August 2010

SA143 Short-Term Forecast for the Japanese Economy (2010/7-9—2012/1-3)

Drawing on Asian Dynamism to Sustain Recovery in Japan
- Domestic Challenges Still to Be Overcome
- Political Initiative Needed to Undertake Painful Reforms

Junichiro Takeuchi
Chief Forecaster, Japan Center for Economic Research

- Sluggish growth expected for the rest of the fiscal year, as companies continue to adopt a cautious approach to business
- Spending by senior citizens will underpin household consumption, but the gap widens with the younger working generation
- Policy responses have been slow, but a resurgent Chinese economy could drive growth in Japan

Nearly a year and a half has passed since Japan's economy started to pick up. During this period, corporate performance largely improved, primarily in the manufacturing sector, due to substantial gains in exports. Since the January–March quarter in 2009, real gross domestic product (GDP) growth has reached an annualized rate of 3.6% on average. The situation may be evaluated as being satisfactory so far.

However, higher corporate earnings do not seem to be reflected much in increases in corporate spending, nor in higher levels of employment and personal income; hence, a virtuous cycle of increased production, income, and spending has yet to be seen. For this reason, the lingering effects of the financial crisis in southern Europe, changes to the export environment, such as concerns about future economic perspectives in the United States and China, and the ongoing appreciation of the yen have quickly dampened the economic outlook in Japan. Share prices, moreover, have dropped to near the lowest levels of this year.

It has been reported that Japan's economy has grown more resilient to an appreciating yen. Indeed, major manufacturers have taken restructuring measures and have succeeded in lowering their break-even point in operating their businesses. But the stronger yen continues to erode the profits of nonmanufacturing firms and small and medium-sized enterprises. The resilience to exchange-rate fluctuations is a feature of just a part of the manufacturing sector and not the economy as a whole. As long as global investors keep shunning other currencies to hedge risks—the primary cause of the appreciation of the yen—intervention in the foreign exchange market and additional relaxation of monetary policy will have little impact on exchange rates for the time being. Industry should thus look instead at the yen's appreciation as an opportunity to acquire foreign companies. Furthermore, the dampening effect of an appreciating yen on the Japanese economy can be offset by capturing the increasing Asian demand.

While the decisions being made by individual companies are quite rational, collectively they have given rise to a fallacy of composition that has slowed the pace of the recovery. This trend can be seen mainly in three areas.

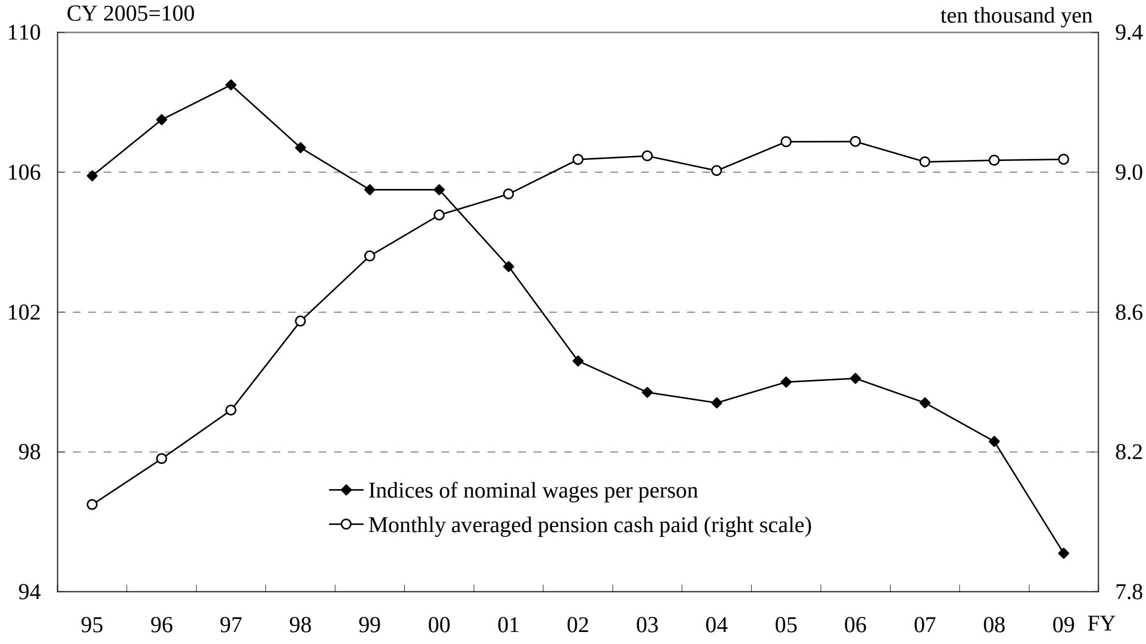
The first is in corporate finance. Many companies are setting aside their profits to repay the loans they obtained immediately after the bankruptcy of Lehman Brothers, and are also opting to raise their share of assets held in cash. Such risk-averse management decisions have been prompted by deep-rooted financial uncertainties, and they more or less characterize the behavior of companies in major developed countries; corporate managers are still haunted by the trauma of the "once-in-a-century" Lehman crisis.

