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SA142 Short-Term Forecast for the Japanese Economy (2010/4-6—2012/1-3)

Recovery Moves Forward, but Slowly
- Once Again Japan Relies on Overseas Economies
- Don't Squander New Graduates, Hire Them

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- A cyclical upturn is in progress, although the growth tempo will slacken soon
- Even if the Greek debt crisis is resolved, Europe and China have difficult medium-term tasks left to tackle
- With the sense of déjà vu growing stronger, wisdom is needed to break out of a vicious circle

Japan's economy has been picking up, and the foundation for recovery is being laid. Recently the economy has been growing faster than anticipated, with real gross domestic product (GDP) in the January–March quarter reaching an annualized growth rate close to 5%.

Much of the momentum comes from an export expansion assisted by the vigorous recovery in China. A rebound in the information-technology sector is also supplying a tailwind. Increasing global demand for personal computers, flat-screen TVs, and smart phones is generating ripples that have spread into related industries making materials and parts. And although the employment and income situation remains severe, households are persistently holding on and underpinning the economy.

Corporate performance, particularly in the manufacturing sector, has improved thanks not only to the recovery in production, but also to restructuring done after the crisis. Corporate managers have become more confident and are gradually stepping up investment.

We at the Japan Center for Economic Research (JCER) have updated our forecast for the Japanese economy, taking the new situation mentioned above into account. We expect Japan's economy to recover moderately with external demand leading the way. The growth rate for fiscal 2010 (April 2010 to March 2011) is projected to reach 2.3%, and that for fiscal 2011 should be 1.6% (see Table). From now on, the growth tempo is expected to decelerate somewhat compared with the past year, for the following reasons. The authorities in Beijing are seeking to slow the expansion of the Chinese economy, which is showing signs of overheating. In addition, the effect of government policy measures encouraging the purchase of eco-friendly electrical appliances and cars will diminish gradually. However, this situation does not mean that the growth of Japan's economy will level off. The effects of robust export growth will spill over to domestic demand, assisting sustained economic recovery. Even so, domestic demand will recover only at a modest pace, and business activity will not gain momentum.

Business fixed investment is expected to pick up, with the focus on renewal projects that were put on hold in the midst of the economic crisis. Clearer signs of improved corporate profitability will become evident during fiscal 2011, and the sense of excess capital stock will gradually recede. That will set the stage for investment projects aimed at boosting capacity. Unfortunately, this investment will be focused on the overseas markets, with investment for the Japanese market remaining sluggish.

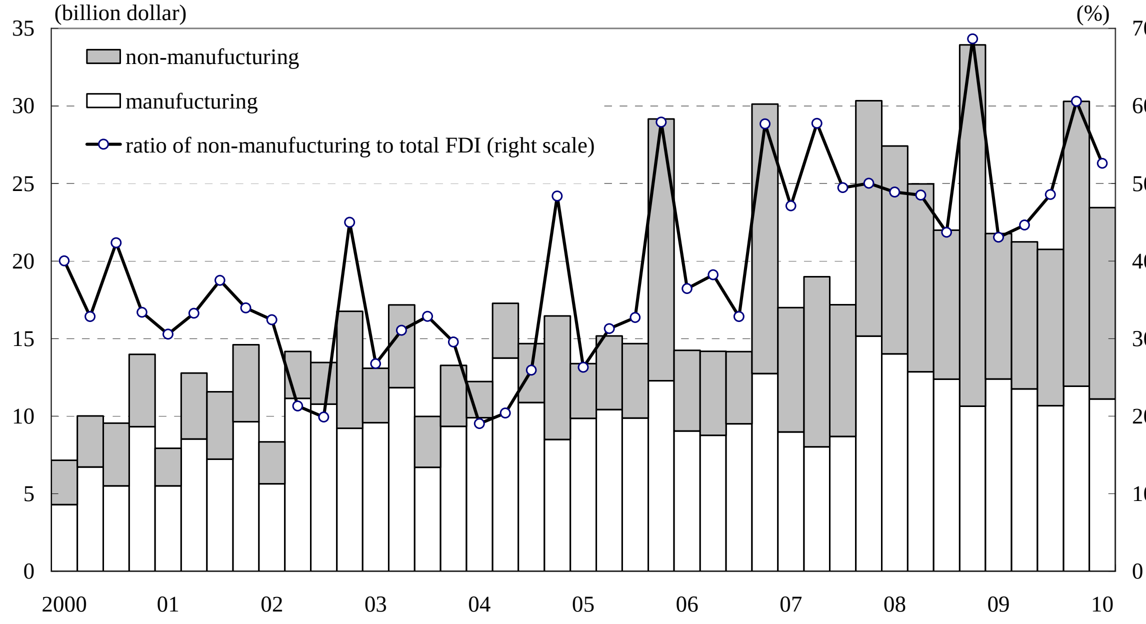
Consumers seem to loosen their purse strings as employment anxieties abate and bonuses are expected to become somewhat larger than last year. The start of child allowances in June will have a marginal effect on consumer sentiment. As other observers have noted, though, renewed consumer spending mainly reflects a weariness with frugality. Once this weariness fades, consumers will simply revert to their former thrifty habits. In a context of little evident improvement in employment and income conditions, there is still deep-seated uneasiness about the future. Many workers, especially those in the prime of their working lives, have their sights firmly fixed on defensive consumption behavior.

