May 2009

SA138 Short-Term Forecast for the Japanese Economy (2009/4-6—2011/1-3)

Recovery in FY2009 to be short-lived, losing momentum in FY2010 as fiscal stimulus effects fade out

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- Government measures succeed in halting freefall.
- Economic activity remains weak as private demand fails to pick up.
- Sustained growth still awaits U.S economic recovery.

Although a bottom appears in sight for the Japanese economy, the level of economic activity remains quite low.

Japan's real gross domestic product (GDP) for the January-March quarter as released on May 20 decreased at annual rate of 15.2% in the worst plunge on record. It also marks the second consecutive double-digit decline following the October-December quarter of 2008, once again underlining the severity of the drop which followed the Lehman shock last autumn. Japan's setback far outstrips that of any other advanced country, including the United States, where the crisis originated. Consequently, the dizzying speed of the downturn raises the possibility that Japan may be first among the world's advanced economies to return to growth in the April-June quarter of this year.

The pace of deterioration in Japan’s economic conditions slowed clearly as a new fiscal year was getting started. Monetary and fiscal policy authorities around the world moved decisively to implement stimulus measures which stopped worsening the sentiment of economic entities. Both advanced and emerging countries worked out cooperating fiscal expansion measures, shoring up aggregate demand. Central banks also initiated buying, and stepped up the amount of government debt securities, even taking such nontraditional monetary policy steps as buying corporate bonds outright.

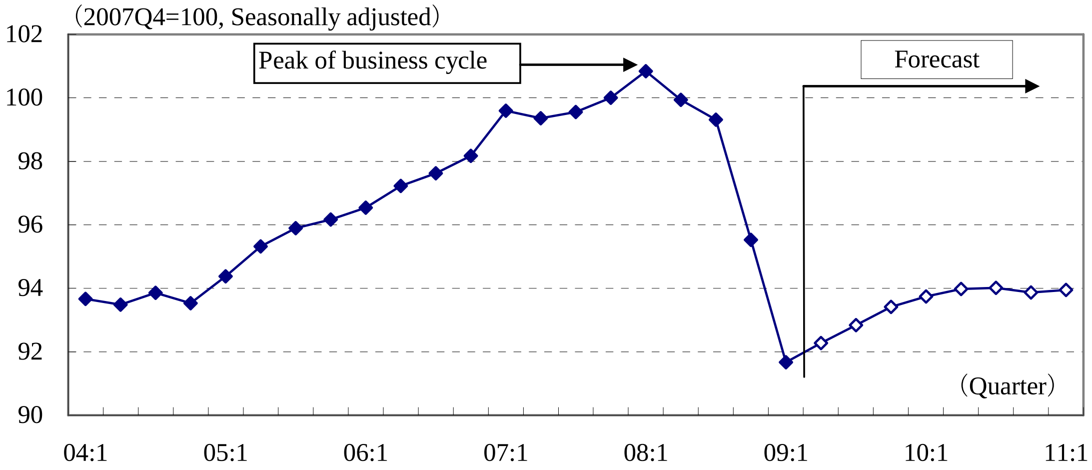
In the wake of these efforts, worldwide stock prices promptly rebounded after touching bottom in early March. Paralyzed financial markets have also begun to function again. Short-term interest rates have fallen, and companies with blue-chip ratings are finding it easier to raise capital in open markets. A look at the real economy shows that inventory adjustments at home and abroad are proceeding steadily as a consequence of drastic cutbacks in production by business firms, which are now expected to increase production in the near future. Following business firms, households are also showing some glimmers of improved sentiment. Special income transfers from the government have been disbursed, and personal consumption is very likely to rise for a time in the April-June quarter, which corresponds with the start of such measures as lower expressway tolls, and the introducing of the measure to promote purchasing of eco-friendly cars and home electrical machinery.

A look further ahead indicates that positive growth rate will for some time continue on a number of factors. First, moves by businesses firms to rebuild inventories will give a boost to the economy. Second, the implementation of successive stimulus measures will raise public investment and government consumption in the form of increased temporary hiring, purchases of televisions supporting digital terrestrial broadcasting, acquisition of official vehicles and the like. Third, growth will be lifted by a rising trend in external demand on such factors as the impact of stimulus measures in foreign countries such as China and the completion of inventory adjustments in local regions abroad.