The second is in corporate spending patterns. Though the economy has bottomed out, business fixed investments have not recovered as quickly as improvements in production and corporate earnings. Apart from replacement investments, new strategic spending to expand production capacity has been flowing overseas. The decision made by major Japanese automakers to re-import popularly priced models from their overseas plants has come as a shock to many, probably more so for its symbolic impact than for the actual volume.

The third area is in employment. The unemployment rate has been rising continually over the past four months, putting recovery in the labor market on hold since early spring. The unemployment rate has been on the rise particularly among the younger generation; actual market conditions are worse than the figures indicate, as they do not include many university students, who have earned the required credits for graduation, but have chosen to repeat a year due to poor employment conditions.

Since production has made a recovery, companies are responding by assigning surplus workers from other in-house divisions and actively utilizing the older labor force. The wages of workers who are reemployed after reaching the mandatory retirement age are much lower than preretirement levels, but they are still higher than wages of new graduates with no work experience. However, the older workers possess skills that make them valuable members of the workforce, and they are

Figure 1. The amount of pension paid remains high while nominal wages have been declining



Sources: Ministry of Health, Labour, and Welfare, "Monthly Labour Survey," "Monthly Pension Report," "Annual Health, Labour and Welfare Report"

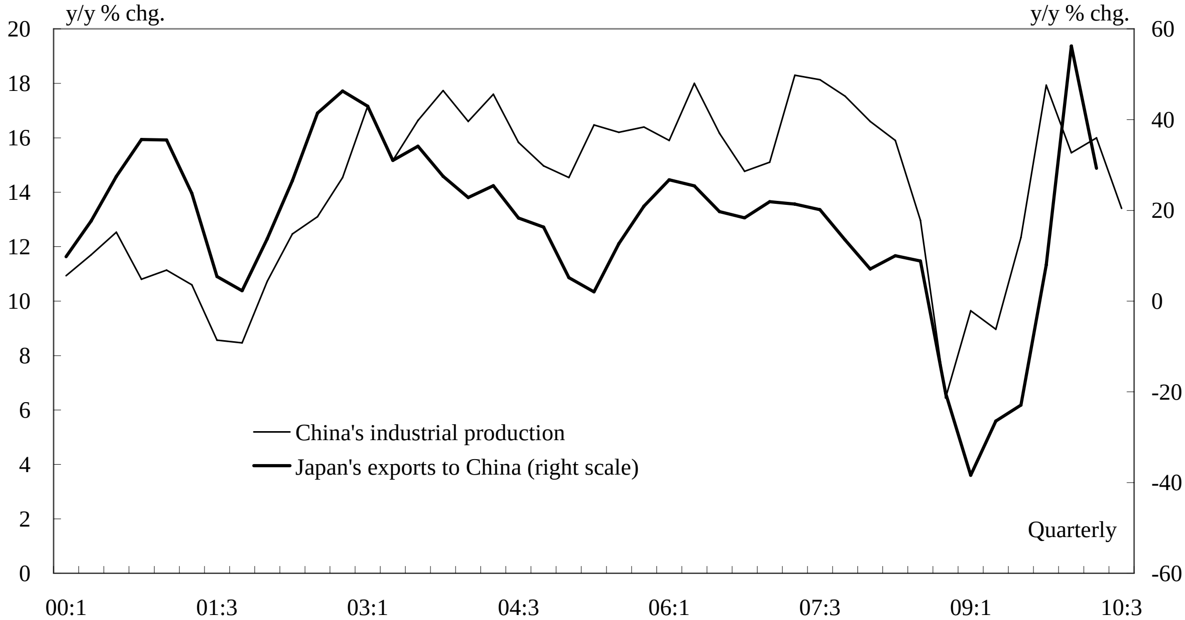
usually rehired on a contract lasting five years at most. Since dismissal laws are quite strict in Japan, employing new graduates usually means guaranteeing them a place in the workforce for almost 40 years. For companies considering moving production overseas, this is a risk that they cannot afford to take.

