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SA144 Short-Term Forecast for the Japanese Economy (2010/10-12—2013/1-3)

"Imperceptible Recovery" Will Follow Economic Standstill

- Remained Caught in a Low-Growth Trap
- Bold Action Forward Needed on a Growth Strategy

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- While policy stimuli fade out, production adjustments will not last long

- Re-acceleration of Chinese economy may be delayed by the authorities' policies to curb inflation

- Judging from Japan's stagnant domestic demand, growth led by external demand seems the only possible scenario

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Japan's economy has been making a gradual recovery, but since this fall, the process has come to a stall, caused by a loss of momentum in three interrelated growth components: demand from emerging countries, policy-supported demand for automobiles and home appliances and demand for information-related goods. As a result, export and production growth have peaked, and with the yen gaining strength combined with falling stock prices, business sentiment and consumer confidence have somewhat declined.

The economy will continue to be stagnant for the remainder of fiscal 2010 (April 2010 to March 2011). However, an entry into recession will be prevented for the following three reasons.

The first is that the current round of production adjustments will not last long. The automobile industry began cutting production early on, anticipating a drop in sales when government subsidies for consumer purchases of eco-friendly cars ended this autumn. The electronic parts industry is facing a global deterioration of the supply-demand balance, however, growth in emerging markets and the launch of new products such as smartphones and tablet computers have broadened the industry's demand base.

Second, momentum left thus far from the recovery, which started in spring 2009, is expected. Business fixed investment and consumer spending should continue to pick up, albeit gradually, through improvements in corporate earnings and household income. Since companies adopted conservative investment plans for fiscal 2010 relative to their improved profits, it is unlikely that they will halt investments out of uneasiness over business prospects for the second half of this fiscal year.

Third, although not a particularly favorable option in my opinion, the five trillion yen (US$60 billion) supplementary budget will underpin the economy.

Based on this analysis, the Japan Center for Economic Research conducted an economic forecast for the period through fiscal 2012 (see the table in the last page). Although the economy is at a standstill at present, recovery is expected to resume through export picking up again. The pace of decline in consumer price index will moderate reflecting improvements in the economic condition, but because of stagnant wages and the appreciation of the yen, on top of the existent supply-demand gap, the end to deflation has yet to come.

This forecast presents a downward revision of the fiscal 2011 outlook we previously projected, taking the following three points into account.

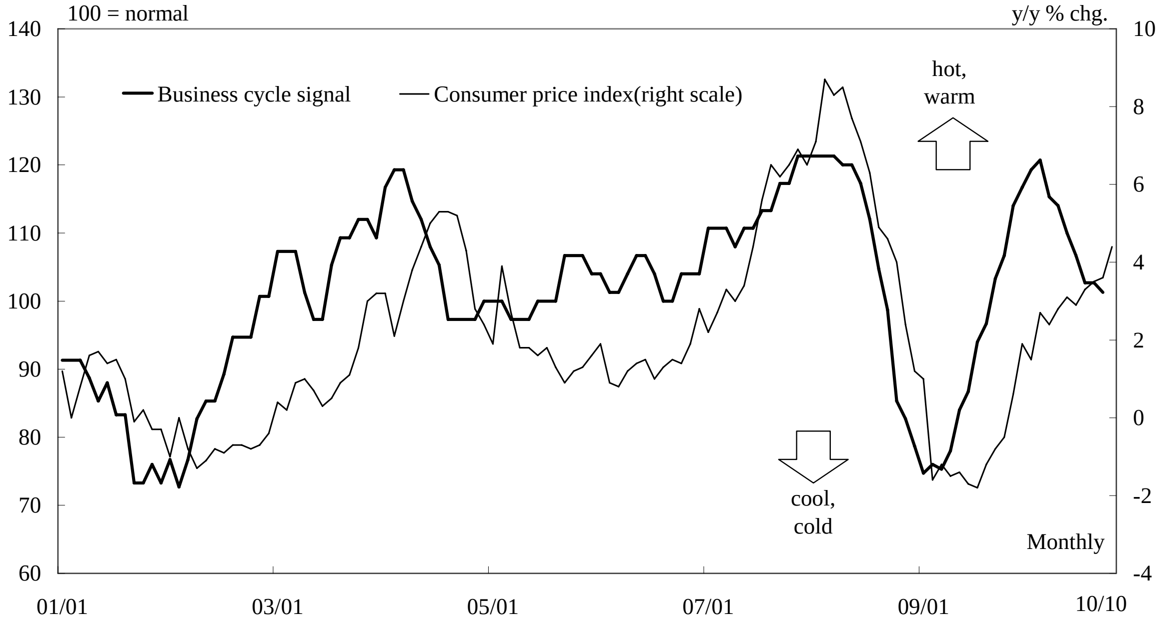
First, we evaluated the strong yen's negative impact on the real economy. The effects of exchange rate fluctuations on Japan's economy are certainly diminishing in the long term; the portion of export goods with a technological advantage has increased, and inter-firm trade denominated mainly in yen has grown.