In this way, our revised outlook foresees continued economic growth through the remainder of FY2009. As shown in Table 1, however, our forecast average rate of growth for FY2009 as a whole is the considerably dire figure of -3.8%. The reason is that, given the drastic downturn in the second half of FY2008, the present fiscal year began from an exceedingly low level, and our forecast therefore factors in a 4.9% "negative carry-over". Factoring out this negative carry-over, we see the economy growing at an average rate of 1.1% for the whole of FY2009, hence our forecast of -3.8% (4.9 - 1.1 = 3.8). Meanwhile, assuming a (positive) carry-over of 1.1% in FY2010, our forecast for growth rate of 0.9% means negative growth rate of -0.2% in that year.

Our reasons for expecting the economy to lose steam from and after FY2010 relate primarily to the weakness of the level of economic activity, as indicated in Figure 1. The inventory rebuilding and public-sector demand we anticipate this fiscal year will be strictly temporary, while the recovery momentum of the private-sector demand which is so critical to a sustainable economic expansion will be fragile. Unfortunately, economic activity by the end of FY2009, following a period of positive growth, will be weak and will not lead thereafter to a recovery in private demand.

Figure1. GDP Forecast of Japan



(Source) Cabinet office, *Quarterly Estimates of GDP*

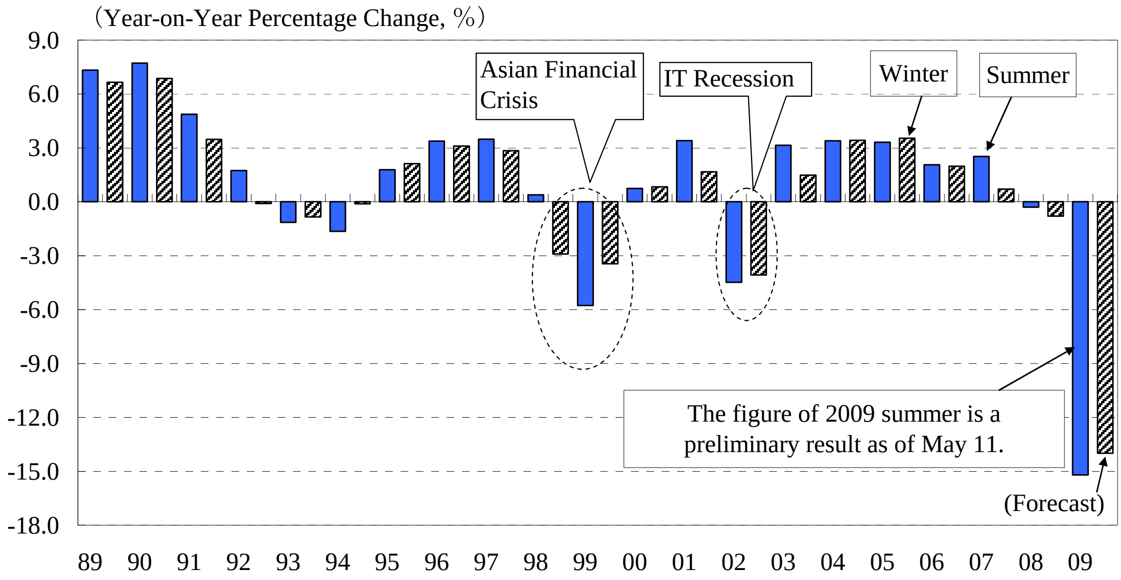
Even if we assume that inventory adjustments run their course, business firms are likely to maintain a tight cap on spending in order to avoid reporting negative earnings for two consecutive years. It is true that they increase production for the moment from extremely low level, but capacity utilization rates will be insufficient to cover fixed expenses, such that corporate profit will continue to deteriorate. As some large manufacturing companies have already announced, they expect to report operating losses for the year ended March 2010, meaning the time is not yet ripe for businesses to begin increasing fixed investments again.

Still saddled with excess capacity, business firms will be compelled to step up restructuring in staffs and production facilities with a view to recovering profitability from FY2011 and after. Given the balance between savings and investment for the country as a whole, it would be helpful if companies were to expand investments, but given stubborn worries regarding cash management and pressure from vigilant shareholders, they are more likely to put spending cuts first and foremost.

A look at households shows that upcoming summer bonuses are set to decline sharply (Figure 2). A great number of regular employees have been retained on payrolls even after the Lehman shock, and unions and employers reached agreement in keeping the level of regular monthly payment Households will be keenly sensitive to the recent crisis from June and thereafter, as smaller bonuses are to be paid out in both the public and private sectors. That, however, will only be the beginning.

