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SA140 Short-Term Forecast for the Japanese Economy (2009/10-12—2012/1-3)

A Gradual Recovery That Depends on Emerging Countries' Growth

The Threat of a Double-Dip Recession in the United States
Watch Out for Adverse Effects from Prolonged Deflation

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- An excess of plant and equipment and workers held by corporate sector may cause growth to pause when the effects of the stimulus measures wear off
- Contrary to the new administration's expectations, domestic demand cannot be counted on for the recovery
- Policy must be based on hard data and actual realities and consider the long-range outlook

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Japan's economy is continuing to improve thanks in large part to the large-scale policy measures adopted at home and abroad. A recent government report reveals that in the July–September quarter of 2009, gross domestic product (GDP) grew at a better-than-expected rate, the second consecutive quarter of positive growth. It is true that the degree to which GDP has recovered still leaves something to be desired (figure 1). Compared with the situation in the spring, however, businesses and the market are considerably more upbeat. Corporate results for the first half of the business year were also looking better, albeit partly as a result of cost-cutting moves. What stands out in the recovery process thus far is that China has returned to vigorous growth and that consumer spending in Japan has held up quite well with help from a series of stimulus measures.

Before considering the prospects for the future, let us review the impact of changes since the start of autumn in the economic climate in Japan and overseas. At home, the single largest change is the shift in economic policy accompanying the recent change of government. The new administration has announced that in order to propagate its policies, it will place emphasis on income transfers and allowances from the government to the household sector. The new policy has been described as one that transfers resources "from concrete to people."

The government has canceled some of the projects included in the supplementary budgets for fiscal 2009 (April 2009 to March 2010), and it is making major changes in the policy on the fiscal

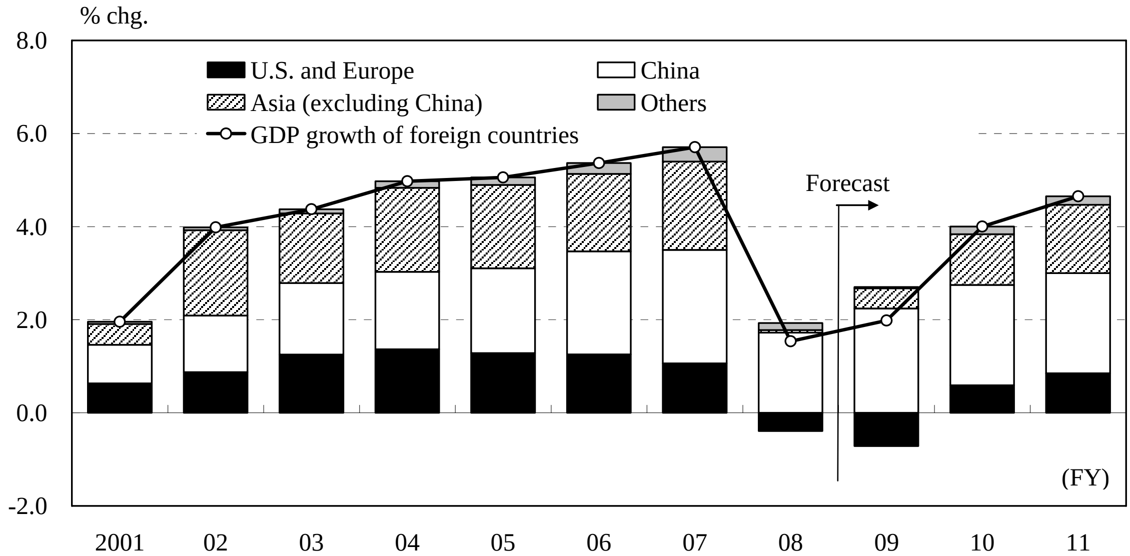
Figure 1. Real GDP of Japan, United States and Euro area

Sources: Cabinet Office; U.S. Department of Commerce; Eurostat.

2010 budget. As a result, the central government's public investment in fiscal 2010 is expected to be slashed by more than 20% from the fiscal 2009 level. The financial resources freed up in this way are to be channeled into income transfers and allowances to the household sector, and the effect should be a rebound in personal consumption starting in fiscal 2010. For two reasons, however, it is difficult to calculate the likely quantitative impact. First, it is not yet clear which of several proposed steps will be taken, such as providing child allowances and abolishing the provisionally higher rates of the gasoline tax. The timing, scale, and funding of the measures have also not been decided on. Second, nobody knows what households will do with the extra disposable income they acquire. Frankly speaking, one cannot be sure how much of it they will spend and how much save until they have it in their hands. This, then, is a bold experiment.