The polarization exists not just in employment. While income levels of the working-age population are continuously declining, pensioners continue to receive high fixed benefits (see Figure 1). This intergenerational imbalance is being reflected in consumption patterns and housing investments. Those taking advantage of the government measures intended to stimulate purchases of consumer durables largely consist of affluent senior citizens. Similarly, the extension of the “eco-point” system, aimed at encouraging sales of energy-saving appliances to environmentally-friendly homes, had the effect of stimulating renovation expenditures among the elderly generation, composed mostly of homeowners.

In its revised projections, the Japan Center for Economic Research expects Japan’s economy to grow at a rate of 2.0% in fiscal 2010 (April 2010 to March 2011), down from an earlier projection of 2.3% (see Table). It has also downwardly revised its forecast for fiscal 2011 from 1.6% to 1.5%.

The outlook until the end of fiscal 2011 is for the economy to continue on its path of a mild recovery, despite some periods of stagnation. The decline in consumer prices should ease, but due to

Figure 2. China's industrial production and Japan's exports to China



Notes: 1.China's industrial production is based on value added.Quarterly figures are 3 month average of yoy growth.
2.The figues for 2010Q3 is that of July.
Sources: CEIC Data Company Ltd.; Ministry of Finance, "Trade Statistics"

the stronger yen, the slump in wages, and the revival of "price-cutting wars," overcoming lasting deflation is not likely until fiscal 2012 and beyond.

In the immediate future, the demand generated by the unusually hot summer, last-minute buying before an October 1 hike in the cigarette tax, and the end of subsidies for energy-saving appliances is expected to push up the growth rate. But the impact of such demand will be short-lived, and is to be followed by a reactionary downturn. The underlying driving forces for sustainable growth, such as exports and production, will gradually weaken as the China-led East Asian economy begins to slow down (see Figure 2). In the face of the yen's appreciation and sluggish stock prices, many managers in Japan will continue to take a "wait-and-see" attitude, remaining very selective about new investments and restricting personnel expenses. Such factors will keep the economy trapped in deflation.

The recovery trend, though, will likely be sustained. Momentum should build up by fiscal 2011 as growth accelerates again in China's economy, creating an increasing trend in exports. The impact of such growth on domestic demand, though, will remain weak, and Japan's economy will fail to increase its tempo of growth. While older consumers will continue spending, the reactionary downturn caused by the end of subsidies and tax breaks for eco-friendly cars and appliances will act as a drag on total consumption. Any increases in housing investments are likely to be limited, and condominium construction will be sluggish owing to land acquisition delays. Moreover, housing for rent will be broadly flat due to rising vacancy ratios. Business fixed investments will increasingly be made abroad, contrary to investments made domestically.

While the changing export environment suggests a tougher economic outlook, Asian dynamism could revive Japan’s economy.

This is because, firstly, China will return to fast-track growth by next year. The current slowdown was intentionally planned by authorities to prevent an overheating of the real estate market. The restraint in lending and public investment immediately caused deceleration in production and imports, a scenario similar to that seen in 2005–06. “Brakes” work quite well in a centralized economy.