The real effective exchange rate (REER) represents the overall competitiveness of a country, reflecting fluctuations in currency values and prices. Currently, the level of the yen in terms of REER is almost 30% lower than that of 1995, when the yen vis-à-vis the dollar hit a record-high. It is said that corporate competitiveness has been sustained in spite of the continuous yen appreciation after the Lehman crisis. However, evaluating an exchange rate based on long-term changes in its level can be misleading. The yen in terms of REER has grown almost 30% stronger over the past two years, and this impact cannot be ignored. In the third markets, compared to rival Korean companies, the competitiveness of the Japanese business sector has declined as a result of substantial won depreciation.

Second, we made a small downward revision in our forecast for the Chinese economy, Japan's largest export market. We previously described China's economy as to having "well functioning brakes and accelerators." However, it is becoming harder for Chinese policy administrators to slow down or speed up the economy, because the size of the economy is augmenting, and the weight laid on a market economy is increasing. Since the beginning of 2010, the Chinese government began taking measures to prevent the real estate market and the economy from overheating such as by tightening regulations, but it has taken time for the effects of these measures to show. Even though the yuan needs to be strengthened to curb price increases, appreciation of the currency has been prevented via market intervention out of fear of a loss in export competitiveness. This has also become a contributory factor to China's excessive liquidity.

While the Chinese economy has slowed down, inflation has accelerated (see Figure 1). There is concern on how increasing upward pressure on wages may affect general prices. Authorities have placed a high priority on fighting inflation, since rising prices impoverish low-income families. Reserve requirement ratios for banks have been lifted intermittently, and steps to control prices have been taken. At the same time, there is concern over the potential damage that a further interest rate

Figure 1. Business cycle signal and consumer price in China



Note: Business Cycle Signal is the signal showing the different level of economic performance which ranges from cool economy to overheated one.
Source: CEIC Data Company Ltd.

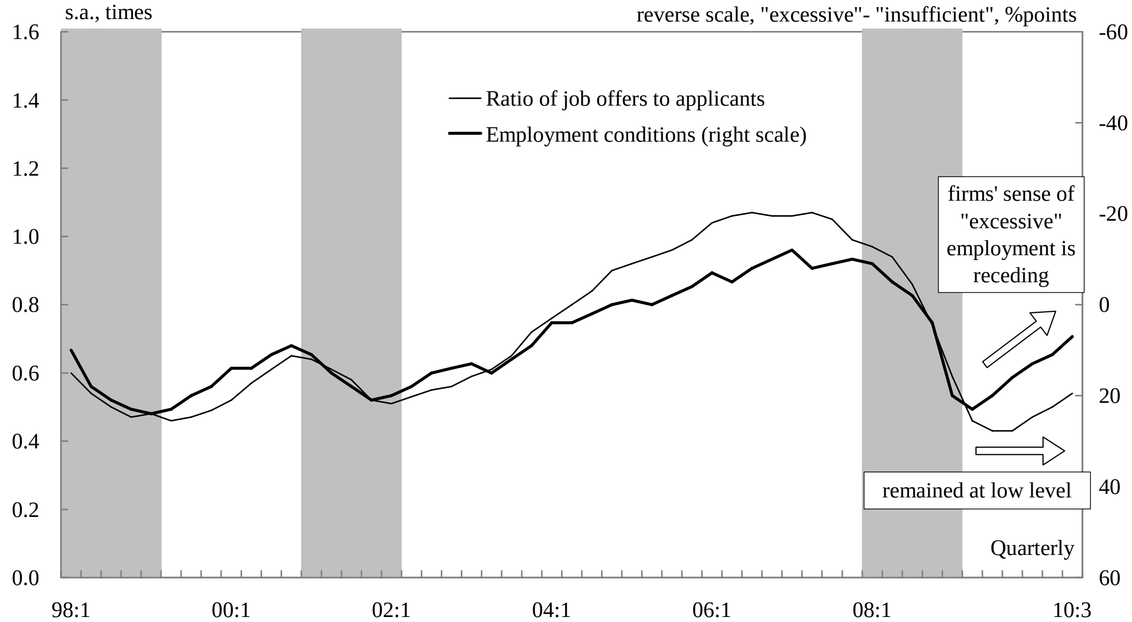
rise could cause to capital inflows, which in turn would cause renminbi appreciation, and damage to the corporate sector. In this way, China's authorities are in a difficult position regarding policy administration. Growth is still expected to pick up toward the fall 2012 leadership change of the Chinese Communist Party, but the faster growth may be somewhat delayed.

