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SAI39 Short-Term Forecast for the Japanese Economy (2009/7-9—2011/1-3)

*Sluggish, barely discernable recovery and scant hopes
for jump-starting private demand
Point to patient, long-term growth strategy as best
policy option*

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- FY2010 loses momentum as public-sector demand fades
- Stock retrenchment pressures in corporate sector limit the private demand
- Export outlook weak amid limits to Chinese demand

With the help of the implementation of stimulus measures at home and abroad, Japan's economy has improved, but it has yet to reach the point where private demand can, on its own, power a self – sustaining expansion.

Real gross domestic product (GDP) figures for the April-June quarter released recently showed positive growth for the first time in five quarters, confirming again that the worst economic situation is over. However, the power of rebound after the steepest descent in the course of the synchronized global recession following the Lehman crisis in September 2008 is weak and the level of economic activities is still very low.

Another concern is that the return to positive growth has almost exclusively been the result of economic stimulus measures taken at home and overseas. First, public spending has increased obviously as a result of stimulus measures. Second, Japanese exports picked up, mainly due to the effects of the policy measures of various countries, especially in China. Third, the improvement in personal expenditures, after substantial decline, has resulted largely from fixed-sum stipend as well as the reduction in taxes for eco-friendly cars and the introduction of subsidies for eco-friendly home appliances. Meanwhile, private nonresidential investment and residential investment have been on the decline. There is no sign of reaching the bottom for private demand.

In view of the economic conditions outlined above, we have revised our economic outlook. Our

current projections for the change in real GDP has a negative 3.0% for FY2009 (April 2009-March 2010) (versus negative 3.8% in our previous forecast) and a positive growth of 1.4% in FY2010 (April 2010-March 2011) (versus positive 0.9%). We have revised up our forecast after factoring in the unexpectedly strong recovery in China.

We believe the Japanese economy through FY2010 will have three defining features. First, growth rate vis-à-vis a previous quarter will keep consistently positive. Second, in the early stages of the economic recovery, the pace of growth will be sluggish. Third, as we move into FY2010, the growth rate will lose momentum (Figure 1). In sum, even if positive growth does continue through FY 2010, it will remain virtually imperceptible.

From now on through FY2009, we will enjoy a solid growth on the impacts of domestic and overseas stimulus measures, as well as the inventory rebuilding in corporate sector, mainly in manufacturing. However, whichever political party takes power in the Diet, maintaining the huge size of public spending in this fiscal year into the FY2010 will be unrealistic. The government sector will therefore almost certainly be negative contributor for the growth.

The extent to which private demand can offset this downward pressure will determine the strength and sustainability of any recovery in the next fiscal year. We believe that private demand may certainly increase, and therefore, the Japan's economy can overcome "fiscal drag" and keep a slightly positive growth. However, private demand never leads to steady growth, because the pace of the recovery would be only modest. Moreover, any untoward developments such as an external shock could easily snuff out that any spark in the private demand at a time when there is little room for more fiscal spending to reignite it.

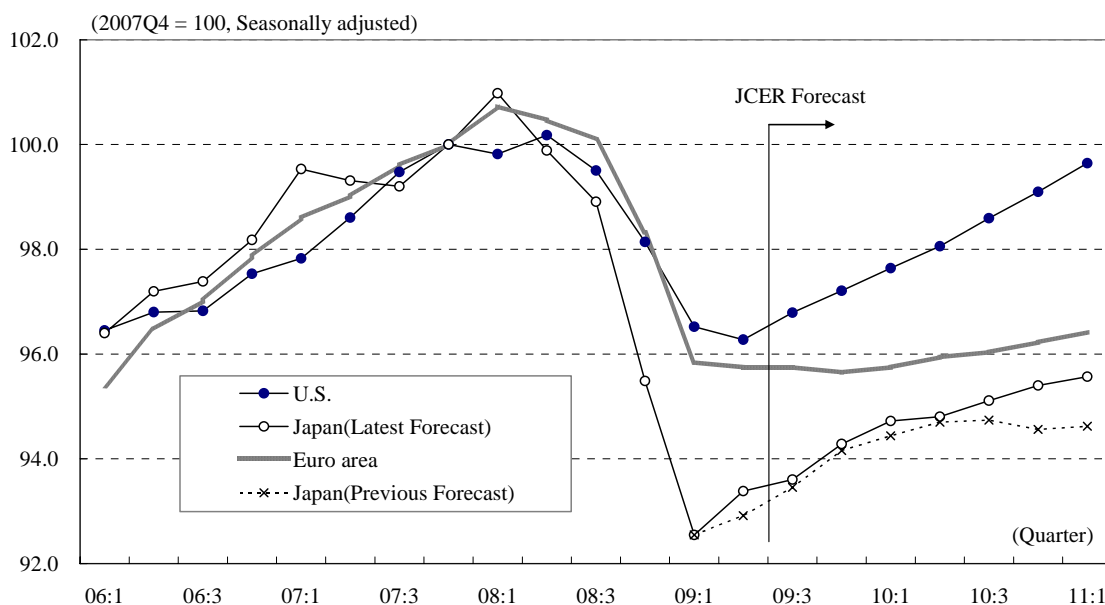
Although business firms are increasingly seeing an end to inventory adjustments, they show no sign of easing up on spending cuts, such as personnel expenses and advertising spending. A look at corporate results as reported for the April-June quarter shows that the earnings in the manufacturing sector have put the worst behind them. Of course, the bottoming of capacity utilization rates has had a positive impact, but the effect of cutback in various costs has also played a major role. In short, the non-manufacturing and household sectors can be seen as the victim of the recovery of manufacturing sector.