As the foregoing review makes clear, the outlook until the end of fiscal 2011 is for a moderate economic recovery led by exports. However, the expected recovery will naturally be accompanied by risks, both at home and overseas.

On the home front, there is certainly cause for concern about a worsening of the terms of trade originating from a steep rise in imported material prices, but growth in production quantities should have an even stronger effect, leaving the positive chain from production through income to expenditures unbroken. The public sector's fiscal position is in even worse shape than those of the countries in Southern Europe currently under attack from the markets, but as Japan's excess savings will last for some time, interest rates for government bonds will not rise precipitously.

The main risks therefore lie in economic developments overseas and unavoidable appreciation of the yen. As can be easily understood, the recent instability in overseas markets presents problems. The debt crisis in Greece is the leading concern. Despite the introduction of an austere fiscal policy

Figure 1. Foreign Direct Investment Inflow to China



Source: Ministry of Commerce, PRC

by the Greek government and the preparation of a bailout package by the European Union (EU) and the International Monetary Fund (IMF), the market turmoil has failed to settle down. Worries have flared up again over possible asset deterioration for financial institutions in Europe. That means that the recovery in Europe is rather fragile, and the clogging of bank-loan arteries is preventing the financial system from functioning.

The outlook for the current sovereign debt crisis remains unpredictable, but it seems that the Greek crisis will not turn into a global catastrophe. First, the business cycle of the world economy is in the midst of an upturn. Second, while the EU's response to the crisis has been delayed, it now seems ready to coordinate action. Third, the world's policymakers have built up experience as they dealt with the international turmoil triggered by the collapse of Lehman Brothers. The eurozone represents a grand experiment in unifying currencies without a political union, and many difficult medium-term tasks must be addressed, such as strengthening rules to enforce fiscal discipline.

Next, let us consider the Chinese economy. We need to be on the lookout for bubbles in China's property market. Already, however, the Chinese authorities have begun to achieve successful results from measures to tighten regulations. But what about the possibility of excessive deceleration in China that market participants fear? Given that the Chinese government has demonstrated skill at both applying the brakes and pressing the accelerator, there seems to be little risk in the short term. Objective evidence of room for further growth can be seen in the expansion of direct investment in China, with nonmanufacturing industries adding weight (see Figure 1). In

China's case as well, it is the medium-term tasks that bear watching. For instance, the country needs to improve its social security setup, and that will be no easy matter.