For our latest economic forecast, we at the Japan Center for Economic Research (JCER) incorporated the measures the new administration has put on the table as far as we could, and we made the assumption that they will have a consumption-creation effect of about 30%. At that rate, the new measures will more or less offset the reduced public investment. The programs introduced by the government in this spring, tax breaks for eco-friendly cars and a point system for eco-friendly household appliances, have produced good results. In this light, it would be desirable to enhance the business-boosting effect of the proposed measures by coupling them with other measures mentioned above to promote consumption and housing investment.

Figure 2. Economic growth of foreign countries



Notes: GDP growth of foreign countries is the average of countries weighted by Japan's exports.
Asia includes Korea, Taiwan and ASEAN5. Others includes India, Russia and Brazil.
Sources: Ministry of Finance, "Trade Statistics"; National statistical office.

Overseas, meanwhile, the dollar has been weakening, causing the yen to climb, while the emerging economies are in the midst of a strong recovery. The effects of these two trends should also tend to cancel each other out.

Based on this reading of the situation, the JCER has updated its outlook for the economy. We now predict a very modest expansion for the overall period through fiscal 2011, though it will pause for a while (see the table). Still, even with this growth, the level of the economy will remain low at the end of fiscal 2011, and deflationary pressure will persist.

In broad perspective, a sense of stagnating business conditions will spread as the effects of the stimulus measures wear off and inventories return to their original level. In a situation where companies still have an excess of plant and equipment and workers, it will take some time for private-sector demand to recover. Probably business will be slow through the first half of fiscal 2010. After that, with exports on an expansionary track, private-sector demand should finally enter a proper recovery phase, and growth in fiscal 2011 should rise to almost 2%.

The new administration is advocating an economic turnaround powered by domestic demand, but in fact the recovery is not likely to be one easily perceived by families. As always, Japan must look to external demand to take the lead. As observed in this column in the August 21, 2008, issue of the Nihon Keizai Shimbun, the upturn from 2002 to 2007 took the form of a “Dejima expansion” powered by spillover effects from a group of major exporters in the manufacturing sector (a reference to Nagasaki's Dejima island, which served as Japan's window to the world during the period of national seclusion). The next upturn is likely to be another "Dejima expansion." Moreover, because Western countries are experiencing only a modest recovery and the yen will probably stick at a high level, growth will depend heavily on demand from the emerging economies, China in particular (figure 2).

The above mentioned recovery scenarios that rely on external demand entail various risks, both external and domestic. Looking abroad, we can see that one risk is of the US economy falling into a double-dip recession, which would cause stock prices and the dollar to weaken. The recovery process in the United States is likely to go more slowly than usual, as it is being hampered by such constraints as (1) deflationary pressure on asset prices, (2) an ongoing struggle in families to balance household budgets, and (3) fragility in the financial system. The service sector, which has always been expected to create jobs, is sluggish, because of feeble consumer spending. That is why the American economy will have to endure a jobless recovery, as there are no other good prospects for new employment.

All this is reason for worrying that the US economy may stumble into a second trough, which could occur if American business gets tripped by, for example, the emergence of problems in commercial real estate. In that event stock prices, which compared with the state of the real US economy seem somewhat overheated, could tumble, while the dollar could weaken (and the yen strengthen). American policymakers would find they have few options for implementing additional stimulus measures, as they would have to rely on foreign buyers if they needed to issue more government bonds. Then in addition, pressure might mount for a correction of China's undervalued yuan, and trade friction could flare up again.

Another risk is overheating in the Chinese economy, followed by a phase of severe retrenchment. China has considerable room for deploying fiscal measures and expanding infrastructure investment, and urbanization investment is expected to be brisk on account of the flow of population from rural areas into cities. For the time being, accordingly, rapid economic growth is likely to continue. What instead is worrisome is the possibility of inflation, including rapidly rising asset prices, which could be triggered by growth of the money supply from expanded bank lending and market intervention to prevent the yuan from strengthening. In this respect, other emerging countries into which funds are flowing present the same risk. Of course, the Chinese economy's robust growth will work to buoy the Japanese economy over the short term. If a deep slump ensues, however, Japan will also suffer. The Chinese authorities have gained confidence from their successful response to the global recession, so what they do on other issues, such as the value of their country's currency, bears watching.