In fact, business firms are pulling the belt on personnel expenses even tighter. Judging from the increase in short-term workers as well as employees on leave, employment conditions are even worse than the unemployment rate, which had already reached the historical high level, would seem to indicate. Against a backdrop of drastic cuts in bonuses and working hours, the decline in wages

has also been accelerating. In addition to this kind of deterioration in corporate earnings and wages, the stock adjustment pressures will do their own part to foment stagnation in domestic private demand.

During the last economic expansion (from the early 2002 to late 2007), nonresidential fixed investments were brisk, but in general, business firms have been seen as cautious in their investment behavior, especially if compared with strong corporate earnings. With hindsight, it appears that fixed investments were indeed excessive, induced largely by the extravagant U.S. consumption and the weak-yen bubble, which gave rise to earnings not justified by the degree of underlying strength in the economy.

Figure 1: The levels of real GDP (Japan, U.S. , and Euro area)



Around 2005, when the Japanese economy was on sustainable recovery path for the first time after so-called “lost decade”, household behavior exhibited the character of a mini-bubble. The boom in luxury condominiums and rental house construction was not unrelated to investor expectations of rising prices. Moreover, jeans selling in the tens of thousands of yen were popular at the time. Now just four year later, the only jeans seeing rising sales are those going for a thousand yen or less. It's like a different world.

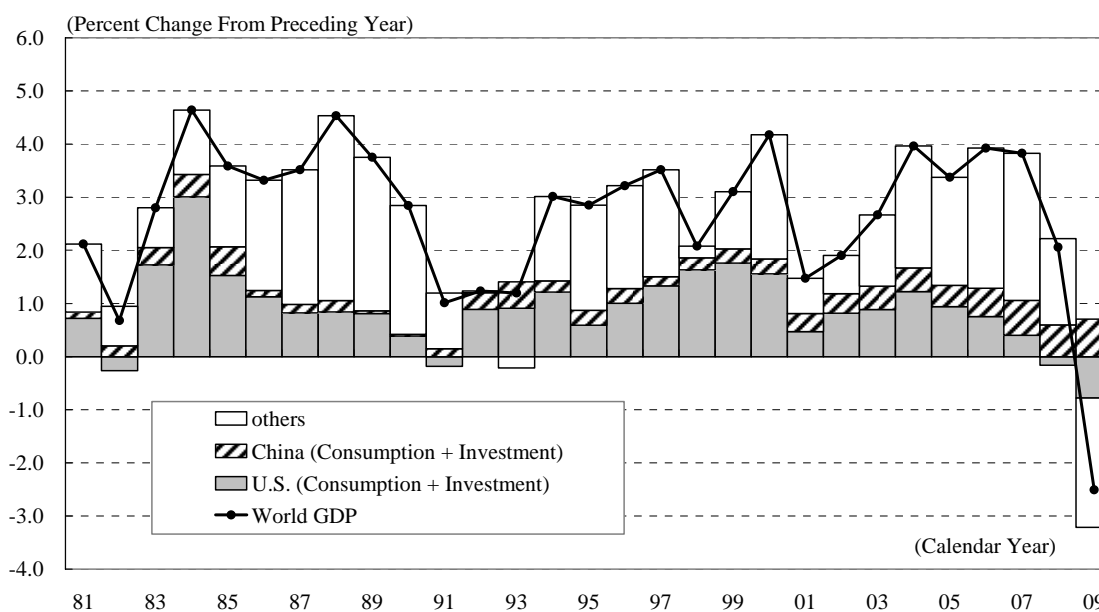
As indicated above, the economy is likely to continue improving normally through the end of FY2009 mainly on the impact of government policy measures. In FY2010, we are likely to see a phase similar to conditions which prevailed in the first half of this decade, following the burst of the

IT bubble. That period was also characterized by a large supply-demand gap, with increasing fears of deflation. It was also a time when the Bank of Japan implemented quantitative easing, following its zero-interest rate policy.