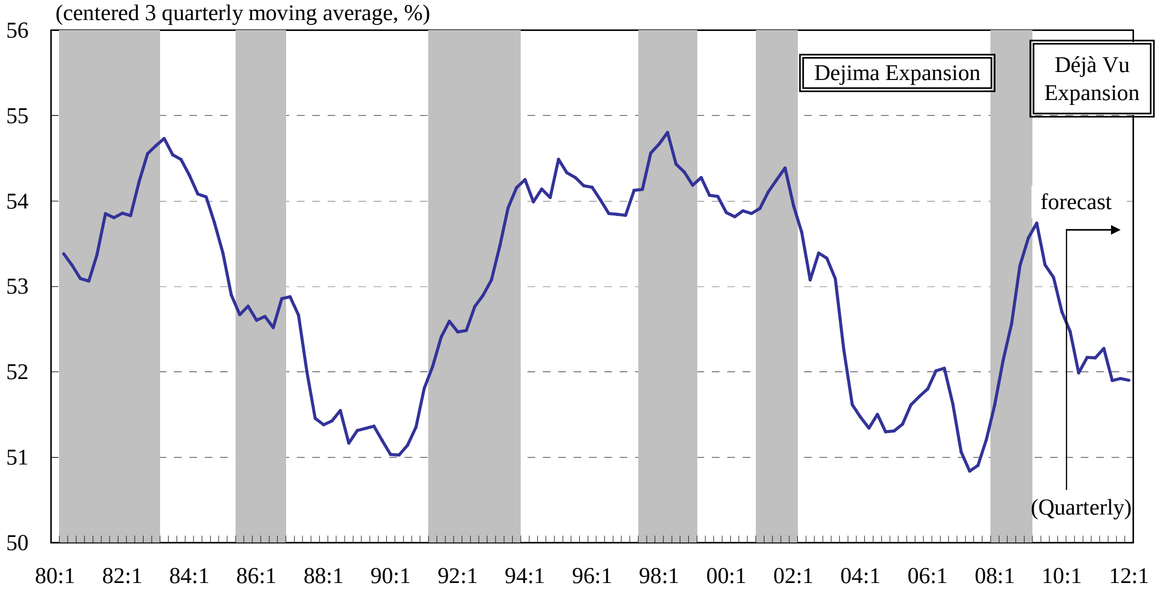
As I emphasized in this column in my last report on the JCER forecasts (in the February 23 issue of the *Nikkei*), Japan is going to see an export-led expansion centered on large manufacturing corporations, but households and smaller companies will be left behind. This lopsided nature of the resumed growth resembles the last economic expansion from early 2002 to autumn 2007, which I call the Dejima expansion. During that period, exporting companies led the economy in a similar way to the Edo-period traders in Nagasaki's Dejima island who had a monopoly from the shogun on external trade. I have nicknamed the current expansion the "déjà vu upturn" because of the similarities in the economic situation with the Dejima expansion. When it eventually comes to an end, probably the cause will again be some sort of shock from overseas.

This sense of déjà vu has been reinforced by developments in many aspects since early spring. Consider the policy debate, for example. Once again, the early recovery has been a time of arguments in favor of holding down government spending in order to restore fiscal health. The role of propping up the economy, we hear, should instead be played by monetary policy, and pressure is being applied on the Bank of Japan to prevent any exit from the easy-money course. Deflationary tendencies will probably diminish from summer next year, at which point monetary authorities may try to turn to an "exit policy." In this case, a vigorous debate on the merits and demerits of this policy will resume.

The path the labor market is taking is also one it has followed before. Companies are continuing to hold down personnel expenditures and shifting to a workforce with variable costs. On the employment front, companies are according priority to making full use of their in-house workers (by restoring overtime and bringing back workers on leave), and they are not generating much demand for outside workers. Enterprises prefer part-time workers for regular employment. Under the circumstances, even a tightening of the regulations on dispatching workers from agencies will not cause the ratio of nonregular corporate personnel to decline. In the negotiations each spring between corporate managers and labor unions, both sides are in agreement that preserving jobs is the first priority, and wage increases are not being granted. Because firms with improved profitability are rewarding their personnel only with bonuses, labor's share of the economic pie is likely to decline once again (see Figure 2).