What the authorities did not anticipate, though, was China’s slower-than-projected recovery of exports caused by slowdowns in the US and European markets. Yet the real estate market is being brought under control, and in 2012, there will be a leadership change. It is likely that in 2011, policies will shift toward economic expansion. Unlike in Japan, economic “accelerators” work well in China; there are plenty of infrastructural investments yet to be done, and because monetary policy is implemented not by controlling interest rates but by ”window guidance” practices, there is little time lag between policy implementation and the appearance of its effect.

Secondly, the rising number of Chinese tourists owing to higher incomes, a stronger yuan, and the easing of overseas travel restrictions, will contribute to a consumption boost in Japan. Chinese travelers today purchase goods and services worth an estimated 250 billion yen annually. In the next five years this could reach 1 trillion yen. The figure is more than three times the value of auto exports to China today; thus, tourism may emerge as a huge “export” industry.

The third aspect is the growth of the East Asian regional economy. The region’s national economies are strengthening their ties with China. Furthermore, following the Lehman shock, many global investors who have become more discerning in their choice of emerging economies are looking less at, for example, Eastern Europe, and more toward East Asia. Direct investments are flowing into the region as a whole because of the quality of its labor force, movements avoiding wage hikes and the concentration of production bases in China, and the prospects of higher demand from the region’s expanding middle class. The rush to build factories throughout the region will lead to increased machinery and infrastructure exports, creating business opportunities for Japanese companies, and it could make up for the deindustrialization in Japan.

As noted above, there is a widening gap between the working and retired populations, as well as between the younger and older generations. Such intergenerational conflicts will hold back Prime Minister Naoto Kan's efforts to build "a society with the minimum level of unhappiness." Clearly, the balance between benefits and obligations must be reexamined so as to prevent a fiscal collapse, but the healthcare reforms being considered for those aged 75 or over will increase the burden on the working-age population. Many have criticized the ceiling system incorporated in the budgetary process for the next fiscal year, but in the absence of a clear political vision on income redistribution, this is all the bureaucrats—who must come up with the requests—can do to avoid any immediate confusion.

Policy responses must be made quickly to support the accelerating trend toward offshore production. However, the lowering of corporate taxes should not necessarily be prioritized; it is anticipated that lower taxation rates will be weighed carefully against tax cuts for companies that hire workers or make business fixed investments domestically, before taking the discussion any further. Greater efforts are needed in the area of economic diplomacy, as many East Asian countries are strengthening their bonds by forging free-trade agreements (FTAs). Geographical proximity and the presence of ethnic Chinese residents within the East Asian region is also facilitating this sense of unity; Japan may face being left out of the trend.

The world continues to undergo changes, while Japan remains preoccupied with its many domestic challenges. Following its defeat in the July House of Councilors election, the Democratic Party of Japan has yet to chart a clear policy direction, even though elections for the party president and the Okinawa governor are coming up. Prescriptions needed to face issues will entail some pain, as vested interests will have to be forgone. Such actions, needless to say, require political initiative. What the country needs now, more than ever, is true political leadership.

（The original Japanese article appeared in the August 24, 2010 issue of the Nikkei）