Third, we also took note of the increased rate at which Japanese companies are moving overseas. Due to the large gap between domestic and external growth rates, companies are becoming more outward-oriented. In the manufacturing sector, the shift to offshore production is moving forward even in material industries and among smaller companies. In the nonmanufacturing sector, retailers and real estate firms are also shifting abroad, and even slow-moving Japanese banks have started to follow this trend.

Business fixed investment and employment in Japan are under downward pressure from this deindustrialization process. Although excess employment has decreased in the current recovery phase, the job market has remained harsh (see Figure 2). If the lack of job openings had been caused by the presence of many redundant in-house personnel, excess employment, as demonstrated by companies through the business survey, would not have mitigated or eased. The current gap between labor demand and excess employment, shown by Figure 2, implies that jobs are steadily flowing overseas.

Fortunately, Japan's private sector is not burdened by an excessive debt load or struggling with other such imbalances. As a result, an export-led business upturn should be achieved if the recovery of the world economy, led by growth in emerging countries, continues. It is certain that a heavy reliance on the Chinese economy will be a major risk factor. Some of the risks posed by dependence

Figure 2. Job offers and firms' sense of excessive employment



Sources: Bank of Japan, "Tankan , Short-term Economic Survey of Enterprises in Japan"
Ministry of Health, Labour and Welfare, "Report on Employment Service"

on China became evident this fall, originating from tension in diplomacy. In a wider perspective, however, it is clear that there are many business opportunities in other parts of Asia. East Asia's middle class is broadening, and a foundation for self-sustained growth is being established in the region. The strong performance of the Indian economy, which is not closely connected to the Chinese economy, can reduce the risk of dependence on China alone.

Elsewhere around the world, the path of recovery of developed economies has remained both sluggish and unstable.

More time is needed for the U.S. economy to get back to its potential growth rate of 2.5~3.0 percent. Stimulating internal demand will not be easy, because balance sheet adjustments in the household sector are putting downward pressure on the economy. As a result, the U.S. is oriented toward an export-led upturn through the weakening dollar. In this situation, the benefits from the upturn will flow mainly into the country's multinational corporations, and will not spill over into smaller companies that play the anticipated role in absorbing employment. Signs of "Japanization" can be seen in the U.S., such as growing concerns over deflation, further nonregularization of employment and a decrease in expected household income.

In Europe, the division of economies into two groups has become evident. Since this summer, the weakening of the dollar had displaced concern about the instability of the euro, but recently, worries have arisen over euro depreciation again. Some peripheral eurozone countries are being protected by the common currency, which prevents speculators from mounting currency attacks on them. However, this also means that they cannot expect a boost in exports through currency devaluation. The financial conditions of a number of these countries are worse than that of Argentina at the end of 2001, when it was forced into debt restructuring. This fiscal crisis in Southern Europe will continue to exist, alongside the risk of further yen appreciation.