How can we bring an end to this vicious circle? When I addressed this question in my previous column, I pointed to a need to hike the current 5% consumption tax among the numerous matters requiring attention. This time I would like to touch on the benefits of utilizing the new crop of

Figure 2. Labor's Share of Income



Note: 1.Labour's share is obtained from dividing nominal compensation of employee by nominal GDP, both of which are seasonally adjusted.

2.Shaded areas indicate recession periods,and the latest business-cycle trough is provisionally depicted as 2009Q1.

Source: Cabinet Office, "Quarterly Estimates of GDP"

graduates and introducing work-sharing arrangements.

Students who graduate next spring will find the entrance to the labor market to be a narrow gate, and many are still looking for jobs. Forcing new graduates to bear the pain of hard times is by no means a new phenomenon in this country. The lost decade of the 1990s was an "employment ice age" for young people leaving school and looking to start work, and the human capital their generation could have supplied was wasted. Even after business finally began to improve, moreover, many members of that generation found that the door to a position as a regular employee was closed to them.

To be sure, firms have reasons for their hiring policies. Because dismissing workers selectively is prohibited as a rule and dismantling of the seniority system in promotion has not made much progress, managers hesitate to offer regular employment to young workers. Companies are asked to preserve the jobs of older workers until their pension benefits kick in. Regular employees also have their mind on other matters. They use less than 50% of the paid leave they are entitled to, an internationally low ratio, and more of them are working longer hours.

Labor and management alike need to take a deep breath and rethink their attitudes. Is there not great merit in making room in the workplace for the young people who will support the social security system in the future? The government ought to be taking the lead in this change of direction, but it does not seem to have its act together. Hiring of civil servants is expected to fall by 40% in fiscal 2011, because of a reluctance to encourage older personnel to accept early retirement amid strong criticism from the public.

Simply expanding the recruitment of new graduates without making any other change would reduce the total income available for existing regular employees. Workers would benefit, however, if they were provided with more leisure time and extra vacation days. Such a response would simultaneously serve as a stimulus measure at no cost to the government. While a recommendation to pursue reform tirelessly starting with minor adjustments hardly amounts to inspiring advice, the government simply does not have the funds to launch a major initiative. As always, the key is to think of what can be done, not to come up with reasons for doing nothing.

In any event, the next few years will be a critical period as an upswing in the business cycle gets underway. With the days of an extremely old-aged society fast approaching, the authorities must lose no time in formulating a growth strategy and tackling the budget deficit. The state, the corporate world, and the household sector are all vaguely aware that doing nothing is not an option. Even so, are people not looking rather too optimistically toward the prospect of an elegant decline? Surely we should set our sights on a more radiant Japan and make use of this rare chance to work together on its realization.