For the present, companies will make use of the greatly expanded government safety net comprising subsidies for employment adjustments and will endeavor to hold on to excess staff. Even so, the unemployment rate is likely to continue rising. But since earnings are unlikely to recover this fiscal year, the possibility is intensified that companies will resort to severe restructuring measures in FY2010 as they step up efforts to cut personnel expenses. There are limits to how far bonuses can be cut, so in the spring labor negotiations next fiscal year, more companies are likely to ask labor unions to choose between retaining staff or cutting salaries.

Figure2. Outlook for Bonus Payment



(Source) Nikkei Inc. *Bonus survey* .

Under such severe employment and income conditions, households are likely to further tighten their belts. This trend is already appearing in the shift in demand to low price apparels including 990 yen jeans and private brand products such as foodstuff. The situation is very similar to the deflation which arose during the manufacturing retail boom and rapid growth period of home center which occurred in the first half of this decade. Given the possibility of renewed fears of deflation going into FY2010, caution will be required.

As seen above, the recovery of Japan’s economy will remain dependent on external demand if domestic economic stimulus measures fail to prompt the pick-up of private demand. Led by public-sector demand and private consumption, China will continue to play the main role in supporting the global economy. However, with Chinese exports recovering at a slow pace as well, private-sector investment will be sluggish, with scant hope for the high growth seen prior to the current crisis.

Ultimately, economies all over the world await a sustained economic recovery in the United States. But the balance sheet adjustments which the U.S. household sector faces in order to correct its past excessive consumption will not be completed in a short time. Consequently, the global economy will remain in the process of correcting accumulated imbalances for the time being, and a slow pace of growth will be the inevitable result.

The same will be true for financial intermediaries. Even if ineffective financial intermediation is less of a drag on the worldwide economy than the period soon after Lehman shock, some time will still be required before financial intermediaries are able to fully play their role of supporting and accelerating economic growth. The shift to a low-leverage economy is likely to become a constraint of economic growth.

Facing an unprecedented crisis, the government and the Bank of Japan have implemented a barrage of bold stimulus measures without fear of the side effects and have succeeded in calming the crisis to some degree. But now that the economy has been rescued from its freefall and financial markets are no longer paralyzed, the judgment of policymakers to choose policy option in order to keep the economy growing without avoiding deflation will be even difficult.

In order to cope with the economic crisis, the government some time goes shelved plans to balance the budget. Although we believe the government's efforts will lift GDP by a percentage point at least, it will remain far short of its level prior to the crisis even as the unemployment rate continues to climb. In view of this situation, the next government, which will assume control in the fall at the latest, may be strongly tempted to draft an additional supplementary budget. But the answer will not be so easy. As tax revenues fall, long-term yields are firming up amid fears over deteriorating supply/demand conditions for government bonds. A look at policy implemented by central banks in the United States and Britain in order to purchase long-term government bonds outright shows that controlling long-term yields is no easy matter.

In drafting supplementary budget to cope with economic crises, governments insisted on the slogans about “wise spending”. However, it seems to contain those measures whose urgency or economic impact remain uncertain. One lesson learned during so-called “lost decade” was that fiscal spending failed to be on the sustainable economic recovery, in turn accumulating huge fiscal deficit.

To put matters plainly, Japanese growth will for the present remain dependent on an economic recovery in the United States. One idea might therefore be to forego any additional supplementary budget in FY2009 and instead to incorporate any long-term growth strategies into the main FY2010 budget. It may be possible to avoid further fiscal spending and to implement measures making it compulsory for employees to use their paid vacations with a view to raising the satisfaction level of the public. It would be a happy circumstance if such efforts stimulated consumption and helped offset the declining birth rate and the graying of the population. It could also tie in with government efforts in the direction of work sharing and work-life balancing.

In any event, the upcoming general elections should not be seen merely as a choice between governments. They should clarify such issues as whether there is to be a supplementary budget, what the various positions are relating to fiscal policy and the choice of cutting taxes or increasing fiscal spending, and where the financing is to come from. The elections should therefore be seen as choice among those policies which will determine the direction in which the country is to proceed.