Table. The Outlook for Japanese Economy

Forecast →

	FY2009 1st Qtr	2nd	3rd	4th	FY2010 1st Qtr	2nd	3rd	4th	FY2011 1st Qtr	2nd	3rd	4th	FY2009 Actual	FY2010 Forecast	FY2011 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	2.5	-0.3	1.0	1.1	0.1	0.5	0.4	-0.0	0.4	0.5	0.6	0.6	-1.9	2.0	1.5
Real gross domestic expenditures (year-on-year)	-5.7	-5.2	-1.0	4.7	2.0	2.7	2.1	1.0	1.3	1.3	1.5	2.1			
Private final consumption (qtr.-to-qtr.)	1.3	0.6	0.7	0.5	0.0	0.5	0.4	-0.3	0.2	0.1	0.2	0.3	0.7	1.5	0.5
Private housing investment (qtr.-to-qtr.)	-9.6	-7.2	-2.9	0.3	-1.3	0.7	1.5	2.6	0.5	0.8	1.7	2.5	-18.5	-2.5	5.5
Private non-residential investment (qtr.-to-qtr.)	-4.8	-1.8	1.5	0.6	0.5	1.9	1.7	0.8	0.6	0.7	0.9	0.9	-15.3	3.8	3.8
Public fixed capital formation (qtr.-to-qtr.)	9.5	-1.8	-1.3	-1.2	-3.4	-7.3	-5.4	-3.2	0.9	1.1	1.3	0.8	9.3	-13.5	-4.6
Domestic demand (contribution)	0.4	-0.5	0.4	0.5	-0.2	0.6	0.5	-0.1	0.2	0.4	0.4	0.4	-2.3	0.6	1.1
Net exports of goods and services (contribution)	2.1	0.2	0.6	0.6	0.3	-0.0	-0.0	0.1	0.1	0.2	0.2	0.2	0.4	1.3	0.5
Exports of goods and services (qtr.-to-qtr.)	10.4	8.5	5.7	7.0	5.9	0.5	0.8	1.2	1.8	2.3	2.5	2.6	-9.5	17.9	7.1
Imports of goods and services (qtr.-to-qtr.)	-5.0	6.3	1.5	3.0	4.3	1.2	1.5	0.8	1.5	1.8	2.0	2.1	-11.8	11.1	6.2
Nominal gross domestic expenditures (qtr.-to-qtr.)	0.6	-0.6	0.4	1.4	-0.9	0.2	0.0	-0.1	0.3	0.4	0.4	0.4	-3.6	0.2	0.9
Indices of Industrial Production (qtr.-to-qtr.)	6.5	5.3	5.9	7.0	1.5	0.8	0.1	0.5	1.1	1.2	1.5	1.6	-8.9	12.0	3.8
Unemployment rate (%)	5.1	5.4	5.2	4.9	5.2	5.1	5.0	5.0	4.9	4.9	4.8	4.8	5.2	5.1	4.8
Compensation of employees (qtr.-to-qtr.)	-1.6	-0.1	-0.7	1.8	-0.1	0.1	-0.3	1.4	-0.6	-0.1	-0.2	1.6	-3.5	1.2	0.5
Newly issued government bonds yield 10-years (%)	1.447	1.344	1.312	1.334	1.271	1.032	1.088	1.134	1.180	1.235	1.294	1.353	1.359	1.131	1.265
Nikkei Stock Average (yen)	9,302	10,129	9,969	10,511	10,346	9,428	9,936	10,353	10,771	11,279	11,815	12,351	9,976	10,016	11,554
Yen : Dollar exchange rate (yen / dollar)	97.3	93.7	89.7	90.7	92.0	86.4	88.4	89.5	89.9	90.4	91.0	92.5	92.9	89.1	91.0
WTI Crude oil price (dollar / barrel)	59.8	68.2	76.1	78.9	78.1	78.6	80.8	82.0	83.0	83.3	83.3	83.3	70.7	79.9	83.2
Domestic corporate goods price index (year-on-year)	-5.5	-8.3	-5.2	-1.7	0.2	0.1	1.2	0.9	0.5	0.7	0.4	0.4	-5.3	0.6	0.5
Consumer price index (excluding fresh food ; year-on-year)	-1.0	-2.3	-1.8	-1.2	-1.2	-0.9	-0.7	-0.5	-0.1	-0.0	-0.2	-0.1	-1.6	-0.9	-0.1
Current account / Nominal GDP (%)	3.0	3.1	3.3	3.9	3.1	3.0	2.7	2.8	2.9	2.9	3.1	3.1	3.3	2.9	3.0
Real GDP of U.S.A. (qtr.-to-qtr.)	-0.7	1.6	5.0	3.7	2.4	1.5	1.6	2.2	2.4	2.6	2.8	2.8	-2.6	2.7	2.2
Real GDP of China (year-on-year)	8.1	9.6	11.3	11.9	10.3	9.1	8.4	8.4	8.3	8.8	9.2	9.6	9.1	9.7	8.8
													(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 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.

Japan Center for Economic Research (JCER)
Nikkei Inc. Bldg. 11F 1-3-7 Otemachi, Chiyoda-ku, Tokyo 100-8066, Japan
Phone: +81-3-6256-7710 / FAX: +81-3-6256-7924
http://www.jcer.or.jp/