（The original Japanese article appeared in the May 28, 2010 issue of the Nikkei）

Table. The Outlook for Japanese Economy

Forecast

	FY2009				FY2010				FY2011				FY2009	FY2010	FY2011
	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	1st Qtr	2nd	3rd	4th	Actual	Forecast	Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	1.8	0.1	1.0	1.2	0.3	0.3	0.4	0.2	0.5	0.5	0.5	0.6	-1.9	2.3	1.6
Real gross domestic expenditures (year-on-year)	-5.7	-5.2	-1.1	4.6	2.7	2.9	2.2	1.2	1.4	1.6	1.6	2.0			
Private final consumption (qtr.-to-qtr.)	1.0	0.6	0.7	0.3	0.2	0.2	0.3	-0.1	0.2	0.2	0.2	0.3	0.6	1.2	0.6
Private housing investment (qtr.-to-qtr.)	-9.8	-7.3	-2.7	0.3	1.1	2.0	2.1	1.3	0.2	0.3	0.5	0.6	-18.5	0.8	3.4
Private non-residential investment (qtr.-to-qtr.)	-3.7	-2.0	1.3	1.0	1.3	1.4	1.6	1.1	0.9	0.8	0.6	0.6	-15.1	4.4	3.9
Public fixed capital formation (qtr.-to-qtr.)	7.3	-1.0	-1.2	-1.7	-6.3	-5.5	-3.9	-2.4	0.6	0.7	0.8	0.4	8.7	-14.2	-3.7
Domestic demand (contribution)	-0.1	-0.2	0.4	0.6	0.2	0.2	0.4	0.0	0.3	0.3	0.3	0.4	-2.4	1.0	1.0
Net exports of goods and services (contribution)	1.8	0.4	0.6	0.7	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.4	1.3	0.6
Exports of goods and services (qtr.-to-qtr.)	10.1	8.6	5.8	6.9	2.3	1.9	1.8	2.1	2.2	2.1	2.1	2.4	-9.6	15.8	8.6
Imports of goods and services (qtr.-to-qtr.)	-3.7	5.6	1.5	2.3	2.1	2.0	2.0	1.6	1.4	1.5	1.6	1.7	-11.8	9.1	6.6
Nominal gross domestic expenditures (qtr.-to-qtr.)	0.2	-0.3	0.3	1.2	-0.2	0.1	0.2	-0.2	0.5	0.3	0.2	0.3	-3.7	0.9	0.9
Indices of Industrial Production (qtr.-to-qtr.)	6.5	5.3	5.9	7.0	2.1	1.1	1.0	1.2	1.5	1.4	1.7	1.8	-8.9	13.6	5.7
Unemployment rate (%)	5.1	5.4	5.2	4.9	4.9	4.8	4.7	4.7	4.6	4.5	4.5	4.5	5.2	4.8	4.5
Compensation of employees (qtr.-to-qtr.)	-1.3	-0.5	-0.7	1.6	-1.8	-0.0	-0.8	2.0	-0.7	-0.0	-0.5	1.4	-3.5	-1.0	0.5
Newly issued government bonds yield 10-years (%)	1.447	1.344	1.312	1.334	1.330	1.360	1.360	1.390	1.430	1.470	1.520	1.570	1.359	1.360	1.498
Nikkei Stock Average (yen)	9,302	10,129	9,969	10,511	10,600	10,985	11,239	11,332	11,764	12,142	12,674	13,389	9,976	11,039	12,492
Yen : Dollar exchange rate (yen / dollar)	97.3	93.7	89.7	90.7	92.5	93.5	95.5	96.9	98.0	98.1	99.1	100.5	92.9	94.6	98.9
WTI Crude oil price (dollar / barrel)	59.8	68.2	76.1	78.9	78.2	82.5	85.5	87.5	88.9	89.0	89.0	89.0	70.7	83.4	89.0
Domestic corporate goods price index (year-on-year)	-5.5	-8.2	-5.2	-1.7	0.4	0.7	1.6	1.5	0.9	0.6	0.6	0.5	-5.2	1.1	0.6
Consumer price index (excluding fresh food ; year-on-year)	-1.0	-2.3	-1.8	-1.2	-1.2	-1.0	-0.6	-0.5	-0.1	0.0	-0.2	-0.2	-1.6	-0.9	-0.1
Current account / Nominal GDP (%)	3.0	3.1	3.3	3.8	3.5	3.3	3.5	3.3	3.8	3.6	4.0	3.8	3.3	3.4	3.8
Real GDP of U.S.A. (qtr.-to-qtr.)	-0.7	2.2	5.6	3.0	2.8	2.2	2.1	2.2	2.8	3.3	3.6	3.5	-2.4	3.0	2.6
Real GDP of China (year-on-year)	7.9	9.1	10.7	11.9	10.1	9.5	9.3	9.2	9.4	9.2	9.1	8.9	8.7	10.1	9.2
													(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 year basis.
4. Figures for GDP components, Compensation of employees, 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 Long-term interest rates, Stock price, Oil price, Exchange rate, and Unemployment rate are shown in average terms for corresponding periods.

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