（The original Japanese article appeared in the May 28, 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	FY2008 Actual	FY2009 Forecast	FY2010 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	-0.9	-0.6	-3.8	-4.0	0.7	0.6	0.6	0.4	0.2	0.0	-0.2	0.1	-3.5	-3.8	0.9
Real gross domestic expenditures (year-on-year)	0.6	-0.3	-4.3	-9.7	-7.7	-6.5	-2.2	2.3	1.8	1.3	0.5	0.2			
Private final consumption (qtr.-to-qtr.)	-1.0	0.1	-0.8	-1.1	0.8	-0.4	0.3	0.3	0.0	-0.2	-0.1	0.2	-0.5	-0.3	0.2
Private housing investment (qtr.-to-qtr.)	-2.0	3.1	5.5	-5.4	-3.3	-1.7	0.2	0.4	0.2	0.6	0.6	0.7	-3.0	-5.2	1.1
Private non-residential investment (qtr.-to-qtr.)	-2.9	-4.4	-6.7	-10.4	-1.7	0.5	-1.6	-1.8	1.9	2.9	0.9	1.4	-10.3	-14.5	2.8
Private inventory investment (contribution)	-0.2	-0.0	0.5	-0.3	-0.4	0.2	0.1	0.0	-0.0	-0.0	0.0	-0.1	-0.1	-0.2	0.0
Government final consumption (qtr.-to-qtr.)	-0.8	-0.2	1.6	0.3	0.4	0.5	0.5	0.4	0.0	0.0	0.0	-0.0	0.4	2.1	0.7
Public fixed capital formation (qtr.-to-qtr.)	-0.8	1.0	-0.1	-0.0	2.2	7.3	8.1	4.0	0.0	-7.2	-7.9	-7.8	-4.5	13.6	-2.9
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)	-1.4	-0.6	-0.6	-2.6	-0.1	0.4	0.5	0.2	0.2	-0.0	-0.2	0.0	-2.2	-1.8	0.6
Net exports of goods and services (contribution)	0.5	-0.1	-3.2	-1.4	0.7	0.2	0.1	0.1	0.0	0.1	0.1	0.1	-1.2	-2.0	0.3
Exports of goods and services (qtr.-to-qtr.)	-0.8	1.0	-14.7	-26.0	3.9	3.2	1.5	1.2	1.0	1.2	0.6	0.9	-10.2	-21.9	4.9
Imports of goods and services (qtr.-to-qtr.)	-4.2	1.5	3.1	-15.0	-2.8	1.6	0.5	0.4	0.8	0.6	0.2	0.4	-3.5	-11.1	2.4
Nominal gross domestic expenditures (qtr.-to-qtr.)	-2.1	-1.5	-1.6	-2.9	0.3	-0.3	-0.0	0.3	-0.2	-0.4	-0.0	-0.1	-3.7	-3.2	-0.4
Domestic corporate goods price index (year-on-year)	4.9	7.3	2.6	-1.8	-5.7	-9.8	-6.7	-3.7	-2.2	-0.9	-0.4	-0.2	3.2	-6.5	-0.9
Consumer price index (year-on-year)	1.5	2.3	1.0	-0.1	-1.2	-2.2	-1.5	-1.1	-1.4	-0.9	-0.9	-1.0	1.2	-1.5	-1.1
Call rate (Uncollateralized, Overnight, %)	0.51	0.50	0.34	0.11	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.36	0.10	0.10
WTI Crude oil price (dollar / barrel)	123.8	118.2	59.1	43.3	52.0	53.5	55.5	57.7	59.0	59.0	59.0	59.0	86.1	54.7	59.0
Yen : Dollar exchange rate (yen / dollar)	104.5	107.6	96.1	93.7	97.5	98.1	98.3	98.8	99.4	100.0	101.0	102.2	100.6	98.2	100.6
Unemployment rate (%)	4.0	4.0	4.0	4.4	4.9	4.9	5.0	5.2	5.4	5.5	5.7	5.7	4.1	5.0	5.5
Indices of Industrial Production (qtr.-to-qtr.)	-1.3	-3.2	-11.3	-22.1	6.8	4.5	1.7	0.9	0.2	0.3	0.6	0.9	-12.7	-14.6	3.6
Current account / Nominal GDP (%)	3.9	3.2	1.7	1.4	2.4	3.0	2.4	2.1	2.4	3.1	3.1	2.7	2.5	2.3	2.7
Real GDP of U.S.A. (qtr.-to-qtr.)	2.8	-0.5	-6.3	-6.1	-2.2	-0.2	-0.1	0.9	1.2	1.5	1.8	1.7	1.1 (C.Y.)	-3.1 (C.Y.)	0.6 (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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