As for the domestic risks of relying on external demand, one concern is that the economy will be further hollowed out. As they strive to meet the demand in emerging countries, manufacturers become motivated to set up production bases close to the places of consumption. A strong yen would reinforce this incentive, and so would the measures the new administration is contemplating to restore limits on the dispatch of workers. Another concern is that deflation will take deep root. Businesses are still engaged in radical price markdowns, or "price destruction" as it is called, to woo economical consumers, and downward price movements are spreading more widely. If deflation continues, small and medium enterprises will face an even more severe economic climate. The government's financial position would also worsen, with tax revenue contracting and the real debt burden growing heavier, which would reduce the leeway of the authorities for responding to any new external shock.

The new administration would be well advised to conduct policy management with the following points in mind while it still enjoys high public support rates. One is the need to have a balanced policy orientation. It is disturbing that much of the recent policy debate has been couched in black-or-white language, as can be seen in the talk of shifting the emphasis "from concrete to people." Other dichotomies we have been hearing about are domestic demand or external demand, companies or households, and the United States or East Asia. Whatever may be appropriate in the political world with its penchant for presenting stances in opposite terms, economic policy management needs to aim for a good balance among opposing positions. This is a matter not of pitting domestic demand against external demand but of considering domestic and external demand, or companies and households, together.

Second, policies should not aim to satisfy the "political" economic agenda; they should be crafted on the basis of hard data and actual conditions. It would appear that political considerations are the primary motive behind the bill the new administration introduced to help small debt-laden companies. It is true that small firms are struggling, but the reason for that is insufficient demand, not banks' reluctance to lend. The proper response, accordingly, is to introduce measures that generate demand instead of giving small firms a holiday on loan repayments.

Third, policy management should not aim to provide stimulus for the immediate future; it should be designed on the basis of the medium- to long-term perspective. To be sure, care must be taken to prevent the economy from falling into a second trough. In the light of the current outlook for Japan, however, there is no choice but to place reliance on China and await progress in the adjustments the United States is making to correct its structural problems. Measures designed to counter short-term business difficulties will only end up worsening the health of public finance. This is a lesson Japan paid a high price to learn back in the years following the collapse of its bubble economy in the late 1980s. What instead is required is strategic implementation of future-oriented policies based on the long-range outlook. Given the critical size of Japan's fiscal deficits, it is clear that whatever the needs may be, there is not that much that can be done. Let us hope that the new administration establishes priorities and carefully implements measures for each, tackling them one by one.