In large part, it was a rise in exports which enabled the economy to pull out of the severe recession and the deflationary trend. China had joined the World Trade Organization, the U.S. economy was also headed toward recovery, and the weak yen lent a considerable help as well.

Can we expect the same lucky situation again? Certainly, the Chinese economy has led the world economy out of the downturn, driven by massive economic stimulus measures, and we are benefiting from that. However, the upward pressure this will put on resource prices, including oil, is a matter of concern for Japan. Also, as Chinese exports continue to stagnate, the recovery in private investment has been slow in coming, making a return to the double-digit growth prevailing in China before the current crisis difficult. China will therefore not become the kind of global economic driver that the United States was (Figure 2).

Figure 2: The growth rate of World GDP and contributions of U.S. and China



(Source) U.S. Department of Commerce, IMF, CEIC

The all-important U.S. economy is putting the worst of the cycle behind it. However, as was shown in the Japanese experience following the collapse of the bubble economy, with deflationary pressures on asset prices persisting, households, business firms and financial institutions as well are being compelled to strengthen their balance sheets, and this will make a strong recovery unlikely.

On the currency markets, there is still a concern that domestic U.S. factors undermining the dollar will in turn appreciate the yen. At the very least, any recurrence of a weak-yen bubble is unlikely. And with all advanced industrialized countries experiencing sluggish growth, any Japanese intervention in currency markets to depreciate the yen would be politically difficult.

As seen above, any significant growth in exports will be unlikely as global imbalances are corrected over the next few years. On the domestic front, adjustments related to excessive productive capacity and employment will also take time to play out. There is little chance of a return to the 2% growth which the Japanese economy boasted in the 2003-2007 period.

Given the above-mentioned severe circumstances internal as well as external, some might think that putting together an additional supplementary budget would be in order, but that is not only unlikely but unfavorable for the economy as well as for the fiscal situation. Though late in coming, a financial and job safety net has been set up after the Lehman crisis, and the measures to boost consumption to escape the “durable goods recession” have had the expected effect. However, the government should not continue indefinitely those measures which favor specific industries such as automobile and electronics. Economic conditions are indeed severe, but as we have indicated, a full-fledged economic recovery will take time. Considering the huge fiscal deficit we faced, the additional fiscal spending, which is liable to unwise spending, is unnecessary. Rather than a hastily prepared supplementary budget, what is most needed is formulation and promotion of a patient strategy for mid-term growth in the FY 2010 budget.

Toward that end, strategic efforts to boost both domestic and external demand will be needed. It will be worth listening to ideas that limited budget should not focus on the public investments in Japan but official development assistance (ODA) aimed at building the infrastructure in emerging economies themselves. The idea is that such efforts would lead to an expansion of infrastructure-related orders for Japanese business firms.

Among measures to boost domestic demand, those aimed at agriculture, education and care for the aged can not serve to stimulate the economy substantially, but there is little choice but to proceed with them. Sustained effort to raise the inadequate birth rate in Japan is necessary as well.

A look at the economic policies presented in the several political platforms ahead of the general election shows the Liberal Democratic Party, as before, favoring the creation of effective demand in a manner aimed at boosting corporate earnings, which would then bleed through to the household sector. The Democratic Party of Japan, meanwhile, stresses the direct benefits to households based on the view that existing firms-to-households channels have been ineffective for the long time. The

measures cited by the DPJ would be seemingly experimental in some ways, but, it will come down to a matter of increasing spending or cutting taxes. The DPJ also advocates scrapping the spousal deduction to finance the child allowance. This is an interesting measure, since it may involve the changes in part-time workers' labor supply.

In this way, the general election this weekend does matter in terms of political changes as well as of policy choices. It will be important for the public to make their voices heard through the ballot box.