Japan's current upturn, like the last business expansion, is likely to continue over the long run, but the recovery will be imperceptible. In fiscal 2012, Japan's real gross domestic product (GDP) should regain the level it was at before the bankruptcy of Lehman Brothers in September 2008, but nominal GDP will still remain at a low level. Japan's economy finds itself caught in a trap as follows.

Companies have focused their efforts on improving their financial positions and cutting costs, in order to survive in a competitive global market. Heavy personnel expenditures continue to be a burden on the management of companies. Although the postwar baby-boom generation have retired, firms still have to pay the wages of the mass-number hired during the economic bubble in the late 1980s. In consequence, companies have taken measures aimed to reduce personnel expenditures, such as by creating subsidiaries and amending personnel systems, but this has resulted in the decline of expected household income.

Regular employees are intent on keeping their own jobs safe, and therefore will no complaints. It is the nonregular employees and new graduates who will suffer. Due to a strong anxiety about their future, the actively working generation will continue to display frugal consumption behaviors apart from in education expenditures for their children. The stability-oriented attitudes of parents have been passed onto their children, who are entering the "school examination wars" at a younger age, and are exhibiting little entrepreneurial spirit. Such phenomena need to be seen as a mirror image of our society. Suffering from a sense of stagnation, it seems as though everyone is scrambling for a seat in a mass game of musical chairs.

In such a situation, people do not hide their discontent toward tax hikes of any shape or form, and they welcome lavish government handouts. Politicians have accommodated to public opinion, resulting in government policies continually placing a heavy emphasis on income distribution. The government needs additional revenue to conduct financial reconstructions and to keep its election campaign promises, but attempts to increase the present five percent consumption tax have failed. This means that the government will continue to use the readiest sources available when it needs additional revenue, drawing on corporate and income taxes.

As far as companies are concerned, some of Japan's biggest corporations may appear as an easy taxation target. In fact, however, corporations are suffering from multiple wounds, none of which have been treated. These include the appreciation of the yen, heavy corporate taxes, stricter restrictions on temporary workers, stronger environmental regulations and the tardiness of Japan's moves to conclude free trade agreements (FTAs). The worsening business environment has made managers cautious about expanding domestic business operations.

Heavier taxes are inevitable for not only the high but also the middle income group; the price to be paid for avoiding a consumption tax hike will be painful. If the marital income tax deduction is abolished, many spouses will enter the labor market. Therefore, for students, the narrow gate into the front lines of employment will grow narrower yet.

So what is to be done? The time for talk has passed; now is the time for action. The government should prepare to materialize the growth strategy, which has been drawn up several times, and get to work on its implementation, or else it will fail to escape from a gradually declining economy. In this game of musical chairs, we must set our sights not on sharing but on increasing the number of chairs. In the process, there is sure to be conflict. However, one of the basic roles of politics is to make adjustments among diverse interests. Let us hope for the administration’s firm resolve in the coming year.

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Table. The Outlook for Japanese Economy