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

The Outlook for Japanese Economy

Forecast

	FY2009				FY2010				FY2011				FY2008	FY2009	FY2010	FY2011
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	Actual	Forecast	Forecast	Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	0.7	1.2	0.2	0.0	0.0	0.1	0.5	0.4	0.3	0.6	0.8	0.8	-3.2	-2.7	0.9	1.9
Real gross domestic expenditures (year-on-year)	-7.0	-4.5	-1.2	2.1	1.4	0.4	0.6	1.0	1.4	1.8	2.1	2.5				
Private final consumption (qtr.-to-qtr.)	1.0	0.7	-0.0	0.3	-0.0	0.2	0.2	0.2	0.1	0.0	0.0	0.2	-0.5	0.4	0.7	0.5
Private housing investment (qtr.-to-qtr.)	-10.2	-7.7	-3.9	0.7	1.4	1.0	1.1	0.5	0.8	0.2	0.7	0.5	-3.0	-19.0	-0.8	2.6
Private non-residential investment (qtr.-to-qtr.)	-4.2	1.6	-0.6	0.0	0.7	0.4	0.8	0.7	1.2	1.4	1.8	2.3	-9.6	-14.1	1.8	4.8
Private inventory investment (contribution)	-0.7	0.4	0.1	-0.0	-0.1	-0.1	0.1	-0.0	-0.1	0.1	0.1	0.0	0.1	-0.4	-0.0	0.0
Government final consumption (qtr.-to-qtr.)	-0.2	0.4	0.7	0.5	0.9	0.9	0.7	0.6	0.2	0.1	0.0	-0.0	0.3	1.3	2.9	1.3
Public fixed capital formation (qtr.-to-qtr.)	7.7	-1.2	2.8	-6.0	-5.8	-5.9	-4.6	-2.6	0.0	1.0	1.2	1.3	-4.4	10.6	-15.7	-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)	-0.8	0.8	0.2	0.0	-0.1	0.1	0.4	0.2	0.1	0.3	0.4	0.5	-2.0	-2.2	0.5	1.1
Net exports of goods and services (contribution)	1.5	0.4	0.0	-0.0	0.1	0.1	0.1	0.2	0.2	0.2	0.3	0.3	-1.2	-0.9	0.4	0.8
Exports of goods and services (qtr.-to-qtr.)	6.4	6.4	2.7	1.3	1.3	1.4	1.8	1.8	2.1	2.8	3.5	3.4	-10.2	-13.7	7.7	9.8
Imports of goods and services (qtr.-to-qtr.)	-4.2	3.4	3.1	2.1	0.9	1.1	1.3	0.8	1.1	1.5	1.7	1.8	-3.6	-10.2	6.5	5.2
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.4	-0.1	0.7	0.1	-1.1	-0.9	1.4	0.7	-0.6	-0.7	1.6	1.1	-3.5	-3.2	-0.5	1.0
Indices of Industrial Production (qtr.-to-qtr.)	8.3	7.4	5.7	1.5	0.2	0.1	0.3	0.4	0.8	1.1	1.7	1.6	-12.7	-9.6	6.3	3.5
Unemployment rate (%)	5.2	5.5	5.6	5.7	5.8	5.7	5.7	5.6	5.5	5.3	5.2	5.0	4.1	5.5	5.7	5.3
Compensation of employees (qtr.-to-qtr.)	-2.1	-0.2	-0.9	-0.3	-0.6	-0.1	-0.4	0.0	-0.1	0.2	0.2	0.2	-0.5	-4.0	-1.6	-0.0
Newly issued government bonds yield 10-years (%)	1.447	1.344	1.362	1.368	1.374	1.380	1.386	1.424	1.462	1.499	1.537	1.633	1.459	1.380	1.391	1.533
Nikkei Stock Average (yen)	9,302	10,129	9,898	10,007	10,137	10,299	10,511	10,756	10,979	11,201	11,788	12,446	10,860	9,834	10,426	11,603
Yen : Dollar exchange rate (yen / dollar)	97.3	93.7	90.1	90.2	91.3	92.3	94.0	95.0	97.7	98.2	98.8	98.7	100.6	92.8	93.1	98.4
WTI Crude oil price (dollar / barrel)	59.8	68.2	77.7	79.9	81.3	82.2	82.2	82.2	82.2	82.2	82.2	82.2	86.6	71.4	82.0	82.2
Domestic corporate goods price index (year-on-year)	-5.4	-8.3	-5.0	-2.0	-0.9	-1.1	-0.9	-0.8	-0.7	-0.6	-0.4	-0.2	3.2	-5.2	-0.9	-0.5
Consumer price index (excluding fresh food ; year-on-year)	-1.0	-2.3	-1.6	-0.9	-1.3	-1.1	-1.3	-1.4	-0.8	-0.6	-0.5	-0.3	1.2	-1.5	-1.3	-0.6
Current account / Nominal GDP (%)	3.3	3.1	2.9	2.8	2.6	2.6	3.0	3.0	2.8	2.8	3.5	3.6	2.5	3.1	2.9	3.4
Real GDP of U.S.A. (qtr.-to-qtr.)	-0.7	3.5	1.8	1.9	2.0	2.5	2.3	2.4	2.7	2.6	2.5	3.2	0.4	-2.5	2.0	2.5
Real GDP of China (year-on-year)	7.9	8.9	10.4	11.1	8.8	9.2	9.3	9.2	9.0	9.0	9.1	9.4	9.0	8.6	9.6	9.1
													(C.Y.)	(C.Y.)	(C.Y.)	(C.Y.)

[Notes] 1. Figures are shown in percentage changes, and contribution means that to real GDP growth.

2. Figures for GDP components 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, compensation of employees, unemployment rate, indices of industrial production and current account are seasonally adjusted.

5. Figures for GDP components, unemployment rate, indices of industrial production and current account are seasonally adjusted.

6. Figures for real GDP of U.S.A. are seasonally adjusted annual rates, at chained (2005) dollars.

7. Figures for real GDP of China are at chained (2005) dollars.

8. Japan's fiscal year is April 1 to March 31.

9. Figures for Stock price, Oil price, Exchange rate, and Unemployment rate are those averaged in the periods.

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