trends. If so, international rules concerning trade and finance, accounting and the like must, of course, be observed. However, Japan should actively participate in the making of new rules, and in this regard, and nurturing human resources with the necessary international skills must be seen as a key issue.

Perhaps the reform which has come to be placed in Japan on investor relations and quarterly reporting may lead to excessive stress on short-term management. In this context, there may be imbalances in the distribution of earnings among interested parties. For example, firms attach importance to the annual dividend per share at the sacrifice of future investment and wages, and in turn strict gross domestic demand. As globalization moves ahead, Japan should rebuild its namesake style of management in the traditional spirit of adapting Western intelligence to the Japanese spirit.

（The original Japanese article appeared in the February 24, 2009 issue of the Nihon Keizai Shimbun）

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	-0.6	-3.3	-2.3	-0.7	0.3	0.2	0.2	0.3	-0.0	0.5	0.4	1.9	-2.7	-3.7	0.9
Real gross domestic expenditures (year-on-year)	0.7	-0.2	-4.6	-7.0	-6.8	-6.0	-2.5	-0.0	1.0	0.7	0.9	1.2				
Private final consumption (qtr.-to-qtr.)	-0.7	0.3	-0.4	0.2	0.3	-0.0	-0.6	0.2	0.6	0.1	0.1	0.3	0.8	0.0	0.1	0.6
Private housing investment (qtr.-to-qtr.)	-1.9	4.0	5.7	-3.6	-2.9	-1.8	0.5	0.3	1.0	0.6	0.2	0.5	-13.0	-1.8	-3.1	1.6
Private non-residential investment (qtr.-to-qtr.)	-2.3	-3.4	-5.3	-6.0	-6.5	-3.0	-0.2	0.4	-0.6	-0.3	2.5	3.7	2.3	-7.7	-16.0	0.7
Private inventory investment (contribution)	0.1	-0.2	0.4	-0.0	-0.3	-0.2	-0.1	0.0	0.0	-0.1	0.2	-0.1	0.1	-0.1	-0.4	-0.0
Government final consumption (qtr.-to-qtr.)	-0.9	-0.2	1.2	1.0	-0.1	-0.0	-0.1	0.2	0.3	0.4	0.4	-0.7	2.2	0.4	1.2	0.7
Public fixed capital formation (qtr.-to-qtr.)	-0.8	1.0	-0.6	0.2	3.0	2.0	1.5	-2.1	-2.4	-0.4	-0.7	-4.2	-5.8	-4.7	4.9	-4.4
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)	-1.0	-0.4	-0.3	-0.7	-1.1	-0.6	-0.4	0.2	0.3	0.0	0.6	0.3	0.7	-1.4	-2.5	0.4
Net exports of goods and services (contribution)	0.1	-0.1	-3.0	-1.6	0.4	0.9	0.7	0.0	-0.0	-0.1	-0.1	0.1	1.3	-1.2	-1.2	0.5
Exports of goods and services (qtr.-to-qtr.)	-2.3	0.6	-13.9	-12.9	-0.2	4.6	3.3	-0.4	1.0	0.1	1.0	1.7	9.3	-7.6	-12.7	4.5
Imports of goods and services (qtr.-to-qtr.)	-3.1	1.7	2.9	-2.5	-3.3	-2.7	-2.0	-0.8	1.3	1.0	1.9	1.3	1.8	0.1	-6.5	1.0
Nominal gross domestic expenditures (qtr.-to-qtr.)	-1.4	-0.7	-1.7	-1.4	-0.4	-0.1	0.1	-0.0	-0.3	-0.5	0.2	0.4	1.0	-2.9	-2.5	-0.5
Domestic corporate goods price index (year-on-year)	4.9	7.1	2.9	-1.7	-5.7	-9.3	-6.6	-3.5	-2.1	-1.7	-1.5	-1.3	2.3	3.3	-6.3	-1.7
Consumer price index (year-on-year)	1.5	2.3	1.0	-0.4	-1.4	-2.5	-1.2	-0.8	-0.7	-0.5	-0.4	-0.3	0.3	1.1	-1.5	-0.5
Call rate (Uncollateralized, Overnight, %)	0.51	0.50	0.34	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.50	0.36	0.10	0.10
WTI Crude oil price (dollar / barrel)	123.8	118.2	59.1	42.1	43.6	46.0	47.8	50.5	50.5	50.5	50.5	50.5	82.1	85.8	47.0	50.5
Yen : Dollar exchange rate (yen / dollar)	104.5	107.6	96.1	89.9	89.7	89.7	90.1	93.0	93.3	95.6	95.7	97.4	114.2	99.5	90.6	95.5
Unemployment rate (%)	4.0	4.1	4.0	4.5	4.9	5.0	5.1	5.3	5.5	5.7	5.9	5.9	3.8	4.2	5.1	5.8
Indices of Industrial Production (qtr.-to-qtr.)	-0.8	-1.3	-12.0	-23.1	-7.4	6.4	7.7	3.0	1.0	0.6	2.8	2.0	2.6	-12.4	-22.9	11.2
Current account / Nominal GDP (%)	3.8	2.8	1.8	2.2	4.6	4.7	4.0	3.7	4.1	4.1	3.6	3.5	4.8	2.6	3.6	3.7
Real GDP of U.S.A. (qtr.-to-qtr.)	2.8	-0.5	-3.8	-5.9	0.2	-0.2	-1.2	1.0	3.1	1.8	2.2	2.9	2.0 (C.Y.)	1.3 (C.Y.)	-2.2 (C.Y.)	0.9 (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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