Forecast →

	FY2010 1st Qtr	2nd	3rd	4th	FY2011 1st Qtr	2nd	3rd	4th	FY2012 1st Qtr	2nd	3rd	4th	FY2009 Actual	FY2010 Forecast	FY2011 Forecast	FY2012 Forecast
Real gross domestic expenditures (qtr.-to-qtr.)	0.4	0.9	-0.4	0.4	0.4	0.3	0.5	0.5	0.6	0.4	0.5	0.5	-1.8	2.7	1.3	2.0
Real gross domestic expenditures (year-on-year)	2.7	4.4	2.6	1.3	1.3	0.7	1.6	1.7	1.9	2.0	2.0	2.0				
Private final consumption (qtr.-to-qtr.)	0.1	1.1	-0.7	0.2	0.3	-0.3	0.1	0.3	0.4	0.1	0.2	0.2	0.8	1.6	0.3	0.9
Private housing investment (qtr.-to-qtr.)	-0.8	1.3	1.0	1.5	0.9	1.4	2.1	2.8	0.5	1.0	1.3	1.5	-18.4	-1.5	5.9	5.9
Private non-residential investment (qtr.-to-qtr.)	1.8	0.8	0.9	1.1	0.8	1.0	1.1	1.1	1.0	1.0	1.0	1.0	-15.3	4.3	4.0	4.1
Public fixed capital formation (qtr.-to-qtr.)	-2.3	-0.6	-6.5	0.3	0.7	-0.6	-0.4	-0.2	-0.2	0.2	0.1	-0.3	9.3	-7.2	-3.3	-0.5
Domestic demand (contribution)	0.1	0.9	-0.3	0.4	0.4	0.1	0.3	0.5	0.5	0.3	0.4	0.4	-2.3	1.3	1.1	1.5
Net exports of goods and services (contribution)	0.3	0.0	-0.1	-0.0	0.1	0.2	0.2	0.0	0.1	0.1	0.1	0.1	0.5	1.4	0.2	0.4
Exports of goods and services (qtr.-to-qtr.)	5.6	2.4	0.2	0.6	1.2	2.1	2.2	1.5	1.8	1.8	1.8	1.9	-9.5	18.6	5.5	7.4
Imports of goods and services (qtr.-to-qtr.)	4.0	2.7	1.3	1.2	1.0	1.5	1.8	1.8	1.7	1.6	1.5	1.6	-12.2	11.8	5.8	6.9
Nominal gross domestic expenditures (qtr.-to-qtr.)	-0.7	0.7	-1.1	0.0	0.1	-0.0	0.3	0.4	0.4	0.3	0.4	0.4	-3.6	0.6	-0.0	1.4
Indices of Industrial Production (qtr.-to-qtr.)	1.5	-1.8	-4.1	0.5	0.9	1.7	2.0	1.5	1.6	0.8	0.8	0.5	-8.9	7.5	1.3	5.4
Unemployment rate (%)	5.2	5.1	5.0	5.0	4.9	4.9	4.8	4.8	4.7	4.6	4.5	4.4	5.2	5.1	4.9	4.6
Compensation of employees (year-on-year)	1.2	1.0	0.9	0.4	-0.1	-0.3	0.1	0.1	0.2	0.3	0.3	0.5	-3.5	0.9	-0.0	0.3
Newly issued government bonds yield 10-years (%)	1.271	1.044	0.976	1.098	1.124	1.158	1.200	1.251	1.303	1.355	1.417	1.469	1.359	1.097	1.183	1.386
Nikkei Stock Average (yen)	10,346	9,356	9,679	9,960	10,150	10,351	10,596	10,914	11,187	11,502	11,838	12,111	9,976	9,835	10,503	11,659
Yen : Dollar exchange rate (yen / dollar)	92.0	85.8	82.1	83.8	85.4	86.2	87.0	88.2	89.3	90.7	92.3	93.9	92.9	85.9	86.7	91.6
WTI Crude oil price (dollar / barrel)	78.1	76.2	83.8	86.3	87.4	88.1	88.3	88.1	88.1	88.1	88.1	88.1	70.7	81.1	88.0	88.1
Domestic corporate goods price index (year-on-year)	0.2	-0.1	0.8	0.6	0.1	0.4	0.3	0.4	0.4	0.4	0.4	0.4	-5.2	0.4	0.3	0.4
Consumer price index (excluding fresh food ; year-on-year)	-1.2	-1.0	-0.6	-0.5	-0.4	-0.2	-0.2	-0.1	-0.0	0.1	0.2	0.3	-1.6	-0.9	-0.2	0.2
Current account / Nominal GDP (%)	3.2	3.6	3.3	3.1	3.1	3.2	3.4	3.2	3.4	3.4	3.7	3.6	3.3	3.3	3.2	3.5
Real GDP of U.S.A. (qtr.-to-qtr.)	1.7	2.5	1.5	1.7	2.8	3.2	2.8	2.4	2.0	2.4	2.8	3.0	-2.6	2.7	2.2	2.5
Real GDP of China (year-on-year)	10.3	9.6	9.3	8.7	8.5	8.3	8.7	8.9	9.4	9.6	9.7	9.8	9.1 (C.Y.)	10.2 (C.Y.)	8.5 (C.Y.)	9.5 (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, 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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