(The original Japanese article appeared in the August 25, 2009 issue of the Nihon Keizai Shimbun)

Table. The Outlook for Japanese Economy

	Forecast												FY2008 Actual	FY2009 Forecast	FY2010 Forecast
	FY2008				FY2009				FY2010						
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th			
Real gross domestic expenditures (qtr.-to-qtr.)	-1.1	-1.0	-3.5	-3.1	0.9	0.2	0.7	0.5	0.1	0.3	0.3	0.2	-3.2	-3.0	1.4
Real gross domestic expenditures (year-on-year)	0.6	-0.3	-4.3	-8.7	-6.4	-5.4	-1.3	2.4	1.5	1.6	1.2	0.9			
Private final consumption (qtr.-to-qtr.)	-1.0	0.1	-0.7	-1.2	0.8	0.1	0.1	0.4	-0.2	0.3	0.2	0.1	-0.5	-0.2	0.5
Private housing investment (qtr.-to-qtr.)	0.0	3.5	2.6	-5.7	-9.5	-5.8	-3.4	-0.1	0.6	1.4	2.0	0.8	-3.1	-16.9	-0.5
Private non-residential investment (qtr.-to-qtr.)	-1.7	-4.9	-7.1	-8.5	-4.3	-3.5	0.2	-0.1	1.4	1.5	1.7	1.9	-9.6	-17.2	3.1
Private inventory investment (contribution)	0.3	-0.2	0.5	-0.2	-0.5	0.3	0.1	-0.2	0.1	-0.0	-0.0	-0.1	0.0	-0.1	0.0
Government final consumption (qtr.-to-qtr.)	-0.7	-0.2	1.3	0.1	-0.3	1.5	2.2	1.1	0.2	-0.3	-0.5	-0.6	0.3	2.9	1.8
Public fixed capital formation (qtr.-to-qtr.)	-5.1	1.7	2.2	2.6	8.1	2.3	0.5	-2.2	-3.8	-5.2	-2.4	-1.3	-4.4	13.4	-9.7
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)	-0.8	-0.8	-0.6	-2.2	-0.7	0.2	0.5	0.1	0.1	0.1	0.2	0.1	-2.0	-2.3	0.7
Net exports of goods and services (contribution)	-0.3	-0.2	-2.9	-0.9	1.6	0.5	0.2	0.4	0.0	0.2	0.1	0.1	-1.2	-0.7	0.7
Exports of goods and services (qtr.-to-qtr.)	-4.1	-0.8	-13.6	-22.5	6.3	6.2	3.0	4.0	1.3	2.1	1.8	1.5	-10.2	-13.6	10.4
Imports of goods and services (qtr.-to-qtr.)	-3.1	0.2	2.5	-14.9	-5.1	3.0	2.0	1.8	1.5	0.8	1.5	1.4	-3.7	-11.9	6.4
Nominal gross domestic expenditures (qtr.-to-qtr.)	-1.4	-2.2	-1.3	-2.6	-0.2	0.1	-0.4	1.4	-1.1	0.5	-0.3	1.3	-3.5	-3.1	0.4
Domestic corporate goods price index (year-on-year)	4.9	7.3	2.6	-1.8	-5.4	-7.7	-3.8	-0.2	1.4	1.0	1.1	0.9	3.2	-4.4	1.1
Consumer price index (excluding fresh food ; year-on-year)	1.5	2.3	1.0	-0.1	-1.0	-2.1	-1.3	-0.6	-0.7	-0.7	-0.9	-0.6	1.2	-1.3	-0.8
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	0.37	0.10	0.10
WTI Crude oil price (dollar / barrel)	123.8	118.2	59.1	43.3	59.8	67.8	70.4	72.7	74.8	74.8	74.8	74.8	86.6	67.7	74.8
Yen : Dollar exchange rate (yen / dollar)	104.5	107.6	96.1	93.7	97.3	95.0	94.9	95.5	96.6	98.1	99.9	101.3	100.6	95.7	99.0
Unemployment rate (%)	4.0	4.0	4.0	4.4	5.2	5.5	5.7	5.8	5.9	5.9	5.8	5.7	4.1	5.5	5.8
Indices of Industrial Production (qtr.-to-qtr.)	-1.3	-3.2	-11.3	-22.1	8.3	5.7	2.1	0.5	0.8	1.5	1.3	0.8	-12.7	-12.5	5.6
Current account / Nominal GDP (%)	3.9	3.2	1.7	1.5	3.1	3.1	3.4	3.2	3.7	3.7	4.0	3.8	2.5	3.3	3.9
Real GDP of U.S.A. (qtr.-to-qtr.)	1.5	-2.7	-5.4	-6.4	-1.0	2.2	1.7	1.8	1.7	2.2	2.1	2.2	0.4	-2.7	1.7
													(C.Y.)	(C.Y.)	(C.Y.)

- [Notes] 1. Figures are shown in percentage changes, and contribution means 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 (2005) dollars.
 6. Japan's fiscal year is April 1 to March 31.
 7. Figures for Call rate, Oil price, Exchange rate, and Unemployment rate show the averages in the periods.

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